CORPORATE GOVERNANCE

Principles, Policies and Practices

SECOND EDITION

A. C. Fernando

ALWAYS LEARNING

PEARSON

Corporate Governance

Principles, Policies and Practices

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CORPORATE GOVERNANCE

PRINCIPLES, POLICIES AND PRACTICES

Second Edition

A. C. Fernando

Former Professor of Economics and Corporate Governance

and

Director, Loyola Centre for Business Ethics and Corporate Governance

Loyola Institute of Business Administration

Chennai, India

PEARSON

Chennai • Delhi • Chandigarh

To
Rex and Reshama
for their constant support and encouragement

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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.
Director
XLRI
Jamshedpur

Preface to the Second Edition

I am happy to acknowledge that the first edition of my 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.

I am thankful to the faculty, students and others who took time to go through the book and also for communicating with me the need to incorporate certain salient features they thought the new edition of the book should have. I am 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 Corporate 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: "Agents and Institutions 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 "Facilitators, Role Players and Regulators", 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 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.

Case Studies: The inclusion of real-world cases appended to 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/acfernando

PowerPoint Lecture Slides: These are available for each chapter. They provide lecture outlines, important concepts and diagrams and additional material that can be used by instructors to deliver effective lectures.

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.

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A. C. Fernando

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.

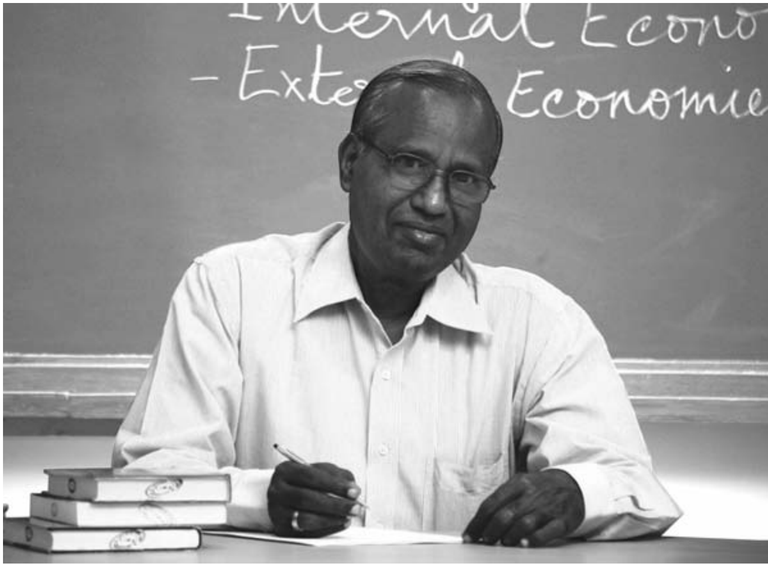
For researchers and advanced learners too, this book provides ample material. An exhaustive reference of books, magazines and journals on the subject is included to facilitate research. Likewise, a long list of Web sites, containing a wealth of material, has been added along with guidelines on corporate 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



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.

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PART ONE

UNDERSTANDING CORPORATE GOVERNANCE

Chapter 1

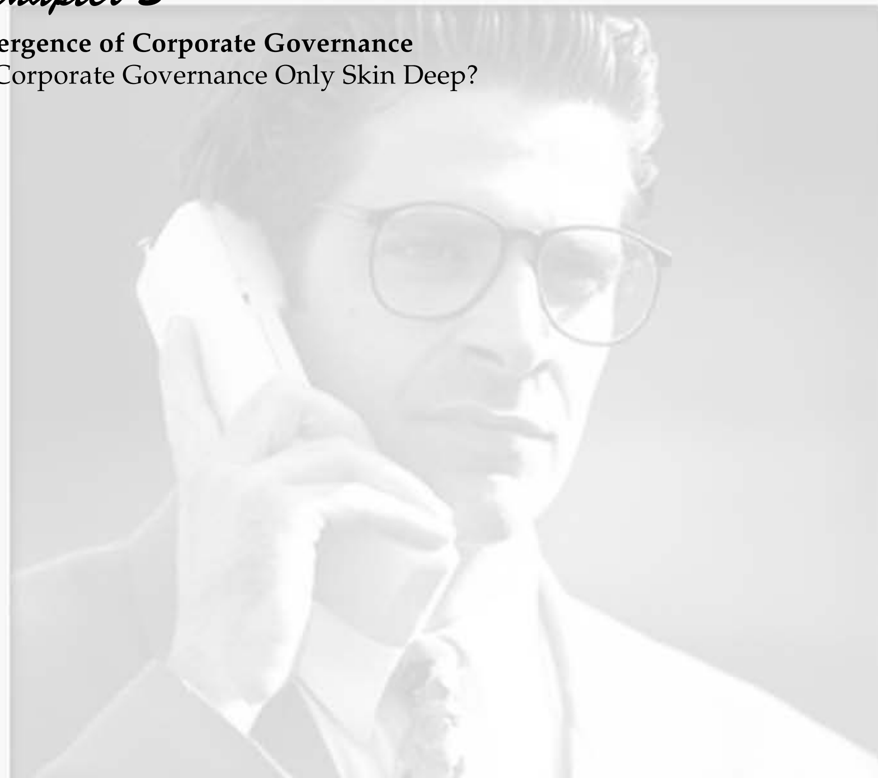
Corporate Governance: An Overview
Case Study Infosys Technologies: The Best Among Indian Corporates

Chapter 2

The Theory and Practice of Corporate Governance
Case Study Tata Steel: A Company That Also Makes Steel

Chapter 3

Landmarks in the Emergence of Corporate Governance
Case Study ITC Limited: Is Corporate Governance Only Skin Deep?



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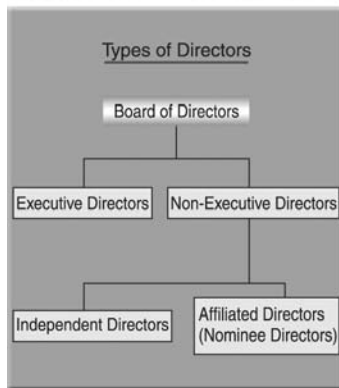


Corporate Governance: An Overview

CHAPTER OUTLINE

- Capitalism at Crossroads
- Increasing Awareness
- Global Concerns
- What is Corporate Governance?
- Governance Is More Than Just Board Processes and Procedures
- A Historical Perspective of Corporate Governance
- Issues in Corporate Governance

Capitalism at Crossroads

The beginning of the twenty-first century was marked by the emergence of corporate governance, as a solution to the collapse of several high-profile corporations, both in the USA and elsewhere. The business world was shocked beyond belief with both the scale and degree of illegal and unethical corporate practices. As a result, "the need for the adoption of good corporate governance principles has been reinforced, and inevitably and inextricably, efforts to this end have gathered momentum every time a new corporate scandal came to light."[1]

In the beginning of the new millennium, several companies in the USA and elsewhere faced collapse because of corporate misgovernance and unethical practices they indulged in. The then existing regulatory framework seemed to be inadequate to deal with the gigantic business conglomerates that committed deliberate frauds.

Corporates in the very citadel of capitalism, the United States of America, were mired in problems and were going through a grave crisis of credibility during the very early years of the new millennium. Companies that were held out till then as role-models in corporate governance were being threatened with widespread exposures of accounting irregularities and fraudulent practices. The Securities and Exchange Commission (SEC) set up under the New Deal to combat the Great Depression, appeared to be inadequately equipped to deal with gigantic business conglomerates such as Xerox, WorldCom and Enron that committed deliberate frauds with a view to boosting their sales revenues and for showing highly inflated profits. If company managements want the market value of their equity shares to climb new peaks year after year, the temptation to fudge accounts and thereby take credit for unearned profits seem to be difficult to resist. Investors, on their part, can neither equate high profits shown by their companies as a sure index of corporate efficiency nor treat a company's failure to maintain a consistent high profit a failure of corporate governance.

The problems of corporate America, as indeed of several developed and more so of developing economies such as India, have a lot to do with the failure of the auditing profession to safeguard consciously the interests of shareholders. There is a growing apprehension among users of audited accounts such as shareholders, financial institutions and banks, government, industry and the public at large, that all is not well with the profession of auditing. The collapse of US corporate giants has only heightened this perception.

In the past few years, the reported corporate lootings have become so frequent, so spectacular that the term "business ethics" seems to sound like a cruel oxymoron. The swashbuckling CEO, the archetypal corporate hero in prosperous times, is now villified as a crook, gambling away the retirement savings of hapless workers and other unwary investors.

America's Hall of Shame—2002

In the year 2000, several American mega corporations collapsed like a pack of cards. The federal administration of President Bush was quick to slap punitive measures on erring corporations and initiated preventive steps to avoid corporate frauds in future. The Sarbanes-Oxley Act made it mandatory for senior executives to certify reports under oath with the pain of severe penalties if proved wrong.

Corporate America's Hall of Shame was littered with failed mega corporations and transnational companies that sound like a virtual "who is who" of international business glitterati.

WorldCom improperly booked $3.8 billion in expenses, thus inflating profits. The founder, Bernie Ebbers, borrowed $408 million from the phone company to cover personal debts. Energy firm, **Enron,** created outside partnerships that helped hide its poor financial condition. Executives earned millions of dollars selling company stocks. The company had to go to bankruptcy court. The accounting firm, **Andersen,** was accused of shredding Enron documents and was convicted for obstruction of justice. Energy company, **Dynegy,** was under investigation for accounting and trading malpractices, in part related to California power crisis. Securities and Exchange Commission sued executives of garbage company **Waste Management** for massive accounting fraud from 1992 to 1997 that resulted in a $17 billion restatement of earnings. Its auditor was Arthur Andersen. **Adelphia Communications** made illegal loans to founder Rigas' family members and

was under investigation for accounting malpractices. Amid questions about its accounting malpractices, **Tyco** Chief Executive, L. Dennis Kozlowiski, was charged with deliberately dodging sales tax on purchase of artwork for his New York residence. Chief Executive, Samuel Waksal, of **Imclone Systems** was charged with insider trading after company's drug application got rejected. Southern California software company **Peregrine Systems** said it might have overstated revenue by $100 million over three years. Three former executives of the drugstore chain **Rite Aid** were indicted for charges of securities and accounting fraud relating to irregularities in the 1990s.

The Bush Federal Administration was prompt to slap punitive measures on erring corporates and preventive steps to avoid future corporate frauds. The new law that has come into force, known as the Sarbanes–Oxley Act, stipulates that chief executive officers (CEOs) and chief financial officers (CFOs) of big companies should swear in front of a notary that their annual and quarterly reports contain no untrue statement and have not omitted any material fact. Over the past few years, more and more companies have made a beeline to make the certification of the truthfulness of their accounting statements. It is now mandatory for both the CEO and the CFO to certify the annual report and also give an assurance that they meet internal controls relating to the circulation of material information regarding the company. This certification means that these officials will be liable for criminal or civil suits for any omissions, false statements and restatements.

Corporate Misgovernance in India

Industrial growth in India along with the development of corporate culture started only after the country became free in 1947. However, with the characteristic of the country's governance continuing to be feudalistic, and its political system degenerating to be pseudo-democratic, the governance of most of the country's industrial and business organisations thrived on unethical practices at the market place while showing scant regard for the timeless human and organisational values in dealing with their employees, shareholders and customers. The increasing corruption in the government and its various services had kept the managements of country's industrial and business organisations above accountability for their misdeeds, encouraging them to indulge in more unethical practices. The state-owned organisations occupying a dominant position in the country's economy and being monopolistic, passed on the costs of their corporate misgovernance to the helpless consumers of their products and services. Organisations in the private sector, barring a few, indulged in all possible unethical practices to fleece their customers on the one hand and denied the state its due on the other. In India, one could see a large number of privately owned business organisations too indulging in rampant corporate misgovernance. The difference is that while in state-owned organisations employees at all levels are seen to indulge in, or contribute to, corporate misgovernance, in privately owned business organisations only employees at top levels are seen to be indulging in corporate misgovernance, indicating that in privately owned business organisations employees at the lower levels of the corporation are better controlled. The scams committed in a number of large privately owned corporations during the last one decade clearly indicate the nature and extent of corporate misgovernance that exists in privately owned business organisations.

In India, the governance of most of the country's industrial and business organisations thrived on unethical practices at the market place and showed scant regard for the timeless human and organisational values while dealing with their shareholders, employees and other stakeholders.

Series of Scams That Shook Investor Confidence

The vital need for corporate governance was first realised in the country with the "Big Bull," Harshad Mehta's securities scam that was uncovered in April 1992

involving a large number of banks and resulting in the stock market nosediving for the first time since the advent of reforms in 1991. This was followed by a sudden growth of cases in 1993 when transnational companies started consolidating 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 roughly Rs. 5,000 crore. The third scandal of the decade was the disappearance of the companies during 1993–94. Between July 1993 and September 1994, the stock market index shot up by 120 per cent. During this boom, 3,911 companies that raised over Rs. 25,000 crore vanished or did not set up their projects. Due to the vanishing companies scam, gullible investors lost a lot of money 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 misleading prospectuses.

Another scam took place in 1995–96. Plantation companies scam saw Rs. 50,000 crore mopped up from gullible investors who were prompted to believe plantation schemes would yield huge returns. The so-called non-banking finance companies scam that took place in 1995–97 also saw more than Rs. 50,000 crore mopped up from the public promising them high returns but vanished. The mutual fund scam saw public sector banks raising between 1995–98 nearly Rs. 15,000 crore by promising huge fixed returns, but all of them flopped. Yet another scandal was the one in which BPL, Sterlite and Videocon price rigging happened with the help of Harshad Mehta. The IT scam between 1999–2000 saw firms change their names to include 'infotech', and investors saw their stocks run away overnight. The year 2001 witnessed yet another scam in which Ketan Parekh resorted to price rigging in association with a bear cartel. One of the most recent and scandalous scams that was said to be the worst compared to all the previous ones here and elsewhere was the Satyam scandal. The promoter of the country's fourth largest IT company systematically siphoned off billions of rupees of shareholders' wealth.

Illegal Tactics of Indian Corporates

Several illegal tactics used by corporates in India over the years are as follows:

- Cornering of industrial licenses mainly with a view to pre-empting competitors to enter into their well-entrenched industry.
- Using import licenses to make a quick profit in the market.
- Illegally holding money abroad to meet business expenses and investments for which government would not allow enough funds.
- Trying to gain special advantages for the business through bribery of concerned officials, generating unaccounted money in the business so as to compensate for penal levels of taxation other "business" expenses and political donations.

> An overwhelmingly large number of Indian corporations used several illegal tactics such as cornering of industrial licenses with a view to keeping away competitors, using import licenses to make a quick profit, illegally holding money abroad, and indulging in bribery, corruption and other unethical practices with impunity.

The extraordinarily high income tax levels of the 1960s led many companies to devise tax evasion tactics in the form of compensation packages for their senior and middle level employees. These elements grew in value over the years, often crossing the lines of legality. Overseas holidays for families shown as business trips, expensive residences shown as in office use, cars for personal use but shown as being used for work, furniture and furnishings, clothing, food and most household expenses being met by the company for employees became relatively common practices for the companies which promised to be honest otherwise. The economy lost tax revenues and the organisations fostered an acceptance of ignoring and violating of laws that were regarded as unacceptable by the company. The net result of such dishonest practices and scams was that the regulators started tightening up especially in the last few years, also public patience ebbed and intolerance to such issues rose. This fuelled a change in the Indian corporate mindset. These scandals led

to the realisation that "corporate governance" was essential and was advocated by financial press, some financial institutions, more enlightened business associations, the regulatory agencies and government.

It is strange but true that early initiative for better corporate governance in India came from the more enlightened listed companies and an industry association. This was quite different from the US or Great Britain, where the drivers of corporate governance were shareholders' groups, activist funds and self-regulatory bodies within capital markets, or Southeast and East Asia, where it was the result of conditions imposed by the IMF and the World Bank in the wake of the financial collapse of 1997–98. When India embarked on its corporate governance movement in 1996–97, the country faced no financial or balance of payments crisis. There were no major internal or external pressures that could have created urgency for better corporate governance.

Reasons for Corporate Misgovernance

For too long, Indian corporates have insulated themselves from wholesome developments evolving elsewhere. A closed economy, a sheltered market, limited need and access to global business/trade, lack of competitive spirit and a regulatory framework that enjoined mere observance of rules and regulations rather than realisation of broader corporate objectives marked the contours of corporate management for well over 40 years, ever since we adopted a socialistic pattern of society.

> The reasons for the corporate misgovernance in India were many: A closed economy, a sheltered market, limited need and access to global business, lack of competitive spirit and an inefficient regulatory framework. These were responsible for the poor governance of companies in India for well over 40 years, between 1951 and 1991.

Apart from forces militating against healthy and transparent governance is the fact that a vast majority of Indian corporates is controlled by promoter families which while owning a negligible proportion of share capital in their companies, rule them as if they are their personal fiefdoms. According to a survey conducted some years ago, family shareholdings in big business groups averaged a mere 3.3 per cent of the aggregate paid-up capital. Under the new economic policy, the fear of hostile raids has made several business houses enhance their stakes but the units still remain captive for a meagre stake. These so-called "owners" view with disdain any suggestion of professional management, which, after all, is the core and essence of corporate governance. In such an unhealthy scenario, corporate democracy, professionalisation of management and transparency of operations were mere rhetoric used to drum up support or elicit a degree of acceptability from gullible investors.

The perpetrators of misgovernance, however, have to face the winds of change in the form of market-driven reforms that are shaking their feeble foundations. Economic liberalisation, a steady dismantling of the control and quota regime, delicensing and deregulation of industries, changes in export-import and overall commercial policies, globalisation of the economy within and outside the ambit of the World Trade Organisation (WTO), the entry of transnational corporations and the take-over bids in an open and competitive environment, have all ripped open the cocoons within which Indian corporates had laid out their cosy existence. These dramatic changes have exposed them to the merciless forces of international competition and forced them to shed their old ways if not switch over to newer norms of corporate governance.

Increasing Awareness

Thus, in the aftermath of economic liberalisation, corporate heavyweights have started mulling over the buzz phrase of corporate governance in hastily convened conclaves and conferences. Apart from the Department of Company Affairs and the

In the aftermath of the pioneering Cadbury Report and economic liberalisation in India, corporate governance gained greater currency and importance in the country. The Department of Company Affairs, the Institute of Company Secretaries and trade associations such as the CII and FICCI, capital market regulator, SEBI and companies such as ICICI took the lead in discussing it and recommending its implementation. By April 2003, every listed company adopted the SEBI code of corporate governance.

Institute of Company Secretaries, the Federation of Indian Chambers of Commerce and Industry (FICCI), the Confederation of Indian Industry (CII), which has worked out a code of corporate governance, the Securities and Exchange Board of India (SEBI) and the Association of Mutual Funds in India (AMFI) just to name a few apex bodies, have discussed it with all the seriousness it deserved. The Industrial Credit and Investment Corporation of India (ICICI) has implemented an internal corporate governance code about ten years ago.

The corporate governance movement in India began in 1997 with a voluntary code framed by the Confederation of Indian Industry (CII). In the next three years, almost 30 large listed companies accounting for over 25 per cent of India's market capitalisation voluntarily adopted the CII code. By 1999, the Securities and Exchange Board of India (SEBI)—India's capital market regulator—got into the act and set up a committee headed by Kumar Mangalam Birla to mandate international standards of corporate governance for listed companies. From 1 April 2001, over 140 listed companies accounting for almost 80 per cent of market capitalisation started following a mandatory code which was in line with some of the best international practices. By April 2003, each and every listed company joined the SEBI code.

How did this sea change occur without the presence of sufficient internal or external pressures? The answer has to do a lot with the change in corporate mindset brought about by economic liberalisation and competition of the 1990s. It is useful to emphasise here the great churning that has been unleashed by a decade of liberalisation. Consider the top 100 companies ranked according to market capitalisation as on 1 April 1991. How has the market treated these companies a couple of years after liberalisation? Very poorly! that is what the market statistics of the time tell us. Simply, yesterday's giants—those who lived off protection and cared precious little for generating greater shareholder value—have been dwarfed by market forces. Compare this with the new players in the corporate sector. They have been doing well. This evidence shows how economic liberalisation, competitiveness and dismantling of controls have reduced entry barriers, and permitted new entrepreneurs to race to the top.

This change has augured well for corporate governance. The new breed of managers is not wedded to the mechanics of yesterday's regime. Instead, they believe in professionalism and the credo of running business transparently to increase corporate value. Thus, the need for good corporate governance is being appreciated as a sound business strategy, and as an important facilitator to tap domestic as well as international capital.

Global Concerns

There are fewer concerns more central to international business and developmental agendas than that of corporate governance. A series of events over the last two decades have placed corporate governance issues at the centre stage both for the international business community and for international financial institutions. Apart from colossal business failures and serious frauds in the USA, several high-profile scandals in Russia and the Asian crisis have brought corporate governance issues to the forefront in developing countries and transition economies. The virtual collapse of the Russian economy in 1998 resulted in large measure from the weakness of governance mechanisms. The abysmal inefficiency of business operations under state control led to the earlier collapse of the Soviet system. But privatisation of industries resulted in a substantial diversion of assets by managers. These managers are said to have robbed share holders, creditors, consumers, the government, workers, in sum all possible stake holders, an estimated

$100 billion and this colossal sum was moved out of the country by these predators. The consequent distrust predictably resulted in the virtual collapse of external capital to firms, illustrating vividly the fact that corporate misgovernance can shake the very foundations of a society, affecting every member therefrom. Likewise, the Asian financial crisis also demonstrated that even strong economies lacking transparent control, responsible corporate boards and share holder rights can collapse quickly as investors' confidence erodes.

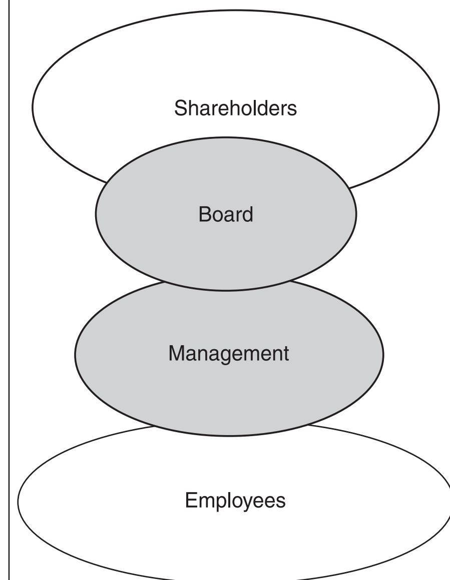
Further, national business communities are gradually realising the fact that there is no substitute for getting the basic business and management systems in place in order to be competitive in the global market and to attract foreign investment.

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 1.1 explains how a corporation is structured.

Figure 1.1

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 best governance practices by corporates, but all 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."[2] Viewed from this perspective, corporate governance focusses on some structures and mechanisms that would ensure the proper internal structure and rules of the board of directors; creation of independent committees; rules for disclosure of information to shareholders and creditors; transparency of operations and an impeccable process of decision-making; and 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 on their investment. How do the suppliers of finance get managers to return some of the profits to them? How do they make sure that managers do not steal the capital they supply or invest it in bad projects? How do suppliers of finance control managers?"[3]

From this point of view, 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 shareholders and others can hold directors accountable.
4. The company adopts 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.[4]

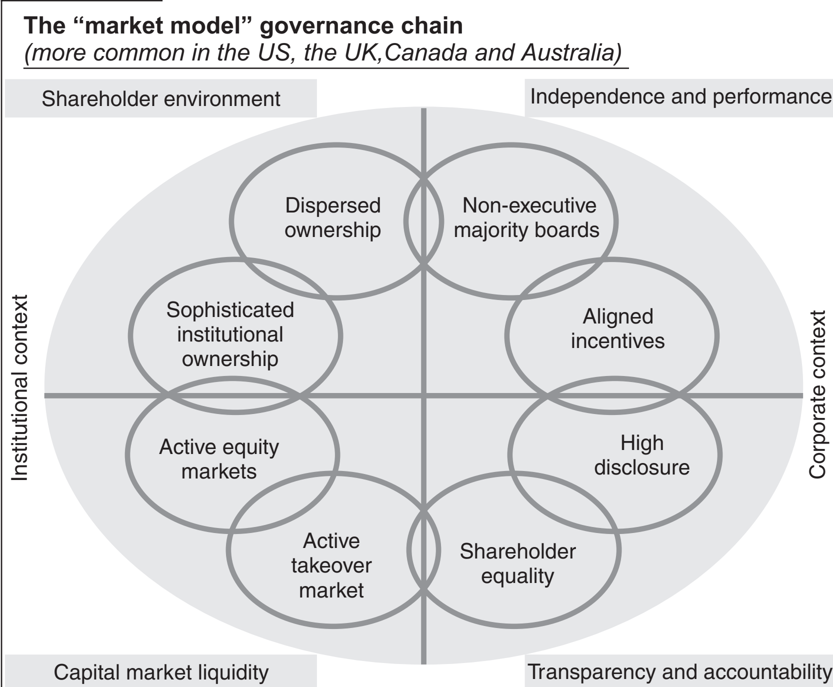
A McKinsey & Company Report published in 2001 under the title "Giving New Life to the Corporate Governance Reform Agenda for Emerging Markets" suggests that by using a two-version "governance" chain model, we can illustrate the governance practices throughout the world.

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, 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.

Figure 1.2

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



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.

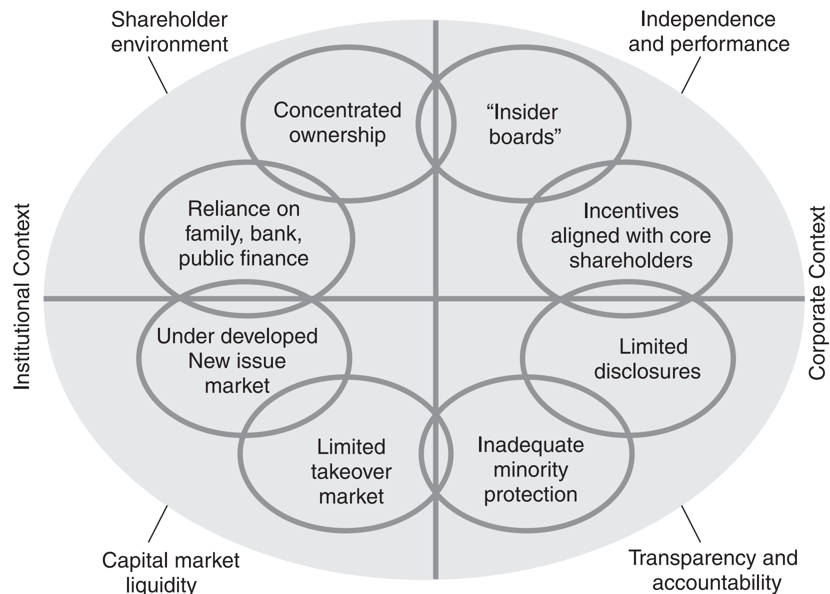
From the Angle of Developed Versus Developing Countries

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.

Figure 1.3

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



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.[5] This view is consistent with both the Anglo-American 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."[6]

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."

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.

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."[7]

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 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, developing 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.[8] 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."[9] 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."[10]

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 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 developing countries and 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.[11]

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 the 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 as a subject, as an objective, or as 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

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."

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.

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 managers of the corporation. For instance, Monks and Minow[12] 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."[13]

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, management, board and other stakeholders (the employees, customers, suppliers, investors and 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.[14] 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 corporate managers and entrepreneurs (corporate insiders) on one hand, and those who invest resources in corporations, on the other."[15]

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."[16]

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.

Governance Is More Than Just Board Processes and Procedures

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

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.

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."[17] 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 wreck 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, UK, France, Germany, Sweden and Australia, important long-term efforts have been initiated in the sphere of company law, mergers and acquisitions by companies.

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, 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 APEC, include secure ownership of their shares, voting rights, the right to full disclosure of information, 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 benefits of exercising their voting rights.

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.

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 deliberations 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 shareholders. Apart from dealers, 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 shareholders, allow employee representation on 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. 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, 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

As we have observed earlier, corporate governance has focussed traditionally on the problem of the separation of ownership by shareholders and control by management. But with the passage of time, experiences gained from 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-run 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 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.

> 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.

TABLE 1.1 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.

Source: *OECD, ICGN, APEC and Cal PERS Web sites.*

The Growth of Modern Ideas of Corporate Governance from the USA

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.

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 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.

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 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 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 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 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 3: "Landmarks in the Emergence of Corporate Governance."

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 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 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 was a wealth-destroying event 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 boards of directors are not only responsible but also needed 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 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.

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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 investors 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. Complacence 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 in it 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 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) Select, decide the remuneration and evaluate on a regular basis, and when necessary, change the CEO.
- (b) Oversee (not directly, but indirectly) the conduct of the company's business to evaluate whether or not it is being correctly managed.
- (c) Review and, where necessary, approve the company's financial objectives and major corporate plans and objectives.
- (d) Render advice and counsel top management including the Board of directors.
- (e) Identify and recommend candidates to shareholders for electing them to the board of directors.
- (f) Review the adequacy of systems to comply with all applicable laws and regulations.
- (g) All other functions required by law to be performed.

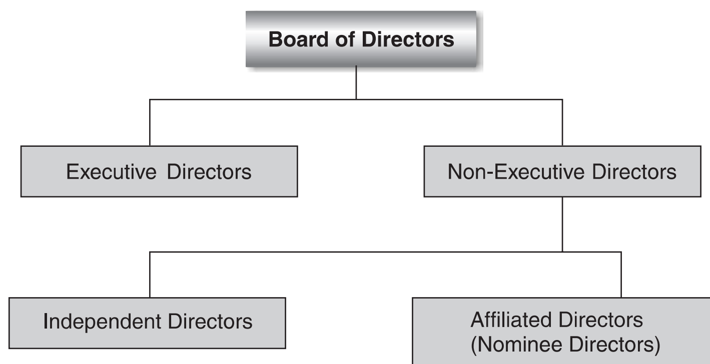
2. Composition of the board and related issues: A board of directors is a "committee elected by the shareholders of a limited company to be responsible for the policy of the company. Sometimes, full-time functional directors are appointed, each being responsible for some particular branch of the firm's work."[18]

The composition of 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 1.4 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 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 executive chairman, at least half of the board should be independent directors."[19]

Figure 1.4

Types of Directors



As shown in Figure 1.4, 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.[20]

3. **Separation of the roles of the CEO and 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 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 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).[21]

> 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 for (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."[22] 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 loopholes and laxity in implementation of the spirit of law.

Shareholders in fact only endorse the board's nominees and it is only in 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 Board's appointments such as: appointment of a 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 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 such 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."[23]

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: (1) 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 precautions are to be taken or what are the positions of the state and 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 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 shareholder's resolutions be "bundled"? i.e. to place together before shareholders for approval a resolution that contains more than one discrete issue and (iv) Should 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 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 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 prefer strongly, corporates that are committed to the overall welfare of people in whose midst they work and make their gains.

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.

> 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.

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 have been an issue at all. Armed with the same information as managers, shareholders and 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 from 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 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 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, government 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 at what needs to be done following corporate governance problems.

Need for and Importance of Corporate Governance

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 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 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.

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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 research has 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 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 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, Birlas, Murugappa's 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 UK, the premium was 18 per cent while it was 27 per cent for Italian and 27 per cent for Indonesian companies.[24] 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, have systems that provide full disclosure of accounting and auditing procedures, allow 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's 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. Practical examples of strategies that create value to corporations are sales and marketing strategies, customer base and branding

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.

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 fulfill investors' expectations and confidence on 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 that were 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 relevance of corporate governance to 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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Case Study

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 infrastructure 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

- Articles from www.domain-b.com
  (a) Infosys, HLL best in corporate governance (November 2, 2001)
  (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).
  (e) That billion-dollar feeling (15 April 2004).
  (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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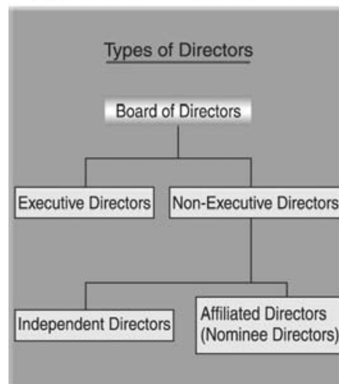

The Theory and Practice of Corporate Governance

CHAPTER OUTLINE

- The Concept of Corporation
- Theoretical Basis of Corporate Governance
- Agency Theory
- Stewardship Theory
- Stakeholder Theory
- Sociological Theory
- Corporate Governance Mechanisms
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The Concept of Corporation

No other institution has contributed so much to the growth of market-driven capitalist economies of the world as modern corporations. The Joint Stock Company which is also known as "Corporation" is the nucleus of all business activities in modern economies. Such a company can be easily set up under the Companies Act. The corporation has become the most important industrial unit or business enterprise or a commercial venture. But it is also a fact that all corporations do not enjoy equal measure of power nor are they equal in terms of size and degree of operations. Be it in a developed country such as the US or a developing country such as India, the major portion of capital is in the hands of few giant corporations which are in a position to exercise considerable control over industrial production and its sale.

> No other institution has contributed so much to the growth of market-driven economies as modern corporations. "Corporation" is the nucleus of all business activities in modern economies. Lawyers and economists describe the corporation as "a nexus of contracts," arguing that the corporation is nothing more than the sum of all of the agreements leading to its creation.

The definitions of the term "corporation" reflect the perspectives, predelictions and the sensitivity of the people writing them. Lawyers and economists describe the corporation as "a nexus of contracts," arguing that the corporation is nothing more than the sum of all of the agreements leading to its creation.

Melvin Aron Eisenberg defines a corporation thus: "The business corporation is an instrument through which capital is assembled for the activities of producing and distributing goods and services and making investments. Accordingly, a basic premise of corporation law is that a business corporation should have as objective the conduct of such activities with a view to enhancing the corporation's profit and the gains of the corporation's owners, that is, the shareholders.

According to Chief Justice John Marshall: "A corporation is an artificial being, invisible, intangible, and existing only in the contemplation of the law. Being the mere creature of the law, it possesses only those properties which the charter of its creation confers on it, either expressly or as incidental to its very existence. These acts are supposedly best calculated to effect the object for which it was created. Among the most important properties are immortality, and, if the expression be allowed, individuality; which a perpetual succession of many persons are considered the same, and may act as a single individual."

What is a Corporate?

In the capitalist economy, the process of capital accumulation that facilitates development of economies by fuelling growth of its various sectors such as industry, agriculture, infrastructure, trade and commerce has become institutionalised by the corporation. The corporation of today has come to replace the sole proprietor of earlier times and tries to maximise its profits and accumulate capital as he did. However, it differs from individual capitalist in two important aspects: (i) The life span of the corporation is much longer, and (ii) it is more rational in decision making by virtue of the fact that it has the benefit of the collective wisdom of the board of directors, and besides, they take decisions using the principles of cost accounting and budget analysis, data collection and processing and managerial consulting.

> The corporation of today differs from individual capitalist in two important aspects: (i) the life span of the corporation is much longer, and (ii) it is more rational in decision-making by virtue of the fact that it has the benefit of the collective wisdom of the board of directors. Besides, they take decisions using the principles of cost accounting, budget analysis, data collection and processing, and managerial consulting.

Though there are numerous definitions of a company, some of which have been quoted earlier, Justice Lindlay's definition is both lucid and comprehensive. In his words: "By a company is meant an association of many persons, who contribute money or money's worth to a common stock and invest it in some trade or business, and who share the profit and loss (as the case may be) arising therefrom. The common stocks so contributed is denoted in money and is 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."[1]

A corporation is an association of persons recognised by the law as having a collective personality. The corporation can act as if it were distinct from its members, it has "perpetual succession" and a common seal. Characteristics of a corporation are incorporated association, artificial legal existence, perpetual existence, extensive membership, separation of management from ownership, limited liability and transferability of shares.

A corporation enjoys some privileges and is also bound by responsibilities, indicated in the following definition: A corporation is an association of persons recognised by the law as having a collective personality. The corporation can act as if it were distinct from its members; it has "perpetual succession" and a common seal. It can therefore CONTRACT quite freely—it can also be fined, but it obviously cannot be sent to prison or incur penalties which can only be applied to individuals.[2]

From the above definitions, the following characteristics of a corporation emerge:

1. **Incorporated association:** A corporation is legally required to be incorporated or registered under the prevalent Companies Act of the country.
2. **Artificial legal existence:** A joint stock company, also referred to as a corporate or corporation, is entitled to a separate legal existence, apart from the persons composing it. In the eyes of law, it is a separate legal person and has rights and duties as any natural person has, though it has no political or civic rights. The Supreme Court of India has defined the legal status of a company thus: "The corporation in law is equal to a natural person and has a legal entity of its own. The entity of the corporation is entirely separate from that of its shareholders; it bears its own name and has a seal of its own; its assets are separate and distinct from those of its members; it can sue and can be sued exclusively for its own purpose; the liability of the members or shareholders is limited to the capital invested by them, similarly the creditors of the members have no right to the assets of the corporation."[3]
3. **Perpetual existence:** The life of a corporation is not contingent on the lives of its members. Its life does not end with the exit, retirement, lunacy, insolvency or death of any or all directors or shareholders. The perpetual existence of the company is preserved by the provision of transferability of shares. A company's existence depends on law. Law creates a company and law only can dissolve it.
4. **Common seal:** Since a company is an artificial person, it cannot sign documents for itself. It functions through natural persons who are usually directors. However, a company having a legal entity is bound by those documents that are signed by the company's CEO and carry the seal of the company. Use of seal is a legal requirement. Under the Indian Companies Act, any document bearing the common seal of the company and duly witnessed by at least two directors of the company is legally binding on the company.
5. **Extensive membership:** There is no maximum limit to the membership of a joint stock company. As the purpose of a company is to raise large capital, shares are sold to a large number of persons. Even men of small means can become part-owners of a company by subscribing to its share capital. Companies such as Reliance have millions of shareholders scattered not only through the breadth and width of the country but also abroad.
6. **Separation of management from ownership:** The divorce of ownership from the actual management of the company is what often causes misgovernance of companies. The shareholders, scattered as they are, are not in a position to take part in the day-to-day administration of their company. They cannot also bind the company by their acts. The actual management is delegated to the board of directors elected by them, who in turn, take major policy decisions and hand over the daily administration to salaried managers. These men, motivated as they are by a desire to show profit, may act capriciously and cause misgovernance.
7. **Limited liability:** Although law provides for creating a company with unlimited liability or a company by limited guarantee, the companies with limited liability are most common. Limited liability implies that the liability of the shareholders is limited to the amount unpaid on their shares irrespective of

the obligations of the company. This means that even in cases when a company suffers heavy losses and incurs large debt obligations, the personal property of the shareholders cannot be seized for repaying the debts of the company provided shares are fully paid. This limitation of liability eliminates the "risk" of investment and has stimulated investment in all kinds of large industries and huge commercial enterprises and has paved the way for the growth of the material civilisation of the world. It has also encouraged large public savings even among the middle and the lower middle classes.

8. **Transferability of shares:** Shareholders of a public limited company can freely transfer their shares to whomsoever they like without seeking permission from the company. Thus a member of a public company can transfer his holdings without the consent of other members. This imparts liquidity to the investment made in the shares of the company. Shares, like commodities, can be bought and sold in a market known as stock exchange. This facility has also stimulated investments. Capital which is locked up in fixed assets of a company has been made liquid and realisable by transferability of shares. But for this facility, large amount of capital which the present day corporates need cannot be mobilised.

The Concept of Governance

The concept of "governance" is as old as human civilisation. Simply stated, "governance" means the process of decision-making and the process by which decisions are implemented (or not implemented). Governance can be used in several contexts such as corporate governance, international governance, national governance and local governance.

> "Governance" is as old as human civilisation. Simply stated, it means the process of decision-making and the process by which decisions are implemented (or not implemented). An analysis of governance focusses on the formal and informal players involved in decision-making and implementing the decisions made.

Since governance is the process of decision-making and the process by which decisions are implemented, an analysis of governance focusses on the formal and informal players involved in decision-making and implementing the decisions made and the formal and informal structures that have been set in place to arrive at and implement the decision.

Government is one of the players in governance. Others involved in governance vary depending on the level of government that is under discussion. In rural areas, for example, other players may include influential landlords, associations of peasant farmers, cooperatives, NGOs, research institutes, religious leaders, finance institutions, political parties, the police, etc. The situation in urban areas is much more complex and includes the urban elite, decision-makers at various levels, both government and the private sector media, elected representatives, government officers of various levels, the middle class, the urban poor, NGOs and interested groups, small scale entrepreneurs, trade unions and so on. At the national level, in addition to the above players, media, lobbyists, international donors, multi national corporations, etc. may play a role in decision-making or in influencing the decision-making process.

All players other than government and the military are grouped together as part of the "civil society". In some countries, in addition to the civil society, organised crime syndicates also influence decision-making, particularly in urban areas and at the national level.

Similarly, formal government structures are one of the means by which decisions are arrived at and implemented. At the national level, informal decision-making structures, such as "kitchen cabinets" or informal advisors may exist. In urban areas, organised crime syndicates such as the "land mafia" may influence decision-making. In some rural areas, local powerful families may make or influence decision-making. Such informal decision-making is often the result of corrupt practices or leads to corrupt practices.

Theoretical Basis of Corporate Governance

There are four broad theories to explain and elucidate corporate governance. These are: (i) Agency Theory (ii) Stewardship Theory (iii) Stakeholder Theory and (iv) Sociological Theory.

Agency Theory

In the modern corporation, where share ownership is widely held, managerial actions depart from those required to maximise shareholder returns. In 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.

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*. 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 shareholders to pursue such objectives, are the *agents*. 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 from 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, "oversight" and corrective systems that can align the objectives of the two sets of players as closely as possible and, hence, minimise agency costs.

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 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. 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 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 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, which 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 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 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 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 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 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.

The stewardship theory of corproate 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 self-serving behaviour and 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.

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 executives, 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 Indian industrialists better understand 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 Stewardship Theories have something in common, there are certain basic differences. The tables set out below summarise the main differences between the two theories.[4]

Davis, Schoorman and Donaldson (1997) state that the owners-managers 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 2.1 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 2.2 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 2.3 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 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)".[5] 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.

Sociological Theory

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.

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.

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 economic and 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 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.

Contemporary Corporate Governance Situation

In many countries, shares of public companies are now held by diverse shareholders: some by private individuals, some by institutional investors such as banks, pension funds and insurance companies, and some by other companies, who might have business relationships with the company. These days, ownership structures of major public companies around the world are complex.

In the original concept of the company, the basis of corporate governance was shareholder democracy. Shareholders were relatively few and close enough to the board of directors to exercise a degree of control. Indeed in millions of smaller, tightly owned companies around the world that is still the situation today.

But for major corporations, particularly those which have their shares listed on a stock exchange, the governance situation has practically changed. In many countries, the shares of public companies are now held by diverse shareholders—some by private individuals, some by institutional investors such as banks, pension funds and insurance companies, and some by other companies, who might have business relationships with the company. Ownership structures of major public companies around the world these days are often complex. The first step in understanding the reality of corporate governance in a given company is to understand the ownership structure and, hence, the potential to exercise power and influence over that company.

In the past, most institutional investors ignored their management or rights as shareholders, preferring to sell their shares rather than getting involved in challenging corporate performance. However, a trend in recent years has been for some institutional investors, particularly in the United States, Great Britain and Australia, to become pro-active, calling for boards to produce better corporate performance, questioning directors' remuneration, and calling for greater transparency on company finances and more accountability from directors. Indeed, one US institutional investor—CalPERS (the Californian Public Employees Retirement System) has produced corporate governance guidelines for companies in which they have invested in France, Germany, Japan and the US.

Growing Awareness and Societal Responses

The growing awareness of corporate governance around the world has been reflected in a plethora of official reports on the subject. These include the American Law Institute Report (1992), the Cadbury (1992), Greenbury (1995) and Hampel (1998) reports from the UK, the Hilmer report (1993) in Australia, the Vienot report (1995) in France, the King report (1995) from South Africa, the OECD report in 1998, as well as studies in Hong Kong, Singapore, Malaysia and elsewhere. In India, the Corporate Governance code was first laid out by the Confederation of Indian Industry (CII) in the wake of interest generated by the Cadbury Committee Report, followed by an in-depth study made by the Associated Chamber of Commerce (ASSOCHAM) and the Securities and Exchange Board of India (SEBI). SEBI appointed Kumar Managalam Birla Committee and adopted its report in mid-2000. The Reserve Bank of India (RBI) also constituted its own committee to study problems and issues relating to corporate governance from the perspective of the banking sector. Based on the inputs from these committees, the Department of Company Affairs amended the Companies Act in December 2000 to include corporate governance provisions which became applicable to all Indian companies effective from 1 April 2001.

Many of the official reports provide a code of best practices in corporate governance, detailing expectations on matters such as board structure, audit and

audit committees, transparency in financial accounting and director accountability. Some institutional investors, particularly in the United States have also called for codes of corporate governance practices; the best known being the CalPERS' Global Principles of Corporate Governance. Increasingly, to obtain access to international equity finance, companies around the world have to respond to the corporate governance requirements of these codes.

Meanwhile the debate on companies' responsibilities to other stakeholders, other than their own shareholders, has been increasing in the US and UK; the Royal Society of Arts' (RSA) inquiry in the UK produced a study called "Tomorrow's Company" (1995), which suggested responsibilities to a wider range of stakeholders.

Further, most major companies now operate through group structures of wholly-owned subsidiary companies, partly-owned subsidiaries in which other external parties have a minority equity interest and associated companies in which the holding company has a significant, but not dominant holding. In addition, the globalisation of business dealings has meant that major companies frequently engage in a variety of joint venture and other strategic alliances with other companies. The second step in understanding the reality of corporate governance in a given company is to understand the network of ownership throughout the group, identifying minority interests in group companies and partner interests in joint venture companies. In India we have several such group structures of companies belonging to family-owned entities such as the Tata's, Birla's, TVS', Murugappa's etc., which are increasingly adopting corporate governance practices in all of their group companies.

Other reasons for the growing concern about corporate governance include changing societal expectations about the social responsibility of private sector companies, the attention being paid to more participatory political systems at national government level and the potential of global communications and information technology to spread ideas and to provide information on companies. The past decade has also seen a massive increase in academic research in corporate governance. At the heart of the exercise of governance over companies is the governing body, typically called the board of directors. It is vital to appreciate the role of the Board.

Corporate Governance Systems

The board of directors seldom appears on the management organisation chart yet it is the ultimate decision making body in a company. The role of management is to run the enterprise while the role of the board is to see that it is being run well and in the right direction.

> The role of the management is to run the enterprise while the role of the board is to see that it is being run well and in the right direction. Corporate governance systems vary around the world. Scholars tend to suggest three broad versions (i) The Anglo-American model; (ii) The German model and (iii) The Japanese model.

Management always operates as a hierarchy. There is an ordering of responsibility, with authority delegated downwards through the organisation and accountability upwards to the ultimate boss. By contrast, the board members need to work together as equals, reaching agreement by consensus or, if necessary, by voting. In almost all dispensations each director bears the same duties and responsibilities under the law. A useful way of depicting the interaction between management and the board is to present the board as a circle superimposed on the hierarchical triangle of management.

This model can be applied to the governance of any corporate entity, private or public, profit oriented or service-based organisation. The circle and triangle model mentioned earlier is a powerful analytical tool.

Corporate governance systems vary around the world. Scholars tend to suggest three broad versions: (i) The Anglo-American Model; (ii) The German Model; and (iii) The Japanese Model.

The Anglo-American Model

In the Anglo-American model, all directors participate in a single board comprising both executive and non-executive directors in varying proportions. 'Anglo-Saxon' approach to corporate governance is the basis of corporate governance in America, Britain, Canada, and Australia.

This is also known as ***unitary board model***, as illustrated in Figure 2.1 in which all directors participate in a single board comprising both executive and non-executive directors in varying proportions. This approach to governance tends to be shareholder-oriented. It is also called the 'Anglo–Saxon' approach to corporate governance, being the basis of corporate governance in America, Britain, Canada, Australia and other commonwealth countries including India.

The major features of the Anglo–Saxon or Anglo-American model of corporate governance are as follows:

(i) The ownership of companies is more or less equally divided between individual shareholders and institutional shareholders.

(ii) Directors are rarely independent of management.

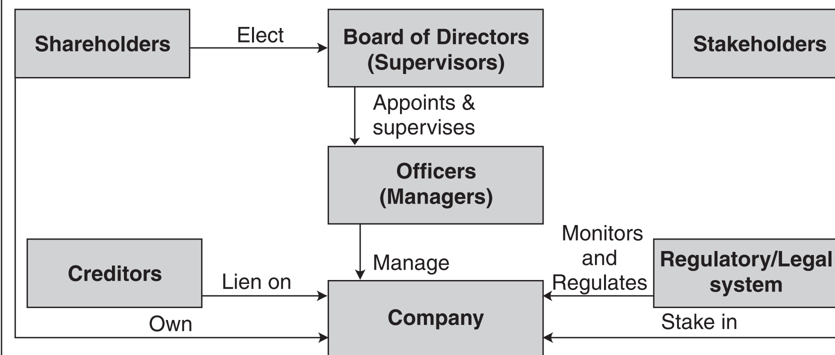
(iii) Companies are typically run by professional managers who have neligible ownership stakes. There is a fairly clear separation of ownership and management.

(iv) Most institutional investors are reluctant activists. They view themselves as portfolio investors interested in investing in a broadly diversified portfolio of liquid securities. If they are not satisfied with a company's performance, they simply sell the securities in the market and quit.

(v) The disclosure norms are comprehensive, the rules against insider trading tight, and the penalties for price manipulations stiff, all of which provide adequate protection to the small investor and promote general market liquidity. Incidentally, they also discourage large investors from taking an active role in corporate governance.

Figure 2.1

The Anglo–American Model



German Model

Corporate governance in the German model is exercised through two boards, in which the upper board supervises the executive board on behalf of stakeholders and is typically societal-oriented. In this model, although shareholders own the company, they do not entirely dictate the governance mechanism. They elect 50 per cent of members of supervisory board and the other half is appointed by labour unions, ensuring that employees and labourers also enjoy a share in the governance. The supervisory board appoints and monitors the management board.

In this model, also known as the ***two-tier board model***, corporate governance is exercised through two boards, in which the upper board supervises the executive board on behalf of stakeholders. This approach to governance is typically more societal-oriented and is sometimes called the Continental European approach, being the basis of corporate governance adopted in Germany, Holland, and to an extent, France.

In this model although the shareholders own the company, they do not entirely dictate the governance mechanism. As shown in Figure 2.2, shareholders elect 50 per cent of members of supervisory board and the other half is appointed by labour unions. This ensures that employees and labourers also enjoy a share in the governance. The supervisory board appoints and monitors the management board. There is a reporting relationship between them, although the management board independently conducts the day-to-day operations of the company.

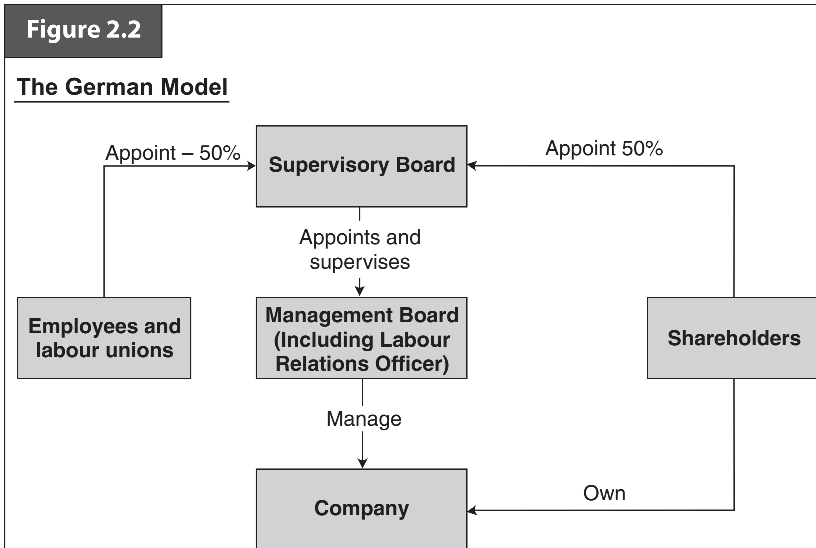
The Japanese Model

This is the ***business network model***, which reflects the cultural relationships seen in the Japanese *keiretsu* network, in which boards tend to be large, predominantly executive and often ritualistic. The reality of power in the enterprise lies in the relationships between top management in the companies in the *keiretsu* network. The approach bears some comparison with Korean *chaebol*.

In the Japanese model (Figure 2.3), the financial institution plays a crucial role in governance. The shareholders and the main bank together appoint the board of directors and the president.

Figure 2.2

The German Model

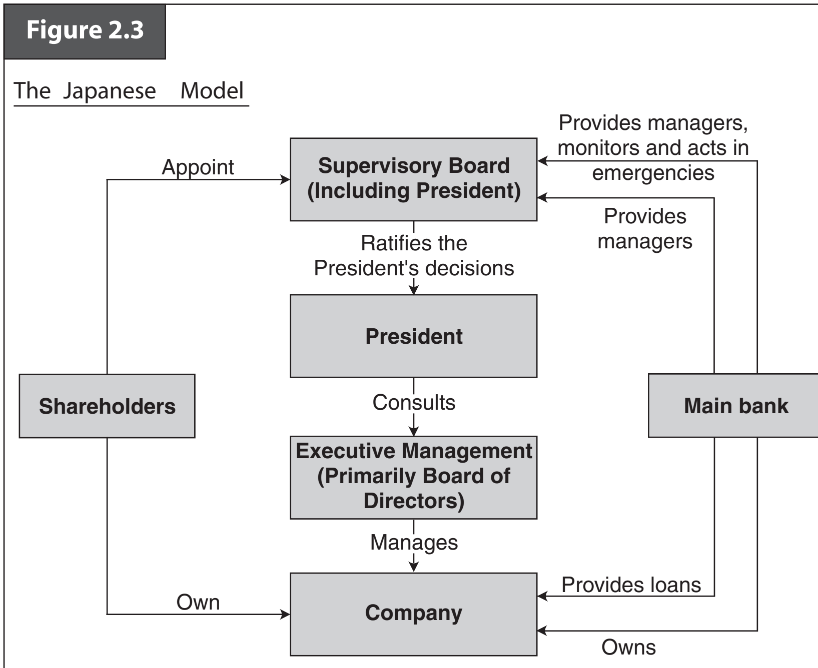


The distinctive features of the Japanese corporate governance mechanism are as follows:

- The president who consults both the supervisory board and the executive management is included.
- Importance of the lending bank is highlighted.

Figure 2.3

The Japanese Model



Common Features in the German and Japanese Models

Despite some differences among the German and Japanese models of corporate governance, there are certain significant features to justify their being bracketed together. Their distinctive features are as follows:

(i) Banks and financial institutions have substantial stakes in the equity capital of companies. Besides, cross-holding among groups of firms is common in Japan.

(ii) Institutional investors in both the countries view themselves as long term investors. They play a fairly active role in corporate managements.

(iii) The disclosure norms are not very stringent, checks on insider trading are not very comprehensive and effective, and the emphasis on liquidity is not high. All these factors lead to the efficiency of the capital market.

(iv) There is hardly any system of corporate control in these countries; mergers and take-overs are rare occurrences.

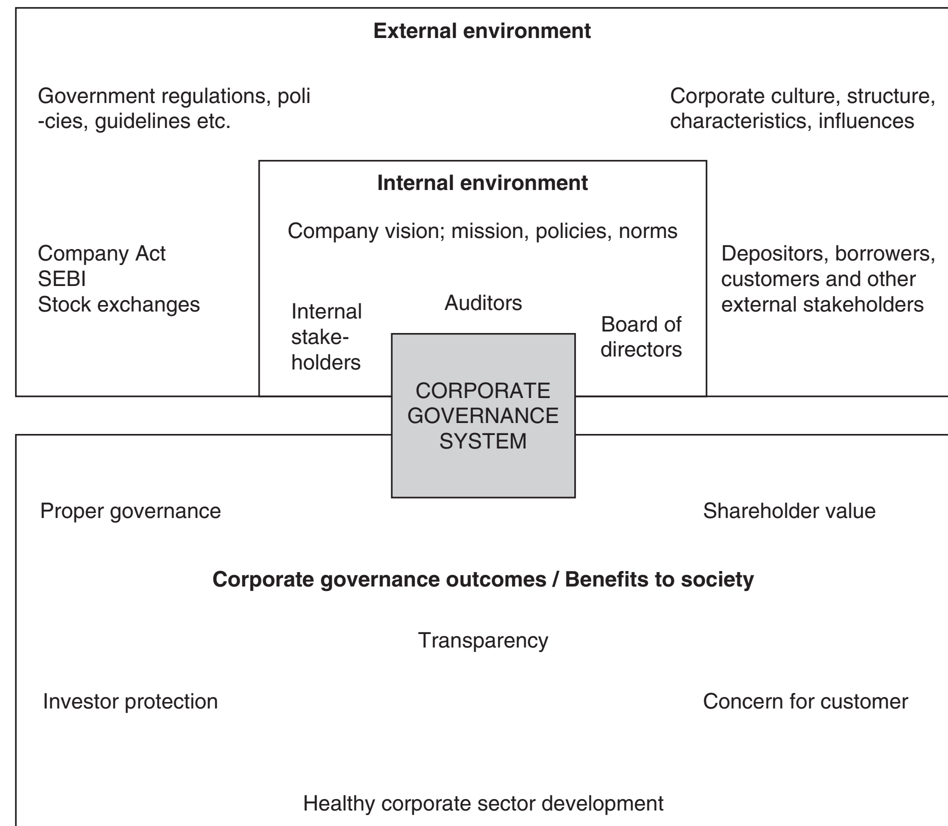
Indian corporates are governed by the Company's Act of 1956 which follows more or less the UK model. The pattern of private companies is mostly that of closely held or dominated by a founder, his family and associates. India has adopted the key tenets of the Anglo-American external and internal control mechanism after economic liberalisation.

Indian Model of Governance

The Indian corporates are governed by the Company's Act of 1956 that follows more or less the UK model. The pattern of private companies is mostly that of closely held or dominated by a founder, his family and associates. Figure 2.4 illustrates how the corporate governance system works in India.

Figure 2.4

Indian Corporate Governance Model



Available literature on corporate governance and the way companies are structured and run indicate that India shares many features of the German/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 oversight committees and the development of a serious fraud office, are further evidence of the drive to seek for 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 Anglo-American practice, namely, a greater role for non-executive directors (NEDs) and the curtailment of interlocking directorates."[6]

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 US committees and their recommendations. Furthermore, a small, *albeit* high profile group of companies have voluntarily adopted Anglo-American protocols in their bid to successfully raise capital from international markets."[7] Thus corporate governance developments in India in recent years show a paradigm shift from the German/Japanese model to the Anglo-American model.

There are primary distinctions between 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 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

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.

TABLE 2.4 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

Sources: *(1) Corporate Governance, The Indian Scenario by Vasudha Joshi, Foundation Books, pp. 124 and 125.*
(2) Large Shareholder Activism in Corporate Governance in Developing Countries: Evidence from India, by Jayati and Subrata Sarkar, International Review of Finance, September 2000, Vol.1, Issue 3.

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:

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.

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.

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

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.

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 personal and 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 inconvenient. It should encourage volunteering amongst its employees and help them to work in the communities. The company should develop social accounting systems and carry out social audit of its operations towards the community, employees and 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.

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.

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.
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

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.

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:

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 and fairly 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 consequences 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 employment of men and women in their work places and hardly treated them humanely taking advantage of the fact that workers had 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.

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2. **Equal opportunities employer:** A company should provide equal opportunities to all its employees and all qualified applicants for employment without regard to 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 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 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, removal and 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 at 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 as to 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

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.

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

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 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 oversight 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 number of their other non-executive directorships.

CONCLUSION

The analysis of the duties, responsibilities and 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 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 fulfill

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
- Governance mechanisms
- Governance practices
- International comparison
- Managerial obligations
- Obligation to customers
- Obligation to employees
- Obligation to investors
- Obligation to society
- Societal responses
- Sociological Theory
- Stakeholder
- Stewardship 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/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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Case Study

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. In 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 steelmaking 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

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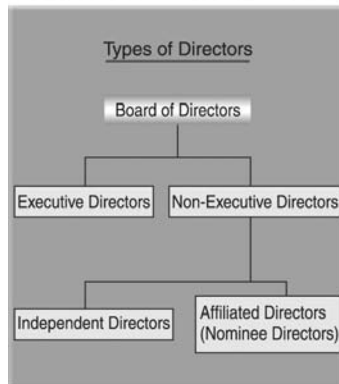

Landmarks in the Emergence of Corporate Governance

CHAPTER OUTLINE

- Introduction
- Corporate Governance Committees
- World Bank on Corporate Governance
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- Sarbanes–Oxley Act, 2002
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- Dr. J. J. Irani Committee Report on Company Law, 2005

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.

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.

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.

Corporate Governance Committees

The main committees to study and discuss issues of corporate governance and known by the names of the individuals who chaired them, are dicussed below:

Cadbury Committee on Corporate Governance, 1992

The stated objective of the Cadbury Committee was "to help raise the standards of corporate governance and the level of confidence in financial reporting and

The Cadbury Committee investigated the accountability of the board of directors to shareholders and to the society. The Cadbury Code of Best Practices had 19 recommendations in the nature of guidelines the board of directors, non-executive directors, executive directors and such other officials.

auditing by setting out clearly what it sees as the respective responsibilities of those involved and what it believes is expected of them".[1]

The Committee investigated the accountability of the board of directors to shareholders and to the society. It submitted its report and associated "Code of Best Practices" in December 1992 wherein it spelt out the methods of governance needed to achieve a balance between the essential powers of the board of directors and its proper accountability.

The resulting report and associated "Code of Best Practices" was generally well received. While the recommendations themselves were not mandatory, the companies listed on the London Stock Exchange were required to clearly state in their statement of accounts whether or not the code had been followed. The companies, which did not comply, were required to explain the reasons for the lapse.

The Cadbury Code of Best Practices had 19 recommendations. The recommendations are in the nature of guidelines relating to the board of directors, non-executive directors, executive directors and those on reporting and control.

Relating to the board of directors, the recommendations were as follows:

- The board should meet regularly, retain full and effective control over the company and monitor the executive management.
- There should be a clearly accepted division of responsibilities at the head of a company, which will ensure balance of power and authority, such that no individual has unfettered powers of decision making. In companies where the chairman is also the chief executive, it is essential that there should be a strong and independent director on the board, who is a recognised senior member.
- The board should include non-executive directors of sufficient calibre and number, for their views to carry significant weight in the board's decisions.
- The board should have a formal schedule of matters specifically reserved to it for decisions to ensure that the direction and control of the company is firmly in its hands.
- There should be an agreed procedure for directors in the furtherance of their duties to take independent professional advice, if necessary, at the company's expense.
- All directors should have access to the advice and services of the company secretary, who is responsible to the board for ensuring that board procedures are followed and that applicable rules and regulations are complied with. Any question of the removal of company secretary should be a matter for the board as a whole.

Relating to the non-executive directors, the recommendations were:

- Non-executive directors should bring an independent judgment to bear on issues of strategy, performance, resources, including key appointments and standards of conduct.
- The majority should be independent of the management and free from any business or other relationship, which could materially interfere with the exercise of their independent judgment, apart from their fees and shareholding. Their fees should reflect the time, which they commit to the work of the company.
- Non-executive directors should be appointed for specified terms and reappointment should not be automatic.
- Non-executive directors should be selected through a formal process—this process and their appointment—should be a matter for the Board as a whole.

For the executive directors, the rcommendations in the Cadbury Code of Best Practices were as given below:

- Directors' service contracts should not exceed 3 years without shareholders' approval.
- There should be full and clear disclosure of their total emoluments and those of the chairman, including pension contributions and stock options. Separate figures should be given for salary and performance related elements and the basis on which performance is measured should be explained.
- Executive directors' pay should be subject to the recommendations of a remuneration committee made up wholly or mainly of non-executive directors.

On reporting and controls, the Cadbury Code of Best Practices stipulated the following:

- It is the board's duty to present a balanced and understandable assessment of the company's position.
- The board should ensure that an objective and professional relationship is maintained with the auditors.
- The board should establish an audit committee of at least three non-executive directors with written terms of reference, which deal clearly with its authority and duties.
- The directors should explain their responsibility for preparing the accounts next to a statement by the auditors about their reporting responsibilities.
- The directors should report on the effectiveness of the company's system of internal control.
- The directors should report that the business is a going concern, with supporting assumptions or qualifications, as necessary.

The stress in the Cadbury Report is on the crucial role of the board and the need for it to observe the Code of Best Practices. Its important recommendations include the setting up of an audit committee with independent members. The Cadbury model is one of self-regulation. It was recognised that in the event British companies failed to comply with the voluntary code, legislation and external regulation would follow.

It would be interesting to note how the corporate world reacted to the Cadbury Report. The report infact shocked many by its boldness, particularly by the Code of Best Practices recommended by it. The most controversial and revolutionary requirement and the one that had the potential of significantly impacting the internal auditing, was the requirement 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.

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, 1995

This committee was set up in January 1995 to identify good practices by the Confederation of British Industry (CBI) in determining directors' remuneration

and to prepare a code of such practices for use by public limited companies of the United Kingdom.[2]

The Committee

- Aimed to provide an answer to the general concerns about the accountability and level of directors' pay.
- Argued against statutory control and for strengthening accountability by the proper allocation of responsibility for determining directors' remuneration, the proper reporting to shareholders and greater transparency in the process.
- Produced the Greenbury Code of Best Practice which was divided into the following four sections:
  - (i) Remuneration committee
  - (ii) Disclosures
  - (iii) Remuneration policy
  - (iv) Service contracts and compensation.

The Greenbury Committee recommended that the UK companies should implement the code as set out to the fullest extent practicable, that they should make annual compliance statements, and that investor institutions should use their power to ensure that the best practice is followed.

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.[3]

The Committee

- Developed further the Cadbury Report.
- Recommended that
  - (i) the auditors should report on internal control privately to the directors.
  - (ii) the directors maintain and review all (and not just financial) controls.
  - (iii) 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[4] 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.

The Combined Code was subsequently derived from Ron Hampel Committee's final report, Cadbury Report and the Greenbury Report. The Combined Code was appended to the listing rules of the London Stock Exchange. Compliance of the code is mandatory for all listed companies in the United Kingdom.

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 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.

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 is 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 concept and focusses on the principles such as transparency, accountability, fairness and responsibility that are universal in their applications.

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.

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.[5] 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, 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.

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:

- 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.

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.

Sarbanes–Oxley Act, 2002

"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.

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 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.

> 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.

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:

- 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 are the residual funds, 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 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 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 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 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:

> 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 present-day corporate frauds and their enforcement was weak and inefficient.

- 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 between executive and 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, 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 provide for the appointment of auditors by shareholders, in practice they work more closely with the company management. Shareholders hardly have a chance to interact with the auditors. Corporate malpractices are often the result of the collusion between management and auditors.
- A large number of companies hardly provide any service to investors, particularly with regard to redressal of grievances, delay in share transfers, dispatch of dividend warrants and share certificates.

The Confederation of Indian Industry's Initiative

> 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.

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 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 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.[7]

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, Indian companies have to attract low cost capital from across the globe. For this, 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 Rs.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 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 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 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 paid-up capital of Rs. 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 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.[8] The Kumar Mangalam Birla Committee's Report is indeed a veritable landmark in the evolution of corporate governance in India.

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 paid-up share capital of Rs. 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, 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 demerits. 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:

- Board of directors
- Audit committee
- Remuneration of directors
- Board procedure
- Management
- Shareholders
- Report on corporate governance
- Compliance certificate from auditors.

> 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.

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 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.

Naresh Chandra Committee Report, 2002

While 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 CEO and 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) 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 CEOs and 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, 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 SEBI's instruction to the companies that they should comply with 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, 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. 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 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. 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 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 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. SEBI wanted to strengthen the means through which the individual investor could be protected.

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, chairman and chief mentor of Infosys Technologies Ltd., and comprised representatives from stock exchanges, chambers of commerce, investors' associations and professional bodies.

Narayana Murthy Committee Report, 2003

The committee on corporate governance set up by SEBI under the chairmanship of N. R. Narayana Murthy which submitted its report in February 2003 was yet another committee on the subject signifying the regulator's anxiety to expeditiously promote corporate governance practices in Indian companies.

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's terms of reference were the following:

- To review the performance of corporate governance.
- 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's report expresses its total concurrence with the recommendations contained in the Naresh Chandra Committee's report on the following counts:

(i) Disclosure of contingent liabilities
(ii) Certification by CEO's and CFO's
(iii) Definition of independent directors
(iv) Independence of audit committees

The committee came out with two sets of recommendations namely, mandatory recommendations and non-mandatory recomendations. The mandatory recommendations focus on strengthening the responsibilities of audit committees, improving the quality of financial disclosures including those pertaining to related party transactions and proceeds from initial public offerings, requiring corporate executive boards to assess and disclose business risks in the annual reports of companies, calling upon the boards to adopt formal codes of conduct; the position of nominee directors and improved disclosures relating to compensation to non-executive directors and shareholders.

Mandatory Recommendations

Audit committee: An audit committee is the bedrock of quality governance. An effective audit committee is a pre-requisite for achieving high standard of governance. The committee recommended a bigger role for the audit committee. The committee suggested that the audit committee of publicly listed companies should be required to review the following information mandatorily:

(i) Financial statements and draft audit reports including quarterly and half yearly information.
(ii) Management discussion and analysis of financial condition and the results of operations.
(iii) Report relating to compliance with laws and risk management.
(iv) Management letters of internal control weaknesses issued by statutory internal auditors.
(v) Records of related party transactions.

In the present dispensations, audit committee, set up as per Clause 49 of the Listing Agreement, is empowered to recommend the appointment and removal of statutory auditors, fixation of audit fee and also approval for payment for any other services in addition to the powers of review etc. If the above powers are added as per the committee's recommendations, the audit committee of the listed companies in India will become one of the most empowered committees in a corporate set up.

The Narayana Murthy committee has not taken a view on rotation of auditors.

Related party transactions: A statement of all transactions with related parties including their bases should be placed before the audit committee for formal approval/ratification and that if any transaction is not on an arm's length basis, management should provide explanation to the audit committee justifying the same.

The existing requirement as per Clause 49 of the Listing Agreement has been reiterated.

Proceeds from initial public offerings: Companies raising money through initial public offering should disclose to the audit committee the uses and application of funds under major heads on a quarterly basis.

Each year, the company shall prepare a statement of funds utilised for purposes other than those stated in offer document/prospectus. This statement shall be certified by the independent auditors of the company. The audit committee should make appropriate recommendations to the board to take steps in the matter.

This suggestion was welcomed by many as it enlarges the existing requirement in this regard and is a response to manipulations perpetrated by some corporates in this area.

Risk management: The committee has deemed it necessary for the boards of companies to be fully aware of the risks involved in the business and that it is also important for shareholders to know about the process by which companies manage their business risks. The mandatory recommendations in this regard are the following:

Procedures should be in place to inform board members about the risk assessment and minimisation procedures. These procedures should be periodically reviewed to ensure that executive management controls risks 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 minimise such risks and any limitation to the risk-taking capacity of the corporations. The board should formally approve this document.

At present, in Clause 49 of the Listing Agreement, there is a stipulation that the management discussion and analysis report forming part of the board's annual report should include discussion on "risks and concerns". The suggestion contained in the report is more elaborate and this would encourage a meaningful discussion at the board level periodically and the company will have the benefit of advice from board members who are in charge of day to day management.

Code of conduct: The committee has recommended that it should be obligatory for the board of a company to lay down a code of conduct for all board members and senior management of the company. This code should be posted on the company's website and 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 COO.

This suggestion which is long overdue in the Indian context is in line with the best practices adopted by corporates in developed economies. In fact, such

matters are included in the charters of companies, sending a clear message to the company's personnel, how serious the company is about ensuring that the code is followed both in the letter and spirit. It is found that in most of the cases the misdemeanours reported were caused by breach of the code of conduct.

Nominee directors: The committee recommended doing away with nominee directors. If a corporation wishes to appoint a director on the board, such appointment should be made by the shareholders. The committee insisted that an institutional director, if appointed, shall have the same responsibilities and shall be subject to the same liabilities as any other director. Nominees of the government on public sector companies shall be similarly elected and shall be subject to the same responsibilities and liabilities as other directors.

This suggestion has become an issue of hot debate in corporate circles and outside. However, in the present context where one finds a nominee director in the board of a company very often working or voting against matters perceived to be in interest to the company, and hence there is ample justification for this suggestion to be implemented. The board of a company is expected to be a cohesive team, characterised by mutual consultations and collective wisdom. There is no place for a person who does not fall in line. The inherent conflict would seriously harm the interests of the company.

Other mandatory recommendations of the committee are the following:

- Compensation to non-executive directors (to be approved by the shareholders in general meeting, restrictions placed on grant of stock option, requirement of proper disclosures of details of compensation).
- Whistle blower policy to be in place in a company.

All these suggestions are well merited and deserve implementation. Some objections raised in certain quarters about the recommendation of the committee with regard to whistle blowing can be met by suitable provisions to avoid frivolous and vexatious complaints.

The non-mandatory recommendations pertain to moving to a regime providing for unqualified corporate financial statements, training of board members and evaluation of non-executive director's performance by a peer group comprising the entire board of directors, excluding the director being evaluated.

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.[10] 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

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 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 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 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 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 differences too between the committee and 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.

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

- World Bank
- Guidelines
- Mandatory recommendations
- McKinsey
- Non-mandatory recommendations
- OECD
- Public company
- Rationale for a review
- SEBI's initiatives

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.

NOTES

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Case Study

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 effectiv-eness 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

1. ITC's Massive Outlay on Paper Plant, *The Hindu* (17 August 2005).
2. ITC Foods to Raise Capacity, *The Hindu* (7 September 2005).
3. Devashwar, Y. C. (at the 94 AGM on 29 July 2005) reproduced in ITC's "Inclusive and Sustainable Growth—ITC's Enduring Contribution".
4. E-Business 101 For ITC, *Economic Times*, New Delhi (28 August 2005).

SUGGESTED READINGS

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- www.co-oDertaivebank.co.uk
- www.iccwbo.ora
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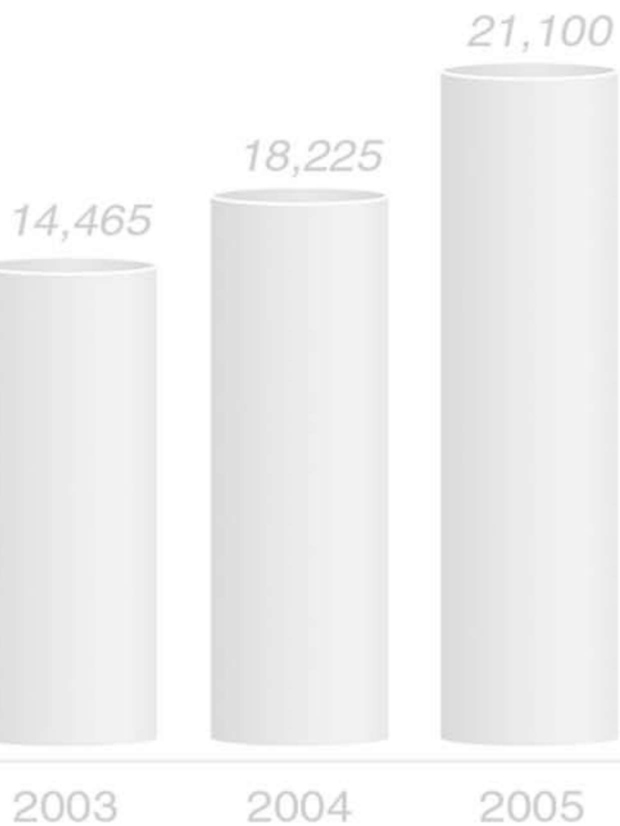
PART TWO

AGENTS AND INSTITUTIONS IN CORPORATE GOVERNANCE



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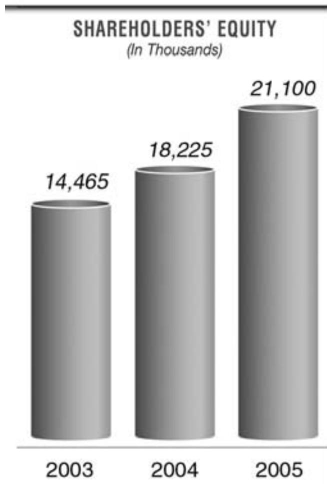

Rights and Privileges of Shareholders

CHAPTER OUTLINE

- Introduction
- Rights of Shareholders
- Views of Various Committees on the Issue
- Poor Track-record of Shareholder Protection
- Grievance Redressal Process

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.

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.

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 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 managers are quite at variance from those of the shareholders. This divergence in objectives between ownership and 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 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 creditors and 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 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 members 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.

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.

Some of the more important rights of shareholders as stressed by the above Acts are the following:

- He has a right to obtain copies of the Memorandum of Association, 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 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

Working Group on the Companies Act, 1996

Various committees have been set up to guide shareholders with regard to good corporate governance practices especially with reference to protection of their long-term interests. One among them was the Working Group on the Companies Act set up in 1996 which has recommended many financial as well as non-financial disclosures.

Various committees have been set up both in India and elsewhere to guide the shareholders with regard to good corporate governance practices especially with reference to protection of their long-term interests. One among them was the Working Group on the Companies Act set up in 1996 by the Government of India which has recommended many financial as well as non-financial disclosures. These disclosures call for greater transparency in the accounting of the organisation. It calls for a tabular form containing details of each director's remuneration and commission which 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. Also, any cost incurred in using the services of a Group Resource Company must be clearly and separately disclosed in the financial statement of the user company. Again, where the company has raised funds from the general public, it would have to give a separate statement showing the end-use of such funds, namely, how much was raised versus the stated and actual project cost; how much has been utilised in the project up to the end of the financial year; and where are the residual funds, if any, invested and in what form. There should also be a disclosure on the debt exposure of the company. With regard to the non-financial disclosure, the Working Group called for 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. The company should also maintain a register which discloses interests of directors in any contract or arrangement of the company, and the fact that such a register is made and is open for inspection needs to be made known to the shareholders in the Annual General Meeting. Details of loans to directors should be disclosed as an annex to the directors' report in addition to being a part of the 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 fulltime directors. The detailed terms of the loan would need shareholders' approval in a General Body Meeting. These are some of the disclosures that need to be made. The company should understand

that though all other things being equal, greater the quality of disclosure, the more loyal are the company's shareholders. Based on these recommendations, a number of changes were introduced in the Companies Bill, 1997. However, since many of these recommendations were not mandatory, it did not have much impact on the corporate governance scenario in India.

CII's Committee on Corporate Governance, 1996

The next committee that had considerable impact on the corporate world with regard to the rights of shareholders to ensure corporate governance in the organisation was the report submitted by the Confederation of Indian Industry (CII). The CII has pioneered the concept of corporate governance in India and is an internationally recognised name in this field. Its code, the Desirable Code of Corporate Governance, was the first of its kind in India and is 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, since the time the code was widely publicised.

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The objective of the CII was to develop and promote a code of corporate governance to be adopted and followed by Indian companies, be these in the private sector, banks or financial institutions, all of which are corporate entities. This initiative by the CII flowed from public concern regarding the protection of investor's interest, especially 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 these, to develop a high level of public confidence in business and industry.

This code required listed companies to give the following information under "Additional Shareholder's Information":

- High and low monthly averages of share prices in a major stock exchange where the company is listed for the reporting year.
- Greater details on business segments upto 10 per cent of turnover, giving share in sales revenue, review of operations, analysis of markets and future prospects.

But the recommendations made by CII were not mandatory just like those of the Working Group and therefore most of the companies did not take them seriously.

Kumar Mangalam Birla Committee, 1999

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.

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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 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 Shareholders

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 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 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 shareholders, who are too numerous and scattered for any meaningful consultation. 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 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 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 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 effective participation, 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. 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

As we have seen earlier, the Companies Act of 1956 confer 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 shareholder meetings, electing members of the board and sharing in the residual profits of the corporation.

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.

The committee, therefore, recommended that as 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 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 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 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 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.

Naresh Chandra Committee, 2002

The report of the Naresh Chandra Committee on audit and corporate governance has taken forward the recommendations of the Birla Committee on corporate governance. It has laid down stringent guidelines defining the relationship between auditors and their clients, an increased role for independent directors by assigning them at least 50 per cent seats on the board of a company. It called upon CEOs and CFOs of all listed companies to certify their companies' annual accounts, set up quality review boards for the ICAI, ICSI, ICWA and a Public Oversight Board similar to the one in the United States.

Another committee that was set up with a view to promoting corporate governance and, through it, long term shareholder value was the Naresh Chandra Committee. The Naresh Chandra Committee's report on "Audit and Corporate Governance" has taken forward the recommendations of the Kumar Mangalam Birla Committee on corporate governance. Two major issues the committee addressed and made appropriate recommendations were:

- 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 a non-executive chairman. It 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 stated that it should have three non-executive directors as its members with at least two independent directors and that the chairman of the committee should be an independent director. But the Naresh Chandra Committee 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 recommended that along with its subsidiaries, associates or affiliated entities, an audit firm should not derive more than 25 per cent of its business from a single corporate client. This, the committee said, 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 a firm once every 5 years.

While the committee said that it had 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 more or less on lines of the American Sarbanes–Oxley Act with certain modifications to suit the Indian corporate sector. The Naresh Chandra Committee on "Corporate Audit and Governance" has recommended an increased role for independent directors by assigning them at least 50 per cent seats on the board of a public limited company with a paid up capital of Rs. 100 million and above, and a turnover of Rs. 500 million and above. It has significantly asserted that nominees of financial institutions (FIs) could not be counted as independent directors.

The committee has further recommended the following:

(a) Asking the auditors to make an array of disclosures.
(b) Calling upon chief executive officers and chief financial officers of all listed companies to certify their companies' annual accounts, besides suggesting.
(c) Setting up of quality review boards for the Institute of Chartered Accountants of India (ICAI), the Institute of Company Secretaries of India (ICSI) and the Institute of Cost and Works Accountants of India, (ICWA) and a Public Oversight Board similar to the one in the United States.

At a time when people are shying away from 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 the fears. To attract quality independent directors on the board of directors of a company, the committee has recommended that these directors should be exempted from criminal and civil liabilities under the Companies Act, the Negotiable Instrument Act, the Provident Fund 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.

Thus it can be seen that though the law has provided for the rights of the shareholder to have access to information as it may seem fit that the shareholder requires, very rarely organisations make this information easily accessible to them. It is because of such prevalent situation that various committees have to intervene and see to it that they are being taken care of. However, notwithstanding all these efforts, nothing concrete has been done by public authorities to prevent corporate misgovernance.

Narayana Murthy Committee, 2003

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 investors and shareholders, as they are the prime constituencies of 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 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 quarterly result and 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 web site.
(c) A board committee under the chairmanship of a non-executive director shall be formed to specifically look into the redressing of shareholder and 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.

> 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.

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.

Poor Track Record of Shareholder Protection

Though the above detailed analysis of shareholders' rights as stressed by the Companies Act, other statues and various committees give an investor or the general readers the impression that there are enough previsions in the laws of the land, there has hardly been any conviction under them all these years. Since 1991 when the Indian economy was liberalised seemed to have opened the floodgates of scams and provided vast opportunities to fly-by-night operators to destroy shareholder values. As the result of some scams such as the Unit Trust of India (UTI) non-banking finance companies', plantations' and vanishing companies', millions of small investors lost their savings and investments. The plight of millions of such small shareholders was indeed pitiable and heart-rending. Most of them, especially those who invested in NBFCs, lost their life-earnings and were driven to the street penniless. In spite of such misery caused to the poor investors and the high dent in their confidence, the government and regulatory authorities were grinding too slowly and did nothing to trace and penalise the scamsters or retrieve and return the poor investors' money.

Between 1991 and 2006, more than Rs. 600,000 million were collected from prospective shareholders by several companies that did the vanishing trick. Though their names are posted in the web, none of the directors or promoters had been prosecuted either by the Registrar of Companies or the Securities and Exchange Board of India who can file criminal complaints against them under Section 621 of the Companies Act. Directors and promoters can be made personally liable for damages for false statements found in the prospectus. Apart from civil liability, Section 63 of the Companies Act stipulates that persons issuing false or untrue statements will be punishable with imprisonment for 2 years. Section 68 stipulates that any person who dishonestly induces other persons to subscribe to shares or debentures can be imprisoned for 5 years. But neither the government nor SEBI has thought it fit to prosecute these scamsters for more than a decade.[1]

Better late than never. However, it is heartening to note that recently, after a decade of inactivity the ministry has cracked the whip on vanishing companies. Prioritising investor protection, particularly small investors, the Ministry of Corporate Affairs (MCA) has initiated prosecutions against vanishing companies under the Companies Act as well as other legislations.[2] According to a spokesman of the Ministry of Corporate Affairs: "On review of the ongoing actions against the vanishing companies, those companies who came up with public issues during 1993–94 and 1994–95 and vanished with public money, focus has been laid on taking timely and effective action against such companies, their promoters and directors." Besides, launching prosecutions under the Companies Act, action has been taken against such entities by way of registering first information report

(FIRs) under Indian Penal Code, and vigorously pursuing the prosecutions already launched.

In its report, the "Special Cell on Vanishing Companies" in the ministry has stated that out of the 52 vanishing companies' cases in the western region, prosecutions have been filed against 48 companies, while the remaining four are under liquidation. "In fact, in the case of Maa Leafin & Capital Ltd, the accused has been convicted for, non-filing of statutory return," a ministry official said. Further, FIRs have been launched against 40 companies, of which 28 have been registered. In the case of Trith Plastic Ltd. of Gujarat, charge-sheet has been filed in the Court and Directors of the company have been arrested.

Of the 36 cases in the southern region, prosecutions have been filed against 32. For non-filing statutory returns, 21 prosecutions have been filed while FIRs have been filed against 19 companies. Of the 19 FIRs launched, nine have been registered. In the case of one company, Global Property Ltd., public issue money has been refunded.

In the northern region, prosecutions have been filed against all 20 vanishing companies. In the case of Simplex Holdings, the accused has been convicted. For non-filing of statutory returns, 19 prosecutions have been filed. In the case of Dee Kartvya Finance Ltd., the accused has been convicted and fined. FIRs have been filed against 15 companies of which four have been registered.

In the eastern region, of the 14 vanishing companies cases, prosecutions have been filed against 11 companies. The remaining three are under liquidation. FIRs have been filed in all 14 cases of which 13 have been registered. Further, 11 prosecutions have been filed for non-filing of statutory returns. In the case of Cilson Organics Ltd. the Managing Director of the company has been convicted and a fine of Rs. 14,000 has been imposed.

However, it should be remembered that it has taken more than a decade for the government to initiate legal action against the scamsters. Besides, it should be kept in mind that the slow-grinding judicial processes will take its own time and if past experience is any indication, it will take another decade or so at the fastest, to get the judgement. Even then, there is no guarantee, that the guilty will be convicted and the poor investors' money returned. This is the state of affairs that has caused untold misery to the poor Indian shareholder/investor.

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.

Besides these rights one enjoys as an individual shareholder, one 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 many 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.

Trading of Securities

A shareholder has the right to sell securities that he holds at a price and time that he may choose.He can do so personally, with another person or through a recognised stock exchange. Similarly, he has the right to buy securities from anyone or through a recognised stock exchange at a mutually acceptable price and time.

Whether it is a sale or purchase of securities, affected directly by him or through an exchange, all trades should be executed by a valid, duly completed and stamped transfer deed.

If he chooses to deal (buy or sell) directly with another person, he is exposed to counter party risk, i.e. the risk of non-performance by that party. However, if he deals through a stock exchange, this counter party risk is reduced due to trade/settlement guarantee offered by the stock exchange mechanism. Further, he also has certain protections against defaults by his broker.

When one trades through an exchange, one has the right to receive the best price prevailing at that time for the trade and the right to receive the money or the shares on time. He also has the right to receive a contract note from the broker confirming the trade and indicating the time of execution of the order and necessary details of the trade; he also has the right to receive good rectification of bad delivery. If he has a dispute with his broker, he can resolve it through arbitration under the aegis of the exchange.

A shareholder has the right to sell securities that he holds at a price and time that he may choose. He can do so personally, with another person or through a recognised stock exchange. Similarly, he has the right to buy securities from anyone or through a recognised stock exchange at a mutually acceptable price and time.

If an investor decides to trade through an exchange, he has to avail the services of a SEBI-registered broker/sub-broker. He has to enter into a broker-client agreement and file a client registration form. Since the contract note is a legally enforceable document, he should insist on receiving it. He has the obligation to deliver the shares in case of sale or pay the money in case of purchase within the time prescribed. In case of bad delivery of securities by the shareholder, he has the responsibility to rectify them or replace them with good ones.

Transfer of Securities

Transfer of securities means that the company has recorded in its books a change in the title of ownership of the securities effected either privately or through an exchange transaction. To effect a transfer, the securities should be sent to the company along with a valid, duly executed and stamped transfer deed, duly signed by or on behalf of the transferor (seller) and transferee (buyer). It would be better to retain photocopies of the securities and the transfer deed when they are sent to the company for transfer. It is essential that one sends them by registered post with acknowledgement due and watch out for the receipt of the acknowledgement card. If one does not receive the confirmation of receipt within a reasonable period, one should immediately approach the postal authorities for confirmation.

Transfer of securities that the company has recorded in its books may be done through a change in the title of ownership of the securities effected either privately or through an exchange transaction. On receipt of the shareholder's request for transfer, the company proceeds to transfer the securities as per the provisions of the law. In case it cannot effect the transfer, the company returns the securities giving details of the grounds under which the transfer could not be effected. This is known as "company objection".

Sometimes, for a shareholder's own convenience, he may choose not to transfer the securities immediately. This may facilitate easy and quick selling of the securities. In that case, he should take care that the transfer deed remains valid. However, in order to avail the corporate benefits such as dividends, bonus or rights from the company, it is essential that he gets the securities transferred in his name.

On receipt of the shareholder's request for transfer, the company proceeds to transfer the securities as per the provisions of the law. In case it cannot effect the transfer, the company returns the securities giving details of the grounds under which the transfer could not be effected. This is known as "Company Objection".

When a shareholder happens to receive a company objection for transfer, he should proceed to get the errors/discrepancies corrected. He may have to contact the transferor (the seller) either directly or through his broker for rectification or replacement with good securities. Then he can resubmit the securities and the transfer deed to the company for effecting the transfer. In case he is unable to get the errors rectified or get them replaced, he has recourse to the seller and his broker through the stock exchange to get back his money. However, if one had transacted directly with the seller originally, one has to settle the matter with the seller directly.

Sometimes, one's securities may be lost or misplaced. One should immediately request the company to record a "stop transfer" of the securities and simultaneously apply for issue of duplicate securities. For effecting stop transfer, the company may require him to produce a court order or the copy of the FIR filed by him with the police. Further, to issue duplicate securities to him, the company may require him to submit indemnity bonds, affidavit, sureties, etc. besides issue of a public notice. He has to comply with these requirements in order to protect his own interest.

Sometimes, it may so happen that the securities are lost in transit either from the shareholder to the company or from the company to him, he has to be on his guard and write to the company within a month of his sending the securities to the company. The moment it comes to his notice that either the company has not received the securities that were sent or he did not receive the securities that the

company claims to have sent to him, he should immediately request the company to record stop transfer and proceed to apply for duplicate securities.

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 4.1

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 4.1 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.

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

- Grievance redressal process
- Guide for protection of investors and shareholders
- Poor track-record
- Rights of shareholders
- 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. Spell out the major issues addressed by the Naresh Chandra Committee. What were the major recommendations of the committee to ensure corporate governance amongst companies?
5. Discuss briefly the recommendations of the Narayana Murthy committee on corporate governance.
6. What is the need and justification for postal ballot? Do you think it will offer better prospects for ensuring corporate governance?
7. 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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Case Study

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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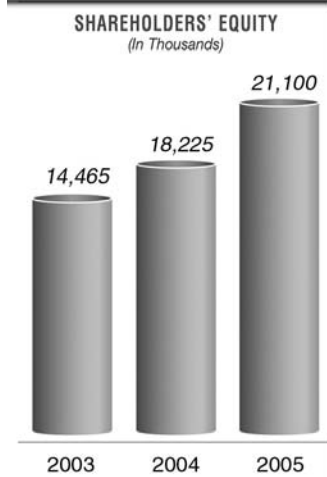

Investors' Problems and Protection

CHAPTER OUTLINE

- Introduction
- Relationship Between Investor Protection and Corporate Governance
- Corporate Governance Through Legal Protection of Investors
- Investor Protection in India
- SEBI's Poor Performance—Suggestions for Improvement

Introduction

Strong investor protection is associated with effective corporate governance. In fact, corporate governance has been advocated by everyone interested in the long term shareholder value, which in turn promotes orderly development of industries and economies. 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 investors finance 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 board of directors of the company may shake their confidence, which in the long run would have a deleterious 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 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 executive decisions on substantial sale or investments, voting out incompetent or otherwise ineligible directors and appointment of auditors. There are also laws that mainly deal with bankruptcy and reorganisation procedures that outline measures and procedures to enable creditors repossess collateral to protect their seniority and make it difficult for firms to seek court protection in reorganisation. In many countries, laws and legal regulations are

enforced in part by different law enforcing agencies such as market regulators, i.e. SEBI, courts or government agencies, i.e. the Department of Corporate Affairs in India and 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 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.

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.

Relationship Between Investor Protection and Corporate Governance

Recent research confirms that an essential feature of good corporate governance is 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 of corporations. Shareholders or investors of a firm are numerous and scattered and therefore cannot manage it. Hence, they entrust the management of the firm to managers who include the board of directors and 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 managers while they delegate responsibilities to them. But when such self-indulgence by managers exceed reasonable limits, principles of corporate governance comes 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. 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, minority shareholders and 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

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.

be stressed that these sharp practices of insiders vary from country to country depending on the existence or non-existence of democratic and corporate values, maturity or otherwise of the securities market, financial systems, pace of new security issues, corporate ownership structures, dividend policies, 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 shareholders or investors, have an inalienable right to have certain corporate information. In 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 had 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 SEBI-appointed Kumar Mangalam Birla committee recommended postal ballot for the benefit of those who could not attend the AGMs held by corporations in cities where their corporate offices are located. The committee recommended that in case of 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 and 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, 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.

Corporate Governance Through Legal Protection of Investors

The objective of corporate governance reforms in most countries is to protect the rights of outside investors, including both shareholders and creditors. Laws and their enforcement are the major factors that help outsiders to invest in corporate firms. Investor protection is an important constituent of corporate governance.

The objective of corporate governance reforms in most countries including several Latin American and Asian countries is to protect the rights of outside investors, including both shareholders and creditors. These reforms have a focus on expanding financial markets to facilitate external financing of new firms to infuse large foreign investments in existing firms, promote external commercial borrowings to help local firms access foreign capital by listing themselves in stock markets overseas, move away from concentrated ownerships, expose native firms to foreign competition wholesome corporate developments elsewhere and also to improve the efficiency of investment allocation.

The importance of legal rules and regulations as a means to protect outside investors against insider expropriation of their money is in sharp contrast to the traditional "laws and economies" perspective and has evolved over the past 50 years. In the words of Rafael La Porta et al: "According to this perspective, most regulations of financial markets are unnecessary since financial contracts take place between sophisticated issuers and equally sophisticated investors. On an average, investors recognise that there is a risk of expropriation and penalise firms that fail to contractually disclose information about them and to contractually bind themselves to treat investors well. Because entrepreneurs bear these costs when they issue securities, they have an incentive to bind themselves through contract with investors to limit expropriation (Jensen and Meckling 1976). As long as these contracts are enforced, financial markets do not require regulation." While this line of argument is an over-simplification of the process, management that gives room for expropriation that takes place in firms and neglects the grey areas that exist in company administration, this perspective too relies on courts to enforce contracts, when disputes arise.

A case in point is Russia which has a good securities law, a good bankruptcy law and an equally good company law in books. Its Securities and Exchange Commission too is independent and aggressive but relatively has few enforcement powers. With an ineffective judiciary, weak enforcement of law, Russia's financial market has not grown in an environment where blatant violations of the law are far too common.

So, in reality, laws and their enforcement are the major factors that help outsiders to invest in corporate firms. Although the reputation and goodwill of a firm do help it raise funds, law and its enforcement are the clinching factors to decide on investment. It is an indisputable fact that to a large extent shareholders and creditors decide to invest in firms because their rights are protected by the law. The outside investors are more vulnerable to expropriation, and therefore, more dependent on law, than their employees or the suppliers, who are useful to them and also have reliable source of information to ward off any problems and are at a lesser risk of being mistreated. Besides, available evidence also suggests that in countries where there is poor investor protection there may be a need to change many more rules simultaneously to bring them up to best corporate governance practice. But this may not be easy as families controlling corporations may object to these reforms. Therefore, law and its enforcement are important means to protect investors and would help promote corporate governance.

Impact of Investor Protection on Ownership and Control of Firms

In many countries, firms are owned and controlled by promoter families and in such closely held firms, insiders use every opportunity to abuse the rights of other shareholders and steal their profits through devious means. In such cases

where there is poor investor protection, large scale expropriation is feasible. Control through ownership acquires enormous value because it gives such owners opportunities to expropriate effectively. Entrepreneurs who promote companies would not like to lose control and thereby give up the chances of expropriation by diffusing control rights when investor protection is poor. Promoter families in countries with poor investor protection would wish to have concentrated control of the enterprises they have floated. However, expropriation can be limited considerably in these family owned firms, by dissipating control among several large investors none of whom can control the decision of the firm without agreeing with others. But then this is a situation well entrenched, closely held firms' promoters would wish to avoid. The evidence from a number of individual countries and the seven OECD countries with poor investor protection shows more concentrated control of firms than countries with good investor protection. In the East, except Japan where there is a fairly good investor protection, there is a predominance of family control and family management of corporations. The evidence available in many countries is in consonance with the proposition that legal environment shapes the value of the private benefits of control and thereby determines the ownership structures.

Therefore, the available evidence on corporate ownership patterns around the world supports strongly the importance of investor protection. Evidence also shows that countries with poor investor protection have more concentrated control of firms than countries with good investor protection.

Studies made by various researchers testify to the fact that in countries where there is a concentration of ownership in the hands of few families, there may be stiff opposition to legal reforms that are likely to reduce their control over firms and promote investor protection. Rafael La Porta et al assert: "From the point of view of these families, an improvement of outside investors' first and foremost right is reduction in the value of control as expropriation opportunities deteriorate. The total value of firms may increase as a result of legal reform, as expropriation declines and investors finance new projects on more attractive terms. Still, the first order effect on the insiders is a massive redistribution of wealth from them to outside investors. No wonder, then that in all countries from Latin America to Asia to Western and Eastern Europe, the families are opposed to legal reform." According to these authors, there is also another reason why the insiders in such firms are opposed to reforms and the expansion of capital markets. Under the existing conditions, these firms can finance their own investment projects internally or through captive banks or subsidiary financial institutions. Studies show that a large chunk of credit goes to the few largest firms in countries with poor investor protection. This was also the case in India as R. K. Hazari and his researchers of the University of Bombay found out in early 60s. Even recently as late as in 2001, it was found that there has been a rapid expansion of assets and turnover of industrial houses owned by families and there is a massive concentration at the top. The assets of Ambanis of Reliance, the Munjals of the Hero group, Shiv Nadar of HCL Technologies, Tatas, Birlas, Jindals, R. P Goenka, Azim Premji of Wipro, TVS, Chidambaram and Murugappa groups have grown tremendously, mostly due to insider domination and poor investor protection in the country. As a consequence of this fertile situation, the large firms obtain not only the finance they need but also political clout that comes with the access to such finance in a corruption-ridden society, as well as the security from competition of smaller firms that require external capital. Thus poor corporate governance provides large family owned firms not only secure finance but also easy access to politics and markets. The dominant families have thus abiding interest in keeping the *status quo* lest the reforms take away their privileges and confer outside investors' protection.

The Impact of Investor Protection on the Development of Financial Markets

Investor protection provides an impetus for the growth of capital markets. When investors are protected from the expropriation of insiders, they pay more for securities which makes it attractive for entrepreneurs to issue securities. Research studies point out that countries with well-developed financial markets, regulated by laws, allocate investment across industries more in line with growth priorities.

Investor protection provides an impetus for the growth of capital markets. When investors are protected from the expropriation of insiders, they pay more for securities which makes it attractive for entrepreneurs to issue securities. Through investor protection, financial markets can develop with ease and perfection, which in turn can accelerate economic growth by (i) enhancing savings and capital formation, (ii) channelising these into real investment and (iii) improving the efficiency of capital allocation, since capital flows into more productive uses. Further financial development improves efficient resource allocation and through this investor protection brings about growth in productivity and output, the two basic ingredients needed to speed up economic development.

Research studies point out that countries with well-developed financial markets regulated by laws, allocate investment across industries more in line with growth opportunities in these industries than countries with weak financial markets or poor regulatory mechanisms. These studies also reveal that (i) most developed financial markets are the ones that are protected by regulation and laws while unregulated markets do not work well, may be due to the fact they allow too much of expropriation of outside investors by corporate insiders (ii) improving the functioning of financial markets confers real benefits both in terms of overall economic growth and the allocation of resources across sectors (iii) one broad strategy of effective regulation and of encouragement of financial markets begins with protection of outside investors, whether they are shareholders or creditors and (iv) enforced outside shareholders' rights, experience in many countries reveal, encourage the development of equity markets as measured by valuation of firms, the number of listed companies and the rate at which firms go for public issues.

However, investor protection does not necessarily mean rights just included in the laws and regulations alone, but the effectiveness with which they are enforced. In countries with poor investor protection, the insiders may treat outside investors fairly well as long as the firms' future prospects are bright and they need the continued external financing by outsiders. But when the future prospects tend to deteriorate, insiders may step up expropriation. In such a scenario, unless there are effective laws against such malpractices and they are effectively enforced, outside investors will not be able to do anything but to withdraw their investments. Therefore, investor protection is absolutely essential for the orderly development and continued proper functioning of capital markets.

Banks and Corporate Governance

Banks play a significant role in the growth of the corporate sector by providing them finance for their operations. But, there are considerable differences between bank-centred corporate governance systems such as those of Germany and Japan compared to market-centred systems such as those of the UK and USA. In the former, the main bank provides both, a significant share of finance and governance to firms while in the latter finance is provided by large number of investors and takeovers play a major governance role.

Banks play a significant role in the growth of the corporate sector by providing them finance for their operations. But, there is a difference in the roles they play in different countries and these diverse roles they play have different impacts, both on investor protection and its end result, corporate governance. There are considerable differences between bank-centred corporate governance systems such as those of Germany and Japan compared to market-centred systems such as those of the UK and the USA. In the former, the main bank provides both a significant share of finance and governance to firms while in the latter finance is provided by large numbers of investors and takeovers play a major governance role.

But the classification of financial systems into bank centred and market centred is neither straight forward nor particularly useful. Rafael La Porta et al point out to studies that showed that in the 1980s when the Japanese economy was being touted as the best and worthy of emulation by other economies, such bank-centred governance was widely regarded as superior, since it enabled firms to make long term investment decisions, delivered capital to firms facing liquidity crisis and

thereby avoiding costly financial distress, and above all, replaced the expensive disruptive takeover with more surgical bank intervention when the management of the borrowing firm under-performed. The rosy situation, however, did not last long enough. When the Japanese economy collapsed in the 1990s, this form of financing and governance was found faulty. Far from being the promoters of rational investment, Japanese banks were found to be the source of the soft budget constraint, over lending to loss making firms that required restructuring and resorting to collusion with managers to prevent external threats to their control and to collect rents on bank loans. Likewise, banks in Germany too were found to be wanting in providing good governance, especially in bad times.

In the ultimate analysis of the two systems, the market based system with its focus on legal protection of investors, seems to be doing better as was demonstrated time and again, the latest being its successful riding of the American stock market bubble of the 1990s.

In conclusion, it is to be stressed that strong investor protection is an inalienable part of effective corporate governance. Financial markets, very vital constituents of economic growth, need some protection of outside investors, whether by courts, market regulators, government agencies or market participants themselves through voluntary codes or guidelines. There have to be radical changes in the legal structure, the laws and their effective enforcement. With the integration of capital markets, the necessity to bring about these reforms is more pertinent today than it was in earlier times.

Investor Protection in India

Small investors are the backbone of the Indian capital market and yet a systematic study of their concerns and attempts to protect them has been relatively of recent origin. Due to lack of proper investor protection, the capital market in the country has experienced a stream of market irregularities and scandals in the 1990s. SEBI itself though formed with the primary objective of investor protection, took notice of the issue seriously only after the Ketan Parikh scam (2001) and the UTI crisis (1998 and 2001) and has developed sophisticated institutional mechanism and harnessed computer technology to serve the purpose. Yet, there are still continuing concerns about the speed and effectiveness with which fraudulent activities are detected and punished, which is after all, should be the major focus of the capital market reforms in the country.

> Due to lack of proper investor protection, the capital market in the country has experienced a stream of market irregularities and scandals in the 1990s. SEBI itself took notice of the issue seriously only after the Ketan Parikh scam (2001) and the UTI crisis (1998 and 2001) and has developed sophisticated institutional mechanism and harnessed computer technology to serve the purpose.

The SEBI–NCAER study (1999) estimated that the investor population in India was 12.8 million or nearly 8 per cent of all Indian households. The bulk of the increase in the number of shareholders had taken place during the boom years 1990–1994 and tapered off thereafter. By 1997 the capital market bubble had burst. The Household Investors Survey of Society for capital Market Research and Development (SCMRD) (1997) revealed the following: (i) a majority of investors reported unsatisfactory experience of equity-investing (ii) 80 per cent of the investors said that they had little or no confidence in company managements (iii) 55 per cent respondents showed little or no confidence on the market regulator, SEBI and (iv) Most preferred saving instruments are government saving schemes and banks' fixed deposits. This reflected a considerable erosion of investor confidence in securities and corporates. Many subsequent investor surveys also found broadly the same investor reactions.

All these surveys underlined the need for restoring the investor's confidence in private corporates, which enjoy little credibility with investors who have badly burnt their fingers in a series of scams. This calls for a credible programme of corporate governance reform, focussing on outside minority shareholder protection. The situation does not seem to have changed much today notwithstanding the

CII's code and SEBI's guidelines and is the reason why investors prefer government securities rather than corporate securities. The sooner this trend is reversed, the better it will be for the development of the capital market in the country.

The N. K. Mitra Committee on Invesotrs' Protection

This committee chaired by N. K. Mitra submitted its report on investor protection, in April 2001, with the following recommendations:

(i) There is a need for a specific Act to protect investor 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 SEBI.
(iv) SEBI should be the only capital market regulator, clothed with the powers of investigation.
(v) The regulator, 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) 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 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 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 malpractice by companies, brokers or any other capital market intermediaries, they can seek redressal of their grievances from 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 whom 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 SEBI
  - Department of Corporate Affairs
  - Department of Economic Affairs
  - Reserve Bank of India
  - Consumer Courts
  - 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, Mutual Fund or the Depository Participant as the case may be. If he is not satisfied with their response, the investor can approach SEBI. SEBI on its part, has instituted a Redressal Mechanism as detailed below in Table 5.1.

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.

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	Shares-related, i.e., non-receipt of share certificates	Investors' Grievances and Guidance Division (IGG)
IV	Debentures related, i.e., non-receipt of debenture certificates, non-receipt of warrants	Investors' Grievances and Guidance Division (IGG)
V	Non-receipt of letter 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 MF's	Mutual Funds Deptt., SEBI
VIII	Complaints relating to Dematerialisation or DP's	Depositories and Custodian Cell, SEBI

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	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 ofdue sornon-delivery of shares by brokers	Rules and byelaws 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

Source: Agarwal, Sanjiv *A Manual of Indian Capital Markets*, p. 198.

Lacunae in Investor Protection

Though there is a redressal mechanism in place in the country, investors could not get their complaints adequately addressed to, much less solved to their satisfaction by these public authorities. Multiplicity of authorities, overlapping functions, lack of knowledge and understanding by the common investor about these agencies and 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.

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 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 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 where the market index went up by 143 per cent between September 1991 and April 1992. The amount involved in the crisis was around Rs. 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 Rs. 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 Rs. 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 Bombay Stock Exchanges to manipulate share prices prior to a rights issue. When the share prices crashed, the broker defaulted and BSE shut down for 3, days as a consequence. The amount involved in the default was about Rs. 170 million.
5. **Sesa Goa (price manipulation at 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 Rs. 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 Rs. 11 million in case of RIL and Rs. 5.8 million in case of 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 Rs. 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 Rs. 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 RBI and SEBI. The amount involved in CRB scam was Rs. 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, executive director and a vice-president of BSE had to resign due to this episode. This incident also highlighted the failure of supervision on the part of SEBI. The amount involved was of Rs. 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 in 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 Reliance, Hindustan Lever, State Bank, Infosys and ONGC. On May 17, Sensex fell by 11.14 per cent. 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, SEBI banned the Swiss investment firm 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 Rs. 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.

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, 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 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 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 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 Rs. 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 SEBI itself.

The foregoing analysis clearly shows that though 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 administration and accountability and restore its credibility as a powerful regulator.[6]

CONCLUSION

An objective analysis of the problems faced by investors in countries like India, leading to an erosion of their confidence in the capital market with the attendant adverse impact on the economic growth shows that the major problems arise due to corporate misgovernance and not due to minor aberrations in following the procedures set by SEBI. To rectify such a situation, actions that lead to corporate misgovernance should be codified and small investors be provided statuary rights to enforce civil liability against the directors to recover the losses to the company and its shareholders due to their misdeeds and non-application of their minds in investment or other decisions that have adversely impacted the shareholders. Some of the misdeeds would include: (i) breach of fiduciary duty (ii) siphoning off corporate funds (iii) misappropriation of company's funds (iv) price manipulation or insider trading (v) manipulation of accounts (vi) failure to disclose conflicts of interests (vii) fraud or cheating (viii) misappropriation of corporate assets (ix) losses caused due to mismanagement or negligence.

In this context, it is pertinent to note that already law courts have started imposing exemplary punishments to directors who violated codes and guidelines on corporate governance provided by competent authorities. In May 2004, Citigroup agreed for a $2.0 billion settlement, and more than a dozen other banks including J P Morgan Chase and Deutsche Bank are likely to fall in line. In January 2005, at the insistence of a US Court, former directors of WorldCom (now known as MCI) have agreed to pay $18 million out of their pockets as part of a shareholder law suit. Likewise, 18 former directors of the collapsed energy conglomerate Enron, agreed to pay $13 million as part of a settlement in another shareholder lawsuit. Though these settlements are subject to confirmation by the concerned US district courts, corporate governance experts had hailed these settlements for setting a new standard in accountability of directors when companies, they oversee go astray. In India too, as per the dictates of a lower court, recently the directors of a non-banking finance company have agreed to pay back to the company a large sum of money it lost, due to their indiscretion in an investment decision.

Another important protection to the investor would be by strengthening the enforceability of accounting standards in India, as has been done in the US through Sarbanes–Oxley Act. In India, though all the accounting standards have been made mandatory as a result of forceful pleas by various committees on corporate governance, they have not yet acquired the legal status in practice. This lack of legal sanction enables violators and wrongdoers go scot-free. Therefore, it is absolutely necessary if the investor is to be protected and corporate governance ensured for the larger benefit of the economy and nation, all the accounting standards should be legally enforced and exemplary punishments meted out to violators.

KEYWORDS

- Development of financial markets
- Grievance redressal mechanisms
- Impact of investor protection
- Lacunae
- Law enforcement
- Ownership and control of firms
- Rights to information

DISCUSSION QUESTIONS

1. What do you understand by investor protection? Why is it needed?
2. Establish in your own words the relationship between investor protection and corporate governance.
3. How can corporate governance be ensured through the adoption and guaranteeting of legal protection to investors?
4. Comment on the means and measures available in India to ensure investor protection.
5. Discuss critically the role of SEBI in ensuring investor protection in India.
6. Explain some of the major investor-related scams in India and suggest measures to avoid such scams in future.

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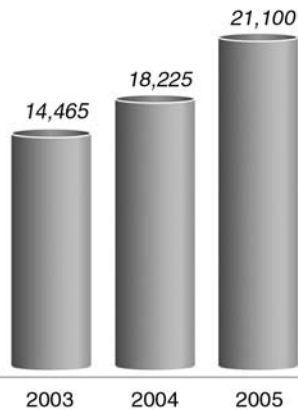

Corporate Governance and Other Stakeholders

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 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 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 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 shareholders, but also to serve the interests of other stakeholders. A corporate does not exist by itself or operates in 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 modern corporations, in which owners and managers of companies are separated. When owners directly manage their own company, governance issues may not be that important. The recent downfall of Enron, 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 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 employees in 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 more important than capital.

The interests of employees can be protected through

- Trade unions
- Co-determination: employee representation on boards of directors.

- Profit-sharing
- Equity-sharing
- "Team production" solution.

Trade unions: Trade unions' role is to represent the collective voice of 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 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 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 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 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 improved employee commitment to management's goals, which motivates the employees to perform better. As a result, there is an alignment of interest between employees and 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 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 participation 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 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.

In India, the importance of good governance has, in recent years, come to be accepted by corporates as elsewhere partly because the scrips of companies associated with sound and transparent management practices tend to attract higher premia in stock exchanges than those entities that, to all intents and purposes, behave like private limited or partnership firms.

However, while good corporate governance is, undoubtedly, of considerable value to those who have invested their money in firms that adhere to its tenets, there is no justification to conclude that it is sufficient in itself. The fact is that companies that practise good governance are of interest to investors because investors believe these companies will perform well, resulting eventually in an increase in their share prices apart from paying handsome dividends. In other words, good corporate governance is valued only inasmuch as it is linked directly to the long-term enhanced potential of a company.

World over, progressive opinion now recognises the need for broader accounting by corporates, encompassing social performance of significance to stakeholders as against mere bottomline accounting that is of interest only to stockholders. Thus, the oil major Shell, has institutionalised stakeholder consultations as part of its corporate strategy, and its statement of business principles now includes its responsibilities towards customers and employees—in addition to shareholders. Interestingly enough, Shell says that its responsibility to shareholders is to provide "acceptable" returns as against maximised returns. And then again, IBM's current corporate social responsibility strategy refers to enhancing stakeholder value and to the delivery of measurable results to society at large. Similarly, Dow Chemicals includes service to stakeholders in its vision statement which says: "To be successful, we have to provide a balance to the needs of all four of these groups (customers, employees, shareholders and society). If we maximise the return to any one or two of these stakeholder groups at the expense of the others, we won't survive very long."

The general public perception is that stockholders are part-owners of the companies they have invested in, and that their interests need not necessarily be congruent with those of the society in which these firms function. While there is undoubted validity to this proposition in the manner it is framed, it rests upon a differentiation that may not be as watertight as it appears. After all, both stockholders and stakeholders are investors in any given company. An investor, by definition, is anyone who commits something of value to risk in the expectation of a return. The term "something of value" can obviously cover time, effort and other values which may not have anything to do directly with money. Take an employee, he or she "invests" his or her life (or, at least, a part of it) in the employer. As such, an employee can be legitimately said to hold equity in the company. Thus, stockholders and stakeholders are both investors in a company.

> In the mid-1990s, Dr. Ralph Estes, published a paper, "The Public Cost of Private Corporations." Dr. Estes' basic contention was simple: Corporations pay the internal costs of doing business—but they do not pay, or even calculate, the costs that their operations impose on society at large.

The Society Bears The Hidden Taxation

With regard to what economists refer to as "external diseconomies" or "social costs", these terms merit examination in some detail. In the mid-1990s, Dr. Ralph Estes, Professor of Business Administration at American University, published a paper, "The Public Cost of Private Corporations" in the journal "Advances in Public Interest Accounting". Dr. Estes' basic contention was simple: Corporations pay the internal costs of doing business—but they do not pay, or even calculate, the costs that their operations impose on society at large. In other words,

Dr. Estes' contention was that the profit and loss statements revealed only the costs companies had internalised and not the uncompensated costs to society, namely the external diseconomies. For the persons affected, these represented "coerced assessments", a form of hidden taxation. To him: "While difficult to measure, these costs are unquestionably real to those on whom they are imposed. They are, however, never reckoned in corporate accounting's narrow calculus. When policy issues such as corporate regulation, taxation, defence contracting, and the system of subsidies, incentives, tax credits, bail-outs, price supports and below market-price fees for grazing, mining and timber rights on public lands that is sometimes referred to as 'corporate welfare' are debated, these social costs should be matched against the social benefits obtained." He adds further: "To improve public policymaking, we should also re-evaluate how we assess the performance of corporations. A scorecard that ignores social costs presents a distorted picture of performance that can influence policymakers to be excessively generous with taxpayer-funded corporate benefits, and overly lax in enforcing corporate regulations." While these ideas were bad enough (as far as the corporates were concerned), what really caught people on the backfoot was Dr. Estes' computation that these social costs or external dis-economies added up to $2.6 trillions (1994), almost twice the entire US federal budget and more than ten times the annual federal deficit. Even worse, as annual corporate profits in the US, on an average, worked out only to about $1 trillion or thereabouts, it was obvious that they were coming from the pockets of stakeholders.

The Stakeholder Alliance

It is in this context that a North American advocacy group, "The Stakeholder Alliance", is attempting to promote "more responsible capitalism by pressing corporations to become fully accountable to their stakeholders". The Alliance has come out with what it calls the Sunshine Standards to provide direction for corporates reporting to stakeholders—employees, customers, communities, suppliers, as well as financial investors—who contribute significantly to the success of corporations or are affected significantly by their actions. According to the Alliance, these standards are intended to supersede the Generally Accepted Accounting Principles (GAAP) issued by the Financial Accounting Standards Board (FASB) and its predecessors that currently govern corporate reporting to stockholders. The fundamental principle underlying the Sunshine Standards has been enunciated as follows: "All information should be provided that stakeholders may need to make rational, informed decisions in the marketplace, and to protect themselves from negative consequences of corporate actions; the disclosure must be complete, accurate, timely, objective, understandable and public."

A North American Advocacy Group, "The Stakeholder Alliance," is attempting to promote "more responsible capitalism by pressing corporations to become fully accountable to their stakeholders."

Customer's Information Needs

Thus, the advocacy group, dealing with customer information needs, stresses the need for corporates to disclose actions on the matters brought by customers and regulatory authorities regarding products, services and market practices: comprehensive legal record relating to products and services, including product liability, injury and wrongful death claims, covering all jurisdictions for five years; and indictments and citations for regulatory violations, giving details of each incident and resulting penalty, settlement, or other disposition. The information needs of customers further include the following:

- Risks of injury from normal usage of products or services.
- Noise, odours and other nuisances or problems associated with their use.

- Design for recycling of products.
- Biodegradability of products and packaging.
- Unusual life cycle costs, including repairs, energy consumption and disposal that will be borne by parties other than the producer or seller.
- Warnings, with appropriate details, regarding unusual contamination and adulteration, exposure and risks during production, shipping, marketing and storage.
- Contents, additives and treatments of food and medicines, sufficient to allow reasonably informed consumers to make rational market decisions and to protect themselves and their families—appropriate descriptions may include pesticides used in fruits and vegetables, hormones and chemicals used in breeding and processing meat, and chemicals used in cosmetics and personal grooming products to which some consumers may be allergic.
- "Well hidden characteristics" or those product qualities which, regardless of expense or purchase frequency, remain hidden even after use—such as the amount of toxic chemicals and nicotine in cigarettes.

The Alliance has also pointed out that customers, in choosing from competing producers and vendors, may legitimately consider standards of social responsibility. These might include such issues as the working conditions under which products are manufactured, sustainability of production and business methods and so on. Decisions that may appear to be "merely" economic are, to many customers, reflections of personal—and possibly intense—religious, moral, political and social convictions. Elaborating on its contention that the Sunshine Standards should supersede GAAP, The Stakeholders Alliance has argued that the scorecard widely used today, accounting's profit and loss statement, is not sufficient.

As stakeholders contribute significantly to the success of the enterprise or are considerably affected by its actions, corporations owe them an accounting. Quite simply, they require a better scorecard.

With a broader scorecard, one that reports effects on all stakeholders, managers will make different decisions. When managers are held directly accountable for injuries that result from their decisions, when the costs of those injuries to employees and customers are reported publicly, and when managers' compensation is affected directly, different decisions will be made. Instead of only being penalised for the expenditures, if the managers are credited for benefits to the community from pollution reduction, they will be better able to weigh effects on all stakeholders.

The Alliance has stated in this regard: "When corporations are fully accountable to stakeholders, when stakeholders are properly viewed as investors in the enterprise instead of merely resources to be consumed, and when managers are held personally responsible for the effects of their actions on stakeholders, corporate managers will behave differently. Their decisions will be directed towards nurturing and developing (instead of merely using or exploiting) the resources the corporation needs for long-term health. Stakeholders will give more to the corporation in return."

Thus a customer who is also a stakeholder of a company contributes towards the success of the enterprise as much as he is affected by the actions of the company.

On 15 March, 1962, President John F. Kennedy declared four rights of consumers—the right to satisfaction of basic needs, the right to safety, the right to be informed, and the right to choose. In 1983, the United Nations recommended that world governments develop, strengthen and implement a coherent consumer protection policy. In India, the Consumer Protection Act, 1986 was passed and the country embarked on strengthening the consumer protection regime.

Consumer Protection Acts

On 15 March 1962, President John F. Kennedy declared before the US Congress the four rights of consumers—right to satisfaction of basic needs, right to safety, right to be informed, and right to choose. We celeberate this day as World Consumer Rights Day. In 1983, the United Nations Secretary General submitted draft guidelines for consumer protection to the Economic and Social Council. Based on it, the Council recommended that the world governments develop,

strengthen and implement a coherent consumer protection policy, taking into consideration the guidelines set out therein. In India the Consumer Protection Act 1986 was passed and the country embarked on an expedition of strengthening our consumer protection regime.[1]

Consumer Protection Act 1986

The word "consumer" is used to describe a customer who buys goods and services from a seller for personal use and not for business purposes. Although the study of consumer is comparatively new, its roots are old. The explosion of interest in consumer matters emerged mostly during the second half of the twentieth century. The reason for this tremendous upsurge of activity is twofold—a combination of new business methods and changing attitudes. The key factors on business methods are to be found in the complexity of the goods themselves and in the changing forms of advertising and distribution.

The explosion of interest in consumer matters is a very recent phenomenon. The reason is twofold—a combination of new business methods and changing attitudes. The all-pervasive, exaggerated and often false claims, made for services and goods, emphasise the imperative need for Consumer Protection Legislation and creation of an awareness about it among the general public.

The second half of the twentieth century has seen a growing tendency for manufacturers to appeal directly to the public by forceful national advertising campaigns and other promotional methods—further influence during the same period has been the development of a huge market, for extremely complex mechanical and electrical goods in many parts of the world. The need for what is called consumer protection has become far greater because the consumer is no longer in a position to rely on his own judgement when buying a complex product say, a computer. The second motivating force is the general move from individualism to collectivism.

The judiciary of the United States has been a long way ahead of many countries in recognising and dealing with consumer problems. In particular, the American courts have increased through their proactive judicial pronouncements the manufacturer's liability in two respects: (i) by moving from negligence liability to strict liability and (ii) by breaking the shackles of the private contract rule. The subject of consumer protection is very much alive in other western countries too.

It is desirable for consumers to be aware of their rights, and to exercise those rights responsibly and intelligently. In these days of audlo-visual publicity on the private and public media, it is indeed very difficult, if not impossible, to verify the exaggerated or false claims made by producers, manufacturers, distributors and dealers of various goods and services. The all-pervasive, exaggerated and often false claims, made for services and goods, emphasise the imperative need for Consumer Protection Legislation and creation of an awareness about it among the general public.

In this connection, there are a number of enactments in India such as the Prevention of Food Adulteration Act 1954, the Essential Commodities Act 1955, the Trade and Merchandise Marks Act 1958, the Drugs and Magic (Objectional Advertisement) Act 1964, the Monopolies and Restrictive Trade Practices Act 1969, the Hire Purchase Act 1972, the Standards Weight and Measures Act 1976, etc. However, the remedies prescribed thereunder are time-consuming, inadequate and expensive. As in other areas of judicial processes, the offenders are hardly caught, proceeded against and rarely, if ever, get convicted. When violators go scot-free, the victims have no remedy but to get frustrated.

Though all these and a number of other statues were proclaimed to be consumer welfare-oriented, none of these conferred a legal right upon an aggrieved individual consumer to seek legal redress and recover costs and damages for injury or loans suffered by him as a result of faulty and defective goods and services, bought or secured for valuable consideration.

The Consumer Protection Act 1906 (COPRA) meets this essential social need to a great extent. A vigilant consumer owes it to himself and his family members

to know and understand the relevant provisions of this significant statue, which is a piece of socio-economic legislation.

The Act (COPRA) is applicable to all defective goods and deficiency in service. “Goods”, under the act mean every kind of moveable property, including stocks and shares, growing crops attached to or farming part of the land. And “Service” means service of any description which is made available to potential users including facilities in connection with banking, financing, insurance, transport, processing, supply of electricity or other form of energy, boarding or lodging or both, entertainment, amusement or the purveying of news or other information.

“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 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.

> 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.”

Corporate Governance and Institutional Investors

Most of the reports on corporate governance have emphasised the role which institutional investors play in corporate governance. The Cadbury Committee

(1992),[2] 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."[3]

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...".

Types of Institutional Investors in India

In India, there are broadly four types of institutional investors:

- The development oriented financial institutions, such as IFCI, ICICI, IDBI, the State Financial Corporations, etc. form the first category.
- The second category covers all the insurance companies such as the Life Insurance Corporation of India (LIC), 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.

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 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.

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 desiderata 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 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 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 too 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 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.

Findings of the Study Conducted by Pitabas Mohanty

However, we find that there is no effect of the investment of the institutional investors on the corporate governance records of companies.

According to a study conducted by Pitabas Mohanty on institutional investors and corporate governance in India, the following relationships were seen:

- There is a positive relationship between the stake of mutual funds and corporate governance index. But there is a negative relationship between the stake of Unit Trust of India and corporate governance index.
- There is also a positive relationship between the debt holding of the Direct Foreign Invesments and corporate governance index.
- There is a negative relationship between the stake by the banks (both debt and equity) and corporate governance index.

When the study considered institutional investors and financial performance, the following results were noticed:

- There is a positive relationship between the stake of mutual funds and financial performance. However, this relationship is one-way only, in the sense that it is financial performance that is determining the stake of the MFs in companies and not the other way round.
- There is a positive relationship between the debt extended by the development financial institutions and the financial performance of companies. This shows that the development financial institutions have lent money to companies with better corporate governance index. It also implies that the development financial institutions' lending money has improved the performance of companies.

However, it should be stressed that in this study, corporate governance was redefined using a narrow perspective by looking only at the shareholders.

Kumar Mangalam Birla Committee and 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 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 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[4] recommends that institutional investors maintain an arm's length relationship with 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 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 management.
- Ensure that voting intentions are translated into practice.
- Evaluate the corporate governance performance of the company.

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. Shareholders are not expected to assume responsibility for the management of corporate affairs.

A company's management must be able to take business decisions quickly. 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 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 well-governed companies in emerging markets. The survey, which covered a sample of 188 companies in six emerging markets to test the link between market valuation and 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 on 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 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 developing and 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 medium and large private or 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 medium and 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 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 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 creditor monitoring and control in market economies: adequate information, market-oriented creditor incentives, and an appropriate legal framework for debt collection. The experiences of emerging economies of 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 medium and large enterprises. Based on these lessons one can arrive at guidelines that could be used by creditors in ensuring that the organisation they lend to is not lacking in 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 bank portfolios. While this may seem obvious, constraints imposed by the poor quality and asymmetric distribution of information in developing and 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 stable market economies, is less binding, owing to the phenomenal pace of change.

Even if information on firms is available from potential borrowers, bank employees are often not trained in 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 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 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 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 non-legal or 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 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 with regard 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 diffuse debt holdings than with concentrated debt. Clearly, the effective exertion of corporate control with diffuse debt depends on the efficiency of the legal and bankruptcy systems.

The ability of diffuse 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 secured creditors and reduces the governance power of 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 diffuse debt. Even where banks or other creditors take over assets of 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 diffuse debt holders seems insufficient to protect the rights of investors and limit managerial discretion.

Concentrated Debt

As with large equity holders, concentrated debt can ameliorate some of the problems with diffuse 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, 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 at protecting outside investors. Also, with poor legal and bankruptcy systems, the flexibility to renegotiate debt arrangements with large creditors may lead to inefficient renegotiation, the continuation of unprofitable enterprises, and impediments to corporate finance since the balance of power in those renegotiations shifts markedly towards debtors. Second, large creditors like 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 forego good investments and take on too little risk because the creditor bears some of the cost but will not share the benefits. More generally, 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 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.

Corporate Governance and the Community

> 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 customers and to guarantee its products and services.

The corporation has grown up with industrialisation, modernisation and now globalisation. The corporation is the work-horse of 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 poor nations and peoples to share in the growing global prosperity.

Only the corporation has been able to combine for economic value creation, financial capital, new technologies, and human resources. Sole proprietorships and partnerships were too small to achieve the scale of research and production that corporations could. 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 different stakeholders. Each stakeholder plays some role in the success of the corporation. Without capital and 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 concern for the physical and 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 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 stakeholders when these duties and obligations often seem to 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 government laws and regulations in all countries in which it operates.
- Its desire to work with others to lead 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.[5]

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 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.

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 so-called "outside" directors on the board, though recent legislation proposes to change that.

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.

No matter the structure, 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 spend the time, to probe into, and give informed opinions about, 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 stakeholders. Corporate governance is there to counteract the 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 management, shareholders and other stakeholders.

The management and 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 external expectations or to external codes or guidelines, like the Caux Round Table Principles for Business.[6] Internal monitoring of compliance, external reporting of performance and independent assurance are matters that should be decided by companies themselves.

Of course, only when companies are profitable can they contribute effectively to the improvement of social conditions by creating jobs and economic growth. Prosperous companies are a precondition for 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.

Practical Steps to Corporate Social Responsibility

Following sound principles of corporate governance and social responsibility may help a company in many ways—all elements of 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.

The International Chamber of Commerce recommends the following nine steps to attain corporate social responsibility:

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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 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—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 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 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 equity and bond holders can exert corporate governance.

Moreover, political economy forces that produce the laws, enforcement mechanisms, 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 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 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 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 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, politicians frequently use state enterprises for personal gains either by placing cronies in position of corporate power, catering to special interest groups, or supporting politically influential unions that help 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 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
- Institutional investors
- Investment decisions
- Profit-sharing
- Team Production Solution
- Hidden taxation
- 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 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.

NOTES

1. Rajah, N. L. "Protecting Consumers", *The Hindu*, (15 March 2005.)
2. Section on "Institutional Shareholders", Para 6.16, Report of the Cadbury Committee to the Financial Reporting Council, London Stock Exchange.
3. Section on Institutional Shareholders, The Kumar Mangalam Birla Committee on Corporate Governance.
4. Kumar Mangalam Birla Committee's Report.
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Case Study

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.

SUGGESTED READINGS

- Crisis Communication Strategies. http://www.ov.edu/deptcomm/dodjcc/groups/ 02C2/Johnson%20&%20 Johnson.htm
- Kaplan, Tamara "The Tylenol Crisis: How Effective Public Relations Saved Johnson & Johnson", The Pennsybrania State University.
- Publications of Johnson & Johnson.

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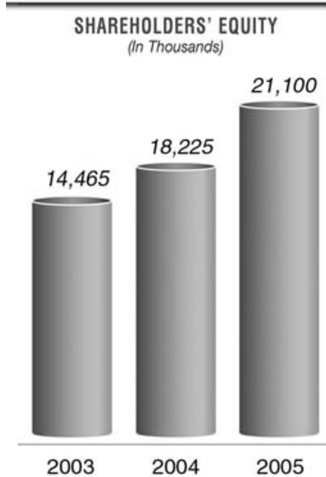


Board of Directors: A Powerful Instrument in Corporate Governance

CHAPTER OUTLINE

- Introduction
- Role of Board in Ensuring Corporate Governance
- Governance Issues Relating to the Board
- The Role of Directors
- Independent Directors
- Directors' Remuneration
- Family-owned Businesses and Corporate Governance
- Some Pioneering Indian Boards

Introduction

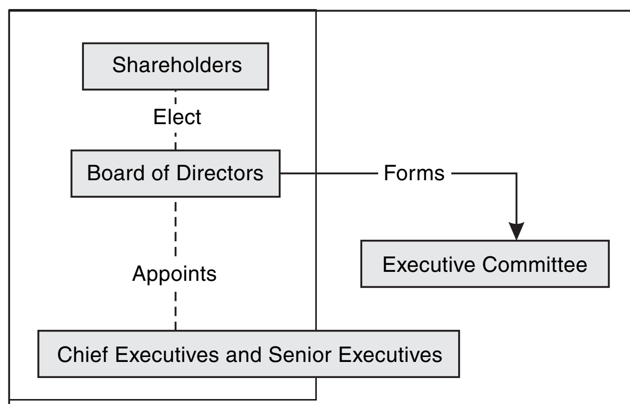
The separation of ownership from active directorship and management is an essential feature of the company form of organisation. To manage the affairs of a company, shareholders elect their representatives in accordance with the laid down policy. These representatives are called the "directors" of the 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 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 CEOs and they further delegate powers to departmental heads in charge of operations. This structure of corporate management is illustrated in Figure 7.1.

Figure 7.1

Corporate management structure



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 shareholders, the board of directors, and in some cases, chief executives to whom the board has delegated some of its powers.

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 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 who has 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 investor protection and 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 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 it is pointed out by some authorities on the subject: "It is doubtful whether there are any instances in Indian corporate 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]

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."

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 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 advices) 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 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 such as: (i) fiduciary duties (ii) duties of care, skill and diligence; (iii) duties to attend 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. Factors such as the type and nature of work, the division of powers between directors and other executives, general usages, customs and conventions in the line of business and whether directors work gratuitously or for a remuneration will have an impact on the standards of care and diligence expected of the directors.

Directors have certain duties to discharge. These are: (i) fiduciary duties (ii) duties of care, skill and diligence; (iii) duties to attend 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. They must not make any secret profit out of their position. 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 directors and other executives, general usages, customs and conventions in the line of business in which the company is engaged and whether directors work gratuitously or for a remuneration will have an impact on the standards of care and diligence expected of the directors.

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 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, 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 general meeting of shareholders and (ii) the board shall exercise its powers subject to the provisions contained in the Ariticles or the Memorandum or in the Federal Acts concerned with companies or any regulation made by the company in any general meeting. But no regulation made by company in 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 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 notice of disclosure of directors’ interest in any contract or arrangement with the company; (d) to receive 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 up to 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 up to 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 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 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 compensation amounts received on 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 spcific 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.

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. In India, the Companies Act does not distinguish between other directors and a nominee director with regard to liabilities for violation of laws by companies.

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, 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.

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 unpublished, price-sensitive information. Otherwise, it could easily expose these institutions and their nominess to 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 Directors

Directors of a company may be held liable under the following situations:

(i) 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) Directors may also incur personal liability under the Act on the following conditions:

(a) On their failure to repay application money if 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.

(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 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 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;

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 failure by the company to pay for goods wherein the name of the company is not mentioned legibly.

(ii) besides, if a director enters into a contract, which is *ultra vires* the Articles of the company, the director is personally liable for 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 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, filling of returns or observance of certain statutory formalities. If they fail to perform these duties, they render themselves liable to penalties.

Directors are also liable to the company under the following heads: (1) *ultra vires* acts, (2) negligence, (3) breach of trust and (4) misfeasance.

1. **Ultra vires acts:** Directors are personally liable to the company in matters of illegal acts. For instance, if directors pay dividends out of capital or when they dissipate the funds of the company in *ultra vires* transactons, they are jointly and severally liable.
2. **Negligence:** A director may be held liable for 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 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

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 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.

Power of Court to Grant Relief

The Companies Act provides under Section 633 the following reliefs to a director: in a proceeding for negligence, default, breach of duty, misfeasance or breach of trust against an officer of a company, it might appear to the Court that the officer has acted honestly and reasonably and that having regard to all circumstances of the case, he ought fairly to be excused. In such a case, the Court may relieve him, either wholly or partly, from his liability.

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The object of Section 633 is to provide relief against undue hardship in deserving cases. But for getting relief under Section 633, it must be proved by the officer concerned that; (a) he acted honestly, (b) he acted reasonably and (c) having regard to all circumstances of the case, he ought fairly to be excused.

However, the granting of relief under Section 633 is discretionary. It may be partial or complete or on certain terms or unconditional. But in a criminal proceeding under Section. 633 in respect of negligence, default, breach of duty, misfeasance or breach of trust, the Court shall have no power to grant relief from any civil liability which may attach to the officer concerned in respect of such negligence, default, etc.

Directors with Unlimited Liability

In a limited company, the liability of all or any of the directors may, if so provided by the Memorandum be unlimited. Likewise, the liability of the manager may also be unlimited. In such a company, the directors and the manager of the company and the person who proposes a person for appointment to any of these offices shall add to the proposal that liability of such person will be unlimited. Before such a person accepts the office, notice in writing that his liability will be unlimited shall be given to him.

If the Memorandum does not contain any provision making the liability of all or any of its directors and manager unlimited, the company may, if so authorised by its Articles and by a special resolution, alter its Memorandum so as to render unlimited liability of any of these personnel. Upon the passing of the special resolution, it shall be deemed as if the provision had been originally contained in the Memorandum. An alteration making the liability of these personnel unlimited shall become effective against the personnel only on the expiry of his existing term, unless he has given his consent to his liability becoming unlimited.

Public Examination of Directors

In case of winding up of a company by the Court, the Official Liquidator may make a report to the Court stating that in his opinion, a fraud has been committed

(a) by any person in the promotion or formation of the company.
(b) by any officer of the company in relation to the company, since its formation.

In such a case, the Court may, after considering the report, direct that the person or officer shall

(a) attend before the Court on a day appointed by it for that purpose, and
(b) be publicly examined (i) as to the promotion or formation or the conduct of the business of the company, or (ii) as to his conduct and dealings as an officer thereof.

Validity of Acts of Directors

Acts done by a person as director shall be valid, notwithstanding that it may afterwards be discovered that his appiontment was invalid by reason of any defect or disqualification or had terminated by virtue of any provision contained in the Articles. But, acts done by a director after appointment has been shown to the company to be invalid or to have terminated shall not be valid.

The effect of these provisions is to validate the acts of a director who has not been validly appointed because there was some slip or irregularity in his appointment. Where there is no real appointment at all, the acts of the person acting as director shall not be validated. The acts of the invalidly appointed director shall be valid only when the board of directors acts *bona fide* and some defect which can be cured later comes to light.

Section 290 of the Companies Act does not validate the acts which could not have been done even by a properly appointed director or the acts of a director who knows of the irregularity of his appointment.

Further, the provisions of Section 290 declaring acts of a director to be valid notwithstanding the subsequent discovery of a defect or disqulifiaction in him give protection only to acts of directors which are otherwise not illegal and do not apply to invalid resolution passed in a meeting not properly convened. Benefit of Section 290 can normally be taken by third parties and not by the directors or their close relations.

De Facto and De Jure Directors

A director who is not duly appointed but acts as a director is known as a '*de facto*' director and is as much liable as a '*de jure*' (appointed as per law) director. Thus, as between a company and third person a '*de facto*' director is a '*de jure*' director.

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.

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 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 relative of such a director, (ii) a firm in which such a director

or relative is a partner, (iii) a private company of which such a director is a director or 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 relative is a partner, any other partner, in such a firm, or a private company of which the director is a member or 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.

Further, in the case of a company having a paid-up share capital of not less than Rs. 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.

> 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

However, an appointment of the above persons can be made as managing director, manager, banker or trustee for the debenture-holders of the company (a) under the company or (b) under a subsidiary of the company if the remuneration received from such subsidiary in respect of such office or place of profit is paid over to the company or its holding company.

Special resolution is necessary for every appointment in the first instance and every subsequent appointment. It is sufficient if the special resolution according to the consent of the company is passed at a general meeting of the company held for the first time after holding of such office or place of profit.

The appointment of the following persons to a place of profit in the company, which carries a monthly remuneration of not less than such sum as may be prescribed from time to time shall be made only with the prior consent of the company by a special resolution and the approval of the central government: (a) partner or relative of a director or manager; (b) firm in which such a director or manager, or relative or either, is a partner; (c) private company of which such a director or manager, or relative or either, is a director or member.

Every individual, firm, private company or other body corporate proposed to be appointed to an office or place of profit under the company, shall, before or at the time of such appointment, declare in writing whether he is or is not concerned with a director of the company in any of the ways referred to above.

If an office or place of profit is held without the prior consent of the company by a special resolution and the approval of the central government, the partner, relative, firm or private company shall be liable to refund to the company any remuneration or other benefit received. The company shall not waive of any sum refundable unless permitted to do so by the central government.

If any party holds an office of profit under the company in contravention of the above provisions, he has or it is deemed to have vacated his office and is also liable to refund to the company any remuneration received. The company shall not waive of recovery of any sum refundable to it unless permitted to do so by the central government.

Prevention of Management by Undesirable Persons

The Companies Act lays down special provisions for preventing the management of companies by certain undesirable persons. Sections 202 and 203 of the Act specifically provide that these persons cannot manage a company or take part in its promotion or formation: An undischarged insolvent cannot (i) act as, or discharge any of the function of, a director or manager of any company, or (ii) directly or indirectly take part or be concerned in the promotion, formation or management of a company.

If the undischarged insolvent discharges any of the aforesaid function, he shall be punishable with imprisonment for a term which may extend to 2 years, or with fine which may extend to Rs. 5,000, or both.

The expression “company” in Section 202 includes (a) an unregistered company and (b) a foreign company which has an established place of business in India.

Fraudulent Persons

Section 203 of the Companies Act gives power to the court to restrain fraudulent persons from managing companies. According to it, the court may issue an order that any of the following persons shall not, without its consent, act as a director, or take part in the promotion, formation or management of a company for a period not exceeding 5 years: (1) a person who is convicted of any offence in connection with the promotion or management of a company or (2) a person who in the course of winding up of a company (i) has been guilty of fraudulent conduct of business or (ii) has otherwise been guilty, while being an officer of the company, of any fraud or misfeasance in relation to the company or of any breach of his duty to the company.

Effectiveness of the Board of Directors

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 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.”

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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, etc. with a view to guiding 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 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 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 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.

Role of the 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, was 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 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 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 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 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 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 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 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. 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 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.

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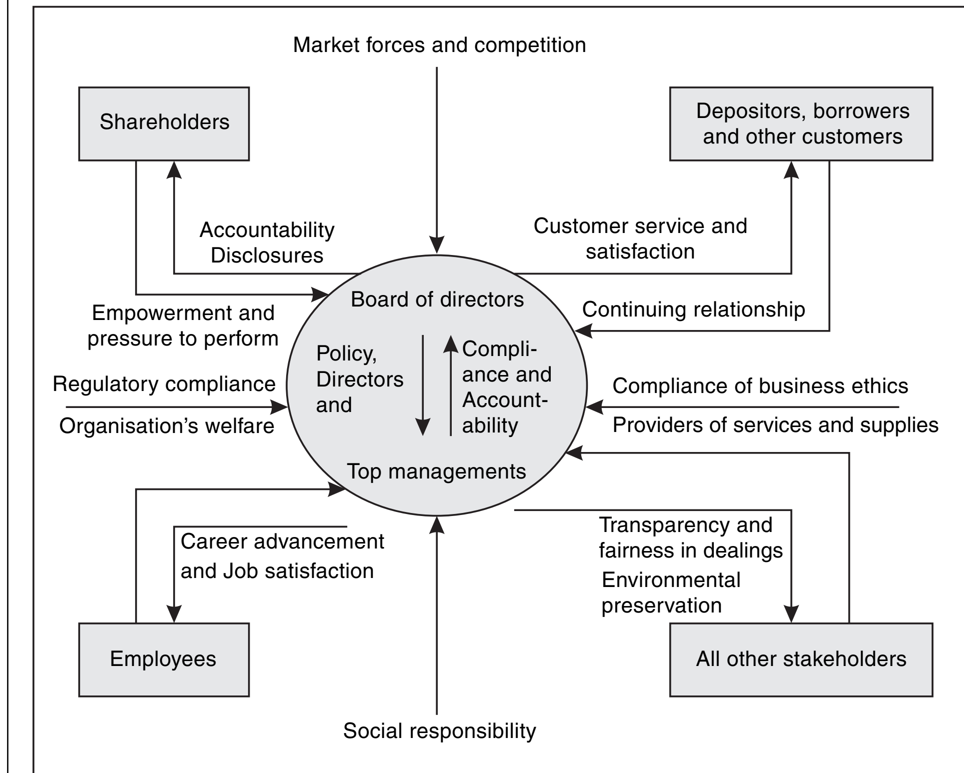
Figure 7.2

Role of the board in the dynamics of corporate governance



The Role of Directors

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.

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 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 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 employment and 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 the 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 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, etc. 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.

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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 stakeholders of the company.

The three caselets discussed below discuss how corporate boards and courts of law are holding 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.

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.

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, 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 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 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, head of CEO recruiting at Korn/Ferry International. Korn/Ferry is planning a boot camp for 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]

Independent Directors

Who is an Independent Director?

There have been a lot of discussions and debates going on in corporate circles and among academicians in recent times on the need for, role of, and importance of independent directors. An independent director is defined as a "non-executive director who is free from any business or other relationship which could materially interfere with the exercise of his independent judgement".[12]

The Companies Act provides a negative definition of an independent director, inasmuch as it renders ineligible eleven categories of persons to be appointed as independent directors in a company, for instance, if a person has held any post in a company at any point of time is disqualified to be independent director of the company. Likewise, any vendor, supplier or customer of goods and services of the company would stand disqualified, notwithstanding the fact that the amounts of transaction are insignificant.[13]

Desirability of Having Independent Directors

Recent literature on corporate governance is replete with recommendations of various committees on the desirability of having non-executive, independent directors on the boards of companies to promote better corporate governance practices. The Cadbury Report identifies two areas where non-executive directors can make an important contribution to the governance process as a consequence of their independence from executive responsibility. First, reviewing the performance of executive management and second, taking the lead where potential conflicts of interest arise, as for instance, fixing the CEO's salary and perquisites or dealing with board room succession. Apart from these, independent directors, being non-executives with no vested interest, can bring in objectivity to the board's decision-making process. Opinions vary on how many independent non-executive directors are required to achieve good corporate governance practice. The UK Combined Code recommended that non-executive directors should make up atleast one-third of the board and that a majority of them should be independent. The IFSA Guidelines and the Toronto Report recommend a higher standard that a majority of directors should be independent, non-executives. IFSA argues that a majority of directors should be genuinely independent in order to ensure that the board has the power to implement decisions, if and when the need arises, contrary to the wishes of management or a major shareholder. IFSA contends that this creates "a more desirable board culture" and imposes a responsibility on the independent majority to be "especially competent and diligent" in carrying out their role.

The Cadbury Report identifies two areas where non-executive directors can make an important contribution to the governance process as a consequence of their independence from executive responsibility. First, reviewing the performance of executive management and second, taking the lead where potential conflicts of interest arise.

The Indian capital market regulator, the Securities and Exchange Commission of India (SEBI) has recently amended Clause 49 of the listing agreement to ensure that independent directors account for at least 50 per cent of the board of directors of listed companies, where an executive chairman heads the board. However, if the chairman is a non-executrive director, at least one-third of the board should consist of independent directors. Several US sets of guidelines prescribe even more numbers of these directors. CalPERS Guidelines recommend that a substantial majority of board members should be independent directors.

Views of Promoters on Independent Directors

While various commitees and foras on corporate governance advocate a sizeable number of independent directors on boards of corporations, and regulators prescribe a large number and equally large role for them, these views have not gone uncontested. Promoters of listed companies are of the view that this is a case of showering authority on people without corresponding, commensurate responsibility.

Their argument is that when a promoter takes most of the risks of the business including offering personal guarantees and pledge of their shares for credit lines in some cases, there is hardly a case for independent directors with no stakes in the business to decorate the boards. If independent advice is indeed required, the same is available to the company from professionals on a commercial basis and directorships need not be offered for this. Moreover, the requirement of 50 per cent representation by independent directors is irrespective of the size of public shareholding. In the case of listed companies with low levels of outside holding, this requirement would amount to a positive discrimination against the interests of the promoter who holds an overwhelming majority of the shareholding and the economic interest in the success of the enterprise.

While voting proportionate to shareholding is recognised in shareholder meetings, many promoters wonder why this has to be any different as far as board representation is concerned. This, some promoters aver, is a classic case of offering power without commensurate responsibility, an impostion of the quota system in a different garb and one more instance of tokenism at work. There is a serious disconnect between the power of decision-making and the economic consequences of these decisions on the promoter. Beyond the usual arguments about representing the interest of the minority shareholder and tenets of good corporate governance, there is hardly any intellectual case made out by the proponents for a disproportionately large share in the Board for independent directors.

After presenting all these negative arguments of promoters, UR Bhat in an article in Economic Times commending SEBI's move to fill the boards with more inependent directors argues that there is enough research literature on the subject of diversity in managing complex work situations that can be justifiably extrapolated to the functioning of boards of directors. According to him, independent directors should be viewed not as a SEBI-foisted nuisance, but sources of diversity in terms of values and information that enhances the quality of decision-making.[14]

UR Bhat argues further that instead of interpreting the new SEBI measure as another instance of tokenism, it would be useful for company promoters to view this as an opportunity to improve the qualities of decision-making in boards. The most important aspect, however, is to get high levels of task commitment from independent directors which is the function of the leader. Leadership no doubt, is an important tool of value creation that should get rewarded for taking calculated risks, though in practice, does somethimes get rewarded for not taking risks. The SEBI move is therefore supportworthy for reasons more than just protecting the interests of minority shareholders and good corporate governance.

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".[15]

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.

Executive Pay, an Unsettled Issue

Executive compensation is still an unsettled issue. There is a controversy regarding the quantum of directors' remuneration, which, however, is not a corporate governance issue. The size of compensation is related to several factors relating to the corporate in question and even to external factors. As discussed earlier, the key corporate governance issues in the matter of directors' remuneration are: (i) transparency, (ii) pay for performance, (iii) process for determination, (iv) severance payments and (v) pensions for, non-executive directors.

Emphasis on Transparency and Disclosure

Almost all committees in their codes and guidelines—the Cadbury Committee's Code, the IFSA Guidelines and the Bosh Report, for example—have emphasised the need for openness, transparency and disclosure in these issues. Shareholders have a right to know the quantum, the basis and the manner of payments to directors. The Securities and Exchange Board of India in the recent changes that are effected in Clause 49 have a section that says that compensation paid to non-executive, independent directors should be fixed by the board and will require previous approval of shareholders. Shareholders' resolution shall specify the limits for the maximum number of stock options that can be granted to non- executive directors, including independent directors, in any financial year and in aggregate, according to the new listing agreement.The remuneration paid to directors should be disclosed in the section on corporate governance in the annual report of the company. This includes details on stock options, pensions and criteria for payment to non-executive directors.

Pay as a Reward for Performance

As there is a considerable stigma relating to excessive executive remuneration, schemes for such payments should be carefully and cautiously structured to ensure that compensations to directors and senior executives do reflect their performance and are in relation to their responsibilites and risks involved in carrying out their functions.

There is a growing acceptance internationally that equity-based remuneration including stock options is an effective way to match remuneration with performance. "Many sets of governance guidelines support the use of shares and options in remuneration packages. An appropriately designed share option scheme will help counter the economic problem of 'agency costs', in which the interests of senior executives may diverge from the best interests of shareholders."[16] The argument in favour of such an arrangement runs like this: "When senior executives own shares, they are encouraged to act in the best interests of shareholders because the financial interests and risks of the executives are equated with the interests and risks of the shareholders."

Compensations to directors and senior executives reflect their performance and are in relation to their responsibilities and risks involved in carrying out their functions. One of the reasons in favour of this "pay-for-performance" concept of executive remuneration is that If executive compensation is directly related to an increase in share price, the benefits executives receive would be proportional to those of all shareholders. This would encourage executives to make decisions which will maximise shareholder wealth.

There are other reasons as well that are adduced in favour of this pay-for-performance concept of executive remuneration. These reasons are given below:

(i) If executive compensation is directly related to an increase in share price, the benefits executives receive would be proportional to those of all shareholders. This would encourage executives to make decisions which will maximise shareholder wealth;

(ii) The share option also will counter the problem of directors being too risk-averse. This is because of the fact while directors and senior executives are blamed for the poor performance of the corporation, they do not receive the benefits when it performs well. This will lead to directors not taking necessary risks and consequently resulting in the company not doing well. These problems can be eliminated if the company's performance is used to determine the directors' remuneration. With regard to remuneration in terms of shares and options to non-executive directors, there are different conventions. In the US, there is no distinction between executive and non-executive directors, both of whom receive share-based remuneration. But IFSA Guidelines, while recommeding the practice to executive directors, prefer non-executive directors to invest their own money in the company. This is recommended because it is the non-executive directors who should be given the responsibility of working out the remuneration package to executive directors and senior executives of the company and the resultant conflict of interest be best avoided by keeping them out. Some writers have worked out a scheme based on recent proposals for improved pay versus performance policies. These are as follows:[17]

(a) Limit the base salaries of top executives.
(b) Base bonus and stock option plans on stock appreciation.
(c) Stock appreciation benchmarks should consider (i) close competitors, (ii) a wider peer group and (iii) broader stock market indices.
(d) Base stock options on a premium marginally higher than the current market price and do not reprice them if the shares of the firm fall below the original exercise prices.
(e) Work out and make available company loan programme that would enable top executives to buy sizeable amount of the firm's stock so that subsequent stock price fluctuations substantially impact the wealth position of top executives.
(f) Pay directors mainly in stock of the corporation with minimum specified holding periods to heighten their sensivity to firm performance.

However, it is to be noted that the pay-for-performance plans should be done in moderation. There is a serious concern among investors that directors and executives tend to overuse this privilege and corner a sizeable portion of benefits that should legitimately go to shareholders.

Performance Hurdles

In fixing directors' remuneration based on performance, there are some constraints that should be taken into account. The scheme should be properly structured so that the benefits conferred on them reflect superior performance.

In fixing directors' remuneration based on performance, there are some constraints that should be taken into account. The scheme to reward directors based on performance should be properly structured so that the benefits conferred on them reflect superior performance.

In a rising share market, when directors' remuneration is linked to share prices, they would gain increasingly higher benefits, regardless of the company's performance. In such cases, hurdles devised to reward better performance may involve comparisons with similar firms in the industry or return on equity measures.

Another means that is advocated in this context of designing performance hurdles is the strategy to be adopted in the exercise price of the shares, i.e. the

price at which the executives are offered the shares. An exercise price equal to the current market price for the company's shares is definitely better than offering it at a discount. Such a strategy would provide a strong incentive to perform.

In many industrially advanced countries, there is an increasing practice of repricing options.This kind of performance hurdle means lowering an option excercise price, especially in the context of a fall in the prices of shares across the stock market which would keep the quantum of promised remuneration intact. "Without the repricing, executives may find a considerable proportion of their remuneration wiped out. Executives would also lose any motivation associated with performance hurdle."

However, some authorities question the logic behind this strategy. According to them, "Repricing of options makes a nonsense of the claim that performance related pay gives managers incentives and risks similar to those of owners. When share prices are rising (even in the context of a rising market), executives are happy to take the credit (and reap the reward). However, when the share price falls, some executives expect a repricing".

The need for repricing would not arise if the performance hurdles are properly structured and linked to comparisons with same type of firms in the industry or based on return on equity measures. Such a strategy would not provide an opportunity for a repricing, as poor performance could not be blamed on market conditions.

Whatever be the strategy adopted, it is necessary to have transparency. Performance hurdles and option exercise prices should be brought to the knowledge of shareholders of the company.

Remuneration Committee

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."

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.

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, 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 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 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 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 non-executive directors.

Directors' Remuneration in India

Section 198 of the Companies Act 1956 deals with over all 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 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.

Prohibition of Tax-free Payments

According to Section 200 of the Companies Act:

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.

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 Mafatilals, Thapars, Singhanias and TVS—some of them being classic examples with different degrees of professionalisation thrown in.

Family-owned Businesses and Corporate Governance

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."[18]

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.

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.

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 ownership and control, on the one hand, and 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.

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 issues of policy and performance.

3. **The topmen will not wear two hats:** The practice of one person combining in himself both the positions of chairman and 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 SEBI and its guidelines, 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 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 boards in India too. 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 financials, not only on the acceptability but also the appropriateness of the accounting and reporting practice." Boards will have to ensure 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 the 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 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 constituancies."

11. Corproates will have their vision, values and responsibilities well defined: 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.

Some Pioneering Indian Boards

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.

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 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:

Some of the examples of creditworthy corporate practices are 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.

1. **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. **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. **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, directors participate along with employees in the annual goal-setting exercise.

5. Board of Godrej Consumer Products and the CII: Godrej Consumer Products consulted the Confederation of Indian Industry (CII) for forming 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. 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 shareholder value. This review has resulted in several recent enhancements, in which Business Integrity Initiatives as highlights of the company's corproate 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 Tata boards: The Tata group of companies have a clearly defined document articulating the values and principles that have governed the manner in which 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 company 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 issues 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
- 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 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 the major recommendations of various committees with regard to the desirability of independent directors in boards of companies?

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Case Study

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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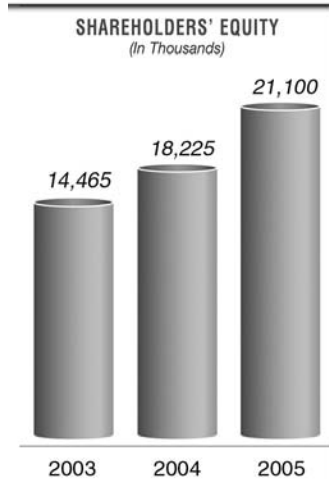

Role, Duties and Responsibilities of Auditors

CHAPTER OUTLINE

- Introduction
- Types of Auditors
- The American Law Governing Auditors' Responsibilities
- Indian Situation
- Naresh Chandra Committee
- Companies (Amendment) Bill, 2003
- Companies (Auditors Report) Order (CARO), 2003
- Corporate Governance and Internal Auditors
- Cost Audit Methodology
- Quality Audit

Auditors who are expected to be the watchdogs of the organisation are often bought in by managements through some profitable assignments. The allegation that annual reports presented by companies today lack truthfulness and transparency need not be stressed. Instances are galore where obliging auditors have helped companies falsify accounts and in window-dressing for small monetary gains.

Introduction

Ethics and values get short shrift in business in two ways; first, by the failure of management and second, by the failure of auditors. Auditors who are expected to be the watchdogs of the organisation are often bought in by 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 various participants of organisations.[1] Recent unearthing of corporate frauds both in developed countries and developing and 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 unethical practices, the Indian government and regulatory bodies as elsewhere have come out with many regulations, re-establishing corporate accountability and reinforcing investor confidence.

Role of Auditors

The allegation that 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 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 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 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 financial statements which are prepared within a framework of recognised accounting policies and practices and relevant statutory requirements."

Types of Audit

There are three types of auditors, namely, internal auditors independent auditors and government auditors.

We can identify three types of audits,[4] namely,

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 specified criteria. The financial statements commonly audited are 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 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 government agencies, stockholders, investors and 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 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 financial statements makes the statements more credible to such users as investors, bankers, labour unions, 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 that 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 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 loans and advances made by the company have been shown as deposits.
- Whether 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 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, objectivity, independence, confidentiality and 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 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 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 physical condition of certain assets.

Responsibilities Regarding the Mis-statement of Financial Statements

With regard to the responsibility of an auditor concerning mis-statements, the position is as follows: If appropriate disclosures regarding the material mis-statement affecting the prior period financial statements is not made, then the auditor should issue a modified report on the current period financials modified with respect to the corresponding figures included. Moreover, when the prior period financial statements are not audited, the incoming auditor should state in the auditor's report that the corresponding figures are unaudited. The auditor should obtain sufficient appropriate audit evidence that the closing balances of the preceding period have been correctly brought forward to the current period and the opening balances do not contain mis-statements that materially affect the financial statements for the current period.

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When the auditor has determined that a mis-statement is, or may be, the result of fraud, the auditor evaluates the implications, especially those dealing with the organisational position of the person or persons involved.

For example, fraud involving misappropriations of cash from a small petty cash fund is ordinarily of little significance to the auditor in assessing the risk of material mis-statement due to fraud. This is because both the manner of operating the fund and its size tend to establish a limit on the amount of potential loss, and the custodianship of such funds is ordinarily entrusted to an employee with a low level of authority. Conversely, when the matter involves management with a higher level of authority, even though the amount itself is not material to the financial statement, it may be indicative of a more pervasive problem. In such circumstances, the auditor reconsiders the reliability of evidence previously obtained since there may be doubts about the completeness and truthfulness of representations made and about the genuineness of accounting records and documentation. The auditor also considers the possibility of collusion involving employees, management or third parties when reconsidering the reliability of evidence.

The auditor is also responsible to communicate that information (mis-statement resulting from fraud) to management, those charged with governance and, in some circumstances, when so required by the laws and regulations, to regulatory and enforcement authorities also. The auditor should communicate these matters to the appropriate level of management on a timely basis, and consider the need to report such matters to those charged with governance.

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.

> 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.

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.

Audit Failures Leading to Corporate Scams

In December 2001, in what is termed as the biggest bankruptcy in 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 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 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 SEC, a Congressional Enquiry and, last but not the least, sacking by Enron.

Shockingly, 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 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 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 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 correspondents of *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 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 market capitalisation, is not solely due to losses incurred; the real reason is the collapse of public confidence in the process of examining a company's health by auditors because audit firms are considered to be 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 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 signed into law on 30 July 2002, the Sarbanes–Oxley Act of 2002. The Act which applies in general to 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 American Law Governing Auditors' Responsibilities

Sarbanes' Oxley Act (SOX) was passed by the US Congress in 2002 with an aim to protect the investors from the fraudulent accounting practices of corporations.

Important provisions contained in SOX Act regarding auditors are given below:

Establishment of Public Company Accounting Oversight Board (PCAOB): The SOX Act created a new board consisting of five members of whom only two will be certified public accountants. All accounting firms will have to register themselves with this board and submit *inter alia* particulars of fees received from public company clients for audit and non-audit services, financial information about the firm, list of firm's staff who participate in the audit. The board will establish rules governing audit, ethics and the firm's independence.

Audit committee: The 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 it should be the independent directors. The audit committee is responsible for appointment, fixing of fees and oversight of the work of independent auditors. The committee is also responsible for establishing, reviewing the procedures for the receipt, treatment of accounts, internal control and audit complaints.

Conflict of Interest: Public Accounting firms should not perform any audit service for a publicity traded company if the CEO, CFO, Controller, CAO or any person serving in an equivalent position was employed by such firm and participated in any capacly in the audit of that company during the 1-year period preceding the date of the initiation of the audit.

Audit Partner Rotation: The Act provides for the mandatory rotation of lead audit partner and partner reviewing audit every 5 years.

Prohibition of Non-audit Services: Auditors are prohibited from providing non-audit services concurrently with audit review services. Non-audit services include book keeping, financial and information system design, internal audit, HRD services, investment advice, investment banking services, legal advice, appraisal, valuation and actuarial services.

Responsibility for Financial Reports: The SOX Act stipulated that the CEO and CFO of a company should prepare a statement to accompany the audit report to certify the "appropriateness of the financial statements and disclosures contained in the periodic report and that those financial statements and disclosures fairly present, in all material respects, the operations and financial conditions" of the company.

Improper Influence on conduct of Audits: As per the SOX act, "It shall be unlawful for any officer or director of an issuer to take any action to frandulently influence, coerce, manipulate, or mislead any auditor engaged in the performance of an audit for the purpose of rendering the financial statements materially misleading".

Indian Situation

Questions about professional competence, ethics and credibility of companies and audit firms have been raised in India too. After all, who can forget the fraud by the largest Indian non-banking finance company, Tata Finance, and its investment subsidiary, Niskalp, which was found to have invested heavily in K-10 scrips. Certain unauthorised financial transactions (including diversion of funds to Niskalp), allegedly undertaken by its (then) management, led by managing director, Dilip Pendse, reportedly caused a loss of Rs. 1.25 billion to Tata Finance. In October 2001, the entire board of Tata Finance including its auditors, S. B. Billimoria & Co. resigned owning moral responsibility for the controversy and the losses suffered.

Questions about professional competence, ethics and credibility of companies and audit firms have been raised in India too. With an aim to protect the investors from the fraudulent accounting practices of corporations, the Indian government as well as the regulatory bodies have appointed many committees. Till date, five committees have played a vital role in framing the responsibilities of the auditors and the audit committees: R. D. Joshi, Birla, Narayana Murthy, Naresh Chandra, and J. J. Irani.

Preventing Fraudulent Auditing Practices

With an aim to protect the investors from the fraudulent accounting practices of corporations, the Indian government as well as the regulatory bodies have appointed many committees. Till date, four committees played a vital role in framing the responsibilities of the auditors and the audit committees: The R. D. Joshi Committee, the Kumar Mangalam Birla Committee, the Naryana Murthy Committee and the Naresh Chandra Committee. All these committees' recommendations focussed mainly on the following aspects of auditing: formation of the audit committee, their responsibilities, rotation of auditors, prohibition of non-audit services and the transparency of financial statement.[9]

A more recent and ominous case is that of Ramalinga Raju, who promoted Satyam Computers, which was credited as the then fourth largest software company in India. The spectacular breakdown of the audit function that enabled Raju to commit fraud in the region of Rs. 40,000 million through manipulation, insider trading, formation of innumerable sister concerns has made a mockery of the audit function as is being practiced now. Naturally, this elicited calls for reform and review of the audit system for public companies in the country. Joint audits, audit rotation and peer review are some of the suggestions that have been floated in recent times. Salman Khurshid, the minister of state for corporate affairs, has recently suggested "dual audit" so that there are two firms keeping a check on each other.

Audit Committee

An audit committee is the committee comprising independent directors. It is responsible for appointment, fixing of fees and oversight of the work of independent auditors. The committee is also responsible for establishing, reviewing the procedures for the receipt, treatment of accounts, internal control and audit complaints. All the committees emphasised more on the formation of audit committee, but the proposed size of the committee differed from one to the other.

The Birla Committee, for instance, specified that the committee should have three minimum independent directors. The committee is required to meet at least thrice a year with a gap of not more than 6 months, with one meeting before the finalisation of annual accounts. Naryana Murthy committee suggested more power and responsibilities for the audit committee. The committee suggested that there should be a mandatory review of crucial information of publicly listed companies. The audit committee, according to them, should review the following information:

- Financial statements and draft audit reports, including quarterly/half yearly information.
- Management discussion and analysis of financial conditions and the results of operations.
- Report relating to compliance with laws and risk management.
- Management letters/letters of internal control weakness issued by statutory and internal auditors.
- Records of related pay transactions

Rotation of Auditors

The Naresh Chandra and the R. D. Joshi Committees insisted upon the rotation of auditors. It is specified that no company shall appoint or re-appoint same auditor for more than five consecutive accounting years. The Naresh Chandra Committee went one step further saying that at least 50 per cent of the engagement team responsible for the audit should also be rotated every 5 years.[10]

Naresh Chandra Committee

Set-up against the background of massive accounting frauds in companies abroad, the Committee on Corporate Audit and Governance headed by the former Cabinet Secretary, Naresh Chandra, has recommended the Chief Executive Officers (CEOs) and Chief Finance Officers (CFOs) of listed companies and public limited companies with paid-up capital and free reserves exceeding Rs. 10 crores or turnover exceeding Rs. 50 crores should certify the correctness of the annual audited accounts of such companies.

The committee has not favoured audit firm rotation, but has suggested that compulsory audit partner rotation. Elaborating on this, the committee said the partners and at least 50 per cent of the engagement team (excluding article clerks and trainees) responsible for the audit of either a listed company or companies

Audit firm rotation—Professional Views

There are certain views in the profession of auditors which approve audit rotation of partners. Commenting on this issue, Mike Rake, chairman of KPMG International, one of the world's Big Five auditing firms, has this to say: "After the series of scandals, there has been a lot of reform, regulation and legislation-some well thought through, some not so well thought through. All the academic studies in the US, Italy, etc. show that rotation of audit firms actually leads to lowering of audit quality and a higher incidence of audit failures. A more sensible solution is to have rotation of audit partners. In the US and the UK, this is required after every 5 years, in the EU, it would be after 7 years. It also means that audit committees must be established throughout public companies, and perhaps not just in public companies. It must be ensured that auditors are independent and effective carrying out their role."

Likewise, Samuel A. DiPiazza, Jr. CEO, Price Waterhouse Coopers, the largest of the big four global audit firms said in an interview to Economic Times (18 February 2003):

> "As for the provision of rotation, let me clarify that it relates not only to the lead auditor but the concurring auditor as well. I think it is a good thing because it immediately raises the focus on the crucial issue of independence of these partners. At PwC, we rotate our auditors as a matter of routine—there is no specific periodicity but it is not common for one auditor to spend more than 5–6 years on a single account."[11]

whose paid-up capital and free reserves exceed Rs. 10 crores or companies whose turnover exceeds Rs. 50 crores, should be rotated every 5 years. However, if required such rotated personnel could be allowed to return after a break of 3 years.

Another recommendation is that a special resolution, disclosing the reasons, be required whenever an auditor, who is otherwise eligible for re-appointment, is proposed to be replaced.

It has also suggested that certain business and other relationships, between an auditing firm and the client, should preclude the audit firm from undertaking audit assignments for that client.

Prohibition of Non-audit Services

The Naresh Chandra Committee has also recommended the prohibition of non-audit services in line with the Sarbanes–Oxley Act of the US. It recommended that auditors should be prohibited from providing non-audit services concurrently with audit review services. Non-audit services include book keeping, financial and information system design, internal audit, HRD services, investment advice, investment banking services, legal advice, appraisal, valuation and actuarial services.

Independence of Auditors

Even though all the committees insisted upon the independence of auditors, it is the Naresh Chandra Committee that insisted much on auditor's independence in the following lines:

- Prohibition of direct financial interest in the audit client by the audit firms, its partners or members of the engagement team as well as their direct relatives.
- Prohibition of receiving any loan and/or guarantees from or on behalf of the audit client by the audit firm, its partners or any member of the engagement team and their direct relatives.
- Prohibition of business relationship with the audit client by the audit firm and other associated persons as mentioned above.
- Prohibition of audit partners and other associated persons from joining an audit client or key personnel of the audit client wanting to join the audit firm, for a period of 2 years from the time they were involved in the preparation of accounts and audits of the client.
- Prohibition of undue dependence on audit client by ensuring that fees received by a firm from any one client and its subsidiaries and affiliates should not exceed 25 per cent of the total revenue of the audit firm, providing certain exceptions in case of small audit firms.
- Prohibiting audit firms from performing certain non-audit services.

Disclosures

Full disclosures of accounts and decisions of management involving the funds of the company to all its stakeholders is a desiderata of good corporate culture. The R. D. Joshi Committee has suggested the imposition of responsibility on the auditors to check and, report diversion, mis-utilisation or misappropriation of funds by companies. Likewise, the Naresh Chandra Committee has recommended that the auditors should disclose implications of contingent liabilities so that investors and shareholders have a clear picture of contingent liabilities.

Qualification in Audit Report

In addition to the existing provisions in the Companies Act regarding qualifications in audit reports, the committee has made further recommendations that the auditor should read out the qualifications with explanations to shareholders at the company's annual general meeting and the audit firm is mandated to send separately a copy of the qualified report to the Registrar of Companies, SEBI and the Principal Stock Exchange with a copy of the letter of the management of the company.

Replacing Auditors

In the event of an auditor being appointed in the place of a retiring auditor, the committee has recommended that Section 225 of the Companies Act be amended to require a special resolution for the purpose and that an explanatory statement giving reasons for such replacement be provided. The outgoing auditor will have the right to comment on the statement.

Formation of Boards for Monitoring Audit Process

The Naresh Chandra Committee has suggested setting up of the Corporate Serious Fraud Office (CSFO) with specialists inducted into a multi-disciplinary team that not only uncovers the fraud but is able to direct and supervise prosecutions under various economic legislations through appropriate agencies. The committee also suggested that three independent quality review boards be constituted, one each for the ICAI[12], ICSI[13] and ICWAI[14] to periodically examine and review the quality of audit, secretarial and cost accounting firms and pass judgment and comments on the quality and sufficiency of systems and practices.

Penalties

Under Section 539 of the Companies Act 1956, penalties for the falsification of the books is laid down. It is said that if an auditor is found to be involved in unethical practices, he will be punishable with imprisonment for a term which may extend to 7 years and shall also be liable to a fine.

Besides, under Section 21 of the Chartered Accountants Act, such an auditor will be prevented from exercising his duty and his license will be cancelled by the ICAI.

Companies (Amendment) Bill, 2003

The Companies Amendment Bill 2003 was introduced in the Rajya Sabha[15] on 7 May 2003. This has been based on the Naresh Chandra Committees' recommendations and the Joint Parliamentary Commission's report. Prompt measures are being taken to ensure better governance imposing more responsibilities on auditors.

Provisions of the Bill Regarding Auditing

Chief accounts officer under Section 2 (9B) and 215 A of the bill: Every public company having a paid up capital of Rs. 3 crores or more shall appoint a whole time qualified Chief Accounts Officer, who shall be a member of the ICAI or the ICWAI. The CAO will be responsible for the proper maintenance of the books of account of the company and shall ensure proper disclosure of all required information and also ensure compliance of the provisions of the Companies Act 1956 relating to the accounts of the company. This provision is in line with the recommendations contained in the R. D. Joshi Committee report.

Disqualification of auditors under Section 226 of the bill: Any person who has a direct financial interest in a company or who receives any loan or guarantee

from the company or who has any business relationship other than that of an auditor or who has been in the employment of the company or whose relatives are in the employment of the company is said to be disqualified to be an auditor under this section.

Further, a person shall not be qualified to be appointed as an auditor of a company, if he receives or proposes to receive more than 25 per cent of his total income in any financial year as his remuneration from the company, provided that this disqualification would not apply during the initial five financial years beginning from the date of commencement of the profession of any auditor or to the auditor whose total income is less than Rs. 15 lakhs in any financial year. This provision is based on Naresh Chandra Committee's recommendations.

Prohibited services for an auditor under Section 226 A of the bill: To ensure the independence of statutory auditors and to prevent any kind of conflict of interest, an auditor is prohibited from rendering certain services. The prohibited services are as follows:

- Accounting and book keeping
- Internal audit
- Financial system design and implementation
- Actuarial services
- As broker or as intermediary referred to in Section 12 of the SEBI Act or investment adviser or investment banking services
- Outsourced financial services
- Management functions
- Any form of staff recruitment
- Valuation services and fairness opinion.

Audit committee of the bill under Section 292 A: The audit committee shall consist of not less than two independent directors and not more than such number of maximum independent directors as the central government may prescribe.

Companies (Auditors Report) Order (CARO), 2003

This order came into effect on 1 July 2003 replacing the Manufacturing and Other Companies (Auditor's Report) Order (MAOCARO). This new order has placed increased responsibility on auditors and calls for greater corporate disclosures. According to chartered accountants, the propriety concept has made greater inroads in the new reporting order.

For example, the auditor will now have to look at whether a term loan has been used for the purpose it was taken. In other words, the end use of funds will have to be correctly assessed. The auditor is also expected to state if funds raised for short-term purposes are being used for long-term investments.

Keeping in mind the increasing number of corporate frauds coming to light, nationally and internationally, MOCARO requires auditors to report whether any fraud on or by a company has been noticed or reported during the year under audit. If yes, the nature and amount involved has to be indicated. Thus, the burden of identifying fraud has now shifted from a company's directors to its statutory auditors.

MOCARO requires auditors to report defaults in repayment of dues to banks, FIs or debenture holders. The period and amount will have to be reported. Additionally, MOCARO requires auditors to provide sufficient reason for offering unfavourable or qualified opinion in case of transactions, which they feel do not follow the general accepted principles of accounting.[16]

The auditors would be further required to state whether the company is regular in depositing undisputed statutory dues pertaining to Investor Education and Protection Fund. The audit report should certify whether the management

has disclosed on the end use of money raised by public issues and the same has been verified.

The report should also comment whether a company which has been registered for a period of not less than 5 years, has accumulated losses at the end of the year that are not less than 50 per cent of its net worth and whether such company has incurred cash losses in such financial year and in the year immediately preceding such financial year.

The auditor has also to certify that whether a company has made any preferential allotment of shares to parties and companies covered in the register maintained under Section 301 of the Companies Act 1956.[17]

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 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 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 international markets.

The now well-known target costing became the mantra in business and industry in the domestic as well as 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 world class wavelength.

Cost Audit Methodology

The Cost Audit methodology as structured originally under Section 233B of the 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 cost audit mechanism.

With the economy moving away from being a centrally controlled model to a competitive, relatively free market model, the role of cost, quality and timely delivery have become the basis for survival. The role of efficiency review from 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 corporate governance and evolve related practices with or without the required legal support.

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 focus on bridging quality gaps is accepted as a part of corporate governance.

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 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 of the attestation perspective, which was emphasised earlier for price control, the efficiency review aspect should be blown in full force to enable better corporate governance. This will make the entire mechanism a value adding framework in today's context of challenges of competitiveness. Ultimately, 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 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 budget formulation, 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 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 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 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 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, internal auditors, and statutory auditors form the foundation on which effective corporate governance has to be built. For 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 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
- 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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Case Study

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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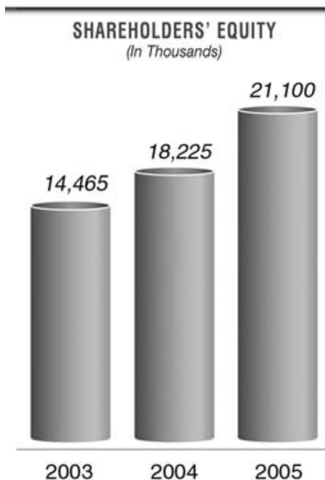

Banks and Corporate Governance

CHAPTER OUTLINE

- 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 Committees's Recommendations

Banks and Corporates

Merchant banks specialise in business connected with bills of exchange, especially the acceptance of foreign bills. A merchant banker is, thus, a financial intermediary who helps in transferring capital from those who possess it to those who need it.

Banks, in a broad sense, are institutions whose business is handling other people's money.[1] A joint stock bank, also generally known as commercial bank, is a company whose business is banking. These are more particularly institutions that deal directly with the general public, as opposed to the merchant banks and other institutions more concerned with trade and industry. These banks specialise in business connected with bills of exchange, especially the acceptance of foreign bills.[2] A merchant banker is thus a financial intermediary who helps in transfering capital from those who possess it to those who need it. Merchant banking includes a wide range of activities such as management of customers' securities, portfolio management, project counseling and appraisal, underwriting of shares and debentures, loan syndication, acting as banker for refund orders, handling interest and dividend warrants, etc. Thus, a merchant banker renders a host of services to corporates and promotes industrial development in the country.[3] Further, there are also investment banks which acquire shares in limited companies on their own account, and not merely as agents for their customers. Sometimes, banks are set up to handle specialised functions for particular industries such as the Industrial Development Bank of India (IDBI), National Bank for Agricultural and Rural Development (NABARD) and Export-Import Bank (Exim Bank).

Banks are thus a critical component of any economy. They provide financing for commercial enterprises, basic financial services to a broad segment of the population and access to payment systems. In addition, some banks are expected to make credit and liquidity available in difficult market conditions. The importance of banks to national economies is underscored by the fact that banking is virtually universally a regulated industry and that banks have access to government safety nets. It is of crucial importance, therefore, that banks have strong corporate governance.

There has been a great deal of attention given recently to the issue of corporate governance in various national and international forums. In particular, the OECD has issued a set of corporate governance standards and guidelines to help governments "in their efforts to evaluate and improve the legal, institutional and regulatory framework for corporate governance in their countries, and to provide guidance and suggestions for stock exchanges, investors, corporations, and other parties that have a role in the process of developing good corporate governance".

Why Corporate Governance in Banks?

If we examine the need for improving corporate governance in banks, two reasons stand out: (i) Banks exist because they are willing to take on and manage risks.[4] Besides, with the rapid pace of financial innovation and globalisation, the face of banking business is undergoing a sea-change. Banking business is becoming more complex and diversified. Risk taking and management in a less regulated competitive market will have to be done in such a way that investors' confidence is not eroded. (ii) Even in a regulated set-up, as it was in India prior to 1991, some big banks in the public sector and a few in the private sector had incurred substantial losses. This, along with the massive failures of non-banking financial Companies (NBFCs), had adversely impacted investors' confidence.

Protecting the interests of depositors becomes a matter of paramount importance to banks. Regulators the world over have recognised the vulnerability of depositors to the whims of managerial misadventures in banks and, therefore, have been regulating banks more tightly than other corporates.

Moreover, protecting the interests of depositors becomes a matter of paramount importance to banks. In other corporates, this is not and need not be so for two reasons: (i) The depositors collectively entrust a very large sum of their hard-earned money to the care of banks. It is found that in India, the

depositor's contribution was well over 15.5 times the shareholders' stake in banks as early as in March 2001.[5] This is bound to be much more now. (ii) The depositors are very large in number and are scattered and have little say in the administration of banks. In other corporates, big lenders do exercise the right to direct the management. In any case, the lenders' stake in them might not exceed 2 or 3 times the owners' stake.

Banks deal in people's funds and should, therefore, act as trustees of the depositors. Regulators the world over have recognised the vulnerability of depositors to the whims of managerial misadventures in banks and, therefore, have been regulating banks more tightly than other corproates.

To sum up, the objective of governance in banks should first be protection of depositors' interests and then be to "optimise" the sharehodlers' interests. All other considerations would fall in place once these two are achieved.[6]

As part of its ongoing efforts to address supervisory issues, the Basel Committee on Banking Supervision (BCBS) has been active in drawing from the collective supervisory experience of its members and other supervisors in issuing supervisory guidance to foster safe and sound banking practices. The committee was set up to reinforce the importance for banks of the OECD principles, to draw attention to corporate governance issues addressed by previous committees, and to present some new topics related to corporate governance for banks and their supervisors to consider.

Banking supervision cannot function effectively if sound corporate governance is not in place and, consequently, banking supervisors have a strong interest in ensuring that there is effective corporate governance at every banking organisation. Supervisory experience underscores the necessity of having the appropriate levels of accountability and checks and balances within each bank. Put plainly, sound corporate governance makes the work of supervisors infinitely easier. Sound corporate governance can contribute to a collaborative working relationship between bank management and bank supervisors.

Recent "sound practice papers" issued by the Basel Committee[7] underscore the need for banks to set strategies for their operations and establish accountability for executing these strategies. In addition, transparency of information related to existing conditions, decisions and actions is integrally related to accountability in that it gives market participants sufficient information with which to judge the management of a bank.

Corporate Governance and the World Bank

The World Bank Report on corporate governance stress on principles on which it is based. These principles such as transparency, accountability, fairness and responsibility which are universal in their application.

The World Bank report on corporate governance is a landmark in the evolution of the theory and its application of this concept of best corporate behaviour. Governance in relation to a business organisation concerns with the intrinsic nature, purpose, integrity and identity of the organisation and focusses primarily on the relevance, continuity and fiduciary aspects of the organisation. It involves monitoring and overseeing strategic direction, socio-economic and cultural context, externalities and constituencies of the organisation. Hence, corporate governance may be called as an umbrella term encompassing specific issues arising from interactions among senior management personnel, shareholders, board of directors, depositors, borrowers, other constituencies and the society at large. It deals with the exercise of power over the directions of enterprise, the supervision of executive actions, acceptance of a duty to be accountable and regulation of the affairs of the corporation.

The World Bank report on corporate governance recognises the complexity of the very concept of corporate governance and, therefore, focusses on the principles on which it is based. These principles such as transparency, accountability, fairness

and responsibility are universal in their application. 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.

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 areas 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 community 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. The World Bank 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.

Basel Committee on Corporate Governance

In 1988, the Bank for International Settlement (BIS)-based Basel Committee on Banking Supervision came out with regulations regarding the capital requirements for banks. Although these were essentially intended for internationally operating banks, in due course, almost all countries adopted these regulations for their banks.

The crux of the Basel I requirements is the assignment of risk weights for different assets in a bank's book and aggregating the risk-weighted assets of which 8 per cent was recommended as the capital of the bank. The committee's recommendations were not mandatory, but the world's central banks speeded up the process of compliance, particularly following the East Asian crisis and the collapse of certain hedge funds in New York which threatened to bring down banking systems of the US and the developed world. India adopted Basel I norms in 1992 closely following the inception of economic reforms.

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From a banking industry perspective, corporate governance involves the manner in which the business and affairs of individual institutions are governed by their boards of directors and senior management affecting how banks

- set corporate objectives (including generating economic returns to owners).
- run the day-to-day operations of business.

- consider the interests of recognised stakeholders.
- align corporate activities and behaviour with the expectation that banks will operate in a safe and sound manner, and in compliance with applicable laws and regulations.
- protect the interests of depositors.

Basel Committee published a paper on corporate governance for banking organisations in September 1999.[8] The committee felt that it was the responsibility of the banking supervisors to ensure that there was effective corporate governance in the banking industry. Supervisory experience underscores the need for having appropriate accountability and checks and balances within each bank to ensure sound corporate governance, which in turn would lead to effective and more meaningful supervision. Sound corporate governance could also contribute to a collaborative working relationship between bank managements and bank supervisors.

Basel Committee underscored the need for banks to set strategies for their operations. The committee also insisted banks to establish accountability for executing these strategies. Unless there is transparency of information related to decisions and actions, it would be difficult for stakeholders to make management accountable.

From the perspective of banking industry, corporate governance also includes in its ambit the manner in which their boards of directors govern the business and affairs of individual institutions and their functional relationship with senior management.

The Basel Committee has also issued several papers on specific topics, where the importance of corporate governance has been emphasised. These papers have highlighted the fact that strategies and techniques that are basic to sound corporate governance include corporate values, codes of conduct and other standards of enterprise.

The Basel Committee has also issued several papers on specific topics, where the importance of corporate governance has been emphasised. These include Principles for the Management of Interest Rate Risk (September 1997), Framework for Internal Control Systems in Banking Organisations (September 1998), Enhancing Bank Transparency (September 1998), and Principles for the Management of Credit Risk (issued as a consultative document in July 1999).

These papers have highlighted the fact that strategies and techniques that are basic to sound corporate governance include the following:

- The corporate values, codes of conduct and other standards of appropriate behaviour and the system used to ensure compliance with them.
- A well-articulated corporate strategy against which the success of the overall enterprise and the contribution of individuals can be measured.
- The clear assignment of responsibilities and decision-making authorities, incorporating a hierarchy of required approvals from individuals to the board of directors.
- Establishment of a mechanism for the interaction and cooperation among the board of directors, senior management and the auditors.
- Strong internal control systems, including internal and external audit functions, risk management functions, independent of business lines, and other checks and balances.
- Special monitoring of risk exposures where conflicts of interest are likely to be particularly great, including business relationships with borrowers affiliated with the bank, large shareholders, senior management, or key decision-makers within the firm (e.g. traders).
- The financial and managerial incentives to act in an appropriate manner offered to senior management, business line management and employees in the form of compensation, promotion and other recognition.
- Appropriate information flows internally and to the public.

"Stakeholders" in the above context include employees, customers, suppliers and the community. Due to the unique role of banks in national and local economies and financial systems, supervisors and governments are also stakeholders.

The reality that various corporate governance structures exist in different countries reflects that there are no universally correct answers to structural issues and that laws need not be consistent in all the countries. Acknowledging this, sound governance can be practised regardless of the form used by a banking organisation.

There are four important forms of oversight that should be included in the organisational structure of any bank in order to ensure appropriate checks and balances:

1. Oversight by the board of directors or supervisory board.
2. Oversight by individuals not involved in the day-to-day running of the various business areas.
3. Direct line supervision of different business areas.
4. Independent risk management and audit functions.

In addition, it is important that key personnel are fit and proper for their jobs. Government ownership of a bank has the potential to alter the strategies and objectives of the bank as well as the internal structure of governance. Consequently, the general principles of sound corporate governance are also beneficial to government-owned banks.

Sound Corporate Governance Practices for Banks

As mentioned earlier, supervisors have a keen interest in determining that banks have sound corporate governance. The practices to be viewed as critical elements of any corporate governance process are:

1. Establishing strategic objectives and a set of corporate values that are communicated throughout the banking organisation: It is difficult to conduct the activities of an organisation when there are no strategic objectives or guiding corporate values. Therefore, the board should establish strategies that will direct the ongoing activities of the bank. It should also take the lead in establishing the "tone at the top" and approving corporate values for itself, senior management and other employees. The values should recognise the critical importance of having timely and frank discussions of problems. In particular, it is important that the values prohibit corruption and bribery in corporate activities, both in internal dealings and external transactions.

The board of directors should ensure that senior management implements policies that limit activities and relationships that diminish the quality of corporate governance, such as conflicts of interest.

The board of directors should ensure that the senior management implements policies that prohibit (or strictly limit) activities and relationships that diminish the quality of corporate governance, such as:

- Conflicts of interest.
- Lending to officers and employees and other forms of self-dealing (e.g., internal lending should be limited to lending consistent with market terms and to certain types of loans, and reports of insider lending should be provided to the board, and be subject to review by internal and external auditors).
- Providing preferential treatment to related parties and other favoured entities (e.g., lending on highly favourable terms, covering trading losses, waiving commissions). Processes should be established that allow the board to monitor compliance with these policies and ensure that deviations are reported to an appropriate level of management.

2. Setting and enforcing clear lines of responsibility and accountability throughout the organisation: Effective boards of directors clearly define the authorities and

key responsibilities for themselves, as well as senior management. They also recognise that unspecified lines of accountability or confusing multiple lines of responsibility may exacerbate a problem through slow or diluted responses. Senior management is responsible for creating an accountability hierarchy for the staff and must be aware of the fact that they are ultimately responsible to the board for the performance of the bank.

3. Ensuring that board members are qualified for their positions, have a clear understanding of their role in corporate governance and are not subject to undue influence from management or outside concerns: The board of directors is ultimately responsible for the operations and financial soundness of the bank. The board of directors must receive on a timely basis sufficient information to judge the performance of management. An effective number of board members should be capable of exercising judgement, independent of the views of management, large shareholders or government. Including on the board qualified directors who are not members of the bank's management, or having a supervisory board or board of auditors separate from a management board, can enhance independence and objectivity. Moreover, such members can bring new perspectives from other businesses that may improve the strategic direction given to management, such as insight into local conditions. Qualified external directors can also become significant sources of management expertise in times of corporate stress. The board of directors should periodically assess its own performance, determine where weaknesses exist and, wherever possible, take appropriate corrective actions.

The board of directors add strength to the corporate governance of a bank when they:

- Understand their oversight role and their "duty of loyalty" to the bank and its shareholders.
- Serve as a "checks-and balances" function vis-à-vis the day-to-day management of the bank.
- Feel empowered to question management and are comfortable insisting upon straightforward explanations from management.
- Recommend sound practices observed from other situations.
- Provide dispassionate advice.
- Are not overextended.
- Avoid conflicts of interest in their activities with, and commitments to, other organisations.
- Meet regularly with senior management and internal audit to establish and approve policies, establish communication lines and monitor progress toward corporate objectives.
- Absent themselves from decisions when their own role or interests are bring discussed or they are incapable of providing objective advice.
- Do not participate in day-to-day management of the bank.

In a number of countries, bank boards as recommended by several committees on corporate governance have found it beneficial to establish certain specialised committees that include the following:

(i) ***A risk management committee:*** This committee is formed with a view to providing oversight of the senior management's activities in managing credit, market, liquidity, operational, legal and other risks of the bank. (This role should include receiving from senior management periodic information on risk exposures and risk management activities.)

(ii) ***An audit committee*:** This committee is formed with a view to providing oversight of the bank's internal and external auditors, approving their appointment and dismissal, reviewing and approving audit scope and frequency, receiving their reports and ensuring that management is taking appropriate corrective

actions in a timely manner to address control weaknesses, non-compliance with policies, laws and regulations, and other problems identified by auditors. The independence of this committee can be enhanced when it is composed of external board members that have banking or financial expertise.

(iii) ***A compensation committee:*** This committee is expected to provide oversight of remuneration of senior management and other key personnel and ensure that compensation is consistent with the bank's culture, objectives, strategy and control environment.

(iv) ***A nomination committee*:** A nomination committee is formed with a view to providing important assessment of board effectiveness and directing the process of renewing and replacing board members.

Senior management is a key component of corporate governance. While the board of directors provides checks and balances to senior managers, senior managers should assume that oversight role with respect to line managers in specific business areas and activities.

4. Ensuring that there is appropriate oversight by senior management: Senior management is a key component of corporate governance. While the board of directors provides checks and balances to senior managers, similarly, senior managers should assume that oversight role with respect to line managers in specific business areas and activities. Even in very small banks, key management decisions should be made by more than one person (four eyes principle). Management situations to be avoided include the following managers:

- Senior managers who are overly involved in business line decision-making.
- Senior managers who are assigned an area to manage without the necessary prerequisite skills or knowledge.
- Senior managers who are unwilling to exercise control over successful, key employees (such as traders) for fear of losing them.

Senior management consists of a core group of officers responsible for the bank. This group should include such individuals as the Chief Financial Officer, division heads and the chief auditor. These individuals must have the necessary skills to manage the business under their supervision as well as have appropriate control over the key individuals in these areas.

5. Effectively utilising the work conducted by internal and external auditors, in recognition of the important control function they provide: The role of auditors is vital to corporate governance process. The effectiveness of the board and senior management can be enhanced as given below:

- Recognising the importance of the audit process and communicating this importance throughout the bank.
- Taking measures that enhance the independence and stature of auditors.
- Utilising, in a timely and effective manner, the findings of auditors.
- Ensuring the independence of the head auditor through his reporting to the board or the board's audit committee.
- Engaging external auditors to judge the effectiveness of internal controls.
- Requiring timely correction by management of problems identified by auditors.

The board should recognise and acknowledge that the internal and external auditors are their critically important agents. In particular, the board should utilise the work of the auditors as an independent check on the information received from management on the operations and performance of the bank.

6. Ensuring that compensation approaches are consistent with the bank's ethical values, objectives, strategy and control environment: Failure to link incentive compensations to the business strategy can cause or encourage managers to book business based upon volume and/or short-term profitability to the bank with little regard to short or long-term risk consequences. This can be seen particularly with traders and loan officers, but can also adversely affect the performance of other support staff.

The board of directors should approve the compensation of members of senior management and other key personnel and ensure that such compensation is consistent with the bank's culture, objectives, strategy and control environment. This will help to ensure that senior managers and other key personnel will be motivated to act in the best interests of the bank.

In order to avoid incentives being created for excessive risk-taking, the salary scales should be set, within the scope of general business policy, in such a way that they do not overly depend on short-term performance, such as short-term trading gains.

7. Conducting corporate governance in a transparent manner:
As set out in the Basel Committee's paper Enhancing Bank Transparency, it is difficult to hold the board of directors and senior management properly accountable for their actions and performance when there is a lack of transparency. This happens in situations where the stakeholders, market participants and general public do not receive sufficient information on the structure and objectives of the bank with which to judge the effectiveness of the board and senior management in governing the bank.

Transparency can reinforce sound corporate governance. Therefore, public disclosure is desirable in the following areas:

- Board structure (size, membership, qualifications and committees); senior management structure (responsibilities, reporting lines, qualifications and experience).
- Basic organisational structure (line of business structure, legal entity structure).
- Information about the incentive structure of the bank (remuneration policies, executive compensation, bonuses, stock options).
- Nature and extent of transactions with affiliates and related parties.

For example, the International Accounting Standards Committee[9] (IASC) defines related parties as "those able to control or exercise significant influence." Such relationships include

(i) parent-subsidiary relationships.

(ii) entities under common control.

(iii) associates.

(iv) individuals who, through ownership, have significant influence over the enterprise and close members of their families.

(v) key management personnel.

The IASC expects that disclosures in this area should include

- the nature of relationships where control exists, even if there were no transactions between the related parties.
- the nature and amount of transactions with related parties, grouped as appropriate.

The Basel Committee recognises that primary responsibility for good corporate governance rests with Boards of Directors and senior management of banks. However, there are many other ways that corporate governance can be promoted, which include government.

Ensuring Sound Corporate Governance Environment

The Basel Committee recognises that primary responsibility for good corporate governance rests with boards of directors and senior management of banks; however, there are many other ways that corporate governance can be promoted, which include the following:

- Government—through laws.
- Securities' regulators, stock exchanges—through disclosure and listing requirements.

- Auditors—through audit standards on communications to board of directors, senior management and supervisors.
- Banking industry associations—through initiatives related to voluntary industry principles and agreement on and publication of sound practices.

For example, corporate governance can be improved by addressing a number of legal issues, such as the protection of shareholder rights; the enforceability of contracts, including those with service providers; clarifying governance roles; ensuring that corporations function in an environment that is free from corruption and bribery; and laws/regulations (and other measures) aligning the interests of managers, employees and shareholders. All of these can help promote healthy business and legal environments that support sound corporate governance and related supervisory initiatives.

The Role of Supervisors

Supervisors should be aware of the importance of corporate governance and its impact on corporate performance. They should expect banks to implement organisational structures that include appropriate checks and balances. Regulatory safeguards must emphasise accountability and transparency. Supervisors should determine that the boards and senior management of individual institutions have in place processes that ensure they are fulfilling all of their duties and responsibilities.

A bank's board of directors and senior management are ultimately responsible for the performance of the bank. As such, supervisors typically check to ensure that a bank is being properly governed and bring to management's attention any problems that they detect through their supervisory efforts. When the bank takes risks that it cannot measure or control, supervisors must hold the board of directors accountable and require that corrective measures be taken in a timely manner. Supervisors should be attentive to any warning signs of deterioration in the management of the bank's activities. They should consider issuing guidance to banks on sound corporate governance and the proactive practices that need to be in place. They should also take account of corporate governance factors while issuing guidance on other topics.

Sound corporate governance considers the interests of all stakeholders, including depositors, whose interests may not always be recognised. Therefore, it is necessary for supervisors to determine that individual banks are conducting their business in such a way as not to harm depositors.

The New Basel Capital Accord (Basel II)

Efforts were made for 6 years to rectify the deficiencies found in the original accord, now known as Basel I. On 26 June 2004, the committee came out with new Basel norms that are expected to change the complexion of banking throughout the world. The final version of the revised accord, titled, "The International Convergence of Capital Measurement and Capital Standards: A Revised Framework" is known in short as the New Basel Capital Accord or simply Basel II. The first version of Basel II came out in 1999. The version was widely debated and after consultation, a revised Basel II document came out in June 2004.

Basel II aims at correcting most of the deficiencies that Basel I suffered from. Basel II rests on three pillars as given below:[10]

The Three Pillars

The overarching goal for the Basel II Framework is to promote adequate capitalisation of banks and to encourage improvements in risk management, thereby strengthening the stability of the financial system.

This goal will be accomplished through the introduction of " three pillars" that reinforce one another and that create incentives for banks to enhance the quality of their control processes.

The first pillar represents a significant strengthening of the minimum requirements set out in the 1988 Accord, while the second and third pillars represent innovative additions to capital supervision.

- **Pillar 1** of the new capital framework revises the 1988 Accord's guidelines by aligning the minimum capital requirements more closely to each bank's actual risk of economic loss.
- **Pillar 2** of the new capital framework recognises the necessity of exercising effective supervisory review of banks' internal assessment of their overall risks to ensure that bank management is exercising sound judgement and has set aside adequate capital for these risks.
- **Pillar 3** leverages the ability of market discipline to motivate prudent management by enhancing the degree of transparency in banks' public reporting. It sets out the public disclosures that banks must make that lend greater insight into the adequacy of their capitalisation.

Implementation of Basel II and Its Impact

A recent survey conducted by the Financial Stability Institute (FSI), Basel, showed that more than 100 countries would implement Basel II in the next few years. The US has already announced that it would be made mandatory for the ten biggest banking groups that control nearly three-fourth of the country's banking assets. It is also expected that Basel II will also be implemented fully in Europe.

The Reserve Bank of India (RBI) started its own consultative process involving various banks and other experts. It has now come out with its final draft version of Basel II.

The Basel II version as drafted by RBI in its letter dated 15 February 2005 is a comprehensive set of instructions, which will initiate a parallel run by banks starting in 2006.

The instructions go into great detail regarding the various classifications of the assets and the weights to be assigned.

What remains is for each bank to adopt one of the methods suggested in the circular for assessing its risk weighted capital.

In a meeting of 60 bankers that aimed at sensitising the bank chiefs about the challenges of Basel II norms, which are due to be implemented by March 2006 by all banks globally, the Deputy Governor of the Reserve Bank of India, Mr. K. J. Udeshi, announced that the RBI would adopt a gradual and sequential approach towards implementation of Basel II norms for the capital adequacy of banks. At the meeting, the RBI has formed a Steering Committee, which in turn will have smaller focussed sub-committees for each of the pillars of Basel II. The Steering Committee will review the issues and suggest a roadmap to adopt the new norms of Basel II.[11]

The Reserve Bank of India has advised Indian banks to adopt Basel II norms by 31 March 2006; however, banks are expected to do a trial or parallel run from 31 March 2005 to fine-tune their systems and procedures.

Once it is implemented, Basel II is likely to have a profound impact on the way banking is conducted worldwide. It could also lead to a shakeout in the industry given the fact that the capital requirements favouring larger banks with better systems in place. This could result in a spate of mergers worldwide, especially among internationally active banks in their struggle to remain competitive.[12]

The implementation of Basel II is imperative in the context of emerging market economies that "may face unique problems in the absence of well-developed credit rating systems, robust data collection mechanisms and other infrastructure". So, non-implementation, without justifiable reasons, will finally get reflected in adverse credit ratings, higher borrowing costs and the consequent effects on the real economy. This is one reason no country can afford to delay implementation of Basel II indefinitely.[13]

Phases of Growth in Indian Banks

Since Independence, organised Western type of banking in India has evolved through four distinct phases.

1. **Foundation phase covering the decades of 1950s and 1960s:** This period witnessed the development of the required legislative framework for facilitating the organisation of the banking system to cater to the growing and development needs of the Indian economy.
2. **Expansion phase of the mid-1960s:** This trend gained momentum after the nationalisation of private banks in late 1960s.
3. **Consolidation phase since 1985:** Greater attention was paid to improving housekeeping, customer service, credit management, productivity and profitability of banks starting 1985 onwards.
4. **Reforms phase commencing from 1991:** Important and significant initiatives were taken with a view to reforming the banking system such as the introduction of accounting and prudential norms relating to income recognition, provisioning and capital adequacy in 1991.

The three constituents of commercial banking structure in India are public sector banks, private banks and foreign banks. Presently, there are 295 banks with 66,514 branches; out of these, as many as 223 banks and 60,640 branches are in the public sector.[14]

Corporate Governance in Indian Banks

Although the subject of corporate governance has received a lot of attention in recent times in India, corporate governance issues and practices by Indian banks have received only a scanty notice. The question of corporate governance in banks is important for several reasons. First, banks have an overwhelmingly dominant position in developing the economy's financial system, and are extremely important engines of growth. Second, as the country's financial markets are underdeveloped, banks in India are the most significant source of finance for a majority of firms in Indian industry. Third, banks are also the channels through which the country's savings are collected and used for investments. Fourth, India has recently liberalised its banking system through privatisation, disinvestments and has reduced the role of economic regulation and consequently managers of banks have obtained greater autonomy and freedom with regard to running of banks. This would necessitate their observing best corporate practices to regain the investors' confidence now that

the government authority does not protect them anymore. Corporate governance in banks has assumed importance in India post-1991 reforms because competition compelled banks to improve their performance. Even the majority of banks and financial institutions, owned, managed and influenced by the government with neither high quality management nor any exemplary record of practising corporate governance have realised the importance of adopting better practices to protect their depositors and the banking public.

Indian Banking Sector's Unique Nature and Its Implications

The unique nature of the banking firm, requires a broad view of corporate governance to be adopted by banks which encapsulates both shareholders and depositors.

The unique nature of the banking firm, be in the developed or developing world, requires a broad view of coporate governance to be adopted by banks which encapsulates both shareholders and depositors. In particular, the nature of the banking firm is such that regulation is necessary to protect depositors as well as the overall financial system. Using this insight, we should examine the corporate governance of banks in India in the context of ongoing banking reforms.

The narrow approach to corporate governance views the subject as the mechanism through which shareholders are assured that managers will act to promote their interests. Indeed, as far back as at the time of Adam Smith, it has been recognised that managers do not always act in the best interests of shareholders, leading to a separation of ownership and control. The separation of ownership and control has given rise to an "agency problem" whereby management operates the firm in their own interests, and not those of shareholders. This creates opportunities for managerial shirking or empire building and, in the extreme, outright expropriation. However, there is a broader view of corporate governance, which views the subject as the methods by which suppliers of finance control managers in order to ensure that their capital is not expropriated and that they earn a return on their investment. Thus, the special nature of banking will call for the adoption of the broader view of corporate governance for banks. Besides, the special nature of banking requires government intervention in order to restrain the behaviour of bank management.

Depositors do not know the true value of a bank's loan portfolio as such information is incommunicable and very costly to reveal. As a consequnce of this asymmetric information problem, bank managers are prompted to invest in riskier assets than they promised they would *ex ante*. In order to credibly commit that they will not expropriate depositors, banks could make investments in brand-name or reputational capital, as these schemes give depositors confidence, especially when contracts have a finite nature and discount rates are sufficiently high. The opaqueness of banks also makes it very costly for depositors to constrain managerial discretion through debt covenants. Consequently, rational depositors will require some form of guarantee before they would deposit with a bank. Government-provided guarantees in the form of implicit and explicit deposit insurance[15] might encourage economic agents to deposit their wealth with a bank, as a substantial part of the moral hazard cost is borne by the government.

However, the special nature of the banking company also affects the relationship between shareholders and managers. For example, the opaqueness of bank assets makes it very costly for diffuse equity holders to write and enforce effective incentive contracts or to use their voting rights as a vehicle for influencing the bank's decisions. Furthermore, the existence of deposit insurance may reduce the need for banks to raise capital from large, uninsured institutional investors who have the incentive to exert corporate control.

A further issue is that the interests of bank shareholders may oppose those of governmental regulators, who have their own agendas, which may not necessarily

coincide with maximising bank value. Shareholders may want managers to take more risk than is socially optimal, whereas regulators have a preference for managers to take substantially less risk due to their concerns about system-wide financial stability. Shareholders could motivate such risk-taking using incentive-compatible compensation schemes. However, from the regulators point of view, managers' compensation schemes should be structured so as to discourage banks from becoming too risky.

Government Control and Withdrawal Effects

In India, the issue of corporate governance in banks is complicated by extensive political intervention in the operation of the banking system. Government ownership of banks is a common feature in India. The reasons for such ownership may include solving the severe informational problems inherent in developing financial systems, aiding the development process or supporting vested interests and distributional cartels. With a government-owned bank, the severity of the conflict between depositors and managers very much depends upon the credibility of the government. Given a credible government and political stability, there will be little conflict as the government ultimately guarantees deposits.

The inefficiencies associated with government-owned banks, especially those emanating from a lack of adequate managerial incentives have led governments under some pressure from international agencies to begin divesting their ownership stakes. In the case of India too, there are subtle pressures on the government from international organisations that provide development funds such as the World Bank and International Monetary Fund to withdraw their stakes in commercial banks. The divestment of government-owned banks raises several corporate governance issues. If banks are completely privatised, then there must be adequate deposit insurance schemes and supervisory arrangements established in order to protect depositors and prevent a financial crash.

On the other hand, if divestment is partial, then there may be opportunities for the government as the dominant shareholder to expropriate minority shareholders by using banks to aid fiscal problems or support certain distribution cartels. A further issue, which complicates the corporate governance of banks in India is the activities of "distributional cartels". These cartels consist of corporate insiders who have very close links with or partially constitute the governing elite. The existence of such cartels will undermine the credibility of investor legal protection and may also prevent reform of the banking system. Obviously, good political governance can be considered as a prerequisite for good corporate governance.

> The Basel Committee norms relate only to commercial banks and financial institutions. Banking and financial institutions stand to benefit only if corporate governance is accepted universally by industry and business, with whom banks and financial institutions have to interact and deal. SEBI, the Indian capital market regulator only partially attends to this need. SEBI is a functional statutory body and it can prescribe regulations only within its functions.

Review of Indian Experience in Corporate Governance

Basel Committee norms relate only to commercial banks and financial institutions. Banking and financial institutions stand to benefit only if corporate governance is accepted universally by industry and business, with whom banks and financial institutions have to interact and deal. SEBI, the Indian capital market regulator, only partially attends to this need. SEBI is a functional statutory body and it can prescribe regulations only within its ambit.

The Kumar Mangalam Birla Committee appointed by SEBI confined itself to submitting recommendations for good corporate governance and left it to SEBI to decide on the penalty provisions for non-compliance. In the absence of suitable penalty provisions, it would be difficult to establish good corporate governance in firms including banks. Some of the penalty provisions are not sufficient enough to discipline the corporates. For example, the penalty for non-compliance of the

stipulated minimum of 50 per cent in respect of the number of directors in the board that should be non-executive directors is delisting of shares of the company. This would hardly serve the purpose. In fact, this would be detrimental to the interest of the investors and to the effective functioning of the capital market.

Similarly, an audit committee, which is in perpetual conflict with the board, may result in stalemates to the detriment of the company. If a company is to function smoothly, it should be made clear that the findings and recommendations of the audit committee need not necessarily have to be accepted by the board which is accountable to the shareholders for its performance and which, under Section 291 of the Companies Act, is entitled to "exercise all such powers, and do all such things as the company is authorised to exercise and do".

Policy Implications

A broad view of corporate governance where regulation of banking activities is required is to protect depositors. In order to deal with these problems, some analysts suggest that India needs to adopt the following measures: gradual liberalisation policies enhancement in the quality of financial reporting system and improvement in investor protection laws.

Thus the special nature of banking institutions necessitates a broad view of corporate governance where regulation of banking activities is required to protect depositors. In developed economies, protection of depositors in a deregulated environment is typically provided by a system of prudential regulation, but in India such protection is undermined by the lack of well-trained supervisors, inadequate disclosure requirements, the high cost of raising bank capital and the presence of distributional cartels.

In order to deal with these problems, some analysts suggest that India need to adopt the following measures: First, liberalisation policies need to be gradual, and should be dependent upon improvements in prudential regulation. Second, India need to expend resources enhancing the quality of their financial reporting systems, as well as the quantity and quality of bank supervisors. Third, given that bank capital plays such an important role in prudential regulatory systems, it may be necessary to improve investor protection laws, increase financial disclosure and impose fiduciary duties upon bank directors so that banks can raise the equity capital required for regulatory purposes. A further reason as to why this policy needs to be implemented is the growing recognition that the corporate governance of banks has an important role to play in assisting supervisory institutions to perform their tasks and allowing supervisors to have a working relationship with bank management, rather than adversarial one.

It is an unquestionable fact that the corporate governance of banks in India is severely affected by political considerations. First, given the trend towards privatisation of government-owned banks in India, there is a need for the managers of such banks to be granted autonomy and be gradually introduced to the corporate governance practices of the private sector prior to divestment. Second, where there has only been partial divestment and government has not relinquished any control to other shareholders, it may prove very difficult to divest further ownership stakes unless corporate governance is strengthened. Finally, given that limited entry of foreign banks may lead to increased competition, which in turn, encourages domestic banks to emulate the corporate governance practices of their foreign competitors, it should be beneficial that India partially opens up her banking sector to foreign banks.

Ganguly Committee's Recommendations

To introduce corporate governance practices in the banking sector the recommendations of the Working Group of Directors of Banks and Financial Institutions, known as the Ganguly Group, will be of interest.[16]

Composition of Boards

In the selection of directors for banks, boards should be more contemporarily professional by inducting technical and specially qualified personnel. To ensure this, companies could call upon the candidates for directorship to furnish necessary information by way of self-declaration, verification reports from market, etc.

(i) Boards should be more contemporarily professional by inducting technical and specially qualified personnel. There should be a blend of "historical skill" set and "new skill" set, i.e. skills such as marketing, technology and systems, risk management, strategic planning, treasury operations, credit recovery, etc.
(ii) Directors should fulfill certain "fit and proper" norms., viz., formal qualification, experience and track record. To ensure this, companies could call upon the candidates for directorship to furnish necessary information by way of self-declaration, verification reports from market, etc.
(iii) Certain criteria adopted for public sector banks such as the age of director being between 35 and 65, that he/she should not be a member of parliament/state legislatures, etc. may be adopted for private sector banks also.
(iv) Selection of directors could be done by a nomination committee of the board. The Reserve Bank of India (RBI) also might compile a list of eligible candidates.
(v) The banks may enter into a "Deed of Covenant" with every non-executive director, delineating his/her responsibilities and making him/her abide by them.
(vi) Need-based training should be imparted to the directors to equip them govern the banks properly.

The Ganguly Committee has suggested the formation of the following committees of the board, in addition to the Nomination Committee: Audit Committee, Shareholders' Redressal Committee, Supervisory Committee and Risk Management Committee. The job of the first two committees is well known in all big corporates in India. Incidentally, the Reserve Bank has prescribed that the audit committee should be presided over by a Chartered Accountant Director, but Ganguly Committee opined that it could be done by any non-executive director.

Risk Management

Risk management has taken centre stage in any discussion on management of banks in the recent past. Banks are in the business of taking deposits, repayable virtually on demand and lending/investing the funds in sliquid assets. The action of converting liquid funds into illiquid assets, with maturity mismatches between the two, is a certain recipe for risk.

Risk management has taken centre stage in any discussion on management of banks in the recent past. To be sure, risk taking is as old as banks. Banks are in the business of taking deposits, repayable virtually on demand and lending/investing the funds in illiquid assets. The action of converting liquid funds into illiquid assets, with maturity mismatches between the two, is a certain recipe for risk. Banks have known and managed this risk fairly well over centuries of their existence. In the last few decades, however, newer varieties of risk have arisen, because, in the pursuit of high returns, banks have embraced higher risks. The risks about which many bankers are not fully familiar are in the realm of off-balance sheet commitment, market risks, interest risks and those associated with derivatives. It will not be an exaggeration to say that a vast majority of directors of banks in India are not aware of the dimension and magnitude of these risks. Since the job of banks is primarily to safeguard the interests of depositors and the shareholders, these risks should be managed professionally.

Only in respect of newer business, it is essential that the board should, with the assistance of experts in the field, lay down detailed guidelines and ask the management to report compliance at periodical intervals. Generally in risk taking, each bank will have a different level of appetite, which needs to be clearly spelt out by the board, on the basis of the recommendations of top management. Further, the review of newer businesses should be at more frequent intervals than that of established businesses.

> Banks in India have recently been asked by the RBI to adopt by 31 March 2007, a new, proactive, approach towards risk management as laid down by the Basel Committee. The details of new regulatory framework, which closely follow what are referred to as Basel II norms, are displayed on the RBI's Web site and will be of immediate relevance to banks and their regulators.

Basel II and Containing Risk

Banks in India were advised by the Reserve Bank of India to adopt by 31 March 2007, a new, proactive approach towards risk management as laid down by the Basel Committee on Bank Supervision, an internationally recognised body of bank supervisors based in the Swiss city of that name. The details of the new regulatory framework, which closely follow what are referred to as Basel II norms, are displayed on the RBIs website and will be of immediate relevance to banks and their regulators. Customers of banks and other laypeople will be more interested in evaluating the practical benefits of what promises to be a more stable financial sector once the norms are implemented. In countries with sound banking traditions including India, financial sector supervisors and banks have long followed risk-minimising practices; while appearing rudimentary in hindsight, these safeguards provided a decent measure of financial sector stability for the less challenging times. Indeed risk management, by whatever name called, has been basic to the banking business, which is more leveraged than any other comparable business. Banks create a multiplier effect by lending (and investing) more than what their level of deposits would normally permit. It is in that context that banking regulators hit upon the idea of asking banks to adjust their capital (the other critical component alongside deposits on (the liabilities side of their balance sheets) in line with their risks profile. The more risks a bank took on, the more it had to provide for by way of capital and reserves. This fairly elementary dictum has been the cornerstone of banking sector regulation over the decades.

In a globalising age, with banks dealing extensively with customers and banks in other countries, it became obvious that the supervisory strategies of particular countries had to be dovetailed to the requirements of a global strategy.

Since 1988, banks in India and a hundred other countries have followed what is now referred to as the Basel I standard—a set of regulatory rules designed to cope with the growing uncertainty in the global financial system. The immediate provocation was the spectacular failure in 1974 of the German bank, Bankhaus Herstatt, with disastrous consequences to banks and institutions on either side of the Atlantic. The Herstatt failure prompted international cooperation among bank supervisors on an unprecedented scale covering a number of areas. Basel I has been quite simple to follow. However, it seemed to adopt "a one size fits all" approach that was found wanting as supervisory complexities grew. Besides, the earlier approach did not segregate the different types of risk banks were required to take on top of the well-recognised credit risk, that is, the chances of a borrower defaulting. Risks relating to interest rate and foreign exchange volatility and other operational matters needed to be quantified and measured and ways found to contain them.[17]

The new Basel II norms address these two deficiencies. A multi-pronged strategy will recognise all types of risks and comprise measures to contain them. The new approach also recognises the need to supplement regulatory stipulation of capital adequacy requirements—still the first pillar of a more comprehensive framework—with other tools. Better regulation and inculcating market discipline among banks have come to be recognised as equally important; they constitute the second and the third pillars. The three mutually reinforcing elements, it is hoped, will have the way for a superior risk containment strategy. The relevance of all these to India is obvious. Many Indian banks are going global and those that will continue to be domestic players exclusively cannot remain isolated from a rapidly globalising system.

Risk Management and Basel II

As we have seen, the Basel Committee on Banking Supervision, at the Bank of International Settlements (BIS), was first set up to discuss global financial issues in the wake of the collapse of Bankhaus Herstatt in 1974. Basel I came into being in 1988 and changed the complexion of banking. It is early to measure the costs and benefits of the Basel II approach but it will fundamentally alter banking practices including those of the supervisor.[18]

The Basel Committee was first set up to discuss global financial issues in the wake of the collapse of Bankhaus Herstatt in 1974. Basel I came into being in 1988 and changed the complexion of banking. It is early to measure the costs and benefits of the Basel II approach but it will fundamentally alter banking practices including those of the supervisor.

With the Reserve Bank of India issuing draft guidelines, the stage has been set for banks to migrate to a new risk-management regime under the Basel II norms. The deadline was 31 March 2007 and for 1 year before that banks were expected to do a parallel run to finetune their systems and procedures. Top bankers say the transition may be relatively smooth, given that they have been sensitised to the needs of a more sophisticated risk-containment scheme thanks to the Basel I accord and the various regulatory measures introduced by the RBI in its wake. Most banks require additional capital. While reworking their capital adequacy requirements under the new guidelines, banks have to outlay more capital under certain heads and less under some other categories. This arises out of the essential difference between Basel I and Basel II approaches.

The former was quite a straight-forward "one-size-fits-all" approach; it did not distinguish between the risk profiles and management standards across banks. But under the new guidelines, banks may have to provide less for credit risks but more for operational (in fact, for the first time) and market risks (these have to be reworked more scientifically). One certain outcome will be a spate of public offerings by the government-owned banks as they try and raise additional resources. The government would naturally support such an endeavour by giving the banks, for instance, greater autonomy than now. The overriding goal of the Basel II framework is to provide adequate capitalisation of banks and encourage improvements in risk management, thereby strengthening the financial system's stability. Towards that it proposes three mutually reinforcing "pillars", which together constitute a more scientific way of estimating risks and, if need be, providing for capital. As explained earlier the first pillar strengthens the capital adequacy standards of the earlier accord. The second emphasises better supervisory review while the third attempts to incentivise market discipline.

In the long run, the Basel II norms will make banks more risk-sensitive and improve their risk-management systems. The argument that such a complex reworking of the risk-management system is not relevant to many Indian banks that have no major international presence does not stand scrutiny. Regulators worldwide are already pushing for these standards and no Indian bank can stay isolated from international developments. The Basel II framework is loaded in favour of larger banks with better systems. They can provide for lesser capital while implementing the more advanced approaches to risk containment.

Reward and Accountability of Directors

The Ganguly Committee appointed by the Reserve Bank of India has rightly observed that the present remuneration in the form of sitting fees is quite low for the work expected of directors. One way of rewarding them is to give them a share in the profits and another is to give them share options in the bank. The committee has suggested share options. Of course, there is one danger that, like some of the top managers in failed companies in the US, the board might pursue short-term profits at the expense of long-term stability; in some cases, there could be a temptation to boost profits by manipulating accounts. One possible way of

The Ganguly Committee appointed by RBI has rightly observed that the present remuneration in the form of sitting fees is quite low for the work expected of directors. One way of rewarding them is to give them a share in the profits and another is to give them share options in the bank. The committee has suggested share options.

curbing it is to stipulate a lock in period of 3 or 4 years for such share options. A question may arise as to weather the nominees of RBI and government should be entitled to such remuneration. The answer is that the Reserve Bank should not have their nominees at all, as suggested by the second Narasimham Committee on Banking Sector Reforms, because a regulator cannot don the role of a participant also. Government should preferably withdraw their nominees from boards of public sector banks and monitor performance only through periodical reports. It is a recorded fact that many such banks faced massive losses, even when government and Reserve Bank nominees were on the boards.

If directors are remunerated on the basis of their performance, they should also be held accountable for non-performance. Almost all the expert committees aver that the directors are accountable to shareholders, but none seems to spell out what it means. Peter Drucker is blunt in saying that "without financial accountability, there is no accountability at all". Thus, if the bank incurs losses over a period or faces sudden collapse, the directors should be made financially accountable. The least that can be done is to ask them to repay the bank a multiple (3, 4 or 5 times) of the money earned by them from the bank in the past few years. It is realised that this is a very crude form of fixing accountability, but a beginning ought to be made in crystallising accountability of directors in some concrete form.[19]

To sum up, effective governance of banks must have the following minimum criteria:[20]

1. The basic objective of governance should be safeguarding depositors' money and optimising shareholders' interests.
2. The directors should be competent and persons of integrity.
3. The chairman of the board should preferably be unconnected with the management of the bank.
4. Board can function through committees and Risk Management Committee assumes special importance in the context of rapid changes taking place in the financial markets. In measuring and monitoring risks, the board should enlist the assistance of experts.
5. The board should forbid banks from pursuing business which might be proper in form, but highly improper in substance.
6. As a general rule, the board should ask the management to spell out as to when a transaction, especially in derivative products, could result in losses and take a view on the probability of incurring the losses. On the basis of the overall risk appetite of banks, the transaction may be approved or rejected.
7. Suitable risk and reward system should be put in place for the directors of banks.

CONCLUSION

After a decade of reforms and being at the crossroad of challenges and opportunities in the wake of the Basel II related changes, how has Indian Banking fared in comparison to its emerging market counterparts? Bandi Ram Prasad, Chief Economist, BSE, (Stock Exchange Mumbai) has come to the following conclusion:[21]

"A major outcome of the reforms in Indian banking is that the focus and emphasis has expanded from issues of viability and profitability that were prominent a decade ago to aspects of competition, consolidation and convergence that have emerged as current concerns. These are critical from the point of view of enabling Indian banks to face international competition and acquire influence in the world of finance."

How Indian banking has grown in size and stature compared to other emerging markets, in particular to BRICS: The share of top Indian banks (those included in the top 1000 banks published by Banker,

London) in Tier One capital of the top 25 banks in the world moved up sizeably from 0.88 per cent in 1993 to 1.96 per cent in ’04, whereas in respect of assets the pace was rather slow; from 1.29 per cent to 1.65 per cent during this period. India’s performance stands out when compared to that of banking systems in BRICS. There is a sizeable erosion of the share of top banks in Brazil and South Korea and with Chinese banks the position remained relatively unchanged which shows that among the banking systems in BRICS, it is India which showed sizeable growth.

Moving to another parameter of how the top bank in India fared against the top bank in selected countries during this period reveals interesting trends. Indian banks have made impressive gains in Tier One capital compared to major banks in the world. For instance; the top bank in India (SBI) in respect of Tier One Capital in 1993 was just 9 per cent of the top bank in Brazil, which by ’04 became 135 per cent. Similar trends were evident in respect of top banks in other countries such as Korea 28 per cent (95 per cent), the USA 7 per cent (9 per cent); the United Kingdom; 5 per cent (12 per cent), Japan 3 per cent (17 per cent); Canada 10 per cent (50 per cent) and Australia 12 per cent (48 per cent). Bracketed figures are for ’04. Tier One capital growth in India is significant when compared to Chinese banks also.

Higher growth in capital but lower growth in assets; sizeable gains as compared to emerging market but a growing gap in relation to mature markets are the major trends evident from India. Three major imperatives that emerge include; enable banks to grow in size, expand the realm of activities these could undertake and sustain the current policy thrust of growth, profitability and productivity.

KEYWORDS

- Basel Committee
- Composition of Boards
- Implementation of Basel II
- Policy implications
- Reward and accountability
- Risk management
- Sound governance practices
- The role of supervisors
- Unique nature
- Withdrawal effects

DISCUSSION QUESTIONS

1. Why is it necessary that corporate governance is more important in banking companies than in others?
2. What does the World Bank have to say about corporate governance? Analyse the bank’s report on corporate governance critically.
3. Comment on the regulations brought forth by the Basel Committee on corporate governance.
4. Discuss the sound corporate governance practices, as recommended by some of the prominent committees on corporate governance.
5. What are the salient features of Basel II recommendations?
6. Make a critical analysis of corporate governance and Indian banks.

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Case Study

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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PART THREE

FACILITATORS, ROLE PLAYERS AND REGULATORS

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10

Business Ethics and Corporate Governance

CHAPTER OUTLINE

- Introduction
- Importance and Need for Business Ethics
- The Indian Context
- Roots of Unethical Behaviour
- Some Unethical Issues
- Corporate Governance Ethics
- How Ethics Can 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 shareholders, employees, customers, dealers, vendors, 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 workers' rights and living wages as in Rerum Novarum of Pope Leo XIII. Some of the Protestant seminaries developed ethics as 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 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.

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, trust in supplier relationships, trust in employee relationships and 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 external stakeholders, then we can call that company as an ethical company.

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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 sometime why even educated, well-positioned managers or employees of some reputed companies act unethically. This is because of 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, etc. 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 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, 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 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 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 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, shareholders, 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) lax government structures and regulations; (iv) sanctions and discriminations in society that can be offset with accumulation of wealth by fair or foul means; (v) uncertainties and fears about the future; (vi) strong family traditions and laws of inheritance in which parents want to leave substantial assets to their progeny; (vii) 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 70s of last century) which discourage 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 corproates in 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 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 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

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.

People often wonder why employees indulge in unethical practices such 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, 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]

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 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?

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.

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.

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, few of them are given below:

Most people want to be ethical in their issues.

- 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 towards 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.

Ethical Decision Making

Ethical decision making is a very tough prospect in this dog-eats-dog world. However, in the long run, all will have to fall in and play fair. The clock is already ticking for the unscrupulous corporates. In this age of liberalisation and globalisation, the old dirty games and unethical conduct will no longer be accepted and tolerated.

Norman Vincent Peale and Kenneth Blanchard in their book, "The Power of Ethical Management", have prescribed some suggestions to conduct ethical business.

- Is the decision you are taking legal? If not legal, it is not ethical.
- Is the decision you are taking fair? In other words, it should be a win-win-equitable risk and reward.
- The Eleventh Commandment —"Thou shall not be ashamed when found", meaning when you are hauled up over some seemingly unethical behaviour, if one's conscience is clear, then there is nothing to be ashamed of.

How Corporates Observe Ethics in Their Organisations?

Organisations have started to implement ethical behaviour by publishing in-house codes of ethics which are to be strictly followed by all their associates. They have started to employ people with a reputation for high standards of ethical behaviour at the top levels. They have started to incorporate consideration of ethics into performance reviews. Corporations that wish to popularise good ethical conduct have started to reward ethical behaviour. Codes promulgated by corporations and regulatory bodies continue to multiply. Some MNCs like Nike, GM and IBM and Indian Companies like Infosys, ICICI, TISCO, ONGC, Indian Oil and several others want to be seen "socially responsible" and have issued codes governing all types of activities by their employees. SEBI, the capital market regulator, CII, Assocham, and such organisations representing corporates have issued codes of best practices and enjoin their members to observe them. These normative statements make it clear that corporate leaders anxious for business growth should not make plans without looking at the faces and lives of those oppressed by poverty and injustice. In fact, today managers and would-be entrepreneurs are groomed to be ethical and socially responsible even while being educated. The Indian Schools of Management (IIMs) and highly rated B-schools like the Xavier Labour Relations Institute (XLRI) and the Loyola Institute of Business Administration (LIBA) have core courses in their curriculum and give extensive and intensive instruction in business ethics, social responsibility and corporate governance. Many corporations conduct an ethics audit and, at the same time, they are continuously looking for more ways to be more ethical.

Some Unethical Issues

As we discuss business ethics, it is necessary to address the ethical 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, etc. 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 Boeing and 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 GE is worth mentioning, "No matter how high the stakes are, no matter how great the 'stretch is', 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, 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 Boeing or the recipient. An employee may never use personal funds or resources to do something that cannot be done with Boeing resources. Accounting for business courtesies must be in accordance with 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.

Insider Trading

This is one form of misuse of 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 ruin 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 channellise 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

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 the honesty and integrity, avoiding actual or apparent conflict of interest in personal and professional relationships.

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. JRDs' 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 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 Tata Steel: a profit-sharing bonus and a joint consultative council. 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. Swaminathn Research Foundation was created in furtherance of his desire.[17]

Corporate Governance Ethics

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 Rugveda 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 with 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 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, 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 better co-operation and 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 would lead 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 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 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 individuals assuming personal responsibility for actions of the organisation. These organisations' ground rules 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. Minimised bureaucracy and control paves 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 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 cerates 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 organisations' goal. 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 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.

How Ethics Can Make Corporate Governance More Meaningful?

(i) Corporate governance is meant to run companies ethically in a manner such that all stakeholders—creditors, distributors, customers, employees, the society at large and governments—are dealt in a fair manner.

(ii) Good corporate governance should look at all stakeholders and not just shareholders alone. Otherwise, a chemical company, for example, can maximise the profit of shareholders, but completely violate all environment laws and make it impossible for the people around the area to lead a normal life. Ship-breaking in Valinokkam, near Arantangi in Tamil Nadu, leather tanneries in South Arcot and hosiery units in Tirupur, have brought about too much of environmental degradation that has unleashed untold miseries to people in and around their locations.

(iii) Corporate governance is not something which regulators have to impose on a management, it should come from within. There is no point in making statutory provisions for enforcing ethical conduct.

(iv) There is a lot of provisions in the Companies Act, for example, in dealing with the following issues: (i) disclosing the interest of directors in contracts in which they are interested; (ii) abstaining from exercising voting rights in matters they are interested; and (iii) statutory protection to auditors who are supposed to go into the details of the financial management of the company and report the same to the shareholders of the company. But most of these may be observed in the letter, but not in spirit. Members of the board and top management should ensure that these are followed both in the letter and spirit.

(v) There is a number of grey areas where the law is silent or where regulatory framework is weak, which are manipulated by unscrupulous persons like Ketan Parikh and Harshad Mehta. In the US, for instance, the courts recognise that new forms of fraud may arise, which may not be covered technically under any existing law and cannot be interpreted as violating any of the existing laws. For example, a clever conman can try to sell a piece of the blue sky. In order to check such crooks, there is the concept of the "blue sky" law. However, such wide-ranging process are not available to courts in developing countries.

(vi) The Securities and Exchange Board of India (SEBI) has jurisdiction only in cases of limited and listed companies and are concerned only with their protection. What about the shareholders and others of other unlisted Limited companies?

(vii) The Serious Fraud Investigation Office (SIFO) in the Department of Corporate Affairs (DCA) has been investigating several "Vanishing Companies". By 2003, SEBI has identified 229 as "vanishing companies"—which tapped the capital market, collected more than Rs. 800 crores from the public and subsequently became untraceable. However, thousands of investors have lost their hard-earned money and no agency has come to their rescue so far.

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 other 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 present day's environment the value based management and 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
- Corporate excellence
- Corruption
- Decision-making
- Ethical education
- Ethical organisations
- Ethical practices
- Ethics in organisations
- Ethics within organisation
- Evolution of ethics
- High productivity
- Insider trading
- Negative image
- Pollution
- 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 relevance of ethics while conducting business.
3. Do you find a contradiction between running profitable business and following 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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Case Study

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 unco-nsolidated 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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11

Corporate Social Responsibility

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 it 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.

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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.

Corporate Social Responsibility and the Stakeholder

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 human capital, the environment and relations with stakeholders.

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.

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 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 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.

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.

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 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).

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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.

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.

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.

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.

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.

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.[9]

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.

*(**Source:** Adapted from K. M. Mittal : Social Responsibilities of Business: Concepts, Areas and Practices (Delhi: Chanakya Publications, 1988), p. 189–260.)*

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.

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Case Study

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?

SUGGESTED READINGS

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12

Environmental Concerns and Corporations

CHAPTER OUTLINE

- 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

Introduction

Given the increasing awareness among people worldwide on the issue of global warming and its attendant problems, the importance of environmental preservation through better state and corporate governance practices cannot be overstressed.

In this chapter, we trace the history, importance and significance of environmental governance and study the role state which is enjoined to play an active role to protect, preserve and nurture all creatures—human being, the flora and fauna and also to maintain ecological balances for the good of all mankind. In this role, governments worldwide are assisted by the environment-conscious public, media, environmental groups and corporations. Corporations have a special responsibility to bear—they having been the major cause for the environmental degradation. They have a stake in preserving the environment and the ecology for posterity. This chapter also discusses the health and productivity consequences of environmental damage, industrial pollution, role of corporates in environmental management and measures to improve their performance in this direction, and in conclusion, discusses India's Environmental Policy.

Corporations have a stake in preserving the environment and the ecology for posterity. There is a clear appreciation today than ever before that environmental quality is an important desideratum in the social and economic development of nations.

Environmental Concerns

It is well known that contemporary environmental problems are serious, but the specific issues, consequences and priorities are vaguely defined and much less explained. However, there is a clear appreciation today than ever before that environmental quality is an important desideratum in the social and economic development of nations.

The growth of consumerism, leading to the high rate of consumption of natural resources, is at the heart of many environmental problems. Traditionally, industry has been driven by consumer demand to produce goods efficiently, regardless of the consequences. Regulation and innovation are changing this system, but yet have not solved the problems. The need to have clean air and water, fertile soil, biodiversity and the overall cleaner world for the people to live in, are all stressed to ensure the health of the global environment. Environmental problems thus continue to pose challenges and opportunities to business as they have for several decades.

History of Environmentalism

Over the last century, many activists, writers and policy makers have stirred debate about the environment. Since the rapid development of the Industrial Revolution, human activity has taken an increasingly heavy toll on natural resources. As early as the turn of the 20th century, the importance of natural resource conservation led to the establishment of National Parks by Teddy Roosevelt's administration. Later, during the 1960s, the human health risks posed by pollution raised much concern Slowly, the concept of environmentalism evolved as attitudes about human impacts on air, water, forests and other aspects of the environment did.

Increasing awareness and consequent concern on these issues were fuelled by informed public sentiment, media coverage, corporate attitudes and government policy. Public protest of air and water pollution led to the passing of many environmental laws by the US Congress and to the creation of the Environmental Protection Agency's (EPA) community-led recycling programmes and protest against polluting businesses in "Not in My Backyard" (NIMBY) campaigns are two examples of how environmentalism has impacted industrial activity. Activists

As early as the turn of the 20th century, the importance of natural resource conservation led to the establishment of National Parks by Teddy Roosevelt's administration. Later, during the the human health risks posed by pollution raised much concern in 1960s. Slowly, the concept of environmentalism evolved as attitudes about human impacts on air, water, forests and other aspects of the environment. Public protest of air and water pollution led to the passing of many environmental laws by the US Congress and to the creation of the Environmental Protection Agency.

have encouraged industry to change practices and innovate in order to improve environmental quality.

Widespread support for environmental protection is a relatively new phenomenon. An enhanced perception of an impending crisis has caused in recent times a spate of law-making, technological innovation, improvisation and even bureaucratic evolution. During the last three decades, businesses have had to respond to many new regulations which have both posed challenges and opened opportunities. However, the interaction of different stakeholders has brought out both strengths and weaknesses of democratic decision making in a capitalistic economy.

The economic implications of environmental problems have been key issues throughout the history of environmentalism. Michael Silverstein argues that environment and economic goals are not irreconcilable.[1] He cites historical evidence dating back to the Industrial Revolution demonstrating that business and environmentalists are not inherently in conflict as they are often perceived to be. The principles of industrial resource use and environmental conservation, he argues, are compatible in that each one focusses on sustainability.

While activists have done much to publicise environmental problems, disasters such as Bhopal, Three Mile Island and Exxon Valdez, and books, such as Rachael Carson's "Silent Spring" have all raised public awareness of the health hazards of pollution and environmental degradation. This realisation has resulted in an increased demand for industry disclosure and accountability. In many cases, increased awareness, regulation and changed practices have resulted in improved environmental quality. However, many challenges remain unresolved. Moreover, there is also a perceptible shift over time from confrontational activism to co-operative problem—solving among stakeholders.

Environmental Philosophy

Environmental philosophy takes a variety of forms and stances, each with some merit, and all adding to our understanding of the relationship between human beings and the environment. A fundamental aspect of environmentalism is that the players who are involved in it are also often motivated by different philosophical approaches to the natural world. By gaining an insight into the ideologies underlying the environmental movement, we can understand the arguments and stances of the players involved. Environmental philosophy is also important since it is useful in changing attitudes towards the environment.

Environmental philosophy takes a variety of forms and stances, each with some merit, and all adding to our understanding of the relationship between human beings and the environment. A fundamental aspect of environmentalism is that the players who are involved in it also are often motivated by different philosophical approaches to the natural world. Environmental philosophy is also important since it is useful in changing attitudes towards the environment.

John Bellamy Foster in "Global Ecology and the Common Good" argues that only a change in common morality will help alter the present means of production and mass consumption, which will otherwise lead to ecological collapse sooner than later. He further argues that the self constructive levels of consumption in developed societies can be curbed by shifting to a more holistic perception of the natural environment. "Nature" according to him should be included as a member of the moral community.

Marisa J. Mazzotta and Jeffrey Kline in "Environmental Philosophy and the Concept of Non-use Value" argue that ideas from various environmental philosophies should be incorporated into economic policy formulation. This is because resource economics, traditionally fails to effectively measure non-use values. This leads to a dilemma in that some natural resources lack an easily measurable monetary value, but are important to ecosystems. According to them the ideologies of anthropocentrism, conservationism, preservationism, biocentrism, ecocentrism, deep ecology, social ecology and eco-feminism are all frameworks applicable to the relation between environment and economics.

Another issue in environmental debates address the legal rights of nature. Joel Schwartz in his article "The Rights of Nature and the Death of God" poses the question as to who should represent nature in a democracy, self-appointed environmentalists or elected officials? The practical implementation of environmental philosophy in the debates of public policy and regulation may be the key to natural resource conservation.

Perhaps the most famous work in environmental philosophy is that of Aldo Leopold who in his book "A Sand Country Almanac, 1948" related his ideas that radically alter the framework in which humans relate to the environment. His concern about environmental degradation led him to argue that nature must be protected both legally and morally. Leopold was an expert in natural resource in management who realised the consequences when human beings are alienated from their natural surroundings. His call for the inclusion of "nature" in the moral community was an argument for preserving the environment for its own sake, not simply for human use.

Environmental Preservation: Role of Stakeholders

Preservation of a healthy environment and ecological balances is everybody's concern. To promote environmental awareness among the people we need the help of different stakeholders to achieve such environmental preservation. These stakeholders are the public, the media, environmental groups, corporations, and the government.

Public Opinion

Public opinion is crucial to the resolution of environmental issues in a democratic society. The public has the power to support interest groups, elect and lobby officials, pay taxes, work for companies, buy products and support or reject policies.

> Public opinion is crucial to the resolution of environmental issues in a democratic society. Public has the power to support interest groups, elect and lobby officials, pay taxes, work for companies, buy products and support or reject policies. The effects of pro-environment public sentiment are evident in many business and government sectors.

In the US, many polls were conducted to determine what the public thought about various issues, and the results were carefully monitored by incumbent politicians. These results indicated that after decades of being on the fringe, environmentalists had succeeded in making many of their points. There is acceptance among the populace that something must be done about environmental problems.

The effects of pro-environment public sentiment are evident in many business and government sectors. Bhushan Bahree and Kyle Pope in their article "Giant Outsmarted" identified the direct correlation between public opinion and environmental policy. They describe how Greenpeace stopped Royal Dutch Shell from scuttling an oilrig in the Atlantic Ocean by organising public protest throughout Europe. The pressure was so much that it forced Shell to alter its policy and dismantle the rig on land at a substantial cost to the corporation. This is a classic example where public pressure compelled a giant corporation change its policy. Here, the perceived risk of environmental damage took precedence over economic considerations thanks to the strong public opinion.

The public perception of environmental risk continues to be a driving force in the US politics. According to Thomas A.W. Miller and Edward B. Keller, health concerns are the primary motivation for public alarm. In their article, "What the Public Wants", the authors describe how specific language that is used to inform the public has a direct effect on their response. One example involves the use of "non-hazardous" or "hazardous" in the description of a waste site. The ambiguous use of these terms can convey an inaccurate sense of the danger to a surrounding community. Besides, the correlation between human and ecological health is often

poorly understood. More public education on environmental issues is required. Communication of problems to the public must improve to build consensus and understanding on vital environmental issues.

The Media

The role of the media in the dissemination of information to the public on issues of grave importance cannot be overstressed. News publications and journals, television and radio are the source of information to the public on environmental issues.

Trends in environmentalism are important to journalism. Studies have shown that positive news about the environment has received considerably less attention than negative news in recent years. This situation is changing and headlines may soon announce the environment-friendly deeds of corporates which may provide valuable publicity to improve their competitiveness in a society that is increasingly conscious of environmental issues. To ensure that the media provides balanced information, it is important for business to play a proactive role in information dissemination. It is a fact that as with many issues, a lack of objectivity often pervades environmental journalism. It is an irrefutable fact that the media wields considerable influence over public perception of environmental groups, corporations and the government.

Environmental Groups

Environmental advocacy groups have evolved considerably from the liberal, anti-business, anti-government periphery of past decades. While some radical groups do remain, many moderate or conservative groups are cooperating with business and government. The role of some groups is shifting from merely bringing attention to environmental issues to working to solve problems.

Many environmental advocacy groups have evolved considerably from the liberal, anti business, anti-government periphery of past decades. While some radical groups do remain, many moderate or conservative groups are co-operating with business and government. The role of some groups is shifting from simply bringing attention to environmental issues toward working to solve problems. These organisations are often a reliable source of information and support and represent public sentiment.

Since environmental groups vary greatly in scale, scope and philosophy, it is difficult to discuss them as a distinct entity. Some of the familiar major groups are: Conservation International, Greenpeace and Environmental Defense Fund. These groups play a significant role in environmental issues and must be taken seriously by decision makers in business and government. Cooperation with these groups is essential in the next phase of the movement: industry innovation. Environmentalists are important both as a source of information and as representatives of public interest, though there are substantial obstacles to co-operation, including conflict of interest, compliance, and the size of companies.

In addition to environmental groups, there are also organisations that are opposed to environmental regulation, the so-called “wise-use” movement. The Competitive Enterprise Institute (CEI) supports free markets and limited government by opposing most environmental statutes and policy. The group frequently criticises the EPA for using inexact science and inefficient protection measures. It is important to recognise that government environmental policy is not perfect. All stakeholders are responsible for working toward a consensus for effective decision-making on these issues.

Corporations

Corporations had been known in the past to be traditionally unsympathetic to environmental problems The pollution and degradation caused by industrial activities in the 19th and 20th centuries created many of these problems in the first

place. As a result of pressure from environmentalists and regulatory legislation, many companies have altered their stance and innovated their policies. In fact, many firms now work proactively to improve environmental quality. This relatively recent phenomenon continues to develop as environmental issues gain the attention of more business professionals.

The key shift occurring in the environmental regulation of industry is *from an emphasis on pollution control to an emphasis on pollution prevention*. With forethought and ingenuity, the goal of the latter idea is to eliminate pollution before it is produced by innovating processes. Environmentalists encourage corporate investment in technologies to reduce the use of contaminants in industrial production. Therefore, there are now many voluntary business initiatives which promote pollution prevention by improving efficiency in production. This approach is popular because corporations can cut costs while improving environmental quality.

The development of corporate environmental policy has ranged from incremental changes to comply with regulations, to substantially innovating processes. It is the latter formulation that was extolled by Stephan Schmidheiny at the UN Earth Summit in 1992. In many cases it has been found that sound environmental policy can parallel the interests of corporations.

The shift of corporate attitudes is key to environmentalism. Dow Chemical, a corporation that dominates an often criticised industry, is a notable participant in corporate stewardship. Consumer and legal pressures have been important incentives for Dow to develop its environmental policy. Is is now a top priority for this corporation to improve its environmental record. The example of Dow serves as evidence that environmental concerns are urgent and are appropriately being included near the top of the corporate agenda.

In the near future, companies that refuse to “go green” will be unable to survive in an environmentally conscious marketplace. Therefore, it is vital that corporate leaders learn to promote resource preservation through reducing waste and maximising resources while improving profits.

The stance of corporations is shifting toward being proactive stakeholders seeking sustainable solutions. Industry has traditionally been at odds with environmentalists, but the paradigm is changing. Holistic management of natural resources and the necessity of response to public concern are playing a greater role in corporate strategy.

Government

The implementation of effective environmental policy has been obstructed by many factors: inadequate scientific knowledge, budgetary deficiency and conflict between disparate interests. The electoral cycle and public emphasis on a sound economy force environmental issues into a political arena which does not always lend itself to timely decision-making. The Environmental Protection Agency, for example, often has difficulty improving environmental quality when its activities are perceived to hurt the economy. While environmental protection is a broadly supported idea, the reality of its costs are unpopular.

Effective environmental policy has been obstructed by many factors—inadequate scientific knowledge, budgetary deficiency and conflict between disparate interests. The electoral cycle and public emphasis on a sound economy force environmental issues into a political arena which does not always lend itself to timely decision-making. The Environmental Protection Agency, for example, often has difficulty improving environmental quality when its activities are perceived to hurt the economy.

The economic costs of environmental regulation have been criticised by the private sector, and usually the Environmental Protection Agency (EPA) is the target of reproach. While the EPA has come under attack for costly litigation and inefficient regulatory policy, it has been instrumental in monitoring the polluting emissions of industry. The agency is still developing its role in public policy and improving environmental quality.

Many stakeholders who advocate or oppose environmental protection seek to influence the government. Even with firm leadership, effective environmental policy will take time to develop in government. The inexactness of environmental

science and costs to the economy are key obstacles to developing an effective and efficient environmental policy.

The stakeholders in environmental issues play important roles in policy formulation. Government directives can prevent some of the most egregious environmental damage from occurring, but lasting solutions will take co-operation from all actors. Partnerships at a local, regional or global level may be the best way for stakeholders to participate in joint efforts to resolve environmental issues.

Future Outlook on Environment

Environmentalism in the 21st century can be characterised by three principles that serve as bases for continued activism and policy formulation. The first is partnerships, an integrated strategy that brings disparate interests together in a cooperative forum to resolve environmental issues. The second is international cooperation which is growing in response to the crisis of global environment. The third is sustainable development.

Environmentalism in the 21st century can be characterised by three principles that will serve as bases for continued actvism and policy formulation. The first of these is partnerships, an integrated strategy that brings disparate interests together in a co-operative forum to resolve environmental issues. This “common sense” approach is proving to be a practical and effective way to address natural resource concerns. Corporations taking this approach benefit from the knowledge and experience of their partners. The second development fundamental to future environmentalism is international co-operation which is growing in response to the crisis of global environment. Environmental issues have reached the world agenda in United Nations programmes, world conferences and international agreements. The third principle that has evolved as a new foundation for environmentalism is sustainable development, a model for conservation which focusses on natural resources consumption. For economic development to be sustainable, the needs of the present must be met without compromising the ability of future generations to meet their own needs. This task will require a fundamental shift in the world economy to limit natural resource consumption and environmental degradation.

Partnerships

Recent co-operation between stakeholders on environmental issues is promising evidence that pressing environmental problems can be resolved. Partnerships are voluntary collaborations between two or more organisations with a jointly defined agenda focussed on a discrete, attainable, and potentially measurable goal. The “life-cycle” of partnerships involves an integrated relationship between stakeholders throughout the decision and implementation process.

It is evident that both corporate and environmental stakeholders gain benefits from co-operation. Dominance of business interests cannot be undermined, but NGOs (Non-governmental Organisations) can maintain substantial influence in the decision-making process by understanding the goals of corporations.

Further evidence of the importance of partnerships is the growing practice of corporations to seek the assistance of NGOs to preserve endangered species in their areas of operation and by pooling the assets of stakeholders and co-operatively reaching a solution.

Partnership may also be an effective way for the government to tap the resources of expertise that exists in environmental groups.

International Issues

Many environmental issues are international by their very nature. These include cross-boundary pollution, common area resources and economic development. Traditionally, state sovereignty and self interest took precedence over the resolution of global problems. In recent decades, an integrated world economy

has emerged which is dominated by multinational corporations. The resulting economic interdependence of nations fosters co-operation in resolving international issues. The worldwide recognition of an ecological crisis has moved the global environment higher on the international agenda. The absence of international government, competition between nations and the complexity of international relations all remain as obstacles to global environmental policy.

The United Nations Conference on Environment and Sustainable Development in 1992 though not the first of its kind, was a major breakthrough for environmentalists. The meetings held in Rio were divided into three levels: government leaders, corporations and NGOs. Each group debated issue of social justice, property rights, North-South relations, forest principles, development, biodiversity, responsibility and technology transfer. While it is significant that world leaders address global problems such as ozone depletion and common area resources, lack of funding remains as an obstacle to permanent solutions. The key success of the Conference was that the environment became a priority on the global agenda.

Sustainable Development

A very significant concept underlying international and domestic environmental policy is sustainable development. Its goal is to ensure that the natural resource needs of the present are met without compromising the ability of future generations to meet their own needs. The implication is that there are limitations to the earth's carrying capacity in the light of present levels of technology, social organisation and population.

A very significant concept underlying international and domestic environmental policy is sustainable development. Its goal is to ensure that the natural resource needs of the present are met without compromising the ability of future generations to meet their own needs.

The evolution of ideas about sustainable development has been substantial, but the next step is to generate effective policy initiatives. While it is clear that current economic practices are unsustainable it is an undeniable fact that developed countries have the knowledge to operate sustainably. The key will be for government and corporations to change practices in shifting to a more efficient model of resource use.

A contradiction of popular opinions about sustainable development is offered by William Nitze in "The Economic Case for Sustainable Development". The author argues that sustainable practices are no more costly than current industrial processes and that the actual barriers to change are inadequate information, training and incentive. He claims that cleaner technologies are very competitive and that public development institutions should attempt to stimulate innovation, rather than dole out funds for incremental costs. He further argues that organisations like the Global Environment Council (GEF), should change the manner in which they help developing countries to focus on sustainability.

Environmentalism in the 21st century is likely to be characterised by various efforts to implement the sustainable development agenda. International organisations, such as the United Nations and World Bank, will be integral to the development of effective global environmental policy. The questions of financing sustainable development, technology transfer and corporate interests need resolution if lasting change is going to take place.

Corporations maintain a dominant role in these issues, those that adopt a proactive stance in environmental stewardship are likely to compete well in the world economy in the years to come.

Costs and Benefits of Environmental Regulation

Environmental regulations are often criticised as being too costly for business. Certainly protecting environmental quality is an expensive task for many regulated industries. Beyond higher costs for individual firms, however, many people argue

that the high level of environmental regulation hurts a country's competitiveness in the world market. Some economists have countered that strict environmental regulation may actually enhance a country's competitiveness by fostering innovation. It is evident that forward-thinking firms can turn environmental regulations to their advantage. They argue that clean business practices are more efficient, and therefore, profitable. It is also important to realise that not all firms are affected equally by environmental regulations.

The effect of regulation upon an economy as a whole remains unclear. Many economists feel that environmental regulations raise the price of inputs, putting businesses at a competitive disadvantage in the world economy and hindering growth. Others argue that forward-thinking regulations in the US encourage firms to innovate, which keeps America at the forefront in technology enhancing US competitiveness. Michael Porter is the leading proponent of the pro-regulation view. He outlines his major arguments in "Green and Competitive". Regardless of the validity of either competitiveness argument, business people should view regulations as an opportunity to gain an advantage for their individual firms.

Trade and the Environment

Historically, nations have had widely varying environmental protection standards. With the increasing recognition that natural resource degradation is a global concern, countries have now begun to negotiate agreements on environmental issues. The lack of standardisation of environmental regulations between countries has complicated trade issues. For this reason, the International Standards Organisation is taking its success in quality standards with the ISO 9000 series to environmental issues. The new standards, called ISO 14000 will have a major impact upon businesses that wish to appear "green."

Historically, nations have had widely varying environmental protection standards. With the increasing recognition that natural resource degradation is a global concern, countries have now begun to negotiate agreements on environmental issues. The first such agreements such as the 1987 agreements, however, have reflected the growing recognition that international trade and environmental protection are intrinsically linked. In the future, any firm with international dealings will have to take environmental issues into consideration.

Because countries have different environmental standards, firms looking to market their services abroad may find it hard to convincingly demonstrate their environmental responsibility to green consumers. The lack of standardisation of environmental regulations between countries has complicated trade issues. For this reason, the International Standards Organisation is taking its success in quality standards with the ISO 9000 series to environmental issues. The new standard, called ISO 14000 has a major impact upon businesses that wish to appear "green".

To help standardise environmental regulations around the world and facilitate collective action on pressing environmental issues, nations have begun to negotiate treaties for the protection of natural resources. The Montreal Protocol is a good example of an international environmental agreement. From an environmental perspective, these international agreements can be very effective in protecting natural resources. Treaties focussing solely on the environment however may not necessarily take economic concerns into due consideration. The resulting costs according to economists may be too high.

In the pursuit of free trade, the world has generally moved towards lowering national trade barriers. National environmental standards, however, can be used as informal trade restrictions requiring that products meet certain restrictions. However, since environmental standard vary widely from country to country, those countries with the highest environmental standards are seen as protectionist. Both environmentalists and free-traders are concerned about the effects of pure trade agreements, such as the GATT Treaty.

The North America Free Trade Agreemnt (NAFTA) is one of first major trade agreements to seriously integrate environmental concerns into trade considerations. Their treaty requires the US, Mexico and Canada to implement pollution prevention strategies and to pursue sustainable development. Future trade agreements will follow NAFTA's lead and promote prudent use of natural resources.

Industrial Pollution

India's Toxic Corridor

The road from Ahmedabad to Mumbai runs through what the rulers of Gujarat proudly refer as the "Golden Corridor" of Chemical Industries. Others know it as the armpit of industrial civilisation in India as the cancer corridor or the toxic corridor.

At least 2000 industries compete for resources in this narrow belt of land hemmed-in by gently sloping hills on the one side and the Gulf of Khambat on the other. Virtually all the rivers—Sabarmati, Mini, Tapi Narmada, Par, Kolak. Damanganga—that enter the corridor leave carrying lethal loads of industrial poisons. A July 2000 World Bank sponsored State Environmental Action plan report lists sections of all these rivers as "critically polluted". That means the rivers are close to losing all capacity to sustain life. The same report also indicates that the groundwater in at least 74 out of 184 talukas in Gujarat is poisonous because of industrial pollution. Another estimate cited by a high powered committee of the Supreme Court says an alarming 70% of Gujarat's water resource is now contaminated by industrial pollution.

Evidence of Pollutants

The carrying capacity of the land in this part of the country is visibly strained and that is telling on the lives of the people living in these areas.

- Villagers in Haria, Umarsadi, Sarigam, Kolak, Ankleshwar and Sarangpur complain that groundwater containing industrial poisons is affecting their health and causing falling agricultural yields.
- Environmental surveys conducted by Greenpeace confirm the widespread presence of industrial poisons in the environment, including dangerous levels of heavy metal and persistent organic pollutants.
- Emerging evidence indicates that the pollutants have entered the human food chain through vegetable and fish from the region.
- Reports from villages surrounding Vapi, Atul and Ankleshwar claim that infertility is on the rise, that young women suffer from frequent miscarriages; and that respiratory and skin diseases are commonplace.
- In Kolak village, which is sandwiched between the Damanganga and Kolak, both of which are polluted by the Vapi industries, villagers report more than 70 cancer fatalities in 10 years.
- The Mitna Machhi, an adivasi community that sustained itself by gathering fish and mud-skippers from muddy river banks, is now supportless because mud-skippers are locally extinct owing to pollution.[2]

Natural Environment and Business

Role of Corporates in Environmental Management

Industry is the world's foremost creator of wealth, employment, trade and technology, controlling and deploying tremendous amount of human and financial resources for economic value addition. It is industrial and business processes that add value to natural resources as these transform them from raw gifts of

TABLE 12.1 Principal health and productivity consequences of environmental damange

Environmental problems	*Effects on health*	*Effects on productivity*
Water pollution and water scarcity—water contaminated by industrial waste and toxic chemicals.	More than 2 million deaths and billions of illnesses a year attributable to pollution; poor household hygiene and added health risks caused by water scarcity.	Declining fisheries; rural household time and municipal costs of providing safe water; aquifer depletion leading on economic activity because of water shortages
Air pollution—caused by energy use, vehicular emissions and industrial production.	Many acute and chronic health impacts: excessive urban particulate matter levels are responsible for 300,000–700,000 premature deaths annually, and half of childhood coughing, 400 million–700 million people, mainly women and children in poor rural areas, are affected by smoky indoor air	Restrictions on vehicle and industrial activity during critical episodes: effect of acid rain on forests and water bodies
Solid and hazardous wastes caused by uncollected wastes in cities.	Diseases spread by rotting garbage and blocked drains. Risks from hazardous wastes typically local but often acute	Pollution of groundwater resources
Soil degradation caused by excessive human activity	Reduced nutrition for poor farmers on depleted soils; greater susceptibility to drought	Field productivity losses in range of 0.5–1.5% of gross national product (GNP) common on tropical soils. Offsite siltation of reservoirs, river-transport channels, and other hydrologic investments
Deforestation—due to industrial pollution, also for living space, firewood, plantations, etc.	Localised flooding, leading to death and disease.	Loss of sustainable logging potential and of erosion prevention, watershed stability, and carbon sequestration provided by forests
Loss of biodiversity—excessive human activity	Potential loss of new drugs	Reduction of ecosystem adaptability and loss of genetic resources
Atmospheric changes—emission of green house gases into the atmosphere and ozone depletion.	Possible shifts in vector-borne diseases; risks from climatic natural disasters; diseases attributable to ozone depletion (perhaps 300,000 additional cases of skin cancer a year worldwide; 1.7 million cases of cataracts)	Sea-rise damage to coastal investments; regional changes in agricultural productivity; disruption of marine food chain

Source: World Bank, World Development Report, 1992 (New York; Oxford University Press, 1992)

nature into useful products. Industry today, carried on by giant corporations, is synonymous with the big corporation. Big corporation is powerful enough to influence any situation, be it developmental or environmental. But the mantle of the big producer, creator of wealth and promoter of industry and commerce worn by the big corporation since the 18th century has been discarded in following the so-called 'green philosophy'. Often blamed for producing massive amounts of waste in an endeavour to produce wealth, they are now expected to become protectors of the environment. The world according to the Brundtland Commission is producing seven times more goods as compared to the 1950s. Today, about 25 years after the Brundtland Report, we are producing several times more goods, but more importantly we are producing several times more waste: solid, aquesous and aerial. In recent years, as awareness about environmental degradation occurring in air, water, soil and the biosphere has grown, most of the blame has been laid at the doorstep of industry, with the big corporations roped in as the main culprits and enemies of the environment. Most types of environmental problems

have been attributed to industry, either local or global. Problems such as global warming, depletion of the ozone layer, increase of instances of health problems, etc. are claimed to be the result of rapid industrialisation without a thought for environmental degradation. Industry could no longer continue to live with that damaging image of being responsible for environmental damage. Therefore, industry and business processes have had to re-examine and re-shape their entire enterprise, right from the nature of the products they made, technologies employed, raw materials used and the way they marketed their products. They are no longer defensive and reactive. They are becoming innovative and proactive.

In the modem world, the role of corporate business has extended from beyond just producing goods and services, or creating jobs, or even promoting industrial growth. Industry's role is fast changing from the one that is negative to the one that is positive in all areas of socio-economic endeavour. They are now expected not only to further degrade the environment; they are to act positively towards the improvement of the quality of the environment. It has been realised by industrialists that it is imperative to perform their conventional tasks of production of material goods in a way so as not to impair the quality of life.

The distinction made by Adam Smith between justice and benevolence is more relevant today to corporate business than it ever was. Justice, according to him, is a negative principle that prohibits harm; benevolence, however, requires positive action for the realisation of an intrinsically desirable goal—the well being of others. The corporate business today has the responsibility towards the society, not only to render social justice, but also to promote the greatest good to the largest number of people. To the established duties of the corporate sector of diverting a portion of their profits to community purpose, production of goods and services, creation and protection of jobs, etc., has been added another one—by far the most onerous, up-to-date, zealous protection of the environment.

However, while growth in technology promoted by big business has created problems of environmental destruction and degradation, it is this growth and technology that also hold the hope for improvement—the solution also lies there. A better choice of technology—both preventive and curative, can reduce damage to environment already done and prevent further damage. The big business has already moved into a new chain of thinking in which technological dimensions are decreased, and importance of social, economic, political, cultural and especially environmental dimensions are growing in importance. This change was first seen in the 1980s, especially in the attitude of chemical and oil companies. By the time world leaders gathered for the Rio Summit in 1992, a Business Council for Sustainable Development (BCSD) formed under the chairmanship of Stephen Schmidhering, a Swiss businessman, with its 50 members, had put together guidelines for environmental friendly behaviour for companies.

Innovative Business Responses to Environmental Regulations

> Those managing business are becoming increasingly conscious of environmental issues and go a step further to convert them to their own advantages. The Environmental Protection Act has acknowledged the potential gains from pollution prevention. Business people have realised the advantages of taking a proactive stance towards environmental regulation. Industry leaders have also realised the potential for additional benefits from pollution prevention.

There are several reasons why those managing business are becoming increasingly conscious of environmental issues and go a step further to convert them to their own advantages:

(i) For management morale to have a good environment record (especially after the Stockholm Convention) and the desire to earn good reputation as protectors of the environment.

(ii) In an era of "lean management", many companies are finding ways and means to cut waste wherever possible. Pollution prevention extends this concept to resources, and firms are finding that they can significantly lower their "end-of-pipe" abatement costs by not creating wastes in the first place. After all,

some argue, what is pollution if not wasted resources? "Waste Not, Pollute Not" is the pollution prevention mantra in American industries. "Doing it for Mother Earth" examines the gains that can be realised in both compliance and profits from pollution prevention programmes.

(iii) The Environmental Protection Act (EPA) has acknowledged the potential gains from pollution prevention as opposed to mere "end-of-pipe" compliance, and recently begun to encourage such practices through the use of voluntary programmes. A break from the traditional strategy of mandating technical abatement solutions, these programmes allow industry to use its innovative ability to protect the environment while lowering costs.

(iv) Business people have realised the advantages of taking a proactive stance towards environmental regulation. Instead of fighting against regulations, some firms are looking beyond mere compliance and improving their environmental performance. There are a variety of innovative business strategies which involve strengthening the firms' bottomline as well as the environment.

(v) Industry leaders have also realised the potential for additional benefits from pollution prevention. By incorporating principles of waste reduction into industry led voluntary programmes they hope to foster positive public opinion and perhaps forestall inefficient regulations, while exhancing industry wide environment performance.

(vi) Products may meet regulatory standards when they leave the factory, but may yet cause environmental damage through future use. Changing regulations may create costly burdens for firms that do not examine the life time effects of their products. For example, many firms in the US are incurring huge remediation cost at Superfund sites, where the polluting actions were not always illegal at the time. Recent trends in regulation suggest that forward looking firms will protect themselves through "green design" of their products and enhance their public image by examining the entire life-cycle of their products.

> Products may meet regulatory standards when they leave the factory, but may yet cause environmental damage through future use. To keep their consumers, who are increasingly environmentally conscious, happy, they have to ensure that their products do not have such hazards. There have been several instances where the consumer movement has made companies change their activities and processes to environment friendly. Eco-labelling is another example of companies trying to pacify consumers.

(vii) To keep their consumers, who are increasingly environmentally conscious, happy companies change their strategies. There have been several instances where the consumer movement has made companies change their activities and processes from that leading to environment degradation to becoming environment friendly. For example, McDonald's fast food chain used to sell hamburgers in polystyrene "clam-shells". Environmentalists followed by school children and other consumers demonstrated outside McDonald's shops and heaps of letters poured into their headquarters at Chicago. The Environmental Defense Fund also approached the company. The company ultimately agreed to replace the clamshells with "quilted paper wrap", which though still not biodegradable, made much smaller waste heaps, about a tenth of the earlier size. The company did not start using washable crockery on the plea that the detergent and hot water used to clean them would itself not be environment friendly as compared to the throw-away packaging carefully destroyed. This resulted in the company to look for ways to cut down waste by using recycled materials in packaging and restaurant furnishing and transporting products such as ketchup in reusable crates.

(viii) Eco-labelling is another example of companies trying to pacify consumers' regarding environment friendliness of their products. The first eco-labelling was done in Germany in 1978. The products carried the "Blue-Angel" label. A study of 22 countries done by the Organisation for Economic Co-operation and Development (OECD) showed that these countries had or were planning eco-labelling. Consumers all over the world today look for the label showing that the product is "green".

(ix) Potential savings through pollution prevention measures is another step in this direction. Companies have found that reduction in the use of raw materials and energy and in the amount of toxic waste they produce, could yield savings.

(x) The fear of incurring the cost of environmental damage that have risen as regulations have been tightened by governments and courts of law, have prompted companies to be eco-friendly.

(xi) In the past, environmental advocacy groups and government regulators were seen as opponents of business. Now, however, some firms are finding that they can save a lot of effort and trouble, if they work with these groups to find solutions acceptable to all stakeholders.

Waste Management and Pollution Control

Environmental damage through industrial activity can be of the following two types :

1. *Depletion of Natural Resources*: Excessive use leads to the reduction in natural resources that are extracted and/or used up in the production of other goods, such as minerals, fossil fuels, etc. These resources are non-renewable. Once extracted, they cannot be replaced. Technology must find a substitute of such raw materials if further depletion of non-renewable resources is to be prevented. Depletion is thus a quantitative concept.
2. *Degradation of the Natural Resources*: Degradation refers to the deterioration of the quality of the environment. All production creates waste and pollution right through the process of manufacturing to the disposal of the final product. Wastes—air, soil and aqueous or solid—degrade the air, soil and water quality and pose health hazards.

Disposing waste into the environment was cheap, if not free, until recently because the costs from pollution were not borne by the producer of that waste. As a result, waste emission has almost surpassed nature's capacity to absorb wastes. Waste management has become essential—in many cases it has been made mandatory through government regulations, but with industry and business becoming environment conscious, waste management is finding an increasingly important place in the agenda of big corporations.

Pollution Prevention

As seen earlier, sustainable development has universally been accepted as the common environmental goal in business circles now. Corporate management has a great deal to offer to achieve sustainable development. To implement sustainable development, it requires promotion and application of pollution prevention, whether through source reduction or clean technologies. An effective pollution prevention programme can yield cost savings that will more than offset programme, development and implementation costs. Cost reduction may involve immediate savings that appear directly on the balance sheet or may involve anticipated savings in terms of avoiding potential costs. Cost savings are particularly notable when the costs result from the treatment, storage or services that produce waste, e.g. material costs can be reduced by adopting processes.

> Implementation of sustainable development requires promotion and application of pollution prevention, whether through source reduction or clean technologies. An effective pollution prevention programme can yield cost savings that will more than offset programme, development and implementation costs. Cost reduction may involve immediate savings that appear directly on the balance sheet or may involve anticipated savings in terms of avoiding potential costs.

Wastes may be air, aqueous or solid emissions, and waste management comprises containment, dispersal and remedial measures. Pollution prevention

management means both management of wastes and production before they create pollution problems. In the past, environment management strategy focussed on pollution control—waste removal, treatment and disposal techniques, etc. mostly in the manufacturing process. However, the problem of environmental degradation is not limited to manufacturing processes only. That is only the first generation problem, i.e. release of waste within the plant. The problem is much more extensive, as besides manufacture, storage, transportation and use of products also contribute to pollution, waste accumulation and environmental degradation. Thus we need to differentiate between waste management strategies and pollution management strategies. While the former emphasises reduction in waste generation and controlling pollutants in waste, the latter seeks not only to improve manufacturing processes, but also consumption of environment friendly products.

The key strategies for Industrial pollution prevention are as follows: a systematic waste reduction audit; material balance; economic balance; identifying waste reduction; use of newer, cleaner technologies; life cycle assessment.

Key Strategies for Industrial Pollution Prevention

1. ***A systematic waste reduction audit***: This will enable manufacturers to inventory and trace input chemicals and to identify how much waste is generated through specific processes. It is an extremely useful tool in diagnosing how a firm can reduce or even eliminate waste.
2. ***Material balance***: Identifying processes, inputs, outputs, recycle and reuse rates, deriving a preliminary material balance and evaluating and re-fixing material balance.
3. ***Economic balance***: Identifying cost and reviews to achieve an economic balance. According to benefit-cost ratio, experience in the industrialised countries has proved that anti-pollution technology has been cost effective in terms of health, property, and environmental damage avoided and that it has made many industries more profitable by making them more resource use efficient. While the economic growth has continued, the consumption of raw materials has held or even declined. For the benefit-cost analysis, industries look for savings and cost effectiveness in any steps they take and any operations they undertake. Pollution prevention has been found to be cost effective and resulting in saving, especially in the long run. Several slogans on pollution prevention programmes clearly indicate this view. For example. Chevron gave the slogan “SMART” (Save Money and Reduce Toxics), Dow Chemicals “WRAP” (Waste Reduction Always Pays). Of course, firms have found that their measures to tackle pollution made big improvements in their environmental performance. Between 1989 and 1991, Chevron Texaco reduced its output of dirty air, water and solid wastes by 40% and toxic emissions by 58%. It would mean saving on waste disposal and clean up operations. Saving from pollution prevention programmes result from several sources. It reduces the need for pollution control equipment and disposal of hazardous and/or non-hazardous wastes. Further, companies found that their pollution prevention and resource conservation and designs and strategies can reduce the use of raw materials and energy costs. Another very important cost saving that results from pollution prevention strategies is the invisible costs such as health problems of workers resulting in decrease in productivity.
4. ***Identifying waste reduction***: Opportunities and implementing them through simple process modifications such as pollution prevention measures through good house-keeping, evaluating opportunities for waste reduction and recycling, designing a waste reduction strategy, implementing internal recycling for same or other use to reduce emission from the process and also to reduce the need for continued supply of raw material inputs.

5. ***Use of newer, cleaner technologies***: Development of preventive technologies to benefit both now and in future, without transferring the problem from one media to another such as air, water and land, which is often the case. For example, waste treatment processes produce large amounts of sludge and residue, which again need disposal programme so as to prevent secondary pollution.

   The answer, therefore, lies in technological change. In the past, technological inventions were mostly made to save resources—both human and natural. The need of the day is to use technological progress for protecting the environment from further damage and damage abatement wherever possible. Experience shows that the technological management has reduced the adverse impact of many activities on the environment. However, the progress in environmental protection technology has failed to keep pace with the fast depletion and degradation of natural resources. Stress has to be laid on both preventive and curative technological progress.
6. ***Life cycle assessment***: This is a process of evaluating the environmental burdens associated with a product or activity. It addresses the entire production system, not just isolated components. It starts by identifying and quantifying energy and material used and waste released into the environment, of assessing the impact of those energy and material uses and releases to the environment and of identifying and evaluating opportunities of affecting environmental improvement. It is a complex process beginning with goal definition, going on to inventory of resources and requirements and assessing, rather than a threat to planet survival. The corporate sector needs to further become proactive, i.e. use technological innovations for environmental progress that can be measured, communicated and also used effectively as a marketing tool to educate all stakeholders.

Business managers must recognise new business ethics and opportunities—clean products and clean technologies will create competitive advantage. Old established companies also need to enter the stream of environmental, technological innovations before the new entrants using the latest, cleaner technologies provide a stiff competition and drive them out of the market. Crime of the future will no longer be failure to comply with regulations. It will be not to act preventively, and failure to measure performance. Judgement pronounced by public opinion in the market, will make or mar the future of a business enterprise. To remain a vital, thriving competitor, a corporate management must gear up to meet the material and produce needs of the next generation of consumers.

> Business managers must recognise new business ethics and opportunities—clean products and clean technologies will create competitive advantage. Companies have realised that they have neither the resources nor the time to damage their environment now and clean up later.

The United Nations Environment Programme (UNEP, l998) has rightly advised corporate managements to take the following steps:

- Commit to make preventive strategy as preferred option to environmental policy
- Develop pollution prevention action plans and programmes with clear, quantifiable and achievable targets and time frames to minimise waste, maximise resource use and avoid risks to human health, safety and environmental quality
- Develop and implement manufacturing processes, new products and services that are congruent with the principle of pollution prevention
- Improving efficiency in resource consumption, reducing use of toxic materials, reducing wastes, and increasing energy and material intensity of goods and services
- Integrate preventive strategies into all relevant units of business and industry organisations and their management systems and all relevant operations
- Conduct pollution prevention training activity and R&D innovative methodology to overcome potential pollution prevention barriers in implementation
- Share pollution prevention experiences and disseminate information

Companies, as also the world, are realising that they have neither the resources nor newer technologies to clean up the environment damaged by them.

Emerging technologies offer the promise of higher productivity, increased efficiency and decreased pollution. Though they may bring problems of new toxic chemicals and wastes and of major accidents of a type and scale beyond present coping mechanism, implemented with caution, there is no reason why they should not lead to a more prosperous and bright future for the corporate world and respectability for management.

Thus company managers' roles and responsibilities are undergoing fast transformation not only in the area of maximising return on investment, but the real life proposition of social responsibility and social accountability. With unprecedented growth in information technology, speedy process of globalisation and 24 hour trading in commodities, foreign exchange, bullion, hedges, futures and options, host of swaps and derivatives, managers and other functionaries of the corporate world have urgent need to re-orient their perception and working style.

Improving Corporate Environmental Performance

Environmental disasters can create serious problems for organisations. A good example is the Bhopal gas tragedy, in which thousands of people lost their lives after methyl isocyanate leaked from the Union Carbide plant in Bhopal. They are now expected to act positively towards the improvement of the quality of the environment from other risks.

Environmental performance has become a critical issue in recent times. Environmental disasters can create serious problems for organisations. A good example is the Bhopal gas tragedy in 1984, in which thousands of people lost their lives after methyl isocyanate leaked from the Union Carbide plant in Bhopal. The 1986 Chernobyl nuclear disaster in Kiev, Ukraine is also etched in the minds of many people. The explosion of the nuclear reactor killed 31 people and released large quantities of radio active substances into the atmosphere. In scale, complexity and long term consequences, it was the most catastrophic incident in the entire history of the use of atomic energy across the world.

Bhopal and Chernobyl did not mark the end of environmental disasters. The Valdez (US) oil spill of 1989 and the Tokaimura (Japan) nuclear accident of 1999, are other prominent examples. In developing countries like India, environmental issues often take a back seat and accidents are quite common.

In Kodaikanal, India, Hindustan Lever, a subsidiary of Unilever Plc, the Anglo–Dutch multinational, dumped mercury waste from its thermometer factory in the surrounding forests and on an innocent local community. When the scandal was exposed, the company denied initially that there was a problem and later fudged facts and figures until the Indian authorities forced them to come clean. Since then Unilever has retrieved and sent some of the waste back to the US for disposal but are shying away from compensating affected workers and further environmental remedial measures.

Bayer A. G., a German transnational continues to manufacture and sell phased out pesticides such as Methyl Parathion (brand name Folidol/Metacid) in Asia despite an assurance to their European investors and stakeholders that they would stop manufacturing these organo-phosphate poisons.

Ship-owning companies such as Bergesen of Norway and Chandris of Greece regularly violate national and international laws and dump their hazardous wastes at ship-breaking yards in India, Pakistan, China, Turkey and Bangladesh. The voluntary guidelines issued by International Marine Organisation are not enough and it is imperative that these guidelines are made mandatory to make the ship-owners liable and responsible.

In the era of globalisation, multinational companies increasingly move around assets, products and wastes on a global chessboard to maximise their profits and minimise their costs. These companies are using differences and loopholes in national environmental and health laws, for example, to export pesticides and

destructive technologies to poorer countries to the detriment of local communities. Most types of environmental problems have been attributed to industry, whether local or global. Problems such as global warming, depletion of ozone layer, increase of instances of health problem are considered to be the result of rapid industrialisation without a thought for environmental degradation.

Industry could no longer continue to live with that bad image of being responsible for environmental damage. They are now expected not only to further degrade the environment, they are to act positively towards the improvement of the quality of the environment from other risks. Typically, a health or safety department deals with issues concerning the environment. Managers are not clear about what and how to invest in improving environmental performance since the benefits are quite difficult to quantify.

Thus, environmental issues must be treated like any other business issue. By tackling environmental problems, there may not be any immediate improvement in the bottom line. At the same time, it is wrong to assume that investments made to improve environmental performance will never pay off. A strategic approach to environmental risks management can generate sustainable, competitive advantages in the long run. For this, environmental issues must be integrated with the companies' corporate strategies.

One of the more prominent and significant ways of integrating environmental issues with the company's corporate strategies is by adopting environmental audit as a means of taking initiative to evaluate environmental performance.

The Need for a New Approach

The time has come for companies to take a fresh look at environmental issues. Attempts to improve environmental performance should be viewed as an opportunity to innovate rather than as a burden. As Porter and Vanders Linde have put it, "The relationship between environmental goals and industrial competitiveness have normally been thought of as involving a trade off between social benefits and private costs. The issue of how to balance society's desire for environmental improvement becomes a kind of arm-wrestling match. One side pushes for higher standards, the other side tries to beat the standards back... The notion of an inevitable struggle between ecology and the economy grows out of a static view of environmental regulation in which technology, products, process and customer needs are all fixed... Properly designed environmental standards can trigger innovation that may partially or more fully offset the costs of complying with them".[3]

> The time has come for companies to take a fresh look at environmental issues. Attempts to improve environmental performance should be viewed as an opportunity to innovate rather than as a burden. Environmental audits provide an in-depth review of the company processes and progress in realising long-term strategic goals.

Environmental Audit

Environmental audits provide an in-depth review of the company processes and progress in realising long-term strategic goals. The concept has come into force in recent years and differs from a financial audit in that it is intended to measure the impact of an organisation's operations on the environment against a predetermined set of criteria and so far as possible to assess them in terms of costs. This audit is part of a continuing and cyclic process rather than an exercise in standard accounting practice at a given point of time. The audit may also be used to assist in determining the environmental expenses incurred by companies.

The environmental audit examines the company's performance as against its policy, and is undertaken with reference to performance of personnel, technology, system and documentation and how these are related to relevant standards of practice. Therefore, environmental audit is in the nature of a corporate policy

audit. The objectives of an environmental audit are evaluation of the efficiency and efficacy of resource utilisation, i.e. man, machine, materials, identification of areas of risk, environmental liabilities, weakness in management system problems in complying with regulatory requirement and insuring the control on waste pollutant generation.

In general, there can be two types of environmental audit: *environmental compliance audit*—checks the degree of conformance to laws and rules prescribed by the relevant regulatory authorities, and *environmental management audit*—an appraisal of the company's internal capabilities to discharge its environment-related responsibilities. A compliance audit may cover issues such as housekeeping, practices followed while storing dangerous chemicals, how hazardous waste is being stored and disposed, the method followed for releasing waste water, etc. Whereas a management audit is more concerned with capabilities, focusses on issues such as organisational structure, accountability, training of employees to respond to crisis situations and relationships between plant personnel and local regulatory authorities. The audit can examine the environmental policy statement of the company, the documented procedures for preventing any damaging crisis situations and the type and frequency of review of the programmes.

If used well, audit can generate various benefits for the organisations. Problems can be corrected before they are too large to fix and opportunities can be identified for cutting costs through various measures.

If used well, audit can generate various benefits for the organisations:

- Problems can be corrected before they are too large to fix
- Opportunities can be identified for cutting costs through measures such as waste
- Minimisation and recycling
- Insurance costs can be reduced
- Employees can be persuaded and motivated to take environment issues seriously
- The corporate image can be improved

More and more companies are now realising the need for a proactive approach to environmental issues instead of passive compliance with the laws. We can take the case of the Canadian paper company as an illustration, when Alberta Pacific Forest Industries (APFI) faced opposition from politicians, farmers, aborigines and other activists over the adverse environmental impact of a proposed pulp mill, it decided to take a range of measures to mitigate the impact. The company designed its plant to keep pollution levels well below those specified by the government. From time to time, APFI apprised the local community of the environment impact of its operations. It also announced plans for afforestation. As a result of all these measures the company successfully improved its relationship with the local community and eliminated costs that could have resulted from potential business disruption. APFI is, however, an exception rather than the rule. Most companies display a high degree of knee-jerk responses to environmental issues. They also believe that command and control mechanisms, and formal procedures and rules will automatically take care of environmental issues.

The right way to manage environmental issues is to integrate them with the company's corporate strategy. This implies collecting and storing information about environmental issues and dealing with environmental risks like other business risks. Companies should have a clear idea of how investments in improving environmental performance will affect their competitive position. Environmental costs normally do not affect all competitors equally and tend to vary with location, size of the facility, technology used and age of the plant apart from the level of awareness of the local populace on environmental issues. Companies that fail to appreciate these differences miss opportunities to put competitors at a disadvantage. For example, vertically integrated and non-vertically integrated players in the same industry may be affected in quite different ways by a new environmental regulation. Through outsourcing, a firm may be able to put vertically integrated competitors to a severe disadvantage.

Most companies fail to get the best returns from their environmental investments due to poor cost- benefit analysis. They undertake grandiose projects that do not yield commensurate benefits. They would be better off if they concentrate on liabilities which are small today but may escalate in future and where efficient options to the problem are available. Companies also tend to overlook some of the non-quantifiable benefits resulting from better employee morale and higher employee productivity.

Sometimes, companies take decisions without a careful analysis of the deeper implications. What seems to be a right decision on the surface later creates serious problems. For example, companies close plants in a hurry without considering the impact of such a decision. Regulators may intervene and demand expensive clean up operations, because there is no more fear about people losing their jobs. Such an eventuality would not have arisen if the plant was operational and there were fears of job losses.

Managers also tend to forget that the essence of environmental issues is managing stakeholder expectations. Very often managers are committed to improved environmental standards but do not involve nearby stakeholders before taking major decisions. Due to poor communication and a failure to take the local community along, they run into problems, even after making heavy investments to improve their environmental management practices.

Managing Environmental Issues

In general, corporate environmental policies may serve one or more of the following objectives:

- Reducing costs through measures such as recycling or energy conservation
- Reducing the possibility of industrial disasters
- Establishing a good corporate reputation and earning the goodwill of people
- Mitigating employees by providing a better work environment
- Maintaining a good relationship with the local community and regulatory authorities
- Conforming to a code of ethics

Reinhardt suggested five different approaches as the following for managing environmental issues[4]

(i) Investing in environment friendly processes or products. The additional costs are recovered from customers through a clear differentiation and product positioning that allows the firm to charge a premium.

(ii) Managing environmental regulations. This includes investing in environment protection and forcing other firms to make similar investments.

(iii) Investing in environmental performance improvement, without increasing costs. This may be possible, for example, if input consumption comes down because of effective recycling. This means the company does not have to charge higher prices to recover the investments made.

(iv) Combining all the three methods mentioned above to change the basis for competition and redefine the market so that both the firm and the environment can benefit.

(v) Looking at environmental issues from a risk management perspective. This involves putting in place systems and processes to prevent or minimise the possibility of accidents and dealing with them effectively when they occur.

However, the specific approach to environmental issues would depend on the industry structure, the firm's competitive positioning, its organisational

capabilities and its perceptions about the response of regulatory authorities and environmental activities. The five approaches are being discussed in detail.

Product Differentiation

There is considerable scope to innovate through better environmental performance. A company can design better performing, higher quality or safer products. There may also be a scope to modify the product so that there is higher resale value. If one or more of such conditions are met, the company may be in a position to charge a premium that more than recovers the costs incurred in improving environmental performance.

Industrial customers are often prepared to pay a premium for products with improved environmental performance if their (customer) own costs can be reduced. Some customers may also be prepared to pay a premium, if they consider the superior product to be a hedge against stringent environment regulations in the future. Ciba Speciality Chemicals is a good example inasmuch as its environment friendly dyes have helped consumers to cut expenditure on salt and water treatment and improve quality. This has enabled Ciba to charge a higher price for its dyes.

In the case of consumer goods, retail customers may be prepared to pay more if the environmental benefits can be projected suitably. For environment friendly products to command a premium in the market, the company's concern about the environment must be consistent with the other signals it sends to customers. If improved environmental performance is not well integrated with the overall product positioning or corporate strategy, it may fail to capture the value created.

Managing Regulation

This can be done in the following two ways:

Self regulation: Firms in an industry can come together and agree to incur additional costs for improving environmental performance. Self-regulation can pre-empt more stringent government regulations. It also gives companies greater latitude in dealing with environmental problems. Self-regulation may also enable companies to develop better environmental standards than the government.

The main problem with self-regulation is that the pay-offs from the improved environmental standards may vary across companies in the industry. Quite often, smaller firms are at a disadvantage while larger firms can leverage the benefits of a good reputation that results from better environmental performance. Thus, self-regulation can change the basis for competition by favouring some firms at the expense of others.

Reinhardt mentions various conditions for the success of a self-regulatory system.[5] The companies in the industry must be able to set measurable performance standards. They should also be in a position to enforce the rules.

The programme must be broad-based, involving a sufficiently large number of companies, especially all the important players in the industry, so that opponents cannot come together and block it. The programme must have credible mechanisms for standard setting, monitoring and enforcement.

Managing government regulation: A firm may try to put pressure on its competitors by influencing government regulators. But straight and simple lobbying of the type Indian companies excel in may not have the desirable impact in the long run. To use this approach successfully, the firm must have a unique competitive advantage when the new laws come into effect. As Reinhardt[6] puts it, "There is no long-term benefit in a strategy of pure rent seeking. Without some complementary investment

in the market place or some pre-existing source of competitive advantage, the pay-off to an investment in regulatory change will be zero; the firm and its rivals will compete away the economic surplus they are trying to divert into their own pocket. The firm should be able to convince customers, rivals and regulators that the new rule it is proposing are feasible and desirable".

Porter and Van Jer Linde argue that any antagonism between the regulators and the industry locks companies into static thinking. It also leads to gross overestimates of the costs involved. In many cases, because of the learning curve effect, the cost of compliance with regulations tends to decrease progressively over time. Hence, aggressive lobbying by an industry to dilute environmental standards may not only be opportunistic but also counter productive. They suggest that companies must keep three points in mind while trying to influence environmental standards being set by the regulatory authorities. The standards must create sufficient opportunities for the industry to innovate, the regulations should leave the door open for further improvements instead of locking companies into a particular technology, the regulatory process should create minimum uncertainty about the outcome expected. It should be emphasised that environmental regulations must focus on outcomes and not technologies.

Generating Cost Savings

Conformance to improved environmental standards may be accompanied by process innovations. These include higher process yield leading to higher resource productivity, less downtime through careful monitoring and maintenance, lower output and energy consumption and reduced material storage and handling costs.

In the hotel industry, for instance, many have reduced solid waste generation and slashed water and energy consumption. *The Hindu* reported on 25 October 2005 that ITC Park Sheraton and Towers Chennai, was chosen as the "Environmental Champion" among large hotels, and awarded the prestigious The Federation of Hotel and Restaurant Association of India (FH&RAI) prize for the hotel which saw a consistent rise its occupancy and a steady decline in power consumption by using solar water heating system, and also for its efforts at recycling of water. The Dutch flower industry at one time faced stringent regulations as the pesticides and fertilisers used in cultivating flowers were contaminating the soil. The industry came up with innovative solutions. It developed a closed loop system to reuse water. In some greenhouses, flowers were grown in water and rock instead of soil. These measures resulted in uniform growing conditions and improved the product quality. As a result, environmental performance improved, even as costs came down. Dow Chemical is another good example of how a company can cut costs and improve environmental performance at the same time. In its California complex, hydrochloric acid gas is scrubbed with caustic soda to produce various chemicals. The earlier practice was to store the waste water in evaporation pond. Regulators insisted that these ponds be closed by 1988.

In 1991, US regulators asked distillers of coal tar to drastically cut their benzene emissions. The regulation motivated Aristech Chemical Corporation of Pittsburgh, Pennsylvania to develop a method for removing benzene from tar in the first processing step itself. This did away with the need for expensive gas blankets. The new pollution control measures enabled Aristech to save $3.3 million.

Redefining Markets

Companies can also try a combination of the various approaches discussed so far. They can use research to develop new ways of offering services to customers and attempt to shape the future of the industry's environment practices. They can reduce

the cost of disposal for customers, through buy-back schemes. They can offer value to customers in ways which competitors cannot match, and charge a premium.

Environmental Risk Management

Reinhardt has identified four different elements of environment risk: probability of occurrence of an adverse event such as an accident; probability distribution of the total costs if the event occurs; allocation of responsibility if an accident occurs; certainty of the assessment. The simplest way to manage environmental risk is to buy an insurance policy.

For many organisations managing environmental issues means avoiding the costs associated with accidents, catastrophes and other environmental mishaps. Reinhardt[7] has identified the following four different elements of environment risk:

- Probability of occurrence of an adverse event such as an accident
- Probability distribution of the total costs if the event occurs
- Allocation of responsibility if an accident occurs
- Certainty of the assessment

In other words, four different tasks have to be performed by managements while dealing with environmental risks. They must minimise the probability of occurrence of the adverse event. They must cut losses when an accident occurs. They should be able to pinpoint responsibility on other parties when the event occurs. They must obtain more information to make the risk assessment methodology as robust as possible. Managers have to use the right mix of risk reduction, risk shifting and collection of information to manage environmental risk efficiently.

The simplest way to manage environmental risk is to buy an insurance policy. This shifts the risk to the insurance company. Such an approach makes sense if the company feels that the premium being paid is small compared to the huge risks involved. Another approach is to set up disaster management cells which can respond quickly when an accident occurs. A third approach involves setting clear guidelines for the operating units in the form of various documents and manuals. Another approach is to link promotion of managers with their contribution to risk management.

Behavioural issues need to be carefully examined so that environmental risks are managed systematically. Reward systems normally favour managers who reduce costs or increase profits. Environment related expenditures show up immediately in the books of accounts but it may take some time for the benefits to be realised. Consequently, there may be a tendency to under-invest in environmental performance improvement measures. Inbuilt mechanisms are necessary to check this.

Though Reinhardt considers environmental risk management as a separate approach, there is a strong case for arguing that the various risk-mitigation measures can be incorporated in each of the four approaches covered earlier. Improving the process, cutting costs, differentiating the product and managing regulation can all be viewed as methods to reduce the risk of incurring heavy losses owing to environmental mishaps.

Thus, environmental issues should be analysed as business problems. A rigorous analysis is necessary to understand which investments generate value for shareholders. While doing the bare minimum to stay on the right side of the law is not acceptable, pouring a large amount of money into environmental projects in the name of discharging social responsibility is unwise. As Reinhardt puts it "Campaigners aren't in business to solve the world's problems nor should they be. After all, they have shareholders who want to see a return on their investments". That is why managers need to bring the environment back into the fold of business problems and determine when it really pays to be green. The truth is that environmental problems do not automatically create opportunities to make money. At the same time, the opposite stance that it never pays for a company to invest in improving its environmental performance is also incorrect.

Managers should look at better environmental performance as an opportunity rather than as a threat. As Porter and Van der Linde put it: "Instead of clinging

to a perspective focussed on regulatory compliance, companies need to ask such questions as 'What are we wasting?' and 'How could we Enhance Customer Value?'

Many companies allow environmental issues to be handled by lawyers and consultants who tend to focus on compliance rather than innovation to correct this situation. Environmental strategies must become the direct concern of the top management. Environmental impact should be incorporated in the overall process of improving productivity and competitiveness. Manages should be proactive and go beyond currently regulated areas. They should look for opportunities to improve design, manufacturing and delivery processes on an ongoing basis.

According to Frank P. Popoff, former CEO of Dow Chemical: "Competitive advantage must not be gained through non compliance or minimum compliance. Some companies try to reduce cost this way but this is deadly. Sooner or later, mandates will come into place to prevent such an approach and put the company at an enormous competitive disadvantage. Success truly belongs, I believe, to those companies that not only comply with environmental standards, whether mandated or self-imposed, but do it more efficiently and effectively than others. If they conserve energy more efficiently through internal cycling or on site disposal they will ultimately reduce cost."

Environmental Management in India

Environmental practices in India have improved significantly in recent times. Used to a fairly lax regulatory environment for a long period of time, many Indian companies had not taken environmental management seriously in the past.

> Environmental practices in India have improved significantly in recent times. Used to a fairly lax regulatory environment for a long time, many Indian companies had not taken environmental management seriously in the past. Now, regulations have become more stringent. Moreover, many companies are looking at environmental management as a means to improve their image and to cut costs.

Now, regulations have become more stringent. Moreover, many companies are looking at environmental management as a means to improve their image and to cut costs. A recent survey of 47 companies conducted by Business Today and Tata Energy Research Institute (TERI) has revealed that 75 per cent of them have an environmental policy. Many companies have quantifiable targets in areas such as emissions. Some companies stand out in their effort to upgrade environmental performance. Not surprisingly, quite a few of these companies are subsidiaries of global companies.

Bayer India believes that the benefits of successful environmental management programmes far outweigh the costs. The company has made substantial investments in incinerators and leased out 30 of its incineration capacity to other chemical firms. The fees charged by the company has enabled it to recover most of the costs. Better environmental practices have also reduced water consumption.

At Philips India's Pimpri Unit, tubelights were earlier flushed with 70 mg of mercury each to ensure that 15 mg stayed in the tube. This increased both environmental hazards and costs. Philips switched over to argon flushing, reducing both pollution and costs in the process. At Tata Steel improved environmental practices have increased profits through lower consumption of raw materials and better utilisation of wastes.

Yet environmental management in India still has a long way to go. Consider the Uranium Corporation of India Ltd. (UCIL) mines in Jadugoda. Children in 15 adjoining villages have been affected by radiation, while many workers are suffering from serious ailments. A study conducted by the Jharkand Organisation Against Radiation (JOAR) in 1998 revealed that many women in the region suffered from miscarriages and still-births—16 of the children born to them died in infancy. Lack of safeguards at the mines has exposed 30,000 people in 30 villages to radiation risks. Nuclear waste has been dumped into waste dumps called "tailing ponds". Wind blows the harmful dust around in summer, while in rainy seasons the river

water gets contaminated. In 1994, there were 17 deaths. By 2001, it had gone up to 31. Many people have been affected by cancer.

According to the UCIL Chairman and Managing Director, Ramendra Gupta, the "pan parag" causes bigger health hazards than uranium mining. He felt the journalists must run after the former instead of the latter. He even cited a report stating that the radiation levels within 5 km of Jadugoda were normal. He also contended that malnutrition and alcoholism rather than radioactivity are causes of illness in Jadugoda.

Many Indian companies look at ISO 14001 certification as an end in itself. Most have not integrated environmental management into the corporate strategy. In many instances, "green initiatives" have been launched without a clear understanding of the potential benefits. In the worst cases, companies flout pollution laws and pay bribes to government inspectors when they visit the premises.

Quite clearly, Indian companies still have a long way to go in the area of environmental management. The cost they may have to incur in the event of mishap, may turn out to be heavy as it happened in the case of Union Carbide's plant in Bhopal.

However, in recent times, public opinion and the active role of the environmentally aware NGOs have gone to courts through public interest litigations to protect the environment for people to have clean air, water and atmosphere. The courts in turn have ordered central and state governments to enforce environmental laws strictly and in extreme cases have come down heavily on polluting industries as in the cases of the hosiery industry in Tirupur and leather tanning activities in some districts in Tamil Nadu. Likewise in Delhi, polluting industries were ordered to be shifted while the metropolitan buses were asked to use non-polluting gas instead of highly polluting diesel.

Charter for Voluntary Pollution Control

The Ministry of Environment and Forests and the industrial sector have entered into a partnership on voluntary pollution control by releasing a Charter on Corporate Responsibility for Environmental Protection in New Delhi in 2003. The charter marks a shift from regulatory enforcement of pollution control norms to voluntary compliance by the industry to significantly enhance the quality of environment.

The Ministry of Environment and Forests and the industrial sector have entered into a partnership on voluntary pollution control by releasing a Charter on Corporate Responsibility for Environmental Protection in New Delhi on 13 March 2003.

The Charter marks a shift from regulatory enforcement of pollution control norms to voluntary compliance by the industry to significantly enhance the quality of environment. The preparatory work in this regard has been completed with the government holding discussions with the representatives of 17 major polluting categories of industries. Basic issues have been identified for evolving an agreement on National Action Programme at a conference of representatives of government and the polluting industries.

In the perception of the government, the regulatory measures have served useful purpose over the years but it is only limited when viewed in terms of overall environmental management. While several industrial units have installed pollution control systems, their operation and maintenance are not yet satisfactory. Also, there were cases where water and air quality did not improve enough though the industries were complying with the effluent and emission standards.

The voluntary Charter seeks to considerably reduce air and water pollution with the industry agreeing on its own volition to take up modernisation of production processes and installation of necessary systems to reduce polluting effluents and their solid wastes. This will be achieved through water and energy conservation, lesser use of raw materials, better monitoring of air and water quality, adoption of waste minimisation options and better work practices.

The Charter also enables the industry to know the government programmes, priorities and concerns in respect of 17 categories of major polluting industries

and gives appropriate time for implementation of action points identified in sectoral discussions, thus reducing the industry from the sudden burden and enforcement pressure. The government is in favour of an agreed pollution control programme with the industries to drive towards self-regulation and voluntary compliance which are expected to bring about a positive change in the status of environment and enforcement.

The 17 major polluting industries identified for preparatory approach towards polluting control are: cement, aluminium, thermal power plants, oil refineries, pesticides, iron and steel, pulp and paper, copper and zinc, distilleries, sugar, petrochemicals, dye and dye intermediates, caustic soda, pharmaceuticals, tanneries and fertiliser industry.

An illustrative account of sector-wise issues being considered for an agreement between the government and industry and for adoption in the form of Charter are the setting up of coal washeries, recycling of ash pond effluents by December 2004, according environmental clearance for new thermal plants and expansion proposals only in the particulate matter emission standard of 100 mg/cubic meter is ensured. Fertiliser units will have to bring down water consumption to 8, 12 and 15 cubic metres a tonne of urea produced per plant based on gas, naphtha and fuel oil respectively.[8]

Corporate India Gets Eco-friendly

From planting trees, to using solar-energy, constructing smart buildings and even collecting litter, corporate India is going all green.[9]

From planting trees to using solar energy, to constructing smart buildings and even collecting litter, corporate India is going all green. As far as the hospitality industry is concerned, the list of initiatives taken by the hoteliers to conserve the environment is exhaustive. Moreover, all of them reuse biodegradable waste generated in their hotels and also deploy various techniques to conserve water.

Private Sector Initiatives

Every corporate wants to be eco-friendly in some way or the other. Take the case of Johnson and Johnson Ltd.'s plant in Mulund, Mumbai, where biodegradable waste is recycled or the Leela Kempinski in Mumbai that has invested in maintaining massive gardens in and around the premises of the hotel to encourage greenery and environment friendly ambience. The hotel also uses natural gas as boiler fuel that almost nullifies the air pollution compared to oil fired ones.

As far as the hospitality industry is concerned, the list of initiatives taken by the hoteliers to conserve the environment is exhaustive. The Orchid, an Ecotel hotel in Mumbai is a best example of this. From the basic architecture of the building, to water conservation, use of rubber wood instead of real wood, use of energy-saving devices, the hotel does it all to qualify as an-eco friendly hotel. The Park in New Delhi, The ITC Park Sheraton and Towers, The Ambassador Pallava in Chennai and The Lake Palace in Udaipur may not be as savvy as The Orchid but they do use energy-saving devices to conserve electricity. Moreover, all of them reuse biodegradable waste generated in their hotels and also deploy various techniques to conserve water.

The mother of all was RETREAT (Resource Efficient TERI Retreat for Environmental Awareness and Training) located in Gurgaon District. The building is country's first-ever eco-friendly building complex. Home to a state-of-the-art training complex cum conference centre of the Tata Energy Research Institute (TERI), the complex is powered by a photovoltaic-gasifier hybrid renewable energy system, which uses waste biomass and solar radiation as sources of energy. It also boasts of the first solar-roof in India. Air conditioning, equivalent to a conventional 35-tonne capacity system, is provided by an early air tunnel, which consumes a fraction of the energy used in a conventional system. The waste-water is treated using plants, which means that the complex emits no waste.

Companies such as LG Electronics have introduced environment-friendly initiatives such as rainwater-harvesting, solar water heaters for canteen applications and converting effluent treatment plant (ETP) sludge into bricks.

Public Sector Efforts

If private sector initiatives in environmental preservation is praiseworthy, the public sector is not far behind. The Power Grid Corporation of India Ltd (Powergrid) constructs, owns and operates extra high-voltage transmission network in India and carries out real time supervision and monitoring of power flow on round-the-clock basis over the entire EHV network of the country. The *National Hydro Power Corporation (NHPC)* is also committed to the goals of sustainable development and is promoting hydropower development in India.

If private sector initiatives in environmental preservation is praiseworthy, the pubilc sector is not far behind.

Bharat Petroleum Corporation Ltd (BPCL), for instance, has taken various initiatives to prevent air pollution. It launched an environment-friendly petrol pump in Delhi. With vapour recovery system, the petrol pump prevents unburned petroleum vapour from entering the atmosphere by converting it into less harmful compounds. Bharat Heavy Electricals Ltd (BHEL) shares the growing concern on issues related to environment and occupational health and safety. The organisation has launched a host of products such as wind electric generators, solar heating systems, solar photovoltaic systems, solar lanterns and battery powered road vehicles in a bid to conserve the environment.

The Punjab National Bank has initiated various environmental drives that include van mahotsav, tree plantation camps, pollution check-up camps, environment awareness camps, maintaining parks, etc. The list is exhaustive. Almost everybody is in the race. And to assist the competitors to take part in the race, there are likes of CoRE, CII's Environmental Management Division (EMD) and Concept Hospitality Ltd., amongst others.

Eco-efficiency Strategy of Powergrid

The public sector unit engaged in power transmission, Power Grid Corporation of India Ltd (Powergrid) constructs, owns and operates extra high-voltage transmission network in India and carries out real-time supervision and monitoring of power flow on round-the-clock basis over the entire EHV network of the country.

With an asset base of 48,000 circuit kms of transmission lines, 82 sub-stations having 46500 MVA of transmission capacity, Powergrid is committed to the concept of eco-efficiency through conservation of natural resources, reduced impact on nature and increasing the service value by use of efficient and safe technology practices. It is an ISO:9001 company and as a part of its sustainability strategy it is adopting a comprehensive integrated management system comprising ISO: 9001 for quality management system, ISO:14001 for environmental management system and OHSAS:18000 for occupational health and safety management system. Some of the initiatives taken up by it to minimise environmental and social impact are: installation of tall towers to minimise impact on flora and fauna in ecologically sensitive areas; compensatory afforestation and massive plantation in all of its installations; rain water collection and harvesting; and preference to use barren or waste land for its installations. After demonstrating its commitment, Powergrid is aspiring and striving to attain global leadership in the transmission sector through continually improving its environmental standards as per international best practices.

It has constituted a committee of eminent persons and experts in this field, which shall not only review the ESPP document keeping in view the international best practices but shall also oversee its compliance by Powergrid. Multilateral funding agencies such as the World Bank and Asian Development Bank (ADB) have been actively associated in operationalising its sustainability strategy.

Hydropower and Sustainable Development

Another public sector unit, the National Hydro Power Corporation (NHPC) is also committed to the goals of sustainable development and is promoting hydropower development in India. As most of its projects are situated in the remote corners of India, which have not seen the face of development earlier, meeting environmental challenges has become a crucial issue.

It aims for minimum destruction and exploitation and go for various conservation measures to restore the resiliency of nature. Nature must not fall apart due to developmental pressure of our dams, is its objective. NHPC's compensatory afforestation and biodiversity conservation measures have helped in restoring the ecological balance of nature; catchment area and reservoir rim treatments are aimed at increasing the life of reservoir; green belts around the company facilities act as carbon sinks, purifying the ambient air for people to breathe; restoration of quarry sites and landscaping have added aesthetics to its surrounding.

NHPC has also undertaken massive afforestation, which is an effective tool in arresting soil erosion and enrichment of environment. At Chamera project, it has planted 100 times the number of trees that were felled. At Dulhasti project, it was 1000 times and at Rangit it was 60 times. NHPC gives special attention to the choice of species with greater emphasis on indigenous species while monoculture plantation is avoided.

India's Environment Policy

The Directive Principles of State Policy of the Indian Constitution commands the state to ensure protection and improvement of environment and to safeguard the forest and wild life. The Directive Principle of State Policy on Environment has been eloquently articulated in Article 48A of the Constitution introduced by the 42nd Amendment in 1977. It reads thus: "The state shall endeavour to protect and improve the environment and to safeguard the forests and wildlife of the country." Likewise, Article 51 (A) (g) lays down protection and improvement of environment as one of the fundamental duties of every citizen. This duty of citizens would mean that every citizen is duty-bound to protect and improve the natural environment of the country including forests, lakes, and wild life and to have compassion for all living creatures.

The duty of citizens entails that everyone is duty-bound to protect and improve the natural environment of the country including forests, lakes and wild life and to have compassion for all living creatures. The Environment Protection Act, 1986 provides for the protection and improvement of environment and for matters connected therein. The Act was the result of India's participation in the Conference on Human Environment held at Stockholm in 1972. There are other Acts also enacted in India relating to environmental issues.

Laws Governing Environment

The Environment (Protection) Act, 1986, provides for the protection and improvement of environment and for matters connected therein. The Act was the result of the participation of India in the United Nations' Conference on Human Environment held at Stockholm in 1972. There were also other Acts enacted in India relating to environmental issues such as (i) Water (Prevention and Control of Pollution) Act, 1974, (ii) Air (Prevention and Control of Pollution) Act, 1981; and (iii) the Factories' Amendment Act, 1987.

Environmental pollution created by individuals or corporates amounts to a public nuisance, and therefore, this can be controlled through Criminal Law. Offensive smells, noise and air pollution are included under "nuisance". Action against such nuisance can be taken if it is repeated and committed continuously. The nuisance may be public or private in nature. The public nuisance interferes with the quality of life of the society. Therefore, pollutions originated from water, air, noise, etc. can be prevented by Civil or Criminal Laws.

The Criminal Prosecution for offence (IPC Z68 OF 1860), (Cr Pc 133 – 144 of 1873) and a civil action by any member of the public with the direction of the court for a declaration of injuntion (Section 91 of the CrPe, 1908) etc. are the remedies for public nuisance. These laws had been enacted with a view to protecting the environment through better planning and regulation.[10] However, these are not enforced effectively to maintain the ecological balances and environmental stability.

The environmental laws are generally enforced by administrative agencies. But due to inadequate staff, insufficient funds and lack of political will, they are not effectively enforced.

The National Environmental Policy, 2004

A Draft National Environmental Policy, 2004, was released in August by the Ministry of Environment and Forests (MoEF) for public discussion. Environmentalists have welcomed it, because though it is more of a strategy paper than a policy pronouncement—it is still a welcome initiative, given the fact that a policy statement on environment and its effective implementation is long overdue and is the dire need of the hour.

Environment and Economy Are the Two Sides of the Same Coin

The National Environment Policy (NEP) emphasises the often-overlooked truth that what is good for the environment is also good for the economy and that environmental protection "cannot be considered in isolation" from the development process. A fair trade-off between environmental costs, as far as they can be ascertained and monetised, and economic development imperatives is possible and desirable. The NEP is, however, quick to qualify that where money cannot compensate for loss of an environmental good, cost-benefit analyses and trade-offs are better avoided.[11]

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Conservation of Life Supporting Systems

The draft policy accords priority to conservation of life-supporting systems such as land, forests and water. The causes of land degradation in India are many, ranging from the direct (water and wind erosion, loss of forest cover, and water logging) to the indirect (fragmentation of land holdings, inadequate tenure rights, wasteful subsidies on agricultural inputs such as water and power).

The NEP's prescription of adoption of "science-based and traditional land-use practices" developed "through research and development" for combating land degradation is too vague and general. Further, land degradation is often the result of unsustainable and incompatible land-use engineered by the market.

Forest and Wildlife Conservation

Forest and wildlife conservation has been the forte of the MoEF. The NEP breaks new ground in pleading for "legal recognition of the traditional rights of forest dwelling tribe" to "remedy a serious historical injustice".

This, however, calls for a major overhaul of the Indian foresters' prevailing mindset that looks upon forests as garrisons to be protected against marauders and of the legal dispensation that extinguishes all traditional rights in protected areas.

Forest Cover

The Ministry of Environment and Forests makes out a case for finding out the ways and means to achieve the target of increasing the forest cover to 25% by the end of the current Five Year Plan and 33% by 2012. This task has been set by the Planning

Commission under the Tenth Plan and approved by the National Development Council. But, given the recent performance of tree plantation, which stood at 1.1 million hectares in 2002–03, achieving an annual plantation rate of 4.2 million hectares appears to be a "gigantic" task for the Ministry. But what is perturbing is the fact that of a total of 33.60 hectares required for the purpose, the government could make available only 4.2 million hectares. For the remaining, it will have to depend on private individuals and institutions for forestation projects.

The present forest and tree cover in the country is 23.03%. Thus, an additional 6.4 million hectares of forest and tree cover is required for achieving the 25% forest cover target by 2007 and an additional 33.60 million hectares for 33% cover by 2012. In annual terms, the increase has to be at least 4.2 million hectares in the next eight years. Much of this has to take place on private, non-government and non-forest waste-lands over which the government has no direct management control. The involvement of people—particularly at the grassroots level—and agencies outside the government will be crucial in this.[12]

Biodiversity Conservation

Biodiversity conservation has received adequate attention in the NEP. An important object of the Biological Diversity Act, 2002 is to check piracy of biomaterial and traditional knowledge and to enforce intellectual property rights (IPRs) over them. The Draft Policy reiterates the letter and spirit of the Act.

Concerns on Fresh Water Resources

While dealing with freshwater resources, the NEP expresses alarm over the wasteful and inefficient use of surface as well as ground water and points to a slew of actions that need to be taken for conservation. The policy also refers to levy of proper user charges to reflect water scarcity and calls for a review of the subsidies now being extended to the agricultural sector. Agriculture consumes nearly 80% of the country's utilisable water. Surprisingly, the NEP makes no reference to the National Water Policy document already available.

Expectedly enough, NEP dwells on subjects such as air quality, mountain ecosystems, wetland conservation, creation of environmental awareness among the masses, and spreading environmental education.

Deficiencies in the Draft Policy

The draft Environment Policy naturally attracted a great deal of attention, controversy and criticism. According to Mr. N. R. Krishnan, former Secretary, Ministry of Environment and Forests, there are, *inter alia*, three notable omissions in the Draft Policy.[13] These are: (i) The NEP is silent on the energy front. Energy has much relevance to environment, particularly in the context of global warming. Viewed in the context of the country's growing needs and the fact that we are already the sixth largest emitter of greenhouse gases that cause global warming, India would be compelled, sooner or later, to accept some limits on its emissions. (ii) Urbanisation has a strong adverse impact on environmental quality. The NEP rightly starts with the premise that the environmental problems of India arise mainly out of its large and growing population. However, the NEP has given short shrift to urbanisation and human settlements. One expects this lapse to be corrected in the final document. The NEP is also silent on the role of urban local bodies in environmental improvement. These institutions are poorly endowed with finances and lack of expertise in managing the local environmental problems. (iii) The NEP has not recognised adequately the potential of the state governments in improving environmental quality. After all, most of the subjects that would fall under the definition of the term "environment" are within the law-making

powers of the state legislatures. Unless and until state governments are motivated enough to implement in letter and spirit the Environment Policy, however effective it looks on paper, the net result will be only poor.

Moreover, as experts insist, environmental management should focus on involving the poor for ecological preservation through mobilising them and by participatory governance. Environmental issues should be discussed among the rural people at the grassroot level of panchayati raj institutions. There is also a need to improve participatory governance by involving the SC/ST people and women. "This will develop the capability of economically and socially disadvantaged groups, particularly women's groups, to deal with community resource management systems with a focus on their livelihoods based on natural resources."

Though the Draft National Environment Policy needs to be improved in the context of certain glaring omissions and the failure to interlink the past and present developments to project a futuristic environment policy, which if properly implemented faithfully would achieve its objectives, the 2004 draft policy on environment forms a good discussion paper. It is likely to generate much interest among industry, academia and civil society.

CONCLUSION

Environmental issues and the concerns they raise amongst the different segments of society are well understood and appreciated today than ever before. Gone are the days when man exploited and used natural resources purely to whet his appetite for increasing consumption of goods and services. Even while such conspicuous consumption remains the halmark of today's materialistic civilization, the understanding and appreciation that these resources are scarce and irreplenishable and their unjudicious use can cause ecological damages have brought about a keener response to preserve the environment. Fortunately, this understanding starts from the very beginning of the formative years of children and students. Corporates too have realised the importance of environmentalism and have now become proactive stakeholders seeking sustainable solutions to such problems. Governments too are being influenced because of the strong advocacy of various stakeholders and even electorates. All these augur well for the protection of the environment.

KEYWORDS

- Biodiversity
- Business responses
- Charter
- Conservation
- Eco-friendly
- Environment policy
- Environmental audit
- Environmental concerns
- Environmental damage
- Environmental groups
- Environmental issues
- Environmental management
- Environmental performance
- Environmental philosophy
- Environmental preservation
- Environmental regulations
- Environmentalism
- Evidence of pollutants
- Forest and wildlife
- Forest cover
- Future outlook
- Generating cost savings
- Government regulation
- Industrial pollution
- Industrial pollution prevention
- International issues
- Key strategies
- Laws governing environment
- Life supporting systems
- Managing regulation
- National Environmental Policy
- Natural environment
- New approach
- Partnerships
- Pollution control
- Pollution prevention
- Principal health and productivity consequences
- Product differentiation
- Public opinion
- Redefining markets
- Risk management
- Role of stakeholders
- Self-regulation
- Sustainable development
- Media
- Toxic Corridor
- Voluntary pollution control
- Waste management

DISCUSSION QUESTIONS

1. What are the environmental concerns of modern societies? How are they being addressed by governments?
2. Trace the history of environmentalism. In this context, discuss the role of various man-made and natural disasters in raising public awareness towards the preservation of the natural environment.
3. Explain in your own words the crux of environmental philosophy. While doing so, discuss the different philosophical approaches adopted by environmentalists to the natural world.
4. Discuss the role of different stakeholders in raising the awareness of different institutions/authorities to preserve the environment.
5. Write short notes on *any two* of the following subjects concerning the environment:
   (i) Role of corporations in environmental management
   (ii) India's toxic corridor
   (iii) Waste management and pollution control
   (iv) Pollution prevention
6. Discuss critically the key strategies for the prevention of industrial pollution.

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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

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.

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The Role of the Media in Ensuring Corporate Governance

CHAPTER OUTLINE

- Introduction
- Importance of Media
- Corporate Governance and the Press
- Adverse Effects of Advertising
- Ethics in Advertising

Introduction

The media can play a major role in corporate governance by affecting reputation in at least three ways. First, media attention can drive politicians to introduce corporate law reforms or enforce corporate laws in the belief that inaction would hurt their future political careers or shame them in the eyes of public opinion, both at home and abroad. Second, media attention could affect reputation through the standard channel that most economic models emphasise. Managers' wages in future depend on shareholders' and future employers' beliefs about whether managers will attend to their interests in those situations where they cannot be monitored. This concern about a monetary penalty can lead mangers not to take advantage of opportunities for self dealing so as to create a belief that they are good managers. Third, media attention affects not only managers' and board members' reputations in the eyes of shareholders and future employers, but media attention affects their reputation in the eyes of society at large.

The media can play a role in corporate governance by affecting reputation. It can drive politicians to introduce corporate law reforms or enforce corporate laws in the belief that inaction would hurt their future political career or shame them in the eyes of public opinion. Media attention affects not only managers' and board members' reputations in the eyes of shareholders and future employers, but it also affects their reputation in the eyes of society at large.

Thus the media do play a role in shaping the public image of corporate managers and directors, and in so doing they pressure them to behave in accordance with societal norms. Depending on the situation this pressure can lead to shareholders' value maximisation.

In a country like India, where there is a variety of newspapers in various languages in circulation, on an average, there is a better environmental responsiveness. This is true even after controlling for the extent of environmental regulation, the availability of information on environmental outcomes, and the level of economic development measured as GDP per capita.

Importance of the Media

The press pressures managers to act not just in shareholders' interest, but also in a publicly acceptable way, and at times this helps a country to improve its corporate governance.

At times, the power of the media is so intense that a change takes place even in the absence of any legal requirement to act or legal liability not to act, for example, the former chief minister of Tamil Nadu Karunanidhi's arrest incident—where the police, in order to maintain a law and order situation, had to release the police tapes, which otherwise were said to be very confidential and not meant for public viewing.

Corporate Advertising

Advertising in India is a big business, though small compared to US and Europe. The main lacuna is that there is no agency or a regulator to control advertising. Advertising is constantly bombarded by criticism. It is accused of encouraging materialism and consumption, of stereotyping, of driving us to purchase items for which we have no need, of taking advantage of children, of manipulating our behaviour, using sex to sell, and generally contributing to the downfall of our social system.

Not only are many different media and techniques employed in advertising; advertising itself is of several, different kinds: commercial advertising for products and services; public service advertising on behalf of various institutions, programmes, and causes; and—a phenomenon of growing importance today—political advertising in the interests of parties and candidates. Making allowance for the differences among the different kinds and methods of advertising, we intend what follows to be applicable to them all.

Harms of Using Advertisement as a Media Tool

Advertising can betray its role as a source of information by misrepresentation and by withholding relevant facts. Sometimes, too, the information function of media can be subverted by advertisers' pressure upon publications or programmes not to deal with questions that might prove embarrassing or inconvenient. More often, though, advertising is used not simply to inform but to persuade and motivate—to convince people to act in certain ways, buy certain products or services, patronise certain institutions, and the like.

Political Advertising

Political advertising can support and assist the working of the democratic process, but it can also obstruct it. This happens when, for example, the costs of advertising limit political competition to wealthy candidates or groups, or require that office-seekers compromise their integrity and independence by over-dependence on special interests for funds. Political parties are using the media as a very effective tool for sending their messages to reach out to the people in the country. "India Shining" is an excellent example, when the Vajpayee government spent more than Rs. 600 crores of public money to get a political mileage, which somehow boomeranged on them.

Media and Corporate Governance

From a policy perspective, this evidence on the importance of media in corporate governance has two important consequences. First, previous research has mostly focussed on the legal and contractual aspects of corporate governance. Research suggests that this focus should be broadened, and that the policy debate should undergo a similar shift in focus. Second, the press pressures managers to act not just in shareholders' interest, but in a publicly acceptable way. This finding brings the role of societal norms to the forefront of the corporate governance debate. With a few notable exceptions, according to Coffee (2001), the role of these norms has been ignored, yet they may present an opportunity for reformers if they can increase communication about behaviour that violates norms and those norms support effective corporate governance. However, they might also represent a major obstacle to any attempt to improve a country's corporate governance system. In countries where firing workers to increase profits is viewed negatively, creating the incentives for managers to do so will be extremely difficult, especially in highly visible companies. This should be openly considered in any realistic plan to reform a country's corporate governance system.

Corporate Governance and the Press

The press also intersects 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 emerging markets? Recent events in the Republic of Korea indicate that it does.

Korea has long been known as a place where 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 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 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 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 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 Commission, 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 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 practice with 19 recommendations, including an enhanced role for 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 of listing that a company to include a statement of performance relative to the code and a written explanation for any variation in its annual reports. It has since become 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 requirements for disclosure rather than compliance.

The extent and 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 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.

Business School Governance and *Business* Week Rankings

In 1988, the magazine *Business Week* started to publish a ranking of the top US business schools. Despite its arguable criteria (most students experience no more than one business school, yet their responses are used to rank them), this ranking gained a lot of attention, and soon assumed the role of a standard in the industry. While there may not be of any systematic study of the effect of the introduction of these rankings on the governance of business schools, their impact is undoubtedly

huge. Suddenly teaching ratings became important and faculties were held accountable, new programmes were introduced to cater to students' needs, and some schools were even caught coaching their students how to respond to the *Business Week* questionnaires.

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 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 newspapers have credibility and thus avoid side deals for fear of losing it. Another is where newspapers do not have credibility and happily accept bribes not to publish damaging information or to publish false damaging information. Important factors that determine which equilibrium prevails are the competitive environment in which 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 wide 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 relative to environmental or corporate governance standards in too stark a way. In the United Kingdom, for example, while the recommendations

developed in the Cadbury, Greenbury, and 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, 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 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 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 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 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 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 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 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

- **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.

> 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.

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 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 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 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) References to eminent personalities/political figures and the use of national emblems are not normally permitted
(e) Comparative advertising should respect the principles of fair competition generally accepted in business.

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 Sec. 36A of the Act, 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.

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The following trade practices are considered to be unfair practices.

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 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 repeat 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 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.

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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 consumers and to 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 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 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 price of 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 medical ethics. Similarly, prescription drugs cannot be advertised for. There are restraints which respect to certain media—liquor or cigarettes cannot be advertised on state channels.

Advertising has a large social responsibility as it is highly visible. The role of 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, contents, 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.

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 helath-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 advertising
- Corrective advertising
- Ethics in advertising
- Fullest possible disclosure
- Governance problems
- Government regulators
- Impact of media
- Institutional investors
- 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?

NOTES

1. Bargain price means
   (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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14

Monopoly, Competition and Corporate Governance

CHAPTER OUTLINE

- Introduction
- The Concept Logic and Benefits of Competition
- Benefits of Competition to Stakeholders
- What is a Good Competition Policy?
- Indian Competition Act
- MRTP Act and Competition Act

Introduction

A monopoly is said to exist where one person or a company controls at least one-third of a local or national market. The attitude of the public in many countries towards complete and partial monopolies has for many years been one of acute and distinct opposition. This has been mainly due to the abuses of monopoly which include: (i) high prices and restricted output; (ii) wrong allocation of resources; (iii) abuse of investors by monopolists painting alluring pictures of high profits and perpetual exploitation of the market; (iv) preventing inventions since a monopolist's profits do not depend upon continuous progress in production; (v) increasing the instability of the economic system; (vi) unfair trade practices such as price discrimination, secret rebates and so on; (vii) undue economic clout being used to curry political favours; (viii) corruption and bribery; and (ix) concentration of economic power in the hands of a few. It is for these reasons that monopoly has been regarded as a social evil and various measures have been designed in free enterprise economies to control and regulate it or in some cases to eliminate it altogether. Moreover, it is an obvious fact that monopoly with its attendant evils such as practices of dominant firms, high prices for poor quality products, cheating the consumer, unfair trade practices that go against rivals in business, corruption and bribery militates against the very principles of corporate governance. This is the reason why societies that value corporate democracies and better governance practices have enacted anti-monopoly laws that have attempted to (a) prevent monopoly firms from coming into existence, (b) get them dissolved if they exist already or split them into a number of competing firms and (c) prevent monopoly firms from indulging in unfair trade practices such as price discrimination and cut-throat competition.

Basically, the difference between a competitive firm and monopoly firm arises from the fact that in the former, supply of a commodity comes from thousands of sellers, each selling a small quantity with a limited capacity to charge high or different prices, while in the case of the latter, there is only one firm controlling the entire supply or a substantially large portion of supply of the product with a capacity to charge high or different prices.

A competitive firm in a free market economy is preferred to a monopoly for a variety of reasons: (i) the consumer stands to gain under it because of low prices available due to intense competition; (ii) firms avoid wastages and duplication of efforts as they have to be competitive; (iii) firms tend to be efficient in a system of the survival of the fittest and therefore they tend to be so and (iv) they maximise the gains for the society as a whole by deploying resources in the best possible use in the context of consumer's tastes and preferences. Competition is thus considered to be the best market situation and its link to corporate governance practices the closest.

> Some of the ultimate benefits expected from competitive markets are increase in the number of producers and sellers in the market, increase in investment leading to increase in supply capabilities, a strong incentive for developing cost-cutting technologies through sustained research and development efforts, reduction in wastage and improvement in efficiency and productivity.

The Concept, Logic and Benefits of Competition

Economists assert that given the resources and technology, an economy is efficient when it is able to provide its consumers with the most desired range of products at minimum cost and this is possible under the mechanism of a competitive market, leading to the determination of equilibrium price. In a particular product segment, marginal cost and marginal utility of a product are exactly balanced at the equilibrium price. Once the efficiency is achieved, it is not possible to reorganise production in order to make someone better off without making someone else worse in that particular situation. In the practical world, however, business decisions are affected more by actual rather than potential competition.

Some of the benefits expected from competitive markets are given below:

- Growth of entrepreneurial culture leading to increase in the number of producers and sellers in the market
- Increase in investment and capital formation leading to increase in supply capabilities
- A strong incentive for developing cost-cutting technologies through sustained research and development efforts
- Reduction in wastage and improvement in efficiency and productivity.
- Greater customer focus and orientation
- Increased possibility for entering and tapping foreign markets
- Conducive environment for growth of international trade and investment.
- Better resource and capacity utilisation
- Wider range of availability of goods and services leading to wider choice for consumers and survival of the fittest whereas the inefficient firm falling by the wayside.

On account of these perceived benefits, governments in free enterprise countries take steps to create and promote competition. This, however, requires a suitable economic system and the constitutional framework as well as an appropriate macroeconomic policy set-up. The transformation of a centrally controlled, planned or socialist economy to a free enterprise system is not easy as was demonstrated in the attempt of erstwhile Soviet-type economies to market-driven economies. It requires major shift in the institutional philosophy of the structure, production system, socio-economic policies and the fundamental philosophy of the government itself. For this, the transition period could be long, painful and problematic. A number of economies in Eastern Europe are facing serious transition problems in the gradual process of liberslisation towards market-oriented system. The movement towards market-based system is generally slow and has to be based on adaptive processes.

Regulation of Competition

While it is important and necessary to promote competition among firms to enable consumers gain maximum advantage from a free market economy, an unregulated competition is bad and may even lead to unmitigated disaster and destruction of the nation's wealth. Competition particularly between firms of highly unequal strength can be self-destructive. In unregulated markets there can be widespread negative spillover effects. The negative effects could be in the form of information asymmetries, unethical collusions, hostile takeovers, malicious interlocking directorates in companies, transfer pricing, strategic market alliances, unjustified market segmentation and differential pricing and a number of other monopolistic and unfair trade practices. These factors result in anticompetitive outcomes, which underscore the need for regulation of competition.

> An unregulated competition is bad and may even lead to disaster and destruction of the nation's wealth. Competition, particularly between firms of highly unequal strength, can be self-destructive. The regulation and protection of competition usually requires a competition policy backed by an appropriate legislation. There are three basic areas of such competition policy—control of dominance firms by regulation, control of mergers to prevent the possibility of emergence of monopolies and control of anti-competitive acts like full-line forcing and predatory pricing.

The regulation and protection of competition usually require a competition policy backed by an appropriate legislation. There are the following three basic areas of such competition policy:

- Control of dominance firms by regulation
- Control of mergers to prevent the possibility of emergence of monopolies
- Control of anti-competitive acts such as predatory pricing.

In India we had a long tenure of Monopolies and Restrictive Trade Practices (MRTP) Act, 1969 replaced recently by Competition Act 2002 which was passed in December 2002. In the UK, Competition Act, 1980, empowers the Office of Fair Trading (OFT) to investigate anti-competition practices. In the US, the Anti-trust legislation seeks to control monopoly and restrictive practices in favour of competition. It specifically deals with price discriminations, exclusive dealings and interlocking directorates and shareholdings among competing companies.

Corporate Governance Under Limited Competition

The influence of competition on the practice of corporate governance can be gauged properly if we look at the risks associated with markets where competition is restricted. Regulatory barriers and firm-level practices have tended to limit the scope of competition in takeovers, disinvestments and privatisation, both in industrial and developing countries.

The influence of competition on the practice of corporate governance can be gauged properly if we look at the risks associated with markets where competition is restricted. While there is an increasing liberalisation of markets for goods and services in recent times in several erstwhile socialist countries and mixed economies like India, the need for corporate control is generally overlooked. Regulatory barriers and firm-level practices have tended to limit the scope of competition in takeovers, disinvestments and privatisation, both in industrial and developing countries. In more advanced markets, it was found that as regulatory barriers were imposed on corporate control transactions, managerial efforts and board supervision became weak. Firms try to postpone addressing business problems. Corporate performance generally declines with adverse consequences for shareholders.

According to a research study on the US corporate sector in late 1980s, when sharply intensified anti-takeover regulations brought control transactions to a halt, a very large number of the leading firms failed to produce any economic value addition for their capital and R&D expenditures. It was true that many firms produced satisfactory results despite the deteriorating business environment, but the average return on investment capital was surprisingly low.

Constraints to Competition in Developing Countries

Among developing countries, restricted competition in the market for goods and services is a more prevalent situation. There are diverse constraints, ranging from anti-competitive practices by firms to government policy restrictions on ownership and entry. Frequently, entry barriers are disguised as regulation purportedly designed to serve the "public interest". In fact, these policies usually give the preferred producers and service providers profits in excess of competitive returns. Such profits, however, come from distorted prices, which is truly a hidden tax on consumers.

With easy if not ensured profits and preferential treatment, such firms have little or no incentive to use resources efficiently. At any given time, firms insulated from competition generally incur costs, which are higher than what is possible under the best technical and managerial practices leading to inefficiency in operations. Over time, these losses are compounded by the misallocation of resources as the distorted price and profit signals lead firms to make poor investment decisions. Notwithstanding such inefficient practices, these firms may still produce satisfactory operating and financial results. High prices mask high costs. And the resulting burden is borne by the society as a whole. India's was a classic example wherein the government adopted between 1951 and 1991 a highly restricted policy in the name of import substitution and protection of home industry, which resulted in gross inefficiency, high prices, shoddy goods and an overheated economy. In such a system, corruption and black money abounded and corporate governance was unheard of.

Banks' Role in Restraining Emergence of Securities Markets

Banks, which play a predominant role in financial intermediation in developing countries, maintain cozy relationships with established and often well-connected businesses, a natural outcome in a protected and profitable business environment in which both the borrowers and the lenders operate. In some countries, commercial firms also own and control major domestic banks, creating business conglomerates

with "in-house" sources of easy financing for themselves, as was the case in India before 20 of these banks were nationalised in 1960s and thereafter. Moreover, bank lending is often determined by political directives, which generally favour large incumbent firms. Some of these practices contributed to the high leverage of leading firms in East Asia, as well as the widespread corporate distress and banking failures in the financial turmoil that occurred in these so-called Tiger Economies in early 1990s. More generally, preferred access to bank credit significantly reduces the need of incumbent firms to rely on securities markets where external financiers often demand transparency and accountability of corporate insiders.

Lack of Competition Promotes Ownership Concentration

Lack of competition accentuates ownership concentration. Owners of incumbent firms have an incentive to retain control of profitable domestic operations. They may choose to remain a private firm or may go public, but without giving up control either by retaining a controlling stake or by issuing non-voting shares. Research findings show that a higher share of the leading firms remains private in less competitive markets. Even within the group of publicly traded companies, a higher proportion of closely held firms are observed in less competitive economies such as India.

While concentrated ownership in individual firms may not cause much concern, there is nonetheless a greater risk of abuse committed by corporate insiders. Unless this risk is mitigated, it is difficult to attract minority and foreign shareholders. Taken to the extreme, ownership concentration and the reliance on internal resources can undermine the development of securities and capital markets, without which corporate governance practices may be too difficult to put in place.

Benefits of Competition to Stakeholders

Competition improves the conduct of managers, as they understand that in such markets only the fittest can survive. This, in turn, improves quality of products and reduces prices for consumers, and maintains or increases market share, and return on shareholders' investment. Consumers in economies having hitherto restricted competition as in India are reaping these benefits. In a much freer market today they enjoy a wide variety of products and services to choose from, competitive prices, technically updated products and other consumer friendly policies such as easy and installment credit, longer warranties etc. These benefits of competition can be analysed from two aspects: (i) competition in the product market and (ii) competition in the capital market.

Competition improves the conduct of managers. This, in turn, improves quality of products and reduces prices for consumers, and maintains or increases market share and return on shareholders' investment.

Competition in the Product Market

Competition is a positive sum game and not a zero sum game. Increased competition can increase shareholder and consumer welfare. Competition provides strong incentives for performance. It aids in defending and expanding market share. It also helps in the provision of accurate information to measure performance, that is, it increases transparency in all operations. Competition to win market share drives greater efficiency and innovation. It passes on lower prices to consumers and eliminates monopoly rents. All this ultimately benefits the consumer.

Impact on management is such that there is a need to actively drive costs down. Benchmark performance measures are available through reference to competitors unlike in monopoly. It encourages a customer-driven market rather than product-driven market. In a competitive market, the consumer is truly the king as it is he who determines the quality and quantity of the products, as reflected in the price mechanism. Competition in product markets is generally associated with allocative and productive efficiency. Competition encourages the supply of goods and services at lowest costs and prices.

Competition in a Capital Market

While the benefits of competition to consumers in the product market can be directly linked to and may reflect corporate governance practices, it may not be so direct in the case of capital market. Often, competition may undermine the development of long-term relation between companies and financial institutions. For example, the willingness of banks to provide rescue finance to firms in financial distress, returns hinge on the expectation that these investments will yield long-term benefits. Where there is competition in financial markets and firms are in financial distress, then the provision of rescue funding by banks may be discouraged. On the other hand, limitations on competition in financial markets may result in monopoly exploitation of borrowing firms. The desire to retain corporate control, i.e. for the ownership of companies drives performance. The threat of takeover acts as discipline on management. The inefficient use of assets and poor strategy or lack of leadership are not rewarded in a competitive environment. Thus a firm that remains competitive will be able to get the required funds through the capital market.

Competition may undermine the development of long-term relation between companies and financial institutions. Where there is competition in financial markets and firms are in financial distress, the provision of rescue-funding by banks may be discouraged. On the other hand, limitations on competition in financial markets may result in monopoly exploitation of borrowing firms.

Economic Power and Political Influence

Regulatory and private restraints on the competitive process have a deeper ramification. Existing firms tend to be relatively large in size and few in number. They have a definite organisational and financial advantage in influencing the legislative and regulatory agenda. In advanced countries, where there is a depth of informed opinions, competing interests and independent media, powerful commercial interests may not always prevail. But, in most developing countries, competing opinions are more limited. In this context, interest groups are more likely to succeed in furthering their own agendas. It is often alleged that street-smart present generation companies like Reliance, wielding enormous political influence grew much faster than those which preferred to be independent. They could not grow much, although they were in the industry for generations.

The close connection between economic power and political influence is generally recognised. The successful resistance of public enterprises to privatisation programmes is an example that has been encountered over a wide spectrum of geographies, cultural and economic environments, ranging from Ghana to India and Thailand. Another example is the successful opposition of domestic bankers in many countries to the competition of foreign banks as it has been happening in developing countries like India. Even under the stress of a crisis, major conglomerates in East Asia were able to water down unfavourable reforms and stretch out the onset of implementation.

Incumbent firms often use their political influence to entrench the position of management and corporate insiders. In many jurisdictions, they can freeze-out minority shareholders at unfavourable prices, dilute the voting power of minority shareholders by issuing new shares in private placements or use other means that

allow them to reject takeover bids without shareholder approval. In spite of the obvious risk to investors, change is not easy to come about.

The ability of existing corporate elite to resist policy reform is a cause for concern. For one thing, inadequate competition limits the access to capital by new or small businesses. Lenders and investors naturally prefer more established firms with significant business advantages. Over time, the industrial structure may be skewed, with a few large conglomerates dominating, and a large number of small firms struggling with little prospect for growth. This has been proved time and again in developing countries like India. Another concern is, with distorted prices that guide business decisions, the pursuit of profits may be detrimental to social welfare. Profitable operations based on domestic prices may actually produce a loss when the inputs and outputs are valued at world market prices. This certainly has been the case with many commodity monopolies in Africa and politically connected conglomerates in East Asia.

Competition and Political Governance

Political governance includes regulatory environment and policy making in public interest. Monopolisation can affect political governance and indirectly affect corporate governance.

Political governance includes the regulatory environment and process. It involves policy making in the public interest. Monopolisation, or lack of competition generally, can affect political governance and indirectly affect corporate governance. Examples of where political governance has greatly influenced competition include many instances where a few incumbent monopolies who accounted for a large share of markets and were not challenged by entry. Examples are galore in banking, insurance, and transport and communication sectors in India where state monopoly firms dominated the industrial scene for more than 40 years with little room for competition. During the pre-liberalisation era, there was an abundance of state-owned monopolies. The License Raj and high license fees created barriers to entry, thus thwarting competition.

Effects of Monopoly on Political Governance

In such a state of affairs,

- The political and economic control may be too concentrated. Democracy and competition get undermined.
- There is reduced political accountability and transparency. There is increased corruption.
- Shareholder interest may be confused or compromised by multiple and conflicting objectives.

Effects of Monopoly on Corporate Governance

Examples abound where due to deliberate state policy and with little objective regulation, politically influential family-owned companies emerge as winners thwarting even the limited competion. Managements are not interested to put in place any corporate governance practices. Their focus is distorted away from commercial objectives towards political influence. Political favours weaken management and accountability. There is lack of transparency, so there is reduced incentive to invest and increased risk in equity markets. The tug-of-war between the Ambani brothers in th recent past and allegations of corporate misgovernance in India's leading and the most successful industrial conglomerate illustrates and proves this point.

Competition in product markets and market for corporate control encourage good governance. For good corporate governance, on one hand, there are ethics, self-regulation and "fair play"; on the other hand, there are sharp practices and "cowboy" behaviour.

Encouraging Good Governance

Competition in product markets and the demand for corporate control encourage good governance. For good corporate governance, on one hand there are ethics, self-regulation and "fair play", on the other, there are sharp practices and "cowboy" behaviour.

The reputation effects of external auditors can be very important in enforcing good governance, particularly where there are complexities and other issues that make shareholder monitoring difficult. Takeover codes should not be "captured", but should maintain a consumer and shareholder focus.

Regulating Good Governance

Competition is not always readily available. There are certain areas where there is no competition in the Indian scenario. These include the non-market areas (e.g. defence). They also include natural monopolies, scale effects and network effects. There are many industrial and service segments in the economy, which are still under the tight grip of the government wherein corporate governance is far from reality.

At the same time, competition is not the only solution to the myriad of problems that exist in such economies. There is a need to regulate certain fiduciary relationships. Steps should be taken to prevent exploitation and/or abuse of information. There should be situations of asymmetric information between buyer and seller.

Enforcement of Good Governance

There can be private enforcement through the market mechanism or through voluntary or self-regulation through trade associations if the losers are sufficiently well-informed, concentrated and having the required expertise. Public enforcement is called for if private efforts do not work or if matter is criminal. The positive effects of competition can also reduce the burden of enforcement.

Public enforcement is resorted to where self-regulation and private enforcement will not work in competition policy because consumers or buyers are not sufficiently informed or concentrated to take a company to a court of law. Those who are most likely to bring suit may not be those affected allowing pass-through without blowing the whistle.

Regardless of competition, it is important to have sound rules and regulations. Enforcement is vital, complementary to competitive mechanisms, and often may be required to put in place corporate governance practices.

Challenges to Good Enforcement

The credible threat of detection whether from private or public investigation/monitoring, requires resources. Meaningful sanctions applied in a timely period with correct burden of proof, depend on legal system and legislative and judicial approaches to white-collar crimes. This is a big challenge in the area of international cooperation as globalisation continues.

Competition Agencies and Competition Policies

Ultimately, the key role of competition is to enhance economic freedom. It provides opportunities for new entrepreneurs and firms to compete on economic merits, and not on the ability to garner political favours. More business ideas get to face the market test. Over time, firms with good governance are more likely to succeed, while those without it will be shunned and weeded out.

Competition policy seeks to prevent anti-competitive practices and business developments or policy reforms which may facilitate these practices. It aims to stop unfair business tactics and abuse of market power or political office to gain excess profits. With a clear set of competition rules, the government is in a better position to resist the lobbying of interest groups for preferential treatment. Experience also shows that useful to maintain economic efficiency as the principal policy objective. Encumbering competition policy with other goals, such as employment, regional development and social pluralism, as has been practised in India, tends to compromise the beneficial result.

To be effective, the enforcement agencies should have adequate independence, resources and the necessary powers to review, investigate and initiate prosecution of anti-competitive practices. Effectiveness is also enhanced in most countries, except perhaps those with very large domestic markets, if the enforcement agencies focus on firm behaviour concerning anti-competitive pricing and business practices. Often structural issues such as market share and industry concentration can be addressed through removal of restrictions on foreign trade and investment, as well as domestic barriers to entry.

In addition to enforcement, an important role of competition agencies is to review and spell out the implications of public policies and regulatory practices on competition and efficiency. "This function increases public awareness of the costs and benefits of alternative policies and helps ensure that government policy initiatives do not work at cross-purposes." Another important role of competition agencies is to collaborate with their counterparts abroad in the sharing of information and experience, as well as in the investigation of cross-country anti-competitive practices, including international cartels, the scale and impact of which is only recently being recognised. In this respect it will be useful to understand the factors that constitute a good competition policy.

The intent of the legislation in India to promote competition is not to prevent the existence of a monopoly across the board. There is a realisation in policy-making circles that in certain industries, the nature of their operations and economies of scale indeed dictate the creation of a monopoly in order to be able to operate and remain viable and profitable as in the case of public utilities such as railways, posts and telegraph departments. This is in significant contrast to the philosophy, which propelled the operation and application of the Monopolies and Restrictive Trade Practices (MRTP) Act, the trigger for which was the existence or impending creation of a monopoly situation in a sector of industry.

What Is a Good Competition Policy?

To accomplish the objectives of free markets a conducive competition policy is regarded for conserving and sustaining the efficiency of open markets. Such a policy should aim at fostering an active competitive environment in which globally competitive firms would emerge with larger investment and higher technological capabilities and would have all policy instruments that would promote competition in markets.

A good and effective competition policy with the objective of restraining the emergence of monopolies and bringing in a competitive market that would ensure benefits to the consumers and overall economic efficiency, and at the same time taking cognisance of the specific needs of a developing country like India, should have the following characteristics:

(i) It should be capable of controlling the misuse of the market power of dominant firms. It should have a clear perception of dominance and should develop unambiguous criteria for determining the abuse of dominance.

A conducive competition policy should aim at fostering an active competitive environment in which globally competitive firms would emerge with larger investment and higher technological capabilities and would have all policy instruments that would promote competition in markets. A good and effective competition policy should be capable of controlling the misuse of the market power of dominant firms.

(ii) It should be able to identify the anti-competitive effects of mergers and acquisitions and provide a prescription to deal with such effects.

(iii) It should check the barriers to entry, subject to the provisions of industrial policy.

(iv) It should be able to identify, monitor and prevent collusion, cooperation or alliances between independent firms in various institutional forms such as cartels and trade associations with a view to restricting, suppressing or modifying competition. Collusion may take a number of tacit or explicit forms and may involve output restriction, price fixation, distribution controls or market sharing. In many cases, collusions are designed to prevent the entry of potential firms.

(v) It should be capable of monitoring and preventing anti-competitive agreements between business organisations.

(vi) It should be able to identify restrictive and unfair trade practices and provide a continuous mechanism to prevent them.

(vii) It must ensure that competition leads to better productivity and efficiency and wider choice to the consumer.

(viii) The policy should apply to all the major segments of the economy including agriculture, agribusiness, manufacturing, infrastructure, utilities and services.

(ix) It must provide suitable defenses and protection measures to the marginal/vulnerable or weaker enterprises in the small-scale sector, which have national importance.

(x) The policy must factor international forces and influences and work in the national interest.

(xi) The policy should be able to create a level playing field for various categories of enterprises and must target an optimum degree of competition; which is in the best interest of the economy from the point of view of growth, equity and social justice.

Indian Competition Act

Competition Act is important for businesses in the following three main areas:

- Commercial agreements and trading practices
- Conduct towards competitors, suppliers and customers, especially in the case of firms with a strong market position
- Mergers and acquisitions

Since the adoption of the economic reforms programme in 1991, corporates have been pressing for the scrapping of the MRTP Act. The argument put forward in favour of scrapping it was that the MRTP Act had lost its relevance in the new liberalised era and global competitive markets. It was pointed out that only large companies can survive in the new competitive markets and therefore "size" should not be made a constraint. Accordingly, the government appointed an expert committee headed by S. V. S. Raghavan to examine the whole issue. The Raghavan committee submitted its report to the government in May 2000. The committee proposed the adoption of a new competition law and doing away with the MRTP Act. The Competition Bill, 2001, was introduced in the Lok Sabha in August 2001 and was referred to the Parliamentary Standing Committee on Home Affairs, chaired by Pranab Mukherjee. The committee tabled its report in the Parliament in November 2002. The report contains two different views. While some members favoured the passage of the Bill, some others contended that by

enacting the Bill at this stage, India would lose its bargaining power at the WTO negotiations. They have, therefore, suggested that the Bill should not be enacted till 1 January 2005 by which time some decisions on issues such as competition policy, trade and investment and related matters have been taken.

Objectives of the Bill

The basic objectives of the Competition Bill designed to replace the MRTP Act were the following:

1. Encourage competition
2. Prevent abuse of dominant position
3. Protect the consumer
4. Ensure a level playing field to participate in the Indian economy

The spirit behind the Competition Bill is that "big" is no more bad, but hurting competition and consumer interest is. For instance, S. Chakravarty, a member of the Raghavan Committee pointed out: "Size is no longer the issue. It could become only when consumer interest is compromised".

The Competition Act, 2002

The objective of the Competition Act is to provide for the setting up of a commission to prevent practices having adverse effect on competition, to promote and sustain competition in markets, to protect the interests of consumers and to ensure freedom of trade carried on by other participants in markets in India.

The Competition Act that extends to the whole of India, except Jammu and Kashmir, received the assent of the President on 13 January 2003. The objective of the Act is to provide, keeping in view of the economic development of the country, (i) for the setting up of a commission to prevent practices having adverse effect on competition (ii) to promote and sustain competition in markets (iii) to protect the interests of consumers and (iv) to ensure freedom of trade carried on by other participants in markets in India, and for matters connected therewith or incidental thereto.

The NDA Government while introducing the Competition Commission of India (CCI) provided for the appointment of a bureacrat to head it. But the Supreme Court disposing of the petitions field by two advocates, stayed this and the central government was asked to consider amendments to the Act.

The Centre informed the Supreme Court that a technical expert and not a judge would chair the commission which would have a maximum of six members, apart from the chairman. However, there would be an Apellate Tribunal to hear appeals against the orders of the Competition Commission. This tribunal would be headed by a sitting or retired Supreme Court Judge or a Chief Justice of a High Court. The other two members would be experts in competition and other related matters.

Competition Commission of India

The Competition Commission of India (CCI) is to be set up as a quasi-judicial body and would have a chairperson and a team comprising two to ten members. The CCI would have separate prosecutorial and investigating wings.

The Bill advocated a regulating body called the Competition Commission of India (CCI). The CCI was to be a quasi-judicial body and would have a chairperson and a team comprising two to ten members. The CCI would have separate prosecutorial and investigating wings. It would be entrusted with various powers such as the power to grant interim relief, enquire into certain combinations, impose fines on the guilty, order divisions of an undertaking, pass "cease and desist", order a demerger and direct payment to be made to aggrieved parties for loss or damage suffered by them. The administration and the enforcement under the Act to be done by the CCI are proactive rather than reactive.

The newly formed Competition Commission of India has started regulations and has been planning to bring big-ticket domestic merger and acquisition (M&A) deals under its ambit as these deals are expected to influence competition.[1]

However, the commission, taking a global cue, has set certain benchmarks in terms of deal size and company turnover for these competition norms to apply. To start with, M&A deals involving companies with a minimum turnover of Rs. 4,000 crore or groups with a minimum turnover of Rs. 12,000 crore would require a clearance from the commission. Apart from these norms, the commission is also said to have *suo moto* powers to intervene in any deal, which may directly or indirectly affect competition in any particular industry or segment.[2]

According to Amitabh Kumar, Director General, Competition Commission of India: "The commission would take up M&A deals, adhering to certain threshold levels, once we complete our initial obligations as mandated by the Competition Commission Act, which include competition, advocacy functions and regulation."

He said that the commission was finalising its draft regulations, which would essentially function like a rulebook, prescribing the conditions to be met for healthy competition in the domestic industry. "The draft regulations are being prepared after extensive study of overseas experience and other quasi-judicial bodies in India. In fact, two firms practising Competion Law in the UK and Belgium have appreciated the draft."

The commission has already done intensive interaction with leading industry chambers as well as set up a Competition Advocacy Committee for imparting the scope for a commission of this sort. The commission has also engaged several research projects with various institutes like the Jawaharlal Nehru University (JNU) and a few other organisations.

As it stands today:

- The commission would have *suo moto* powers to intervene in any M&A deal, which may affect competition in any industry or segment.
- Draft regulations of the commission would function like a rulebook for prescribing conditions for healthy competition.
- Competition Advocacy Committee set up to examine scope for such a commission.
- The commission has engaged in research projects with various institutes, including the Jawaharlal Nehru University and other organisations.

The Three Focus Areas of Competition Act

The focus of the Competition Act was on three identified areas where anti-competitive practices could prevail.

1. Agreement Amongst Enterprises: The Act deals only with those agreements between enterprises, which have an appreciable adverse effect on competition. This means that all restrictive agreements are not held to be anti-competitive. The rule of reason is to determine whether an agreement is anti-competitive. The objective of the rule of reasons is to determine whether on merits the activity promotes or restrains competition. To determine this, the CCI will consider the structure of the market as well as the action in question. The CCI is vested with the power to enquire into cartels of foreign origin directly as well.

2. Abuse of Dominance: The Act regulates all agreements, which could result in abuse of dominance. The enterprise should be "dominant" and the agreement should have resulted in "abuse" of the dominance. Dominance has been defined as "the position of strength in the relevant market enjoyed by an undertaking which enables it to operate independent of competitive pressures in the relevant market and also to appreciably affect the relevant market, competition and consumers by its actions.

'Abuse' would include agreements charging or paying unfair prices, restriction of quantities, markets and technical development. It includes discriminatory

behaviour, predatory pricing and any exercise of market power leading to the presentation, restriction of distortion of competition.

3. Mergers of Combination Among Enterprises: The Act regulates all mergers, which create a position of dominance post-merger. It is understood that the government would make pre-merger notification if required, voluntary. It also provides for a deemed approval of a merger in the absence of a response from the CCI within a period of 90 days. However, it would be mandatory for financial institutions, foreign institutional investors and venture capitalists to file the details of acquisition with the CCI within a week of entering into an agreement.

The CCI, however will have the power to make an investigation into a merger even after 1 year of the pre-merger notification either *suo moto* or on a complaint. The Act rules out any post-merger review for individual company mergers, which have a combined turnover of less than Rs 3,000 crore or a combined asset size of upto Rs 1,000 crore in India.

The MRTP Act and the Competition Act

The Competition Act is meant to replace the MRTP Act, which controls and regulates the growth of enterprises. The MRTP Act presumes that all restrictive trade practices are anti-competitive and requires registration of the said agreements. Under the MRTP Act, dominance *per se* is considered bad. Under the Competition Act it is the "abuse of dominance" that is considered bad. Therefore, the CCI can enquire into any agreement that is in contravention of the Act either in its own knowledge or on receipt of complaints or any reference by the central/state government only if dominance has been abused by an enterprise.

> The Competition Act is meant to replace the MRTP Act, which controlled and regulated the growth of enterprises. The MRTP Act presumed that all restrictive trade practices were anti-competitive and required registration of the said agreements. Under the MRTP Act, dominance per se is considered bad while under the Competition Act it is the 'abuse of dominance' that is considered bad.

The Competition Act in contrast to the MRTP Act is more industry-friendly. It is designed to foster and maintain competition. While the MRTP Act was very reactive, rigid, had no teeth and its Commission acted more like an extended arm of the Department of Corporate Affairs, the Competition Act provides more autonomy to the Competition Commission. It is expected to be more flexible and proactive.

The *raison d'etre* of the Competition Act is to create an environment conducive to competition. However, in a significant departure from the letter and spirit of the MRTP Act, the Competition Act does not openly condemn the existence of a monopoly in the relevant market. This is reflected in Section 3, which states that enterprises, persons or associations of enterprises or persons shall not enter into agreements in respect of production, supply, distribution, storage, acquisition or control of goods or provision of services, which cause or are likely to cause an "appreciable adverse effect" on competition in India. Such agreements would consequently be considered void. The species of agreements which would be considered to have an "appreciable adverse effect" would be those agreements which directly or indirectly determine purchase or sale prices, limit or control production, supply, markets, technical development, investment or provision of services, share the market by allocation of *inter alia* geographical area of market, nature of goods or number of customers or which directly or indirectly result in bid rigging or collusive bidding. Specific examples of the types of agreements, which, if they cause an "appreciable adverse effect", are "tie-in arrangements".

Section 4 clearly stipulates "No enterprise shall abuse its dominant position." "Dominant position" is the position of strength enjoyed by an enterprise in the relevant market, which enables it to operate independently of competitive forces prevailing in the market, or affects its competitors or consumers or the relevant market in its favour. Dominant position is abused when an enterprise imposes unfair or discriminatory conditions in purchase or sale of goods or services or in

the price in purchase or sale of goods or services. There is also abuse of dominant position when an enterprise limits or restricts production of goods or services or technical or scientific development, acts in a manner which denies market access, prevails upon contracting parties to be contractually bound by acts which are not a part of the intent of the parties as well as by the use of dominant position in one relevant market to enter or protect another relevant market. Again, the philosophy of the Competition Act is reflected in this provision, where it is clarified that a situation of monopoly *per se* is not against public policy but, rather, the use of the monopoly status such that it operates to the detriment of potential and actual competitors.

The Competition Act is designed to regulate the operation and activities of "combinations," a term, which contemplates acquisitions, mergers or amalgamations. The operation of the Competition Act is not confined to transactions strictly within the boundaries of India but also such transactions involving entities existing and/or established overseas.

The Competition Act is also designed to regulate the operation and activities of "combinations", a term, which contemplates acquisitions, mergers or amalgamations. A combination is discussed and defined on several levels, including any acquisition where the parties to the acquisition (the acquirer and the enterprise) have assets in India worth more than Rs. 1,000 crore or turnover in excess of Rs. 3,000 crore or within or outside India, in the aggregate, assets worth more than $500 million or turnover in excess of $1,500 million. Thus, the operation of the Competition Act is not confined to transactions strictly within the boundaries of India but also such transactions involving entities existing and/or established overseas.

It is also important to understand and appreciate the intent of the Competition Act. The objective of the Act is not to prevent the existence of a monopoly across the Board. As has been pointed out earlier, policy-makers have realised that in certain industries, the nature of their operations and economies of scale indeed dictate the creation of a monopoly in order to be able to operate and remain viable and profitable. The word "monopoly" is no longer taboo in corporate and political India.

The Act declares that a person and enterprise are prohibited from entering into a combination, which causes or is likely to cause an "appreciable adverse effect" on competition within the relevant markets in India. Such combinations would be treated as void. A system is provided under the Act wherein at the option of the person or enterprise proposing to enter into a combination may give notice to the Competition Commission of India of such intention providing details of the combination. The Commission, after due deliberation, would give its opinion on the proposed combination. However, entities which are not required to approach the Commission for this purpose are public financial institutions, foreign institutional investors, banks or venture capital funds which are contemplating share subscription, financing or acquisition pursuant to any specific stipulation in a loan agreement or investor agreement.

Restrictions on the Applicability of the Act

The sweep of the Competition Act is not such as to include all agreements within its ambit. Thus, agreements which are entered into in respect of various species of intellectual property rights and which recognise the proprietary rights of one party over the other in respect of trade marks, patents, copyrights, geographical indications, industrial designs and semi-conductors are not within the purview of "anti-competitive agreements". The inherently monopolistic rights, which are created in favour of *bona fide* holders of various forms of intellectual property, have been treated as sacrosanct.

Change in the Mindset Needed

Though our policy makers have realised of late the importance of competition for a growing economy in a globalised market, there is still a blurred vision among them in understanding and implementing a competition policy.

Pradeep S. Mehta in his article "Competitiveness via Competition" in *Economic Times* (23 November 2004) argues: "It is important to understand the distinction between competition policy and competition law. Competition policy, which we do not have, needs to be a stated government intent on how it aims to promote competition in our economy. It will envelop various other policies, viz., investment, trade, labour, consumer etc. to ensure that wherever there are conflicts, decisions to promote competition would get priority. A good example of this is the continuous de-reservation in the SSI sector. A competition law is a market instrument to ensure that firms behave and trade in a fair manner. However, the competition law cannot be a panacea to cure all ills of the market place."

Mehta further argues that the market place comprising enterprises, farmers and households, consumes a large number of goods and services whose efficiency and competitiveness are determined by the input costs. When the new Competition Act 2002 was being debated, many business interests lobbied against it, for the valid fear that it might be a new avatar of the control regime's MRTP Commission, and not a modern market regulator. This was based on the assumption that once again like all our new regulatory bodies, we would have retirees manning the system whose knowledge about economics and laws is inadequate. If we take the telecom regulator as an example, the CUTS research shows that the telecom sector's phenomenal growth as a consequence of increasing competition is unfortunately true only to a partial extent. The incumbent government operator, BSNL, which owns 60% share of the market, reports to the same ministry as the Telecom Regulatory Authority of India (TRAI) does. It gets a more favourable treatment from the government. While TRAI, some of whose members and staff are former BSNL employees, too gives it a preferential treatment. One instance of BSNL's status leading to anti-competitive outcomes is that it operates an Internet service and offers it to consumers as a package deal at a low cost *vis-à-vis* the charge on the use of the phone time. However, consumers of other Internet service providers, who obtain the service through landline network of BSNL, are not able to get the same pulse rate as is being charged to Internet consumers of BSNL. Independent ISPs cannot, therefore, compete effectively with BSNL and they are fast losing their consumers.

In the goods sector, particularly the raw material and intermediate goods sector, lack of competition affects our firms. In many areas, there is a dominant player or if there are many, then they implicitly and/or explicitly behave in the same fashion. The chances of abuse are high in India due to high levels of concentration in many goods sectors. We can take the textile input sector, as an example. In this industry, both fabrics and garments, have a high growth potential following the demise of the WTO's textile quota system of the two critical inputs: Reliance is the dominant player in the polyester staple fiber with a market share of 54%, while Grasim is the dominant player, almost a monopoly, in the viscose staple fiber with 91% of the market share. *Per se* they may not be indulging in anti-competitive practices but the possibility is distinct.

This adequately makes the point that an effective competition law, including international cooperation to deal with cross-border issues, will not only promote consumer welfare, but also the business welfare, i.e., better competitiveness.

Competition Boosts Corporate Governance

In a competitive environment, firms generally cannot expect to earn excess profits. An industry that generates above-average profits tends to attract new competitors, which bring forth additional supply and drive down profitability. Where natural barriers to entry are high, excess profits may persist and interim regulation may be needed to protect consumers. Over time, however, technological advances and

entrepreneurial innovations tend to chip away the natural barriers, unless they are prevented by regulations.

To withstand competition, firms need to rely on operational efficiency. Unless their production and administrative costs are kept below prevailing market prices, which may be determined by efficient competitors at home or abroad, they cannot service their debt and meet shareholders' expectations. Investors need to evaluate the viability and cash flows of projects, rather than relying on preferential treatments or on market power. Under effective competition, preferential treatment can be quickly detected and brought to light by those who suffer the adverse consequences.

Where competition is intense and global in scope, more firms realise that corporate governance makes good business sense. Investors seek out firms that run the business efficiently, treat shareholders equitably and comply with high standards of disclosure, even when they are not mandatory. By applying good governance, a firm can earn a good reputation and efficient access to finance, which in turn enhances their ability to compete. In effect, good governance becomes an instrument of competitive strategies.

CONCLUSION

The absence of monopoly and existence of a situation wherein competition flourishes is a characteristic feature of a vibrant capitalist economy. Monopoly by its very nature kills competition and creates an environment wherein it destroys the benefits that ought to accrue to consumers in a competitive society, such as lowest prices, better quality goods, etc. Competition by promoting the survival of the fittest ensures optimum production and also consumer sovereignty. Therefore, eradication of monopoly and promotion of competition are the twin features of a competitive society, which underpins a real free enterprise economy.

KEYWORDS

- Abuse of dominance
- Agreement amongst enterprises
- Capital market
- Combination among enterprises
- Competition Commission of India
- Competition policies
- Constraints to competition
- Economic power
- Effects of monopoly
- Good Competition Policy
- Good governance
- Limited competition
- Logic and benefits of competition
- Ownership concentration
- Political governance
- Political influence
- Product market
- Regulation of competition
- Securities markets

DISCUSSION QUESTIONS

1. Explain how a monopoly comes into existence. What are the effects of monopoly on corporate governance?
2. What is competition? What are the benefits competition confers on consumers and the larger society?
3. If competition is beneficial to consumers and the society at large, why is there a need to regulate competition?
4. Discuss the constraints that restrain competition in developing countries.
5. Explain briefly the benefits of competition to different stakeholders in society.
6. Discuss the salient features that should be incorporated in a good competition policy.

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15

The Role of Public Policies in Governing Business

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
- MRTP Act, 1969
- 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

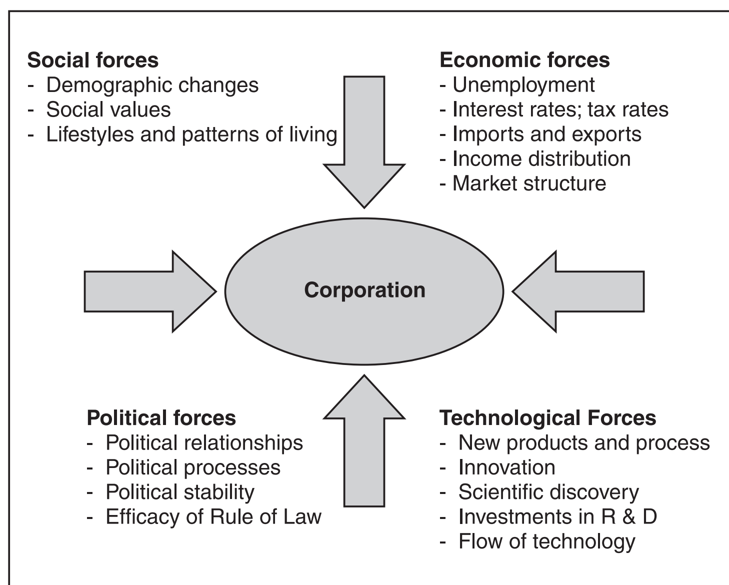
Buchhoz in his book *Business Environment and Public Policy* says that the major public policy areas that stemmed from the Great Depression were economic

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.

Figure 15.1

Shaping of public policies



Need for Public Policy in Business

As shown in Figure 15.1, 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.

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

> 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 ievel.

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.

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

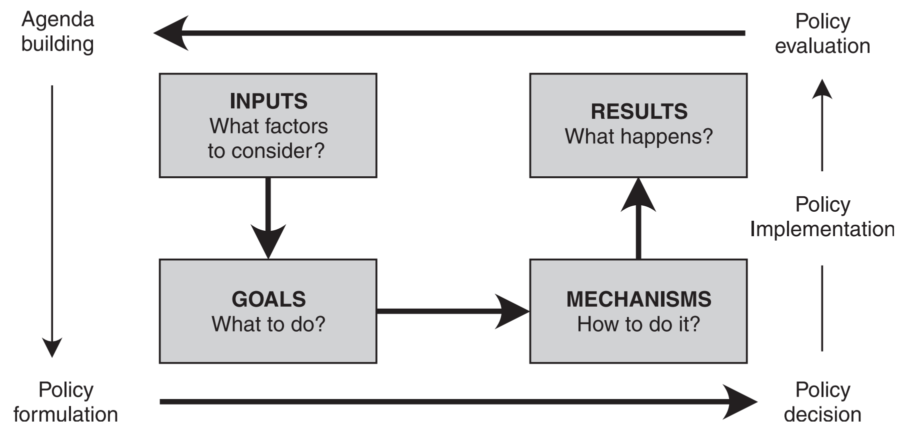
A government action that goes into its making in terms of public policy and execution can be understood in terms of several basic elements. Many factors or *inputs*, influence the development of public policy. Government may determine its course of action on the basis of several factors such as economic 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 15.2

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

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.

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.

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

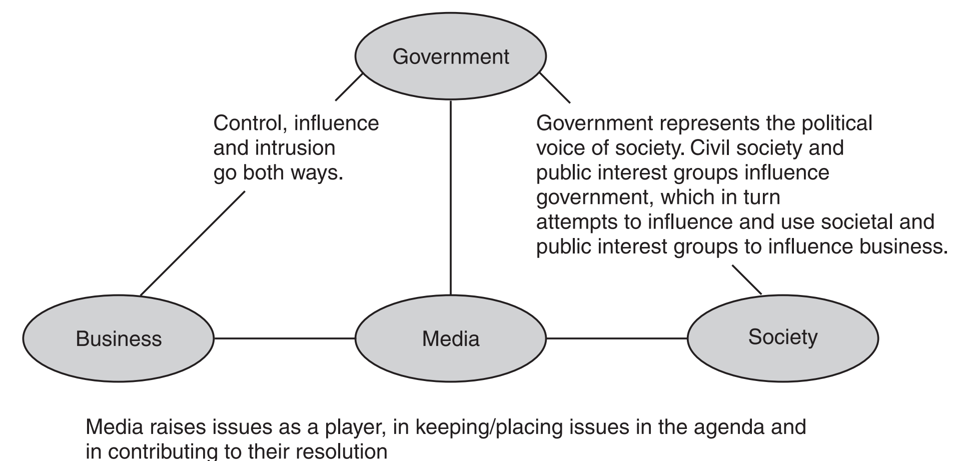
The role of government as an agent representing citizens of a country, and as such has to play its part in managing the modern economy, is widely accepted today. Businessmen und-erstand and accept the fact that governments can create or destroy the basic conditions necessary for business to compete and citizens to prosper.

Modern governments, administer their economies through macro-economic policies. To-day's social environment is tied to the effectiveness of government in creating conditions for growth of the modern economy.

Governments gen-erally accept the view that their key role is to create

Figure 15.3

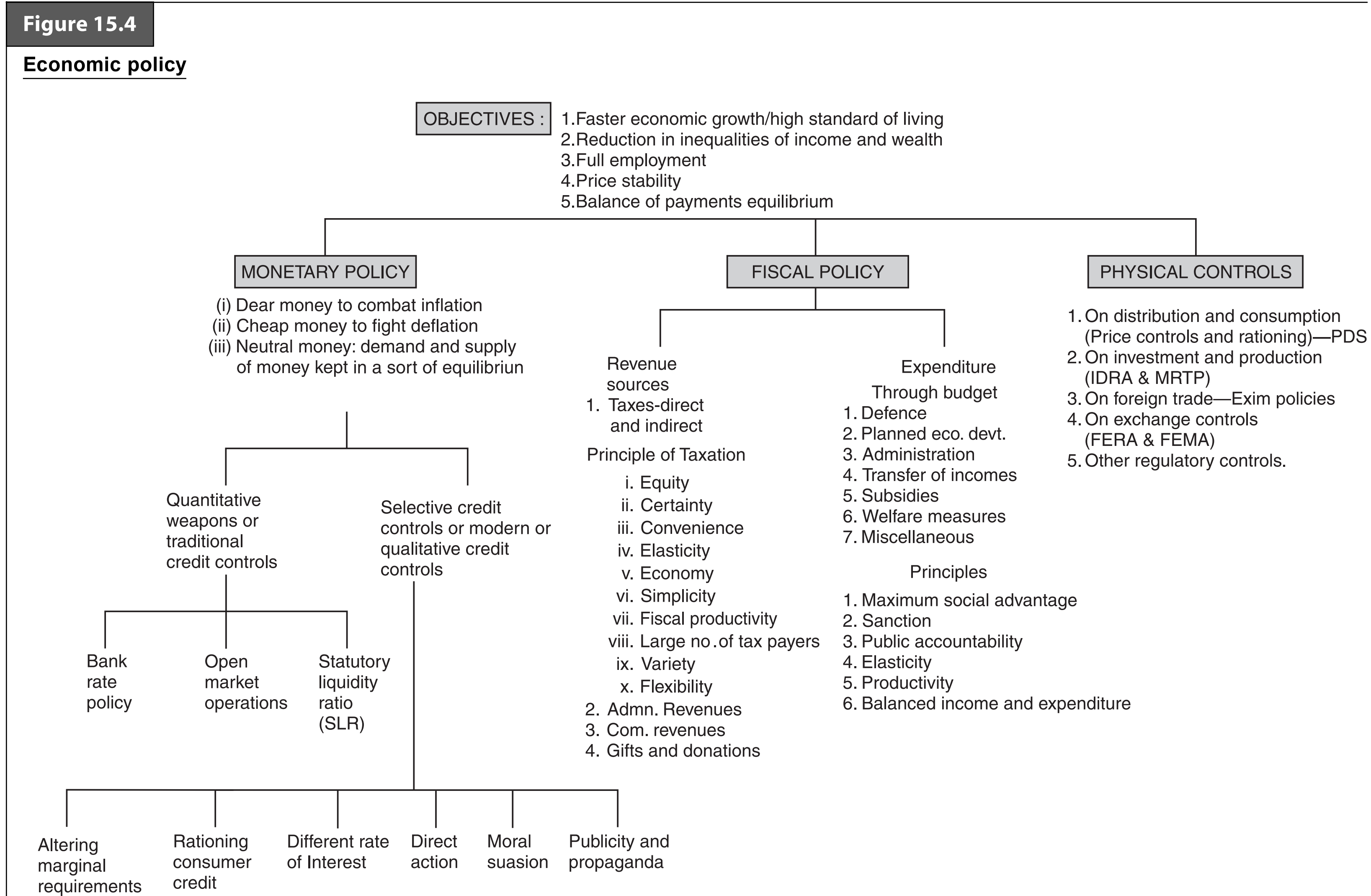
Business-government-society-media relationship



Constituents of Economic Policy

Figure 15.4

Economic policy



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 15.4 illustrates the complex nature of how economic policy works through its various constituents.

Economic 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 15.4.

> 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.

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

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. 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.

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.

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, (in) 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 eneterprises!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.

The Environment Protection Act, 1986

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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 followig:

(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 Rs. 5 plus additional fine upto Rs. 5 per week in case of continuing offence. (Maximum fine imposable Rs. 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 Rs. 500.

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.

Payment of Bonus Act, 1965

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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 Rs. 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 Rs 6,500 p.m., 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 Rs. 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. 01 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—12% 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 Rs. 5000 per month, the contribution payable to Pension Fund shall be limited to the amount payable on his pay of Rs. 5000 only, however, the employees may voluntarily opt for the employer's share of contributions on wages beyond the limit of Rs. 5000 to be credited to the Pension Fund.

The Workmen's Compensation Act, 1923

The Workmen's Compensation Act 1923 aims to provide workmen and/or their dependents some relief in case of accidents arising out of, and in the course of employment and causing either death or disablement of workmen. It provides for payment by certain classes of employers to their workmen compensation for injury by accident.

Who is a Workman?

Workman means any person (other than a person whose employment is of a casual nature and who is employed otherwise than for the purposes of the employer's trade or business) who is:

(i) A railway servant as defined in section 3 of the Indian Railways Act, 1890 not permanently employed in any administrative, district or sub-divisional office of a railway and not employed in any such capacity as is specified in Schedule II

(ii) Employed in any such capacity as is specified in Schedule II

Whether the contract of employment was made before or after the passing of this Act and whether such contract is expressed or implied, oral or in writing, the Act is applicable to all.

The provisions of the Act have been extended to cooks employed in hotels, restaurants using power, liquefied petroleum gas or any other mechanical device in the process of cooking.

Employees Entitled to Compensation

Every employee (including those employed through a contractor but excluding casual employees), who is engaged for the purposes of employer's business and who suffers an injury in any accident arising out of and in the course of his employment, shall be entitled for compensation under the Act.

The Consumer Protection Act caters to the needs of the consumers, and a variety of services such as banking, financing, insurance, transport, housing construction, entertainment have been made available to the consumers. Any person who has bought goods for a consideration and finds any defect in the quality, quantity, potency, purity or standard of the goods has hired or availed any service for consideration and finds any fault, imperfection, shortcoming, or inadequacy in the quality, nature and manner of performance in relation to the service can approach the courts.

Consumer Protection

Consumer Protection Act

Industrial development in the field of manufactured goods has led to the influx of various consumer goods into the Indian market to cater to the needs of the consumers and a variety of services such as banking, financing, insurance, transport, housing, construction, entertainment have been made available to the consumers.

In order to protect the consumers from exploitation and to save them from adulterated and substandard goods and deficient services, the Consumer Protection Act came into force on 15 April 1986 and it applies to the whole of India except the State of Jammu and Kashmir.

Eligibility to File a Claim

Any person who

- has bought goods for a consideration and finds a defect in the quality, quantity, potency, purity or standard of the goods
- has hired or availed any service for a consideration and finds any fault, imperfection, shortcoming, or inadequacy in the quality, nature and manner of performance in relation to the service can approach the courts.

However, if a person has bought the goods for resale or for a commercial purpose, he is not a, consumer.

Limitation

Within what period can a complaint be filed?

A complaint should be filed at the earliest but not later than *TWO YEARS* from the date on which the cause of action arose. However, the court may entertain the complaint after a period of 2 years if the complainant is able to satisfy the court that there was sufficient cause for the delay.

Appeals

An appeal against the order of the District Forum are to be filed to the State Commission, against the order of the State Commission to the National Commission and against the order of the National Commission to the Supreme Court. All appeals are to be filed within 30 days of the order appealed against and are to be accompanied by a certified copy of the order.

Food Adulteration Under the Prevention of Food Adulteration Act, 1954

The Prevention of Food Adulteration Act, 1954 aims at making provisions for the prevention of adulteration of food. The Act extends to the whole of India and came into force on 1 June 1955.

The Prevention of Food Adulteration Act, 1954 aims at making provisions for the prevention of adulteration of food. An article of food shall be deemed to be adulterated if the article sold by a vendor is not of the nature, substance or quality demanded by the purchaser or which it purports to be.

What is Adulterated Food?

An article of food shall be deemed to be adulterated under the following conditions:

(a) If the article sold by a vendor is not of the nature, substance or quality demanded
by the purchaser or which it purports to be

(b) If the article contains any substance affecting its quality or of it is so processed as to injuriously affect its nature, substance or quality

(c) If any inferior or cheaper substance has been substituted wholly or partly for the article, or any constituent of the article has been wholly or partly abstracted from it, so as to affect its quality or it is so processed as to injuriously affect its nature, substance or quality

(d) If the article has been prepared, packed or kept under insanitary conditions whereby it has become contaminated or injurious to health

(e) If the article consists wholly or in part of any filthy, putrid, disgusting, rotten, decomposed or diseased animal or vegetable substance or being insect-infested, or is otherwise unfit for human consumption

(f) If the article is obtained from a diseased animal

(g) If the article contains any poisonous or other ingredient which is injurious to health

(h) If the container of the article is composed of any poisonous or deleterious substance which renders its contents injurious to health

(i) If the article contains any prohibited colouring matter or preservative, or any permitted colouring matter or preservative in excess of the prescribed limits

(j) If the quality or purity of the article falls below the prescribed standard, or its constituents are present in sub-standard proportions or its constituents are present in proportions other than those prescribed, whether or not rendering it injurious to health

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 Rs. 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.

Service Tax

Service tax is an indirect levy imposed under Chapter V of the Finance Act, 1994 as amended. The tax is applicable to services specified in the chapter called “taxable services”. At present the rate of Service Tax is 8% to be levied on the “value of taxable service”. Generally speaking “value of taxable service” means the gross amount received by the service provider for the taxable service rendered by him. The person who provides the taxable service on receipt of charges is responsible for paying the Service Tax to the government. Where the service is provided by a person other than Indian resident or who does not have any establishment in India, then the services receiver in India is liable to pay service tax.

Service Tax is administered by the Central Excise Commissionerates working under the Central Board of Excise & Customs, Department of Revenue, Ministry of Finance, Government of India.

The Monopolistic and Restrictive Trade Practices Act, 1969, was enacted to ensure that the operation of the economic system does not result in the concentration of economic power in hands of few and to prohibit monopolistic and restrictive trade practices. The MRTP Act has now been replaced by the Competition Act.

MRTP Act, 1969

The Monopolies and Restrictive Trade Practices Act 1969 was enacted for the following reasons:

(i) To ensure that the operation of the economic system does not result in the concentration of economic power in hands of a few

(ii) To provide for the control of monopolies

(iii) To prohibit monopolistic and restrictive trade practices

The MRTP Act extends to the whole of India except Jammu and Kashmir.

Unless the central government otherwise directs, this Act shall not apply to the following:

(a) any undertaking owned or controlled by a government company
(b) any undertaking owned or controlled by the government
(c) Any undertaking owned or controlled by a corporation (not being a company established by or under any central, provincial or state Act)
(d) any trade union or other association of workmen or employees formed for their own reasonable protection such as workmen or employees
(e) any undertaking engaged in an industry, the management of which has been taken over by any person or body of persons under powers by the central government
(f) any undertaking owned by a co-operative society formed and registered under any central, provincial or state Act
(g) Any financial institution

The MRTP Act has now been replaced by the Competition Act, the details on which have been covered in the chapter on Monopoly, Competition and Corporate Governance.

Small-scale Industries Tax Exemption Scheme

The contribution of small-scale sector in the industrial growth of the Indian economy and to the gross domestic product is significant besides the potential for employment generation. The small-scale sector has for itself a special dispensation in the central excise law in order to make it competitive in the domestic and global market. Central Excise duty concessions have been extended to the units in the small-scale sector based on their turnover so as to facilitate them to graduate by availing these concessions in a graded manner.

Eligibility

Manufacturers of specified commodities having clearances not exceeding Rs. 3 crores in the preceding financial year are eligible for this exemption.

Registration of Small-scale Companies

Every manufacturer of excisable goods is required (under Rule 174 of Central Excise Rule 1944) to get registered with the Central Excise Department before starting production.

- The SSI must file for registration when their turnover crosses Rs. 1 crore. The application for the registration should be submitted to the jurisdictional range superintendent of central excise.
- The Registration Certificate will be automatically granted. If it is not granted within 30 days of the receipt of the application, it is deemed to have been granted.
- There is no fees for registration and a factory or a unit is to be registered only once.
- There is no need for renewal of the registration.
- The registration is applicable only for the premises where the manufacture is taking place.
- A separate registration is required for each premise.
- In case a new product is to be manufactured, the registration certification should be endorsed for the additional items.

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

- Commercial policy
- Financial involvement
- Fiscal policy
- Framing public policy
- Monetary policy
- National economic policy
- Organisational involvement
- Policy decision making
- Political involvement
- Public policy in business
- Shaping of public policies
- Strategic public policy involvement
- Taxation policy

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.

SUGGESTED READINGS

- Anti Dumping Duties—http://www.amir-jordan.org/amirl_web/pri/wto/antidumping.htm
- Business and Society by POST, LAWRENCE, WEBER.
- "Corporate Responsibility in the Global Village: The Role of Public Policy." By Susan Ariel Aaronson and James T. Reeves.
- Corporate Governance—The Dire need of the hour by Prof. A. C. Fernando LIBA.
- CSR & Public Policy—http://www.socialdialogue.net/en!en_csr_index.htm
- Customer Tariff Acts—http://exim.indiamart.com/act-regulations/customs-act-1962-sec-121-160.html
- Corporate Affairs & Public Policy—www.oecd.org/daf/corporate-affairs
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- Labour Policy—http://www.unido.org/en! doc/ 4825
- Privatisation & Globalisation Policies—http://www.columbia.edu/-ta63/index.html
- Public Policy for Corporate Social Responsibility—*Djordjija Petkoski* World Bank Institute and *Nigel Twose*—World Bank Group.
- Policy Decision Making—http://www.aeco.ttu.edu/Courses/4305/index.htm

16

SEBI: The Indian Capital Market Regulator

CHAPTER OUTLINE

- Introduction
- Phenomenol Growth of Indian Capital Market
- Role of Securities Market in Economic Growth
- The Securities and Exchange Board of India
- SEBI'S Role in Promoting Corporate Governance
- SEBI's Record of Performance
- SEBI's Role in the New Era
- SEBI's Shortcomings
- Suggestions for SEBI's Improvement

Capital is an essential input for economic development. Capital investment leads to economic growth, only if channelised into productive activities. The securities market is the channel through which investible resources are routed to companies, and enable them to produce goods and services. A well organised and efficient securities market is conducive to sustained economic growth.

Introduction

Capital is a *sine qua non* for economic development. Without capital, land will be barren, labour idle and organisation rudderless. Capital enables the entrepreneur to bring together the other factors of production. It is necessary to build and develop infrastructure, buy and put in place plant and machinery, for use as working capital, and for setting up markets and so on. Capital grows out of savings of the community. Capital investment would lead to economic development only if channelised into productive activities. The securities market is the channel through which investible resources are routed to companies. The securities market converts a given stock of investible resources to a larger flow of goods and services. A well-organised and efficiently functioning securities market is conducive to sustained economic growth.

Capital Market

Industry raises finance from the capital market with the help of a number of instruments. Broadly speaking, corporates have a choice of (i) equity finance and (ii) debt finance. Experience in different countries varies. Generally, equity-based capital is cheap and less cumbersome to manage and service. Substituting equity finance for debt finance makes domestic firms less vulnerable to fluctuations in earnings or increases in interest rates. During the last decade, more than a third of the increase in net assets of large firms in developing countries across the world, has been secured through equity issuance. This pattern contrasts sharply with that of the industrial countries, in which equity financing during the same period has accounted for less than 5% of the growth in net assets.

In the liberalised economic environment, the capital market plays a crucial role in the process of economic development. The capital market has to arrange funds to meet the financial needs of both public and private sector units, from domestic as well as foreign sources. What is more critical is that the changed environment is characterised by cut-throat competition. Ability of enterprises to mobilise funds at cheap cost will determine their competitiveness *vis-à-vis* their competitors in order to perform well in a highly competitive environment.

Phenomenal Growth of Indian Capital Market

There was an appreciable growth in the capital market in the post-independence era, especially after 1985.The Indian capital market by 1990 was one of the fastest growing markets in the world. Indian corporations raised domestic debt and equity totalling $ 6.4 billion equivalent in 1994-95, $ 8.5 billion in 1996-97. Indian companies have also been raising substantial sums in the international capital markets- $ 4.7 billion in 1994-95, $ 2.3 billion in 1995-96 and $ 4.7 billion in 1996-97.

At the time of independence, there were very few corporations in India. Notwithstanding the absence of a corporate culture in the post-independence era, there was an appreciable growth in the capital market especially after 1985. The Indian capital market by 1990 was one of the fastest growing markets in the world. The number of companies listed on the stock exchange, close to 6000, was the second highest after the US and by 1995 the number rose to 8593. Presently, there are more than 10,000 listed companies in the country's 25 stock exchanges. Shareholding public is estimated at 20 million. Value of securities traded increased from $5 billion in 1985 to $21.9 billion in 1990, which was the fourth largest amongst the emerging markets of the world. Market capitalisation increased from $14.4 billion in 1985 to $38.6 billion in 1990, $65.1 billion in 1992, $80 billion in 1993 and exceeded $120 billion in 1998–99. Turnover ratio (total value traded as percentage of average market capitalisation) rose to 65.9. Resources raised from the capital market by the non-government public limited companies increased from Rs. 7,063.4 million (US $731 million) to Rs 52,668.0 million in 1982–83.

Indian corporations raised domestic debt and equity totalling $6.4 billion equivalent in 1994–95 and $8.5 billion in 1996–97. Indian companies have also

Figure 16.1

Growth Pattern of the Indian stock market

Sl.No	As on 31st December	1946	1961	1971	1975	1980	1985	1991	1995
1	No. of Stock Exchanges	7	7	8	8	9	14	20	22
2	No. of listed companies	1125	1203	1599	1552	2265	4344	6229	8593
3	No. of stock issues of listed companies	1506	2111	2838	3230	3697	6174	8967	11784
4	Capital of listed companies (Cr. Rs.)	270	753	1812	2614	3973	9723	32041	59583
5	Market value of capital of listed companies (Cr. Rs.)	971	1292	2675	3273	6750	25302	110279	478121
6	Capital per listed company (4/2)	24	63	113	168	175	224	514	693

Note: Presently, there are 25 stock exchanges in the country.
Source: Various issues of Bombay stock exchange's official directory.

been raising substantial sums in the international capital markets—$4.7 billion in 1994–95, $2.3 billion in 1995–96 and $4.7 billion in 1996–97. There has been a recent dramatic shift toward increased issuance of debt instruments. The equity-debt split was 97% 3% in 1994–95 by 1996–97, it was 23% to 77%.

Figure 16.1 portrays the overall growth pattern of Indian stock markets since independence. It is quite evident from the table that Indian stock markets have not only grown in number of exchanges, but also in number of listed companies and in capital of listed companies. The remarkable growth after 1985 can be clearly seen from the table, and this was due to the favourable government policies towards securities market.

However, the functioning of the stock exchanges in India suffered from many weaknesses such as long delays in transfer of shares, issue of allotment letters, and refund, lack of transparency in procedures and vulnerability to price rigging and insider trading. To counter these shortcomings and deficiencies and to regulate the capital market, the government of India set up the Securities and Exchange Board of India (SEBI) in 1988. Initially, SEBI was set up as a non-statutory body, but in January 1992 it was made a statutory body. SEBI was authorised to regulate all merchant banks on issue activity, lay guidelines, supervise and regulate the working of mutual funds and oversee the working of stock exchanges in India. SEBI, in consultation with the government, has taken a number of steps to introduce improved practices and greater transparency in the capital market in the interest of the investing public and the healthy development of the capital market.

Nature of the Indian Capital Market

The Indian capital market, like the money market, is known for its dichotomy. It consists of an organised sector and an unorganised sector. In the organised sector of the market, the demand for capital comes mostly from corporates, government and semi-government organisations. The supply comes from household savings, institutional investors such as banks, investment trusts, insurance companies, finance corporations, government and international financing agencies.

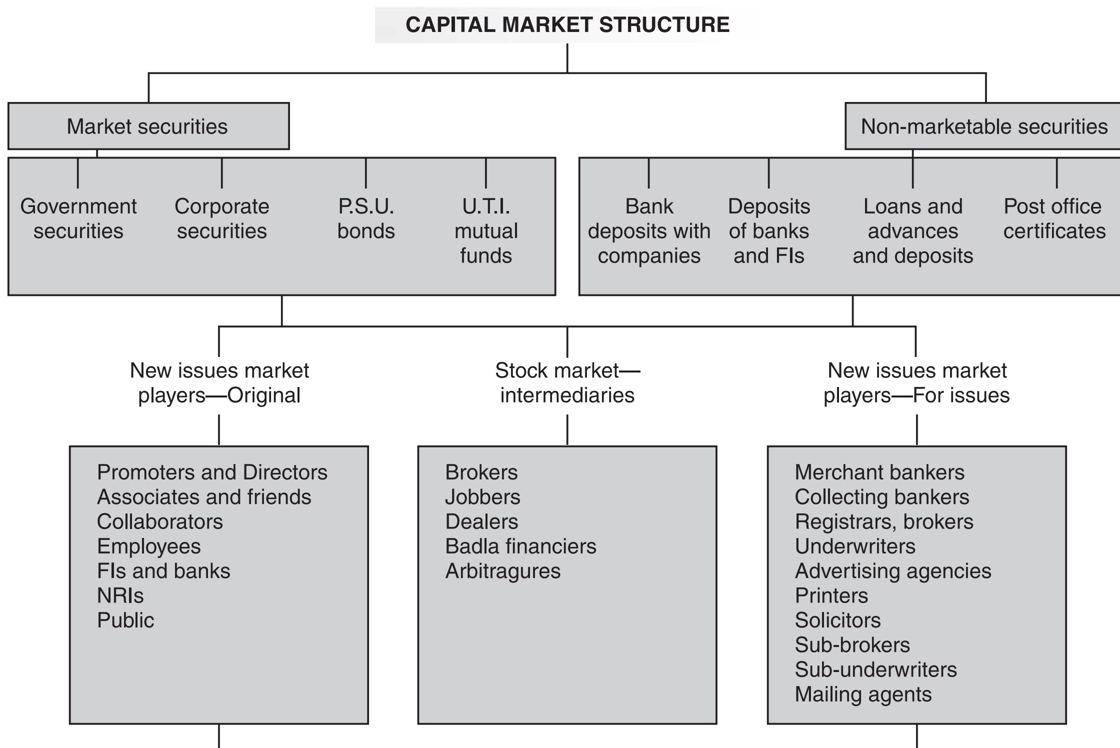
The unorganised sector of the capital market on the supply side consists mostly of indigenous bankers and moneylenders. While in the organised sector

the demand for funds is mostly for productive investment, a large part of the demand for funds in the unorganised market is for consumption purpose. In fact, many purposes, for which funds are very difficult to get from the organised market, are financed by the unorganised sector. The unorganised capital market in India, like the unorganised money market, is characterised by the existence of multiplicity and exorbitant rates of interest, as well as lack of uniformity in their business transactions. On the other hand, the activities of the organised market are subject to a number of government controls, and of the market regulator, SEBI. Though efforts were initiated to bring the unorganised sector under some sort of regulatory framework or at least to bring in some discipline such as registration, these were not successful and this segment is by and large outside the effective government control.

The organised sector has been subjected to increasing insitutionalisation. The public sector financial institutions account for a large chunk of the business of this sector.

Figure 16.2

Capital market structure



Source: Figure adopted from V. A. Avadhani, Indian Capital Market, Himalaya Publishing House, Mumbai, 1997.

Development of the Indian Capital Market

The Indian capital market, as pointed out earlier, has undergone many significant changes since independence. The important factors that have contributed to the development of the Indian capital market are given below:

1. **Legislative measures:** Laws such as the Companies Act, the Securities Contracts (Regulation) Act and the Capital Issues (Control) Act had empowered the government to regulate the activities of the capital market with a view to assuring healthy trends in the markets, protecting the interest of the investor, efficient utilisation of the resources, etc.

2. **Establishment of development banks and expansion of the public sector**: Starting with the establishment of the Industrial Finance Corporation of India (IFCI), a number of development banks have been established at the national and regional levels to provide financial assistance to enterprises. These institutions today account for a large chunk of the industrial finance.

   The expansion of the public sector in the money and capital markets has been accelerated by the nationalisation of the insurance business and the major part of the banking business. The Life Insurance was nationalised in 1956 and the General Insurance in 1972. The Reserve Bank in India was nationalised as early as 1949. The Imperial Bank, the then largest commercial bank in India, was nationalised and established as the State Bank of India in 1955. Fourteen major private commercial banks were nationalised in 1969. With the nationalisation of six more leading private banks in 1980, over 90% of the commercial banking business came to be concentrated in the government sector.

   Thus, an important aspect of the Indian capital market is that a large part of the investible funds available in the organised sector is owned by the government. However, the new economic policy has changed the trend, and brought in the private sector in a large measure.
3. **Growth of underwriting business**: There has been a phenomenal growth in the underwriting business, which was mainly due to the public financial corporations and the commercial banks. After the elimination of forward trading, brokers have begun to take on underwriting risks in the new issue market. In the last one decade the amount underwritten as percentage of total private capital issues offered to public varied between 72% and 97%.
4. **Public confidence:** Impressive performance of certain large companies such as Reliance Industries, Tisco and Larsen & Toubro encouraged public investment in industrial securities. Booms and the consequent declaration of hefty dividends in the mid-80s boosted investor confidence.
5. **Increasing awareness of investment opportunities**: The improvement in education and communication has created more public awareness about investment opportunities in the business sector. The market for industrial securities has become broader.
6. **Capital market reforms:** A number of measures have been taken to check abuses and to promote healthy development of the capital market. The enactment of the Securities and Exchange Board of India Act, 1992 and the establishment of the Securities and Exchange Board of India (SEBI) as a capital market regulator are important milestones in the process of reforms in this sector.

Deficiencies in the Indian Capital Market

The Indian capital market suffers from the following deficiencies:

- Lack of diversity in the financial instruments
- Lack of control over the fair disclosure of financial information
- Poor growth in the secondary market
- Prevalence of insider trading and front running[1]
- Manipulation of security prices
- Existence of unofficial trade in the primary market, prior to the issue coming into the market
- Absence of proper control over brokers and sub-brokers
- Passive role of public financial institutions in checking malpractices
- High cost of transactions and intermediation, mainly due to the absence of well-defined norms for institutional investment.

> The Indian capital market suffers from deficiencies like, lack of diversity in the financial instruments lack, of control over the fair disclosure of financial information, poor growth in the secondary market, prevalence of insider trading and front running.

In a planned economy, like the one we had prior to liberalisation, when the stock exchanges performed a residual role, these deficiencies did not matter much. On the other hand, in a market-driven economy towards which we are moving, capital market is expected to perform multifarious and facilitative functions, such as:

- Privatisation and a greater role for the private sector imply a large demand for equity finance
- Equity market should enable investors to diversify their wealth across a variety of assets
- Stock markets should perform a screening and monitoring role
- A financial system that functions well requires that the whole financial sector functions efficiently.

In view of its importance, the continuing shortcomings point to the inability of the market to function at a level that is expected.

Impact of Globalisation

With the gradual opening up of the Indian economy, increasing importance of foreign portfolio investment in the market and drastic reduction in import tariffs that has exposed Indian companies to foreign competition, Indian capital market is acquiring a global image. Till recently, participants in the Indian capital market could, to a large extent, afford to ignore what happened in other parts of the world. Share prices largely behaved as if the rest of the world just did not exist. However, now the that Indian capital market responds to all types of external developments, such as US bond yields, the value of the Euro or for that matter of any other currency, the political situation in the Gulf or new petrochem capacity in China.

The Indian capital market is on the threshold of a new era. Gradual globalisation of the market will mean the market will be more sensitive to developments that take place abroad; there will be a power shift as domestic institutions are forced to compete with the Foreign Institutional Investors (FIIs) who control the floating stock and are also in control of the Global Depository Receipts (GDR) market.

In short, the Indian capital market is on the threshold of a new era. Gradual globalisation of the market will mean the following changes:

- The market will be more sensitive to developments that take place abroad.
- There will be a power shift as domestic institutions are forced to compete with the Foreign Institutional Investors (FIIs) who control the floating stock and are also in control of the Global Depository Receipts (GDR) market.
- Structural issues will come to the fore with a plain message: "Either reform or despair."
- The individual investor in his own interest will refrain from both primary and secondary market; he will be better off investing in mutual funds.

Role of Securities Market in Economic Growth

In the words of G. N. Bajpai, former SEBI Chairman: "It is the securities market which reflects the level of corporate governance of different companies and accordingly allocates resources to best governed companies. If the securities market is efficient, it can penalise the badly governed companies and reward the better-governed companies. Hence, not only the corporate governance standards need to improve, but also efficiency and efficacy of securities market need to improve so that the resources are directed to the deserving companies, which can really boost economic performance. The securities market cannot make best allocation of resources if the standards of corporate governance are not followed in letter and spirit."

"A well functioning securities market is conducive to sustained economic growth. A number of studies, starting from World Bank and IMF to various

scholars, have pronounced robust relationship not only one way, but also both the ways, between the development in the securities market and the economic growth. This happens, as market gets disciplined, developed, efficient and it avoids the allocation of scarce savings to low-yielding enterprises and forces the enterprises to focus on their performance which is being continuously evaluated through share prices in the market and which faces the threat of take over."[2]

Though the classical economists led by Adam Smith believed that over time savings would be equal to investment, it does not seem to happen in actual practice. The reason is not far to seek. The savers are different from investors and their motives are also different. The result is disequilibrium between the two. To quote G. N. Bajpai again: "The unequal distribution of entrepreneurial talents and risk taking proclivities in any economy means that at one extreme end, there are some, whose investment plans may be frustrated for want of enough savings, while at the other end, there are those who do not need to consume all their incomes but who are too inert to save or too cautious to invest the surplus productively. For the economy as a whole, productive investment may thus fall short of its potential level. In these circumstances, the securities market provides a bridge between ultimate savers and ultimate investors and creates the opportunity to put the savings of the cautious at the disposal of the enterprising, thus promising to raise the total level of investment and hence growth. The indivisibility or lumpiness of many potentially profitable but large investments reinforces this argument. These are commonly beyond the financing capacity of any single economic unit but may be supported if the investor can gather and combine the savings of many.[3] Moreover, the availability of yield bearing securities, makes present consumption more expensive relative to future consumption and, therefore, people might be induced to consume less today. The composition of savings may also change with fewer savings being held in the form of idle money or unproductive durable assets, simply because more divisible and liquid assets are available."

The securities market facilitates the globalisation of an economy by providing connectivity to the rest of the world. This linkage helps the inflow of capital into the country's economy in the form of portfolio investment. Besides, a strong domestic stock market performance will also enable well-run local companies to raise capital abroad. Some of the Indian companies like Reliance, Infosys, L & T, Tata Steel and many others have, for instance, successfully tapped markets abroad and secured huge amounts, a prospect unthinkable hardly a decade back or even now in the domestic market. This practice will, in turn, help raise the efficiency of domestic corporates once they are exposed to international competitive pressures and the necessity of not only surviving amidst competition but also to perform well for their continued survival.

The existence of a domestic securities market will deter capital flight from the domestic economy by providing attractive investment opportunities locally. Economists also point out that a developed securities market successfully monitors the efficiency with which the existing capital stock is deployed and thereby significantly increases the average rate of return on investment. Having established the importance of the securities market for promoting corporate governance standards, and equally important economic development of a country, let us turn to India and its securities market.

Abolition of Controller of Capital Issues and Emergence of SEBI

Earlier, prior to the setting up of SEBI, the Capital Issues (Control) Act, 1947 governed capital issues in India. The main objectives of this Act were: (i) to ensure

that investment in the private corporate sector does not violate priorities and objectives laid down in the Five Year Plans or flow into unproductive sectors; (ii) to promote the expansion of private corporate sector on sound lines in general, and further the growth of particular corporate enterprises having sound capital structure and (iii) to distribute capital issues time-wise in such a manner that there is no overcrowding in a particular period. The Act was enacted to ensure sound capital structure for corporate enterprises, to promote rational and healthy expansion of joint stock companies in India and to protect the interests of the investing public from the fraudulent practices of fly-by-night operators. The authority for control of capital issues was vested with the Controller of Capital Issues (CCI), according to the principles and policies laid down by the central government. However, the office of the Controller of Capital Issues which was functioning more like an extended arm of the government controlled, rather than guided the orderly development of the capital market and became an anachronism in the new era of a liberalised economy.

The Narasimham Committee on the reform of the financial system in India recommended the abolition of the CCI. The committee in its report submitted in 1991 on the financial system argued that the capital market was tightly controlled by the government and there were a number of restrictions placed by the CCI on the operations of this market. This restrictive environment was "neither in tune with the new economic reforms nor conducive to the growth of the capital market". The committee strongly favoured substantial and speedy liberalisation of the capital market by closing down the office of the CCI. It suggested that SEBI set up in1988 should be entrusted with the "task of a market regulator to see that the market is operated on the basis of well laid principles and conventions". It was also recommended that SEBI should not become a controlling authority substituting the CCI. The government of India accepted this recommendation, repealed the Capital Issues (Control) Act, 1947 and abolished the post of the Controller of Capital Issues.

The significance of this step lies in the removal of bureaucratic hurdles in the way of capital issues. In order to raise capital from the market, the companies were required earlier to obtain consent from the CCI who decided the terms and conditions, the amount of capital to be raised and the pricing of public issues. With the abolition of the CCI, companies became free to issue capital and determine the issue prices based on market conditions. For this, however, they are expected to abide by guidelines prescribed by SEBI. In other words, SEBI has been empowered to control and regulate the new issue and old issues market, namely, the Stock Exchange. The following pages provide details of the objectives, powers, responsibilities, success and failures of SEBI—India's capital market regulator.

> The SEBI Act, 1992 was enacted "to provide for the establishment of a board to protect the interests of investors in securities and to promote the development of, and to regulate the securities market and for matters connected therewith or incidental thereto."

The Securities and Exchange Board of India

The Securities and Exchange Board of India Act, 1992 was enacted by the Indian Parliament "to provide for the establishment of a Board to protect the interests of investors in securities and to promote the development of, and to regulate the securities market and for matters connected therewith or incidental thereto".

Objectives of the Board

Section 11(1) of the Securities and Exchange Board of India Act, 1992 explains the powers and functions of SEBI. As per the Act, it shall be the duty of the board to protect interests of the investors in securities and to promote the development of, and to regulate the securities market by such measures as it thinks fit.

The statutory objectives of the SEBI as per the Act are given below:

(i) Protection of investors' interests in securities
(ii) Promotion of the development of the securities market
(iii) Regulation of the securities market; and
(iv) Matters connected therewith and incidental thereto.

Functions of the Board

To realise the above core objectives and to carry out its tasks, the Act spells out the functions of SEBI in greater details, as under: [4]

> The act spells out the functions of SEBI regulating the business in stock exchanges and any other securities markets, registering and regulating the working of stock brokers, sub-brokers, share transfer agents, bankers to an issue, trustees of trust deeds, registrars to an issue, merchant bankers, underwriters, portfolio managers, invesment advisers and such other intermediaries who may be associated with securities markets in any manner; prohibiting insider trading in securities.

(a) Regulating the business in stock exchanges and any other securities markets
(b) Registering and regulating the working of stock brokers, sub-brokers, share transfer agents, bankers to an issue, trustees of trust deeds, registrars to an issue, merchant bankers, underwriters, portfolio managers, invesment advisers and such other intermediaries who may be associated with securities markets in any manner
(c) Registering and regulating the working of the depositories, participants, custodians of securities, foreign institutional investors, credit rating agencies and such other intermediaries as the board may, by notification, specify in this behalf
(d) Registering and regulating the working of venture capital funds and collective investment schemes including mutual funds
(e) Promoting and regulating self-regulatory organisations
(f) Prohibiting fraudulent and unfair trade practices relating to securities markets
(g) Promoting investors' education and training of intermediaries of securities markets
(h) Prohibiting insider trading in securities
(i) Regulating substantial acquisition of shares and take over of companies;
(j) Calling for information from, undertaking inspection, conducting inquiries and audits of the stock exchanges, mutual funds and other persons associated with the securities markets and intermediaries and self-regulatory organisations in the securities market
(k) Performing such functions and exercising such powers under the provisions of the Securities Contracts (Regulation) Act 1956 as may be delegated to it by the central government
(l) Levying fees or other charges
(m) Conducting research
(n) Calling from or furnishing to any such agencies, as may be specified by the board, such information as may be considered necessary by it for the efficient discharge of its functions
(o) Performing such other functions as may be prescribed

Powers of the Board

To carry out its responsibilities under the Act, the board is entrusted with the same powers as are vested in a civil court in respect of the following matters, namely:

(i) The discovery and production of books of account and other documents at such place and such time as may be specified by the board
(ii) Summoning and enforcing the attendance of persons and examining them on oath
(iii) Inspection of any books, registers and other documents of stockbrokers, sub-brokers, and share transfer agents etc.

The board is empowered under the SEBI Act to issue directions to the following intermediaries: Stock-brokers, sub-brokers, share transfer agent, banker to an issue, trustee of trust deed, registrar to an issue, merchant banker, underwriter, portfolio manager, depository, depository participant, custodian of securities, foreign institutional investor, credit rating agency or any other intermediary associated with the securities market.

Matters To Be Disclosed by the Companies to the Board [Section 11A]

The board may, for the protection of investors, specify the following by regulations:

(a) The matters relating to issue of capital, transfer of securities and other matters incidental thereto

(b) The manner in which such matters shall be disclosed by the companies.

Power to Issue Directions

Under Section 11B of the SEBI Act, the board is empowered to issue directions to the following intermediaries:

- Stock-brokers, sub-brokers, share transfer agent, banker to an issue, trustee of trust deed, registrar to an issue, merchant banker, underwriter, portfolio manager, investment adviser and such other intermediary who may be associated with securities market
- Depository, depository participant, custodian of securities, foreign institutional investor, credit rating agency or any other intermediary associated with the securities market
- Sponsors of venture capital funds, or collective investment schemes including mutual funds
- And to any company with regard to matters to be disclosed by the companies as specified in Section 11A.

Registration of Intermediaries

Different intermediaries mentioned above can commence functioning in their respective activities only after registration with the SEBI and complying with requirements as stated under specific regulations intended for each.

(1) No stock-broker, sub-broker, share transfer agent, banker to an issue, trustee of trust deed, registrar to an issue, merchant banker, underwriter, portfolio manager, investment adviser, and such other intermediary who may be associated with securities market shall buy, sell or deal in securities except under and in accordance with the conditions of a certificate of regulations made under this Act.

(1A) No depository [participant] custodian of securities, foreign institutional investor, credit rating agency or any other intermediary associated with the securities market as the board may, by notification in this behalf specify, shall buy or sell or deal in securities except under and in accordance with the conditions of a certificate of registration obtained from the Board in accordance with the regulations made under this Act.

(1B) No person shall sponsor or cause to be sponsored or carry on or cause to be carried on any venture capital funds or collective investment schemes including mutual funds unless he obtains a certificate of registration from the board in accordance with the regulations.

SEBI has issued detailed rules and regulations to be adhered to by each of the intermediaries above specified.

Establishment of Securities Appellate Tribunals

The SEBI Act also contained a provision for the establishment of an appellate authority to arbiter and exercise power in matters of disputes over SEBI's decisions as a regulator.

The central government shall by notification, establish one or more Appellate Tribunals to be known as the Securities Appellate Tribunal to function as Appellate Authority and hear appeals.

Civil Court Not to Have Jurisdiction

It is stipulated in the SEBI Act that under Section 15(Y) that no civil court shall have jurisdiction to entertain any suit or proceeding in respect of any matter which an adjudicating officer appointed under this Act or a Securities Appellate Tribunal constituted under this Act is empowered by or under this Act to determine and no injunction taken or to be taken in pursuance of any power conferred by or under this Act. However, appeals against the decision of the Securities Appellate Tribunal can be preferred before a High Court.

Strengthening of SEBI

In January 1995, the Government of India promulgated an Ordinance to amend SEBI Act, 1992, so as to arm the regulator with additional powers for ensuring the orderly development of the capital market and to enhance its ability to protect the interests of investors. The important features of this Ordinance are the following:

> In January 1995, the Government of India promulgated an ordinance to amend SEBI Act, 1992 to arm the regulator with additional powers. Among other power it has been empowered to file complaints in courts and to notify its regulations without prior approval of the government, provided with regulatory powers over companies in the issuance of capital, the transfer of securities and other related matters, and to impose monetary penalties on capital market intermediaries and other participants for a listed range of violations.

1. To enable SEBI to respond speedily to market conditions and to reinforce its autonomy, it has been empowered to file complaints in courts and to notify its regulations without prior approval of the government.
2. SEBI is now provided with regulatory powers over companies in the issuance of capital, the transfer of securities and other related matters.
3. SEBI is now empowered to impose monetary penalties on capital market intermediaries and other participants for a listed range of violations. The amendment proposed to create an adjudicating mechanism within SEBI for imposing penalties and also constituted a separate tribunal to deal with cases of appeal against orders of the adjudicating authority. Earlier, the SEBI Act provided for the suspension and cancellation of registration and for the prosecution of intermediaries, which led to the stoppage of business. The new system of monetary penalties constitutes an alternative mechanism for dealing with capital market violations.
4. While investigating irregularities in the capital market, SEBI is now given the power to summon the attendance of and call for documents from all categories of market intermediaries, including persons from the securities market. Likewise, SEBI has now the power to issue directions to all intermediaries and persons connected with securities markets with a view to protecting investors or securing the orderly development of the securities market.
5. It was thought that SEBI has all necessary powers to control and regulate the securities market on the one side and effectively protect the interests of the shareholders on the other. However, the stock markets in India have gone through one of the worst and most prolonged crisis in their history, due to the inability of the market regulator to bring to book market violators.

SEBI (Amendment) Bill, 2002

Notwithstanding the regulator's best efforts, the stock market was plagued by price manipulations and insider trading. SEBI known for its low indictment rate of violators of its rules hardly penalised insider traders and was dubbed a toothless tiger. Unscrupulous players and fly-by-night operators abounded, manipulated the system and share prices with impunity, while the regulator watched helplessly from the sidelines. In its defence, SEBI has been pointing

out that the law did not give it adequate powers and that the existing penalties (Rs. 5,000 to 5 lakh) were too meagre to deter violators. Taking cognisance of this constraint, the government introduced the Securities and Exchange Board of India (Amendment) Bill, 2002 in the Lok Sobha in November 2002. The Bill was passed by the Parliament on 2 December 2002. It replaced the Ordinance issued by the government on 29 October 2002. The Bill made four key changes that gave SEBI extensive powers to regulate the market. The changes made under the amended Act were as under:

(1) Search and seizure powers: Earlier, a SEBI officer could only ask market players for specific documents, which allowed the latter to conceal incriminating documents. In the new Act, SEBI's officers, armed with a search warrant from a judicial magistrate, can search the entity's premises and even seize documents.

(2) Freeze bank accounts: SEBI can now impound cash proceeds and securities connected to any transaction it is investigating. It can also, with authorisation from a judicial magistrate, freeze bank accounts of any person or entity involved in any market violation for a duration of 1 month.

(3) Greater monetary penalties: Earlier, the maximum fine that SEBI could impose on a violator was only up to Rs. 5 lakh. This limit has now been increased manifold in market manipulation or insider trading violations, the fine could go up to Rs. 25 crore or three times the profits made by the entity concerned. For other violations such as non-disclosure, a fine upto Rs. 1 crore could be levied on violators.

(4) More board strength : The strength of the SEBI's board has been increased from six to nine of which three (excluding the chairman) will have to be full-time directors. Till the amendment of Act, the SEBI chairman was the only full-time director. The Securities Appellate Tribunal (SAT), the SEBI body that decides on appeals made by market intermediaries and companies against orders passed by the SEBI chairman, has also been strengthened with an increase in number of members from one to three. The idea is to move from individual based to group-based decision making, thereby reducing the possibility of any error or bias.

SEBI's Role in Promoting Corporate Governance

G. N. Bajpai, former Chairman, Securities and Exchance Board of India, claimed in an international conference in 2003: "With the objective of improving market efficiency, enhancing transparency, preventing unfair trade practices and bringing the Indian market up to international standards, a package of reforms consisting of measures to liberalise, regulate and develop the securities market was introduced in the 1990s. The practice of allocation of resources among different competing entities as well as its terms by a central authority was discontinued. The issuers complying with the eligibility criteria now have freedom to issue the securities at market-determined rates. The secondary market overcame the geographical barriers by moving to screen-based trading, which made trading system accessible to everybody anywhere in the Indian sub-continent. Trades enjoy counter-party guarantee. The trading cycle has been shortened to a day and trades are settled within two working days while all deferral products are banned. Physical security certificates have almost disappeared. A variety of derivatives are available. In fact, some reforms such as straight through processing in securities, T+2 rolling settlement, clearing corporation being the central counter party to all the trades on the exchanges, real time monitoring of brokers positions and margins, and

automatic disabling of brokers' terminals are singular to the Indian securities market. Indian disclosure and accounting standards are as modern, updated, potent and versatile as those of any other market. Today, the Indian securities market stands shoulder to shoulder with most developed markets in North America, Western Europe and Far East."[5]

According to SEBI's former chairman, The Securities and Exchange Board of India has been focussing on the following areas to improve corporate governance:

(i) Ensuring timely disclosure of relevant information
(ii) Providing an efficient and effective market system
(iii) Demonstrating reliable and effective enforcement
(iv) Enabling the highest standards of governance.

Disclosure standards

The erstwhile SEBI chairman, G. N. Bajpai, claims quoting academicians and researchers that disclosure standard in the Indian regulatory jurisdiction are at par with the best in the world. According to him this is a feedback from several global organisations, both regulatory and market participants.

SEBI has ensured that a company is required to make specified disclosures at the time of issue and make continuous disclosures as long as its securities are listed on exchanges. The standards for these disclosures including the content, medium and time of disclosures have been specified in the Companies Act, Disclosure and Investor Protection Guidelines, Listing Agreement Regulations relating to insider trading and takeover etc. These disclosures are made through various documents such as prospectus, quarterly statements, annual reports etc. and are disseminated through media, web sites of the company and the exchanges, and through EDIFAR (Electronic Data Information Filing and Retrieval) system maintained by the regulator. These disclosures relate to financial performance, sharehoding pattern, trading by insiders, substantial acquisitions, related party disclosures, audit qualifications, buyback details, corporate governance, actions taken against company, risk management, utilisation of issue proceeds, remuneration of directors etc. All listed companies and organisations associated with securities markets including the intermediaries, asset management companies, trustees of mutual funds, SROs, stock exchanges, clearing house/corporations, public financial institutions, professional firms such as auditors, accountancy firms, law firms, consultants, etc. assisting or advising listed companies are required to abide by the Code of Corporate Disclosure Practices specified in SEBI (Insider Trading) regulations.

SEBI has ensured that a company is required to make specified disclosures at the time of issue and make continuous disclosures as long as its securities are listed on exchanges. The standards for these disclosures including the content, medium and time of disclosures have been specified in the Companies Act, Disclosure and Investor Protection Guidelines, Listing Agreement Regulations relating to insider trading and takeover etc. These disclosures are made through various documents such as prospectus, quarterly statements, annual reports etc.

Efficient and effective market system

In the opinion of the chairman of SEBI, the Indian securities market has a large infrastructure to meet the demands of a sub-continental market. Presently, there are 25 stock exchanges and about 10,000 brokers, 15,000 sub-brokers, more than 10,000 listed companies, 500 foreign institutional investors, 400 depository participants, 150 merchant bankers, 40 mutual funds offering over 450 schemes, and 20 million investors. Yet, there is only one regulator. Not only the numbers are gigantic but also the systems and infrastructure are equally atlantean and sophisticated. All stock exchanges in India offer on line, fully automated, nation-wide anonymous, order-driven screen based trading system. It has a comprehensive risk management system. The depositories legislation ensures free transferability of securities with speed, accuracy and security. The securities are transferred electronically in demat form. Further, Indian accounting standards follow international accounting standards (principle based) and are by and large aligned. In addition to creating an efficient trading platform and settlement mechanism, SEBI's focus is substantially directed towards the following:

(a) Provision of timely availability of high quality price sensitive information to the market participants to enable them take informed decision and ensure efficient price discovery
(b) Maintenance of high quality of services and fair conduct for market participants. The regulations specify high standards to become market intermediaries and require them to abide by a code of conduct
(c) Ensuring that the market is fair, transparent and safe so that issuers and investors are at ease to carry out transactions.

Reliable and Effective Enforcement

SEBI aims at ensuring that no misconduct goes unnoticed or unpunished. It keeps an eye on the happenings in the market and identifies anything unusual or undesirable which may adversely affect the efficacy of the market. Every market participant, irrespective of his size and influence in the market or in the policy, is held accountable for his misdeeds. The proactive approach of the regulator in enforcement can be gauged from the fact that during the financial year 2002–2003, SEBI passed 561 orders, out of which over 350 were punitive.

Highest Standards of Governance

SEBI has avowed that its regulation and guidance of the country's securities market would spell success in the area of corporate governance. The Kumar Mangalam Birla Committee of the Indian jurisdiction outlined a code of good corporate governance, which compared very well with the recommendations of the Cadbury Committee and the OECD codes. The code was operationalised by inserting a new clause (Clause 49) to the Listing Agreement (LA) and have been made applicable to all the listed companies in India in a phased manner. Following the implementation of the Birla committee recommendations, substantial developments took place in the corporate world and securities market, which required revisit of the issue. The Narayana Murthy Committee has refined the corporate governance norms, which are proposed to be implemented through modification in the listing agreement. The government also appointed few committees to suggest ways and means of realising good corporate governance. Based on their recommendations, government is trying to provide statutory back-up to corporate governance standards.

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The initiatives for improvement in corporate governance, according to G. N. Bajpai, come mainly from three sources, namely, the market, regulator and the legislature. While the legislative initiative is directed towards bringing about amendments to the basic law–India's Companies Act to include certain fundamental provisions related to corporate governance, dynamic aspects of corporate governance such as disclosures, accounting standards etc. are being pursued through the regulatory initiatives by bringing about amendments to the Listing Agreement. Such an approach is aimed at because a comparatively more complicated and protracted process is involved in the amendments to legislation in a truly democratic society like India's. The most important initiative comes from market forces and mechanisms, which encourage and insist on the management's improving the quality of corporate governance. Indian market has formalised such forces in the form of a rating called "Corporate Governance and Value Creation Rating", which according to SEBI chairman is quite unique in the world and is sought after voluntarily by companies.

SEBI's Record of Performance

R. Rajagopalan in his book *Directors and Corporate Governance* makes the following observation on the role of SEBI: "The Securities and Exchange Board of India and its various committees should be complimented for many things happening

in the capital market in India. Be it in the area of protection of small investors' interests, or technology upgradation or development of securities market, SEBI has indeed been working with commensurate speed and efficiency in the last couple of years. There has, however, been a common perception that SEBI has not developed a cadre of regulatory personnel to effectively track violations. After the Harshad Mehta's securities scam in 90s which was blamed on a systemic failure, the system needed a thorough overhauling. However, nothing really happened. Later another scamster, Ketan Parikh made use of the loopholes in the system to his advantage. He was instrumental in rigging the prices of shares resulting in heavy losses to the investing public, which led to erosion of faith in the capital market. Over the years, quite a few companies raised money through IPOs and disappeared without a trace. It is not seen that the perpetrators of these frauds are promptly brought to book."

SEBI's Role in the New Era

In the changed environment of the Indian economy, when after more than four decades of heavy regulation and anemic growth, with the government slowly opening the economy to market forces, and promoting modification of financial institutions, SEBI has to play a proactive role as a capital market regulator. SEBI's performance has to be judged in the context of its efficiency in this dynamic environment.
The SEBI has made progress in a number of areas:

- Abolition of capital issues control and retaining the sole authority for new capital issues
- Regulation and reform of the capital market by arming itself with necessary authority and powers
- Regulating stock exchanges under Securities Contracts Regulation Act
- Bringing all primary and secondary market intermediaries under the regulatory framework
- Enforcing the companies to disclose all material facts and specific risk factors associated with projects while going in for public issues.

The record of the SEBI, over the period, has indeed been encouraging. SEBI has sought to check and control unfair practices on the stock exchanges, acted against transgressing companies, brokers accused of rigging prices, and scrips showing large price movements. At the same time, SEBI has sought to reduce regulation, and instead to leave it largely to the players in the market.

The capital market is composed of two constituents: the primary market and the secondary market. While the primary market deals with the issue of new stocks and shares, the secondary market deals with the buying and selling of existing stocks and shares. SEBI, as a regulator of capital market, has to play a regulatory role in both these markets. With a view to improving practices and ensuring greater transparency in capital markets so as to have a healthy capital market development and promote corporate governance among companies, SEBI has taken several steps as given below:

Primary Market Reforms

The primary capital market plays an important role in the overall functioning of securities market. Vibrancy of primary market, among other things, is a function of macro economic factors, industrial output and demand. Over the years, the Securities and Exchange Board of India, the market regulator, has taken several initiatives to improve the operational efficiency and transparency of the primary market, which provides investors with issues of high quality and for firms a market

where they can raise resources in a cost-effective manner. However, despite these measures the primary market remained lackluster in recent years.

Bonds have been the primary instruments for the resource mobilisation in the primary market followed by equity. Equity with premium compared to the previous year, more than doubled in 2002–2003, while issues in the public sector were dominant during the year, compared to the issues in the private sector, which raised about 87 per cent in the previous year.

With regard to the primary market, the following major changes have been effected by SEBI: Relating to new issues new norms were introduced; freedom to fix par value of shares; guidelines for tightening the entry norms issued; relating to IPOs measures were spelt out; investor protection measures were taken; cost reduction measures.

With regard to the primary market, the part of the capital market that concerns with the issues of new stocks and shares, the following major changes have been effected by SEBI:

1. **Relating to new issues**: In case of new issues, the SEBI has introduced various guidelines and regulatory measures for capital issues with the objective of strengthening standards of disclosures, and certain procedural norms for the issuers and intermediaries with a view to removing the inadequacies and systemic deficiencies in the issue procedures. Companies issuing capital in the primary market are now required to disclose all material facts and specific risk factors regarding the projects; they should also give information regarding the basis of calculation of premium. Companies are free to fix the premium. SEBI has also introduced a code of advertisement for public issues with a view to ensuring fair and truthful disclosures. The prospectus should not contain statements that would mislead the investors. The SEBI has also put in place a system of appointing its representatives to supervise the allotment process and to minimise malpractices in the allotment of oversubscribed issues. Prudential norms have also been laid down for right issues.
2. **Freedom to fix par value of shares**: The SEBI has dispensed with the requirement to issue shares with a fixed par value of Rs. 10 and Rs. 100 and has given the freedom to companies to determine the par value of shares issued by them. Companies with dematerialised shares have been allowed to alter the par value of a share indicated in the Memorandum and Articles of Association. The existing companies, which have issued shares at Rs. 10 and Rs. 100, can avail of this facility by consolidating, splitting their existing shares.
3. **Guidelines for tightening the entry norms**: Guidelines for tightening the entry norms for companies accessing capital market were issued by the SEBI on 16 April 1996. Accordingly, a company should have a track record of dividend for a minimum 3 years out of the immediate preceding 5 years. If a manufacturing company does not have such a track record, it can access the public issue market subject to the condition that projects have been appraised by a public financial institution or a scheduled commercial bank and such appraising agency is also participating in the project fund.
4. **Relating to IPOs**: To encourage Initial Public Offers (IPO), SEBI has let companies determine the par value of shares issued by them. SEBI has permitted issues of IPOs to go for "book building", i.e. reserve and allot shares to individual investors. However, the issuer will have to disclose the price, the issue size and the number of securities to be offered to the public.
5. **Investor protection measures**: On 15 June 1998, SEBI advised investors to exercise a greater deal of caution while investing in plantation companies. At the same time, plantation companies and other collective investment schemes were directed to obtain credit rating from accredited agencies prior to the issue of advertisement.
6. **Cost reduction measures**: To reduce the cost of issue, SEBI has made underwriting of issue optional, subject to the condition that if an issue was

not underwritten and was not able to collect 90% of the amount offered to the public, the entire amount collected should be refunded to the investors. The lead managers have to issue due diligence certificate, which has now been made part of the offer document.

7. **Relating to private placement market**: Private placement market has become popular with issuers because of stringent entry and disclosure norms for public issues. Low cost of issuance, ease of structuring investments and saving of time lag in issuance has led to the popularity and rapid growth of private placement. Total resource mobilisation through private placement market had risen by more than three times between 1995–96 and 1998–99.
8. **Banker to the issue under SEBI's purview**: The "Banker to the Issue" is now brought under the purview of SEBI for investor protection. The Unit Trust of India (UTI) has been brought under the regulatory jurisdiction of SEBI.
9. **Regulations on acquisitions and takeovers:** SEBI has raised the minimum application size and also the proportion of each issue allowed for firm allotment to institutions such as mutual funds. SEBI has also introduced regulations governing substantial acquisition of shares and take-overs and lays down the conditions under which disclosures and mandatory public offers have to be made to shareholders.
10. **Merchant banking under SEBI's jurisdiction**: Merchant banking has been statutorily brought under the regulatory framework of SEBI. Merchant bankers are now to be authorised by SEBI and have to adopt the stipulated capital adequacy norms, abide by a code of conduct which stipulates a high degree of responsibility towards inspectors in respect of the pricing and premium fixation of issues. Merchant bankers will also have to adhere to provisions relating to disclosures or offer letters for issues.
11. **Permission to set up private mutual funds**: The government has now permitted the setting up of private mutual funds. A few have already been set up. All mutual funds are allowed to apply for firm allotments in public issues. To improve the scope of investments by mutual funds, the latter are permitted to underwrite public issues. SEBI has relaxed the guidelines for investment in money market instruments. The market regulator has issued fresh guidelines for advertising by mutual funds.
12. **Making companies provide authentic information:** SEBI has advised stock exchanges to amend the listing agreements to ensure that a listed company furnishes annual statement to the stock exchange showing the variations between financial projections and the projected utilisation of funds in the offer documents and the actual utilisation. This would enable shareholders to make comparisons between promises and performance of companies they invested in.
13. **Making companies comply with issue norms**: In order to make companies exercise greater care and diligence for timely action in matters relating to the public issues of capital. SEBI has advised stock exchanges to collect from companies making public issues, a deposit of 1% of the issue amount which could be forfeited in case of non-compliance of the provisions of the listing agreement and non-dispatch of refund orders and share certificates by registered post within the prescribed time.
14. **Scrutiny of offer documents**: SEBI scrutinises offer documents to ensure that the company in the offer document has made all disclosures. All the guidelines and regulatory measures of capital issues are meant to promote healthy and efficient functioning of the issue market.

15. **Access to international capital market**: Since 1992, the government of India has permitted Indian companies to access international capital markets through Euro equity shares. Initially, the Euro-issue proceeds were to be utilised for approved end uses within a period of 1 year from the date of issue. Since there was continued accumulation of foreign exchange reserves with the Reserve Bank and there were long gestation periods of new investments, the government allowed the issuing companies to retain the Euro-issue proceeds abroad and repatriate them to the country only as and when expenditure for the approved end uses were incurred.

The government of India has also liberalised investment norms for Non-Resident Indians (NRIs) so that they and overseas corporate bodies can buy shares and debentures without prior permission of the Reserve Bank of India which has been the practice followed hitherto.

Secondary Market Reforms

In the secondary market, SEBI has initiated measures: registration of intermediaries, reconstitution of stock exchange governing bodies and regulation of collective investment schemes.

In the matter of reform of the secondary market, a market that is engaged in the buying and selling of old stocks and shares, SEBI has initiated the following measures:

1. **Registration of Intermediaries**: SEBI has started the process of registration of intermediaries, such as the stockbrokers and sub-brokers under the provisions of the Securities and Exchange Board of India Act, 1992. The registration is made on the basis of certain eligibility norms such as capital adequacy, infrastructure etc. There has been much opposition and resistance to this step of SEBI.The capital market regulator has also made rules for making client-broker relationships more transparent, particularly with reference to the segregation of client and broker accounts.
2. **Reconstitution of stock exchange governing bodies:** To make the governing body (GB) of a stock exchange more broad-based, SEBI has issued guidelines for its composition. According to these guidelines, the governing body of a stock exchange should have five elected members, of which not more than four nominated by the government or SEBI and three or fewer persons nominated as public representatives. During 1994–95, SEBI has reconstituted the governing bodies of stock exchanges.
3. **Measures to speed up settlements:** SEBI has prohibited "renewal" of transactions in 'B' group securities, so that transaction could be settled within 7 days.
4. **Simplification of procedures**: Since 1992, SEBI has constantly reviewed the traditional trading system in Indian stock exchanges. SEBI is simplifying procedures and achieving transparency in costs and prices at which customer orders are executed, speeding up clearing and settlement and finally transfer of shares in the names of buyers. SEBI is setting up depositories, which would immobilise securities and help eliminate paper work—this would give impetus to the growth of stock markets.
5. **Regulations on insider trading**: SEBI has notified regulations on insider trading under the provisions of SEBI Act. Such regulations are meant to protect and preserve the integrity of stock markets and, in the long run, to help inspire investor confidence in them. Despite these regulations, insider trading is rampant in our stock exchanges, and rigging the market and manipulating stock market price quotations are quite common. M. S. Shoes East Ltd. fiasco was an example of market rigging in March 2001; SEBI could do nothing about it though it was known that coteries of stockbrokers connived to hammer the Bombay Stock Exchange with rigging.

6. **Regulation of collective investment schemes**: SEBI's regulations for collective investment schemes (CIS) were notified on 15 October 1999. CIS includes any scheme, or arrangement with respect to property of any description, which enables investors to participate in the scheme by way of subscription and to receive profits or income or produce arising from the management of such property. Under the SEBI Act and Regulations framed thereunder, no person can carry on any CIS unless he obtains a certificate of registration from SEBI. All existing CISs were required to apply for registration by 14 December 1999.

7. **Regulation of foreign investments**: The government has allowed foreign institutional investors (FIIs) such as pension funds, mutual funds, investment trusts, asset or portfolio management companies etc. to invest in the Indian capital market provided they are registered with SEBI. Till January 1995, as many as 286 FIIs have been registered with SEBI. There were only ten in January 1993. The cumulative net investment of FIIs on Indian equities has increased from $200 million in January 1993 to $3 billion in January 1995, and to $60 billion as on May 2005, according to a report in Economic Times (11 May 2005) reflecting the healthy impact of economic liberalisation policy of the country and to some extent, the prevalence of low rates of interest abroad. The government of India has now permitted joint venture stock broking companies to have non-Indian citizens on their boards of directors.

Further, SEBI has introduced measures in the secondary market, delisting guidelines, central listing authority, derivative trading, and demutualisation and corporatisation of regional stock exchanges.

8. **Introduction of compulsory rolling settlement**: In keeping with international best practice, SEBI has introduced compulsory rolling settlement of select scrips on 10 January 2000. In June 2000, SEBI introduced derivatives trading. As far as internet trading is concerned, SEBI has prescribed minimum technical standards to be enforced by stock exchanges for ensuring safety and security of transactions via the internet. Rolling Settlement has been extended to all scrips on all the stock exchanges with effect from 31 December 2001. SEBI has further decided to shorten the rolling settlement cycle from present T+5 to T+3 for all listed securities from 1 April 2002. The markets have now moved to T+2 settlement from 1 April 2003.

9. **One point access to investors**: In July 2002, SEBI launched a centralised internet based filing system for listed companies called EDIFAR (Electronic Data Information Filing and Retrieval System), which requires companies to post disclosures as per the listing agreement with the stock exchange on the EDIFAR website at the same time as they submit them to the exchange. The objective of EDIFAR is to provide investors simultaneous, one-point access to key information on all listed companies.

   Beginning July 2002, SEBI has been posting all orders passed by its chairman against errant companies and market intermediaries on its website. This provides useful information to investors.

10. **Introduction of takeover codes:** With regard to mergers and acquisitions, SEBI has made several investor-friendly amendments to the takeover code in recent months. For example, preferential allotments were brought under the ambit of takeover code in September 2002. This would stop the practice of promoters making preferential allotments to avoid making an open offer to other shareholders. Acquirers also have to disclose their holding more frequently, which increases transparency.

11. **Trading of government securities through order-driven screen-based system:** With a view to encouraging wider participation of all classes of investors, trading in government securities through a nationwide, anonymous, order-driven, screen-based trading system of the stock exchanges, in the same manner in which trading takes place in equities,

was launched on 16 January 2003, initially on Bombay Stock Exchange (BSE), National Stock Exchange (NSE) and Over the Counter Exchange of India (OTCEI).

12. **Delisting guidelines:** The market regulator has issued the SEBI (Delisting of Securities) Guidelines, 2003 on 17 February 2003. The guidelines provide that companies can delist from stock exchanges only by offering an exit route to remaining shareholders through a "reverse book building" process. This mechanism would leave the option of pricing to the investors and would be totally transparent to the market. Further, the promoter shall offer a floor price on the basis of average of previous 26-weeks high and low prices to investors.

13. **Central listing authority:** To bring about the uniformity in scrutinising listing applications across the stock exchanges and to strengthen the listing agreements, SEBI has, in April 2003, established the Central Listing Authority in Mumbai. Former Chief Justice of India, Justice M. N. Venkatachelliah, has been appointed as the president of the Authority. There shall be eight other members of the Authority, all of whom shall hold office for a period of 3 years. They shall discharge the following functions: (i) processing the application made by corporates, mutual funds, or collective investment schemes and (ii) making recommendations as to listing conditions.

14. **Derivative trading**: The Central Government lifted the prohibition on forward trading in securities by a notification issued on 1 March 2000 rescinding the 1969 notification. With the enabling enactment of the Securities Laws (Amendment) Act, 1999 in December 1999, trading in stock index futures started in June and July 2001 respectively. Single stock futures have also been introduced since 9 November 2001.

    Interest Rate Derivatives trading was formalised on the stock exchanges with the launch of futures on 10-year zero yield coupon bond and zero-coupon notional T-Bill in June 2003.

15. **Demutualisation and corporatisation of regional stock exchanges**: Recently (2004), the Securities Contract (Regulations) Act (SCRA) was amended through the promulgation of an ordinance to make corportisation and demutualisation of stock exchanges mandatory. The ordinance has been issued on the basis of the recommendation of a group under the chairmanship of Justice M. H. Kania, former Chief Justice of India, to advise the government on the issue of corporatisition of stock exchanges. The amendment not only requires separation of ownership and trading rights, it also requires that the majority ownership rests with the public and those without any trading rights. Also through these conditions, the government has signalled a major shift in its earlier stand that stock exchanges should be self-regulating agencies of their members. It now desires that they should be externally regulated.

Traditionally, the Regional Stock Exchanges (RSEs) functioned as mutual societies owned and operated by member brokers. A few of them have already switched to the corporate form. The new action plan now requires them to segregate ownership rights from trading rights. Professionals rather than broker representatives will conduct the affairs of the exchanges. Can the RSEs come together as has been proposed many times and transform themselves into the country's third exchange along with the National Stock Exchange (NSE) and Bombay Stock Exchange (BSE)? That is a moot question, though few will question the need for increased competition that will give greater choice to investors.

However, in practice, it has always been difficult to form a third all India exchange. Despite the current moves to restructure the RSEs, there is no guarantee that a demutualised and corporate exchange by itself will be the recipe for survival

and eventual success. On the contrary, in the opinion of experts, there are valid reasons to be skeptical. The RSEs, in their new form will require a large number of stock market professionals who are scarce. Besides, an exchange operating for profit may sacrifice regulatory concerns for commercial gains.

At present stock exchanges in India are "mutual" and non- profit organisations enjoying tax exemption. The trading members are stockbrokers who also own, control and manage such exchanges for their mutual benefit. The ownership rights and trading rights are combined together in a membership card, which is not freely transferable.

On the other hand, a "demutual" exchange is one in which three distinct sets of people own the exchange, manage it and use its services. The three stakeholders are shareholders, brokers and investing public. The management is vested in a board of directors, assisted by a professional team. A demutualised exchange is generally a profit organisation and a tax paying entity. The ownership rights are freely transferable and there is no membership card.

At present stock exchanges in India are "mutual" and non-profit organisations enjoying tax exemption. The trading members are stockbrokers who also own, control and manage such exchanges for their mutual benefit. The ownership rights and trading rights are combined together in a membership card, which is not freely transferable. A publicly held organisation is in a position to ensure greater transparency in dealings, accountability and market discipline and is amenable to changes.

A typical mutual exchange managed by broker's representatives is not an ideal model for an enlightened self-regulatory organisation. In this regard, a demutualised framework is expected to have a balanced approach without the inherent conflict of interest. It can generate a greater management accountability. In a competitive environment stock exchanges require funds and to raise funds, mutualised organisations suffer from their own limitations, whereas a demutualised set-up can tap capital markets. A publicly held organisation is in a position to ensure greater transparency in dealings, accountability and market discipline and is amenable to changes. However, a demutualised and corporate form of stock exchange is not an unmixed blessing either. According to C. R. L. Narasimhan, an authority on the subject, they have the following disadvantages:[6]

(i) It is not as though the new governance structure will automatically be free from pitfalls. There may arise a different conflict of interest. The new look demutualised exchange operating on profit considerations may opt for a course that may conflict with the regulatory role expected of it.

(ii) Although it is unlikely to happen immediately in India, a corporate stock exchange may be listing its shares on an exchange possibly with its own self.

(iii) While a demutualised structure segregates the different roles of owner's controllers and traders, it is still necessary to invite eminent people on its Board. That is to ensure that the exchanges take care of public interest too and not merely ensure their commercial character.

(iv) In the demutualised exchanges, share capital will be subscribed to by different investors including the trading members. It may become necessary to prescribe a ceiling on voting powers somewhat akin to what obtains today in banking regulation and law. This, of course, is a handicap that has to be overcome by anybody concerned with capital market.

(v) An amendment to the Securities Contracts Regulation Act is on the cards: other legal changes/concessions are also necessary before demutualisation takes place.

(vi) As in many other areas of the capital market it has been easy to identify what is wrong with the existing system of stock exchange governance. It has been only slightly more difficult to suggest an alternative system, in this case the demutualised exchange.

It is also likely that the government will push for a speedy transition to the new mode of governance. However, even if the board objectives are achieved, it is likely that the perception of the exchange may not improve dramatically over the short term.

SEBI's Shortcomings

SEBI suffers from a number of shortcomings like lack of adequate required power.

Though SEBI has come a long way in acquiring more powers and wielding great authority in regulating the Indian capital market, it also suffers from a number of shortcomings. These are as follows:

1. **Lack of adequate required power:** While creating the SEBI, the Government of India seems to have been influenced by regulatory measures adopted in the US to guide the country's securities market into orderly development. The counterpart of SEBI in the US is the Securities and Exchange Commission (SEC). However, SEC is entrusted with more penal powers to discipline recalcitrant traders in the market. To make SEBI perform and act like SEC, the Government of India should have provided it with powers to penalise and debar wrongdoers. The Indian government should also consider granting powers for *suo moto* action on any matter concerning the capital market. If SEBI is an intrinsic part of the process of economic structuring, as it is made out to be, then there is every reason to stress that it should be empowered to play an active role in the capital market.
2. **Buckles under pressure**: Even while analysts bemoan SEBI's lack of empowerment to wield any power with authority in bringing to book wrongdoers, it is a moot point whether the organisation is really interested in exercising its existing authority. It seems to buckle under pressure when there is every reason to be firm. The M S Shoes East fiasco in which SEBI remained a mute spectator is a case in point. A recent (October, 2004) revision of Clause 49 of the listing agreement (LA) is another point in question. Bowing to intense pressure from corporate and industry chambers against its earlier mandatory requirement with regard to independent directors and whistle-blower policy, the market regulator has now considerably diluted this clause by issuing a master circular which supercedes all earlier ones. Earlier, as part of the mandatory requirement under Clause 49 of LA, SEBI had asserted that independent directors might have tenure, not exceeding in the aggregate, for a period of 9 years on the Board of a company. Had SEBI insisted on the independent directors issue which was an essential ingredient of promoting better governance practices among Indian corporates, many companies would have been forced to remove passive directors appointed by them and bring in new faces to the board.

   Likewise, another mandatory requirement for the corporates was to have the whistle blower policy. SEBI's earlier circular had provided for a whistle blower policy through which a company should establish a mechanism for employees to report to the management concerns about unethical behaviours, actual or suspected fraud, or violation of the company's code of conduct or ethics policy. This mechanism could also provide for direct access to the chairman of the audit committee in exceptional cases. Once established, the existence of the mechanism may be appropriately communicated within the organisation. The provision of having a whistle-blower policy too has now been made a non-mandatory requirement. In this context, SEBI watchers argue: "It is sad that SEBI buckled under pressure from the intense lobbying by corporates. Some of the promoters are against the whistle-blower policy. This does not suit their working style.'' Such fickle-minded approach on the part of the regulator not only brings to the fore its inability to enforce well-intentioned regulations evolved out of considerable experience, thought, and deliberation, but also SEBI could not be believed to promote corporate governance practices with any degree of commitment to the cause.

3. **The legacy of Nehruvian socialism dies hard**: For most of the problems SEBI faces, and with its current positioning and dispensation, it is unable to find solutions to, are part of the legacy of Nehruvian socialism. A regulatory framework that works like an appendage or an extended arm of a government department in a free and a fiercely competitive environment is bound to face serious problems.

SEBI suffers from other shortcomings such as mammoth size of the market and inefficient handling, inefficient standard regulatory model.

4. **Mammoth size of the market and inefficient handling**: Regulation of the Indian capital market poses a number of problems. The value of transaction in India's capital market is very large and its close day-to-day supervision is impossible. The original conception embodied in the Securities Contracts (Regulation) Act, was that stock exchanges were self-governing associations of brokers, which would be given a local monopoly of the city in which they were situated in return for providing public services of a certain minimum standard. The standard was to be defined by the rules and practices of the stock exchange, and regulated by instructions from the government (i.e, the Finance Ministry). In practice, however, this model of regulation had worked very badly, and the government had been quite unable to improve its working. The standard practice of the Controller of Capital Issues in respect of these shortcomings was to issue instructions to the stock exchange, but to do nothing further to ensure compliance, and consequently compliance was minimal. SEBI, after the abolition of the office of the Controller of Capital Issues has taken over supervision of stock exchanges, and has not brought any new fresh initiatives to its job as a capital market regulator.

   As a result, SEBI's initiatives to regulate stock exchanges too have been ineffectual; they were involved in considerable wrangles without significantly improving the working of the stock exchange. This is because SEBI's approach is as bureaucratic as its predecessor. Both are of the same type; they involve rule making without much thought of rationale or consequences.

5. **Inefficient standard regulatory model:** The standard model on which SEBI operates is that of the country's central bank, namely, the Reserve Bank of India (RBI), which is similar to that of many regulatory authorities abroad including the Bank of England and the Federal Deposit Insurance Corporation and the Securities and Exchange Commission of the US. For every agent in the capital market, SEBI lays down a number of do's and dont's of various degrees of seriousness. It prescribes two degrees of penalty: suspension or cancellation of registration. To discover delinquency, SEBI requires that the agent maintains certain records and reserves, the right to inspect the records, either after giving notice or in a simple raid. This model of regulation has actually been seen to work very badly in the case of banks; they have been routinely inspected by RBI for decades, and have steadily deteriorated in spite of it. SEBI's inspection may work even less well, for SEBI cannot afford the vast work force RBI has acquired over time.

6. **SEBI should identify delinquents speedily and penalise them**: Further, no thought has been given in or outside SEBI about the effectiveness of regulation, which depends on the speed and certainty with which delinquencies are discovered and punished, and the matching of the severity of the crime and the degree of punishment. SEBI should distinguish between substantial delinquencies, e.g. fraud, insider trading, delays, or failure to address customers' complaints and procedural deficiencies, e.g. failure to keep account books in particular forms. It should concern itself only with the first, while it should not spend too much of its time and efforts on the second. It should spend a great deal more of energy on complaints to discover delinquencies; and it should take much more frequent and quicker action against such delinquencies. It should employ a broader range of graduated penalties

instead of just suspension and cancellation of registration; in particular, it should use more frequently heavy financial penalties commensurate with the crime.

7. **Problems that SEBI has not tackled:** While the capital market reforms are impressive, there are still areas that present major problems. The market has still not recovered from its skittishness about IPOs. The debt market presents the biggest problems. While there is an active debt market, the longest maturities are less than 7 years. Consequently, many large Indian companies look to foreign capital markets for longer-term debt and equity. On the domestic debt side, the lack of a debt yield curve, and a stamp tax on debt transactions have prevented a secondary-debt market from developing. Finally, the fact that pension funds and banks cannot invest freely in private sector debt or equity eliminates major demand from the market.
8. **There is a long way to go**: Indian capital market institutions are still not completely upto world standards. Settlement of stock transactions takes place 5 days after agreement while the international standard is for settlement by the third day. The use of a securities depository has not been fully adopted. The regulator has also held back the creation of specialised products, such as index futures and other derivatives that can add liquidity to the market.

Critics of SEBI's role and the way it has been functioning point out that India's capital markets so far are not sufficiently mature, nor do they guarantee sufficient levels of investor protection to constitute an effective governance mechanism as they do in Anglo–American countries. Besides, unlike the US Securities and Exchange Commission (SEC), SEBI does not have direct oversight over the auditing and accounting profession. SEBI has left it to the Institute of Chartered Accountants of India to set and monitor standards closer to international norms. This dichotomy in authority in enforcing auditing and accounting standards so essential for promoting corporate governance also make SEBI as a less powerful market regulator *vis-à-vis* the SEC of United States.

Dhanuka Committee recommended that all provisions related to listed companies referring to capital market and insurance or dealing in securities wherever found in Companies Act are administered by SEBI; SEBI should be the sole authority for framing regulations for all matters related to such issues; SEBI should be authorised to frame regulations relating to transfer of securities and must be vested with powers of investigation and enforcement; and the scope of powers and functions of the SEBI board be enlarged and a new definition of issues is drafted because the definition under the Companies Act is far too limited as all issuers are not companies but other form of legal entities which currently do not come under its purview.

Dhanuka Committee

The Dhanuka Committee was appointed to examine all current capital market regulations and to suggest amendments to them. In its report the committee recommended that SEBI's powers be enlarged to enable it to be an effective market regulator. It has recommended the following:

- All provisions related to listed companies referring to capital market and insurance or dealing in securities wherever found in Companies Act are administered by SEBI
- SEBI should be the sole authority for framing regulations for all matters related to such issues
- SEBI should be authorised to frame regulations relating to transfer of securities and must be vested with powers of investigation and enforcement
- The scope of powers and functions of the SEBI board be enlarged and a new definition of issues is drafted because the definition under the Companies Act is far too limited as all issuers are not companies, but other form of legal entities which currently do not come under its purview.

Suggestions for SEBI's Improvement

In the light of recommendations of various committees and criticisms of analysts of capital market, a number of suggestions can be made to improve SEBI's performance in future.

SEBI needs to be vested with more powers; among these mention may be made of the following important ones:

- To monitor effectively the working of stock exchanges
- To insist on companies for the supply of extensive information on a regular basis
- To penalise members of stock exchanges who were found to violate securities laws
- To debar wrond-does from any activity in the stock market and impose on them civil penalties and initiate criminal proceedings
- To make rules about the manipulative practices
- To move court for checking insider trading
- To prosecute a company and its directors *suo moto*, even without receiving complaints by an aggrieved investor in respect of supplying inadequate and incorrect information.

CONCLUSION

To make SEBI perform and act like the Securities and Exchange Commission of the USA, government should provide it more powers to penalise and debar the wrongdoers. Further, government should also consider granting it powers for *suo moto* action on any matter connected with the capital market. Thus, if SEBI is to be successful in its role as a regulator, it needs to have more powers to prosecute the errant members of the system. If every announcement could be taken to court and eventually get it changed, there is no case for setting up of a separate regulatory body like SEBI. However, the consolation is that things are changing *albeit* slowly. Critics also have to appreciate the fact that in a developing economy such as ours where almost all economic institutions are nascent or just evolving and in transition, immediate and appropriate responses to fast changing and dynamic economic and commercial situations—good or bad for the overall development of the economy—may not be forthcoming in a measure that is available in mature and developed economies. This is exactly the crux of the problem that developing economies face and that is one of the reasons why they are poor and impoverished. It may take some more time and efforts for them to catch up with more efficient and mature institutions of developed countries. The deficiencies of SEBI as a capital market regulator have to be understood and appreciated in such a context.

KEYWORDS

- Capital market
- Deficiencies
- Disclosure standards
- Economic growth
- Effective enforcement
- Effective market system
- Emergence of SEBI
- Impact of globalization
- Jurisdiction
- New economy
- New Era
- Powers of the board
- Primary market reforms
- Registration of intermediaries
- Role of securities market
- Secondary market reforms
- Securities Appellate Tribunals
- Standards of governance

DISCUSSION QUESTIONS

1. What do you understand by the capital market? What were the factors responsible for the phenomenal growth of the Indian capital market, especially after 1951?
2. Discuss the different stages in the development of the Indian capital market. What are the deficiencies one observes in the Indian capital market?
3. Discuss the role of securities market in the economic growth of a country with special reference to India.
4. What were the circumstances that led to the abolition of the Controller of Capital Issues and the emergence of the SEBI?
5. Discuss the genesis, objectives, functions and powers of the SEBI.
6. Discuss the role of SEBI in promoting corporate governance. Explain its role especially with reference to primary and secondary market reforms.

NOTES

1. Insider trading implies trading in the scrip of a company by such a person who is closely associated with it and has access to unpublished price-sensitive information. Front running is indulged in by brokers. On being advised by institutions to execute bulk orders (buy or sell) that have the potential to push the market price (up or down), the brokers make deals in advance of institution orders and make profits for themselves.
2. Speech on "Corporate Governance and Development: Why it Matters?" by G. N.Bajpai, Chairman, SEBI.
3. *Ibid*. At the meeting of "Global Corporate Governance Forum" held on 4 November 2003 in Paris.
4. Bharat's Manual of SEBI, Act, Rules, Regulations, Guidelines, Circulars, etc. September 2003.
5. This quote and the following analysis are based on an edited extract of the speech delivered by G. N. Bajpai, Chairman, SEBI, at 2003 Lex Mundi and Global Forum (Jointly organised by Lex Mundi and Global Corporate Governance Forum of the World Bank).
6. Better corporate governance for stock exchanges by C. R. L. Narasimhan in *The Hindu*, 15 March 2004.

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Case Study

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?

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The Role of the Government in Ensuring Corporate Governance

CHAPTER OUTLINE

- Introduction
- Different Roles of Government in the Economy
- State Intervention in a Developing Economy
- Public Governance and Corporate Governance
- Political Governance Requires Restraints of Power
- Public Versus 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 anarchy of production, unemployment, and economic instability.

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 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 occurrance 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 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 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 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 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 enforcement of a governmentally provided legal structure.
2. The claim that the market mechanism leads to 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 competition in factor and 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 for 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 developing and developed countries.
7. In 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 national production and a vast expansion of its laws, regulations and executive fiats governing economic affairs.
9. Even in free market economies, 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 way 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: the regulatory role, the promotional role, the entrepreneurial role and the planning role.

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

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
(i) Direct controls (ii) 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 developed as well as 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 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 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 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 massed 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 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 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 has been a tendency in many developing countries to assign a dominant place to the government-owned public sector, as was evident in India.

State Intervention in a Developing Economy

State intervention is inevitable in 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:

> 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.

(i) Simple market forces cannot ensure 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 into 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

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 within 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 political society or within 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 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:

- 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.

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.

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 over-reach 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.[2]

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."[3]

The Limits of Corporate Power

Millstein and Katsh assert that there are definite restraints for corporates exercising unbridled power as opined by Ralph Nader. They expostulate five basic theories that guide the state for exercising control over the behaviour of corporations. *First*, states have the inherent and inalienable political right to charter laws and regulations, limiting *de jure* what the corporation does and how it is done. *Second*, corporates face *de facto* limitations in the laws of supply and demand operating through the market mechanism and the profit motive. The free play of market forces and the competitive markets for goods and services, of course, are ensured through the state putting in place anti-trust and securities' regulation. *Third*, the state offers incentives as well as deterrents to corporations through the system of taxation. In every decision-making and economic behaviour, corporations will have to reckon these. "Tax legislation clearly demonstrates the dangers of tinkering with powerful economic forces without considering the entire matrix of incentives and constraints which determine economic behaviour."[4] *Fourth*, state and federal (central) governments' administrative codes and regulatory statutes impose on corporations certain direct, command-type controls. These may have considerable impact on various socio-economic situations that influence the corporations, and the economy itself, in many unintended ways. These may include labour relations; equal employment opportunities; community-wise quotas and reservations; occupational safety and health; environment; social security measures and social safety net to safeguard the poor and under-privileged; consumer protection and energy consumption, etc. *Fifth*, there is the impact of social forces on corporate behaviour, with specific attention to public opinion in general and to activate special interest groups in particular. All these groups exercise the checks and balances that keep the corporates under control so that they do not become social monsters, and fatten themselves on the miseries of the stakeholders.

However, there are anamolies, inconsistencies and incompatibilities which have crept into the system over time, as well as the growing divergence between the intentions of the government and empirical results of its actions. Moreover, with increasing changes coming into the functioning of the free enterprise system and the growing needs of a fast-growing consumerist society, when being catered to by the mammoth size mega corporations, the dynamics of the situation brings in a lot of confrontation and conflicts. For instance, the regulatory systems that were put in place after the Great Depression to regulate the corporations served the purpose admirably well until the business organisations such as Enron and WorldCom grew far beyond the most sanguine expectations of their promoters. With such stupendous growth of corporations and the required regulations lacking behind to keep them under check, they discovered several grey areas to play ducks and drakes with the investors' hard-earned funds by circumventing government regulations and hoodwinking the regulators. If free societies rely more and more on private ownership of economic resources, on the one hand, and develop, due to historical reasons based on past experience, a discomfort with the discretionary powers of the managers, on the other, they should work out a system to strike a judicious balance between the two, so that neither their growth imperatives, nor equity as their driving force, is jeopardised.

Demand for Corporate Constitutionalism is a Knee-jerk Reaction

Reformers who desire greater corporate democracy have mistakenly called for constitutionalism, a principle of public government, to be applied to the operation of the private corporations. Freedom, without the existence of constitutional restraints, according to them, may lead to corporate absolutism in the economic sphere. According to these critics, the concentration of the control of property in the hands of a few managers, no matter how dispersed the actual stock ownership may be, threatens the idea of pluralism. What has resulted has been a call for the development of means by which the powers of these private governments can be moderated regarding those both inside and outside of the firm.

There has been a recent demand for due process in corporations. Critics argue that when a corporation has the power to affect a great many lives, it should be subject to the same constraints under the constitution that apply to the government. Some have advocated the control of corporations by external agencies such as central or federal governments. Others have recommended control through internal, institutional devices such as: (1) stakeholder directors on the Board, (2) social audits, (3) the preparation of community impact analyses, (4) the implementation of plant closing restrictions, (5) full-time, outside, professional directors, (6) ethics committees, and (7) separating the Board chair (external) from the president (internal).

Reformers who desire greater corporate democracy called for a principle of public government, to be applied to the operation of the private corporation. Freedom, without the existence of constitutional restraints, according to them, may lead to corporate absolutism in the economic sphere. Critics argue that when a corporation has the power to affect a great many lives, it should be subject to the same constraints under the constitution that apply to the government. Others have recommended control through internal, institutional devices such as: stakeholder directors on the board, social audits, the preparation of community impact analyses, the implementation of plant closing restrictions.

Some critics maintain that large corporations, because of their size, special legal status, and economic, political, and social impacts, have as much public power as do states, and therefore, they as private governments should be federally chartered, constitutionally limited, and held to higher levels of social responsibility than non-corporate firms. They argue that modern corporations represent large concentration of power and have the potential to effect great changes in society. Instances are galore to prove this contention. From matured to nascent democracies, money power of corporates and the considerable political clout they exercise as a result have influenced elections and elected officials, including presidents and prime ministers. In other words, social responsibility arises from social power. Because corporations can affect the interests of others, they must be concerned with social responsibility. Advocates of corporate democracy theory even go so far as to call for restraints on the control of shareholders and managers so that the corporation can be run as a democracy in the interests of all of its constituents. Reformers have failed to recognise that commerce is essentially different from government and that methods appropriate to government are not germane to commercial enterprises. Unlike coercive governments, commerce is based on ideas such as trade, voluntary agreements, honesty, trust, confidence in strangers, openness to strangers, competition, inventiveness, efficiency, initiative and enterprise, thriftiness, dissent for the sake of the job, etc. Thus, there are some special features that corporates exhibit which make them very different from political institutions. These are as follows.

Corporations Are Voluntary Associations

A corporation, is created through the exercise of individual rights (i.e. freedom of association and freedom of contract). People have an inherent right to form a corporation by contract for their own benefit and in their mutual self-interest. Based upon a consciousness of common interests, the corporation is an association of individuals who engage in a particular type of contractual relationship with one another in order to pursue common business objectives, and is governed by rules of the individuals' own making, and is said to be able to assert rights and assume obligations. When rights and obligations are imputed to a corporation,

what is really being referred to are the rights and obligations of its members who create and sustain it.

Corporations are properly viewed as voluntary associations and as private property. Arising from individual contracts, corporations are not the creation of the state—the state simply recognises and records their creation in a similar fashion as it does with births, marriages, sales of real estates, etc. The corporate charter is merely the articles of incorporation which are not related to state authority and do not obligate the corporation to serve the public interest. Since corporations are not created by the state, the government has no authority to tell them what to do or what not to do, as long as they operate within the four corners of the law.

The state grants a charter as a legal technicality and neither creates nor changes the essence of these voluntary associations whose success depends upon the social bonds that unite their members and upon the human need for group membership. The state may choose to recognise these units but in so doing it simply acknowledges that, which already exists. The corporation is an association of human beings bound together in order to achieve a purpose. Positive law alone cannot provide the community of purpose necessary for a corporation to exist. In fact, the equivalent of a corporation frequently exists in the absence of legal action.

Corporate Governance Requires the Freedom to Create and to Execute

In government, executive power is feared and thus checked—in the corporation it is desired and, therefore, fostered. Since a corporation is not a political community, checks and balances are not appropriate to it. In a corporation, the whole idea is to accomplish certain goals and to create something new. In government, the point is to keep leaders from doing anything beyond their stated powers. In corporations, we value swift action. Contrariwise, in government we desire judiciousness and deliberation.

> In a corporation, the whole idea is to accomplish certain goals and to create something new. In government, the point is to keep leaders from doing anything beyond their stated powers. In corporations, we value swift action, which in government we desire judiciousness and deliberation. The corporation can only survive and prosper if it meets the needs of its customers and the purposes of its investors including the provision of goods or services at a profit along with fiduciary care for resources invested in it. With respect to corporate governance, owners are in sufficient control via the buying and selling of shares and other actions.

Investors who have an idea, combine their resources, and attempt to create new wealth, create corporations. The corporation can only survive and prosper if it meets the needs of its customers and the purposes of its investors including the provision of goods or services at a profit along with fiduciary care for resources invested in it. A corporation is created to attain specific purposes. It follows that the problem of corporate governance is not to check power—it is to summon up and channel power toward the accomplishment of organisational objectives. No one should desire a “separation of powers” within a corporation, executives must be permitted to execute.

With respect to corporate governance, owners are in sufficient control *via* the buying and selling of shares and other actions. Discontented shareholders may theoretically bring a suit against the directors and managers when they spend the shareholders’ money on unauthorised projects that are not in the owners’ interest or engage in other *ultra vires* acts. It is more likely that they will vote against such directors, remove the managers, or simply sell their shares. In a publicly owned corporation, the owners may be located all over the world. However, it is more probable that a large percentage of the shares of any major firm will be owned by particular mutual funds and pension plans, who act as proxies for a large number of individuals. The relationships between shareholders and corporate managers, and shareholders and money managers are principal-agent relationships. The growth of mutual funds and pension plans means broader stock ownership and stronger pressure on behalf of stockholders to keep managers in line. Since directors of mutual funds and pension plans want to invest in highly profitable firms, there is a powerful motivation for corporate directors and managers to continue to work hard and creatively. Money managers, as agents of the absentee-owner shareholders, can vote a CEO out of office by taking control of the board

of directors or can sell the stock of companies from which they no longer expect competitive returns.

We are in an era of "fiduciary capitalism" in which there is a concentration of ownership in the hands of a relatively small number of decision makers. However, in fact, legal ownership is still widely dispensed and the fiduciary duty of the money managers of mutual funds and pension plans gives them the responsibility to exercise the powers of ownership. The fiduciary standards require that the fiduciary takes only those actions that a prudent person would take regarding the management of the resources entrusted to the fiduciary. In discharging their fiduciary duty, money managers purchase securities and vote proxies. In essence, they exercise ownership rights, although on behalf of their beneficiaries. The idea of the morality of the principal-agent relationship is certainly not new. For example, the Biblical Parable of the Talents clearly illustrates the idea that separating control from ownership does not strip the owner of his rights.[5] Today, we have simply added the idea of the fiduciary responsibility of the mutual fund or pension plan manager as a middleman, between the owners and the managers of a corporation.

Corporations Do Not Possess the Power of Coercion

Ethically, a corporation's "power" is irrelevant. Unlike governments, a corporation does not enjoy the power of coercion. The idea of a private government is oxymoronic. Only the State can force people to do things through its political, military, and police power. When a business offers a *quid pro quo* to its potential customers, employees, and others, it simply adds to their existing set of options—this in no way constitutes an exercise of power. Therefore, only governments should be constitutionally limited by legal restraints imposed on power holders to keep power from being abused.

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What about the possibility of the abuse of power by individual managers over employees within a corporation? Certainly, corporations need to give authority to command others and provide the means necessary to gain obedience to these commands. Authority, the right to be obeyed by others, requires power. In a corporation, authority and power should be restricted to assigned legitimate areas. Power exercised without authority is illegitimate. Surely, any well-run corporation will have internal due process policies and procedures to provide some assurance of non-arbitrariness by requiring those who exercise authority to justify their actions. In a free society, if management's order is not agreeable to a worker who believes it to be arbitrary or not within the manager's legitimate sphere of authority, the worker can choose to: (1) initiate the firm's due process procedures, (2) ignore the manager's overstepping of his authority or (3) terminate his relationship with the company.

Public Versus Corporate Governance—A Study of Comparison

Link Between the Two Systems

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 registration of companies, their structure, and settlement of disputes, to laws relating to the capital market and punishment for unethical practices such as insider trading.

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 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 private gain". If the public servants are going to exploit their position for private gain, then the quality of public governance suffers. If the quality of public governance suffers, 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 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 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 corporations have an important duty to contribute to 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.

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. In fact, 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 bring in greater discipline for 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 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 public governance and 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, junk bond 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 corrective measures are contemplated along with research to arrest such crimes. To tackle cyber crimes, it becomes necessary to have international standards and international cooperation. This is also going to contribute significantly to 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 society.

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 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 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 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. The basic framework of the Constitution in India depends on the three main pillars, namely, judiciary, executive and the legislature.

The basic framework of the Constitution in India depends on the three main pillars, namely, judiciary, executive and the legislature. It is axiomatic that the basic structure of the Constitution is not to be tampered with. One of the areas 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 better public governance but also for better corporate governance.

Governance Is a Matter of Continuous Learning

Ultimately, both better public governance and 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 and 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 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 rule of 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 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 audit committees or accounting compliance may lead to trivialising the concept. As a consequence, companies may just present their accounts better and continue to ignore 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 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.

The scope of government relations with 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 business.
- It uses its contracting power to get business do things it wants.
- It promotes and subsidises business.
- It is an architect of economic growth.
- It protects interests of society against business exploitation.
- It directly manages large areas of private business.
- It is a national security protector.

Governments Have to be Proactive in the Following Areas

- Government should ensure that stakeholders' interests are protected by continuous monitoring of companies, to see that they do not cheat their stakeholders.

- 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), Telecom Regulatory Authority of India (TRAI), and Insurance Regulatory and Development Authority (IRDA). These regulatory authorities have some important functions to perform to ensure 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 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 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.

There are laws for employer protection also to save them from illegal strikes and lock-outs that cause production losses and the like.

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. Government makes investments in capital goods industries in which most private companies can not invest because of some constraints such as huge investments and long gestation period as in the power sector, oil sector, telecom and airlines industries and so on. In the above mentioned industries, Indian government had invested huge sums of money and developed them over a long period of time. Government can also play a major role in developing and building corporate culture by taking measures to diversify investments, protect investors and boosting their confidence in times of financial crises.

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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 public sector enterprises, reducing the role of the Inspector Raj in the economy, allowing 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 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 transparently blameless conduct of its own affairs. It should legislate, regulate, and ensure proper conduct of organisations, and enable them to adopt 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 sections of society on the importance of ensuring better governance practices both among corporates and in 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 Enron and 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

- Different roles of government
- Comparative study
- Corporate constitutionalism
- Developing economy
- Enactment of laws
- Entrepreneurial role
- Globalisation
- Government regulation
- Government relations with business
- Information Technology
- Limiting corporate power
- Political governance
- Power of coercion
- Promotional role
- Public governance
- Regulatory role
- Restraints of power
- Role model
- Role of Judiciary
- State intervention
- 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 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?

NOTES

1. Sullivan, John D. Centre for International Private Enterprises www.cipe.org
2. Nader Ralph and Mark Green in the New York Times, on 28 December 1979. Quoted by Ira M. Millstein and Salem M. Katsh in *The Limits of Corporate Power*, New York: Macmillan.
3. Millstein, Ira M. and Salem M. Katsh in *The Limits of Corporate Power*, New York: Macmillan, p. XVII.
4. Boris Yavitz in his Foreword to the book *The Limits of Corporate Power*, Opp. Cited.
5. A parable was told by Jesus Christ to illustrate the right of the master to reward his servants on the basis of their commitment and performance. As per the parable, the master entrusted his assets to three servants and then departed the country, thereby creating a situation involving the separation of ownership and control. Two of the servants invested the assets, were very productive, and therefore, were rewarded when the master returned. The third buried the assets, returned them without earning any interest on them, and was punished.
6. "Government Against Policing in Corporate Governance," *Economic Times*, 19 October 2004.

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PART FOUR

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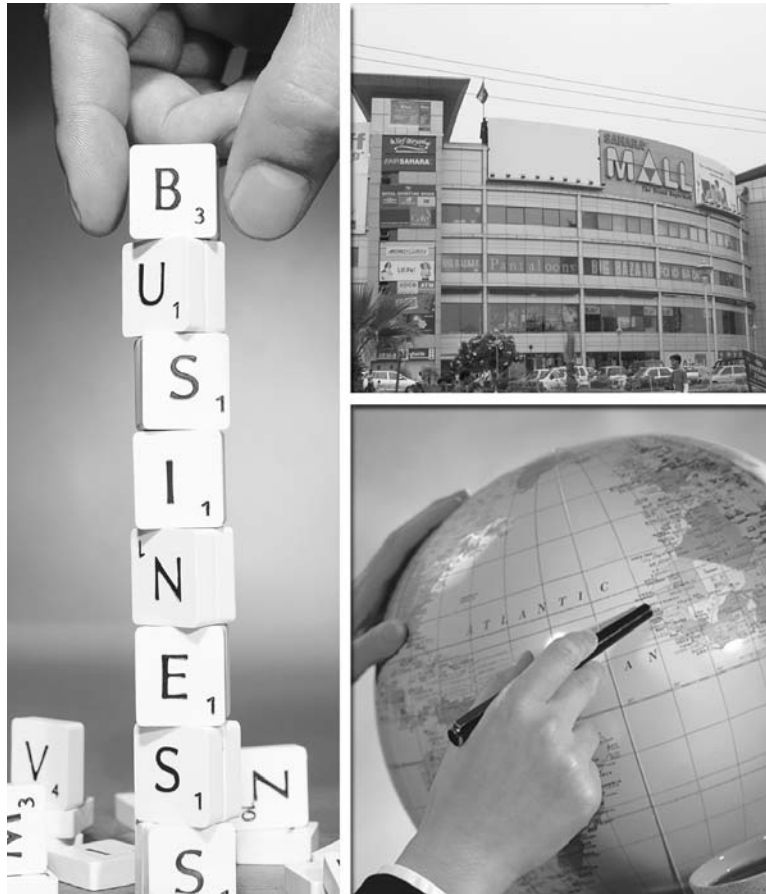

Corporate Governance in Developing and Transition Economies

CHAPTER OUTLINE

- Introduction
- Problems Faced by Developing and Transitional Economies
- Defining Corporate Governance
- Corporate Governance Models
- The Institutional Framework for Effective Corporate Governance
- Corporate Governance Challenges in Developing, Emerging and Transition Economies
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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 internal and external. Lack of transparency and disclosures and inequitable treatment of shareholders, window dressing, fudging of accounts and funneling of corporate funds into private channels were all becoming too common. Earlier, the common perspective of corporate governance was to respect the individual system of each country.

Introduction

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 board members and auditors conspired to defraud their stakeholders, both internal and external. The problems of misgovernance were deep-rooted and did not emanate only from the dichotomy between ownership and management. Lack of transparency and disclosures and inequitable treatment of shareholders, window dressing, fudging of accounts and funnelling of corporate funds into private channels were all becoming too 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 misdemenours 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 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 developing and 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 developing and transition economies should try to put in place required systems and institutions with a view to benefiting from the world-wide application of the principles and percepts of best corporate governance practices. In this chapter, we will analyse the problems and issues confronted by 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 corporations and 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 society can be sure that large corporations are well-run institutions to which investors and lenders can confidently commit their funds. It is now increasingly clear that having a transparent and fair system to govern markets, equitable treatment of all stakeholders, and a chance for every entrepreneur with a good product to be successful, is as important to 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.

Problems Faced by Developing and Transition 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.

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 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.

In 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 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 financial sectors, weak legal and judicial systems, absent or under-developed institutions and scarce human resource capabilities.

The need for corporate governance in developing, emerging and 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. Developing and 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 developing, emerging and 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 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

Some of the problems facing these economies are lower economic growth, dominant public sector lack of awareness among shareholders, greater government influence, and less autonomy to enterprises.

- Lack of effectiveness of privatisation
- Lack of awareness among shareholders
- Greater government influence, and less autonomy to enterprises
- Largest shareholders in most of the companies are the privatisation 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 few individuals and family-owned corporations
- Lack of strong legal protection for investors in developing countries that leads to 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 abuse of internal information, and are often manipulative
- Redrawing property rights and contract laws are slow in coming
- 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 shareholders, creditors and other stakeholders such as employees, 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 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 can be held to high standards of competency, ethics, and responsibility.

Corporate governance is directly related to financing and investments. For countries in transition, the scarcity of domestic savings demands that capital should be directed towards the most profitable companies, which is possible only if principles of corporate governance are given publicity, transparency and monitoring; in addition, due to the imperfection of 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 public sector firms as for 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 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 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."

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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]

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

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.

In 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.

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 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 illiquid 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 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 insider systems, owners in outsider systems 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 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 directors

and owners, and to frequent ownership changes because 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 insider and 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 internal and external controls. Internal controls are arrangements within a corporation that aim to minimise risk by defining the relationships between managers, shareholders, boards of directors, and 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 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 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 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 18.1.

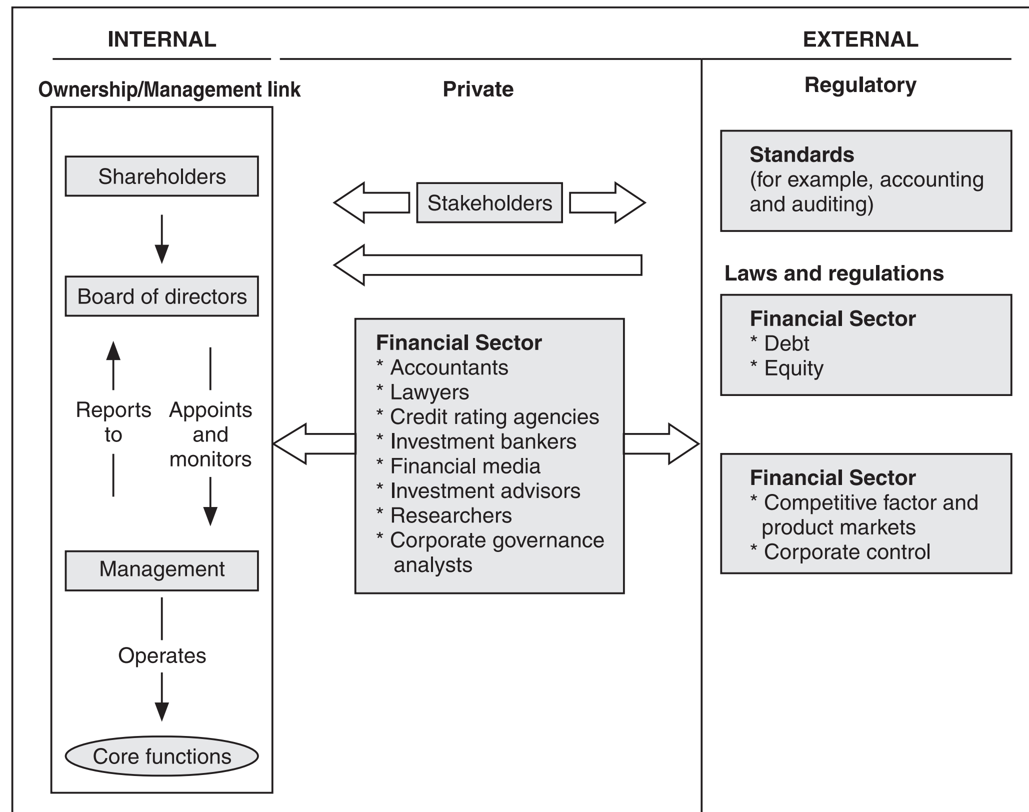
It can be observed from the illustration of the framework that there are internal and external forces that interface and interact with one another and have an impact on the behaviours and activities of corporations. While the internal forces define the relationships between and among the key players of the corporation, the external forces help in effecting the discipline and conduct of beahviours.

In 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 envision the situation

wherein the internal and 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]

Figure 18.1

Modern corporations are disciplined by internal and external factors



Source: World Bank, Corporate Governance: Framework for Implementation, Overview, 1999, www.worldbank.org., p.5.

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 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 transition economies these mechanisms of market discipline hardly work because of the lack of such institutions as stock markets and an efficient banking sector.

The Institutional Framework for Effective Corporate Governance

As we have seen earlier, developing countries and transition economies lack the required framework to put in place best corporate governance practices. The following are the desiderata for such a framework:

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, has the property 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.

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.

In this context, there are a few key types of legislation. The first is legislation that gives corporations juridical 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 legislation that permits the establishment of joint stock companies.

2. Contract law: Very few business transactions will occur without 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 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 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 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 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 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 relative 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 weather 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 for changes or to discipline managements by shifting their capital elsewhere.

Similarly, disclosing information about 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 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, severed. Similarly, there is increasing discussion about whether or not developing countries should require that commercial and 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 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 markets 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 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 emerging markets.

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.

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 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 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 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 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 insiders and outsiders by seeking and providing information to outsiders about the performance of 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 insiders and 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 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 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 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 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. 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 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 developing, emerging and 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 thus 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 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 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.

In many developing, emerging, and transition economies public sector companies contribute more to the nation's gross national product, employment, income, and capital use than private sector firms. Moreover, public sector companies often shape public policies. As a result, instituting sound corporate 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 active owners and skilled managers. In the meantime, 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 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 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 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 western-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.

Current Corporate Governance Settings in Transition Economies

In 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 emerging and 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 diffuse ownership, it enables insiders to strip assets and leave little value for minority shareholders.[5]

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.

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. 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 financial sectors. State authorities and 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 enterprises and banks are especially crucial in view of the shortage of capital and credit, and continue 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 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 citizens of a country own the firms, in practice control rights rest with 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 formal institutions are weak, informal constraints play a larger role in shaping firm behaviour.

Indian cos Committed to Best Global Practices[6]

According to Stephen Wagner, Indian companies are increasingly putting in place best global practices. At the same time, they have to resort to regular evaluation at all levels with a view to sustaining good corporate governance. "Corporate governance has evolved enormously in India and many big companies in the country are committed to embrace global best practices for their business," observed Stephen Wagner, Chairman Emeritus of global consultancy Deloitte's Global Centre for Corporate Governance. "Good governance at companies usually translates into good financial numbers while just having good names on the (firms') board need not ensure the same."

In India, the issue of corporate governance came into limelight after the Rs 14,000 crore Satyam accounting fraud by its founder-chairman Ramalinga Raju was brought to the notice of the public.

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

- Transition economies
- Anti-corruption strategies
- Competitive markets
- Contract law
- Effective corporate governance
- Emerging economies
- Enforcement capacity
- Exit mechanisms
- Bankruptcy and foreclosure
- Fair taxation regimes
- Governance challenges
- Governance framework
- Governance models
- Governance settings
- Government agencies
- Insider system
- Outsider system
- Participation
- Property rights
- Reputational agents
- Routine mechanisms
- Sound securities markets
- Stakeholder relationships
- Successful strategies
- The institutional framework
- Transparent and fair privatisation procedures
- Well-informed media
- Well-functioning judicial system
- Well-regulated banking sector
- 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?

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Case Study

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 maintaining 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 vulnerable 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)
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Corporate Governance: The Indian Scenario

CHAPTER OUTLINE

- Introduction
- Emergence of Corporate Governance Issues in India
- Efforts to Initiate Corporate Governance in the Country
- Implementation of Recommendations of Birla Committee Report
- Pioneers in Good Governance Practices
- Need For Accounting Standards
- Corporate Governance Rating
- Corporate Governance in India—A Performance Appraisal
- The Future of Corporate Governance in India

Corporate governance has come to the centrestage nowadays because of two reasons. First, after the collapse of the Soviet Union and the end of the cold war in 1990, it has become the conventional wisdom that market dynamics must prevail in economic matters. Secondly, it has also coincided with the thrust given to globalisation that involves freer movement of the economic factors of production, namely, physical capital in terms of plant and machinery, financial capital in terms of money invested in capital markets or in FDI, technology, and labour moving across national borders.

Introduction

Corporate governance as a means of achieving equitable prosperity for the people of all nations has nowadays come to the centrestage because of two reasons: First, after the collapse of the Soviet Union at the end of cold war in 1990, it has become the conventional wisdom all over the world that market dynamics must prevail in economic matters. The concept of government controlling the commanding heights of the economy has been given up as being unproductive. This, in turn, has made the market the most decisive factor in settling economic issues. Second, it has also coincided with the thrust given to globalisation because of the establishment and administration of the World Trade Organisation and the member nations of the WTO trying to bring down the tariff barriers. Globalisation involves free movement of the four economic factors of production, namely, physical capital in terms of plant and machinery, financial capital in terms of money invested in capital markets or in FDI, technology and labour moving across national borders. The pace of movement of financial capital has become quicker because of the pervasive impact of information technology and the world having shrunk into a global village. When investments take place in emerging markets, investors want to be sure that not only the capital markets or enterprises in which they invest are run competently, but they also have good corporate governance. "Corporate governance represents the value framework, the ethical framework and the moral framework under which business decisions are taken."[1] In other words, when investments take place across national borders, investors want to be sure that not only is their capital handled effectively and adds to the creation of wealth, but business decisions are also taken in a manner which is not illegal or involve moral hazards.

Why is Corporate Governance Important?

Corporate governance is important for a society due to many reasons as given below:

(i) It lays down the framework for creating long-term trust between companies and the external providers of capital.

(ii) It improves strategic thinking at the top by inducting independent directors who bring in a wealth of experience and a host of new ideas.

(iii) It rationalises the management and monitoring of risks a firm faces globally.

(iv) It limits the liability of the top management and directors by carefully articulating the decision making process.

(v) It ensures the integrity of financial reports.

(vi) It helps to provide a degree of confidence that is necessary for the proper funding of a market economy.

The Need for Corporate Governance in India

If corporate governance has to take root in a country it will, to a large extent, depend on the economic and business environment that has been created by public governance in the country; there cannot be good corporate governance if public governance is weak. The dramatic collapse of corporations like Enron has highlighted the reality of how companies, which were the darlings of the stock market and held up as models for vigorous and innovative growth, can ultimately fall like a pack of cards when fraud and dishonesty became their operational

guide. The association of the accounting firm, Andersen has also raised a doubt about the credibility of even highly regarded global players. In the Indian context, the need for corporate governance has been highlighted because of the series of scams that had become an annual feature ever since the government liberalised the economy in 1991. Since then, there had been the Harshad Mehta scam, Ketan Parikh scam, the UTI scam, Vanishing Companies scam, Bhansali scam and so on. In the Indian corporate scene, it is very clear that unless we induct global governance standards, the scope for scams may rise in the years to come. To reduce it to the minimum, there is an urgent need to improve corporate governance in the country.

In the Indian corporate scene, it is clear that unless we induct global standards, the scope for scams may increase in the years to come. To reduce it to the minimum, there is an urgent need to improve corporate governance in the country. The legal and administrative environment in India provides great scope for corrupt practices in business.

The legal and administrative environment in India provides greater scope for corrupt practices in business. For more than five decades since independence, lack of transparency and financial disclosures, corruption and mismanagement have been accepted as a way of life and taken in a stride in an insulated, licence-ridden and non-competitive economic environment. As a result, unless a management is committed to be honest and observes the principles of propriety, the atmosphere is too tempting not to observe good corporate governance in practice. We should approach the issue of corporate governance in India not merely from the point of view of the Companies Act or the SEBI guidelines or the codes evolved out of recommendations of committees such as the Kumar Mangalam Birla Committee or the Rahul Bajaj Committee, but look at the entire network of various rules and regulations impinging on business so that there is an integrated holistic system, created for ensuring that transparency and good corporate governance prevail.

Ethics and Values in Corporate Governance

No discussion on public affairs will be complete without a reference to ethics and values. The quality of corporate governance is also determined by the manner in which top management, particularly the board of directors, allocates the financial resources of the company between themselves and other interested groups such as employees, customers, government, etc. The basic qualities invariably expected in this regard are trust, honesty, integrity, transparency and compliance with the laws of the land. There is an increasing body of public opinion that would expect a business enterprise not only to be a mere economic unit but also to be a good corporate citizen. For this, its corporate governance must be based on a genuine respect for business ethics and values. But unfortunately the business environment in India is replete with unethical situations such as bribery, corruption, insider trading and malpractices of various kinds that—"insiders" do not think foul of siphoning off funds that ought legitimately to belong to "outsiders" and stakeholders. However, it is heartening to note that things are slowly moving for the better mainly because of the opening of the economy to global players.

The ethical climate in any business or capital market depends on three factors: (i) the individual's sense of value, (ii) the social values accepted by business and industry. When Harshad Mehta scam took place, it was claimed that the manner in which the bank receipts were being treated was the prevailing norm. Perhaps a similar argument would have been given to the Ketan Parikh scam. In other words, practices, which are later on found to be highly objectionable, became acceptable because that was the prevailing market practice. Social values will depend upon the standards set up by professional bodies such as the Institute of Chartered Accountants of India or the Institute of Cost and Works Accountants of India and so on. (iii) The third and perhaps the most decisive factor is the system. It is here we face the main challenge. Our system encourages lack of corporate governance. If those who violate the norms are effectively punished,

then the fear of punishment will make the violators adhere to the principles of corporate governance. What we lack in India today, which comes in the way of corporate governance, is presumption that violators may not be detected, and even if detected, they could go scot free with their wrongdoings. If we want to usher in an era of better corporate governance in the country, the focus has to be turned effectively on creating a proper climate of public governance and making changes in the various regulations impinging on the working of an enterprise or a body like the capital market.

The Companies Act, the Harbinger of Corporate Governance

In India, until recently company legislation has been the main instrument to promote corporate governance. The Companies Act 1956 was a consolidating legislation with far reaching impact that significantly altered the structure of corporate management in India. Subsequently, incorporating recommendations of the Bhabha Committee, this Act legislated, inter alia, the abolition of the system of managing agencies, an institution that had served the country truly and well during the early days of corporatisation and more significantly industrialisation, but fallen into disrepute through abuse and malpractice in its application by its latter day exponents.

In India, until recently company legislation has been the main instrument to promote corporate governance. Tracing its origins to the mid-nineteenth century, and thereafter closely following similar developments in the United Kingdom, the Companies Act 1956 was a consolidating legislation with far reaching impact that significantly altered the structure of corporate management in India. Subsequently, incorporating recommendations of the Bhabha Committee, this Act legislated, *inter alia*, the abolition of the system of managing agents, an institution that had served the country truly and well during the early days of corporatisation and more significantly industrialisation, but fallen into disrepute through abuse and malpractice in its application by its latter day exponents. With this, a pernicious vehicle for siphoning off corporate wealth for the benefit of a few dominant and controlling shareholders was sought to be destroyed. Subsequent amendments in the later part of the twentieth century essentially built upon the basic 1956 edifice, and usually attempted to plug observed loopholes in practice. A completely revised, updated, and in-tune-with-the-times, abridged version of the legislation was introduced in the parliament some years ago, but more urgent and necessary revisions to meet the requirements of a changing business environment were enacted through an amendment in 1999. Another amending bill introduced in the late 1999 and modified in 2000 has already been approved by the parliament. This offers further inputs for improving standards of corporate governance in the country.

The Emergence of Corporate Governance Issues in India

The Stock Exchange of London appointed, as discussed earlier, the famous Cadbury Committee which submitted its report in 1992 that included the "Code of Best Practices" to be practised by listed companies. Sir Cadbury Report was implemented by the London Stock Exchange as part of its Listing Agreement with its member companies. The Cadbury Report is generally considered to be the foundation stone of corporate governance.

In India, the real history of corporate governance dates back to the year 1992, following efforts made in many countries of the world to put in place a system suggested by the Cadbury Committee. The Confederation of Indian Industry framed a voluntary code of corporate governance for listed companies in 1998. This was followed by the recommendations of the Kumar Mangalam Birla Committee set up in 1999 by SEBl culminating in the introduction of Clause 49 of the standard Listing Agreement to be complied with all the listed companies in stipulated phases. The Kumar Mangalam Birla Committee divided its recommendations into mandatory and non-mandatory. Mandatory recommendations included such issues as the composition of the board, appointment and structure of audit

committees, remuneration of directors, board procedures, additional information regarding management, discussion and analysis as a part of the annual report, disclosure of directors' interest, shareholders' rights and the compliance level of corporate governance in the annual report. Its non-mandatory recommendations included issues concerning the chairman of the board, setting up of remuneration committee, half yearly information to the shareholders, use of postal ballots for certain key decisions, appointment of nominee directors and obligations of institutional shareholders.

Efforts to Initiate Corporate Governance in the Country

The Companies Amendment Act, 2000

Many provisions relating to corporate governance such as additional ground of disqualification of directors in certain cases, setting up of audit committees, directors' responsibility statement in the directors' report, etc. were introduced by the Companies (Amendment) Act, 2000. Corporate governance was also introspected in 2001 by the advisory group constituted by the standing committee on International Finance Standards and Codes of the Reserve Bank of India under the chairmanship of Dr. Y. V. Reddy, the then Deputy Governor.

The Enron debacle of 2001 involving the hand-in-glove relationship between the auditor and the corporate client, the scam involving the fall of the corporate giants in the US like the WorldCom, Qwest, Global Crossing, Xerox and the consequent enactment of the stringent Sarbanes–Oxley Act were some important factors which prompted the Indian government to do something to put in place proper governance mechanism in the structure and system of administration of listed public limited companies.

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Naresh Chandra Committee, 2002

In the year 2002, a high–level committee was appointed to examine and recommend drastic amendments to the law involving the auditor client relationships and the role of independent directors by the department of company affairs in the Ministry of Finance & Company Affairs under the chairmanship of Naresh Chandra. The committee was asked to examine various corporate governance issues and to recommend changes in diverse areas such as: (a) the statutory auditor-company relationship so as to further strengthen the professional nature of the interface; (b) the need, if any, for rotation of statutory audit firms or partners; (c) the procedure for appointment of auditors and determination of audit fees; (d) restrictions, if necessary, on non-audit functions; (e) independence of auditing functions; (f) measures required to ensure that the management and companies actually present "true and fair" statement of the financial affairs of companies; (g) the need to consider measures such as certification of accounts and financial statements by managements and directors; (h) the necessity of having a transparent system of random scrutiny of audited accounts; (i) adequacy of regulation of chartered accountants, company secretaries and other similar oversight functionaries; (j) advantages, if any, of setting up an independent regulator similar to the Public Company Accounting Oversight Board in the SOX Act, and if so, its constitution; and (k) the role of independent directors and how their independence and effectiveness can be ensured. We have already seen

rather elaborately the recommendations of the Naresh Chandra Committee in the Chapter 3, "Landmarks in the Emergence of Corporate Governance."

Narayana Murthy Committee, 2003

The Company Law Amendment Bill, 2003 envisaged many amendments on the basis of reports of the Naresh Chandra committee and the subsequently appointed N R Narayana Murthy committee. Both the committees have done an excellent job to promote corporate governance practices in India.

The Company Law Amendment Bill, 2003 envisaged many amendments on the basis of reports of the Naresh Chandra Committee and the subsequently appointed N. R. Narayana Murthy Committee. Both the committees have done an excellent job to promote corporate governance practices in India. The Narayana Murthy Committee's report summed up the utility of the corporate governance in the following words: "Effectiveness of a system of corporate governance cannot be legislated by law nor can any system of corporate governance be static. In a dynamic environment, systems of corporate governance need to be continually evolved. The committee believes that its recommendations raise the standards of corporate governance in Indian firms and make them attractive for domestic and global capital. These recommendations will 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 in the new millennium." Introduction of corporate governance norms consequent to the debacles of famous corporates was a good augury for the corporate world. Stakeholders, financial institutions, bankers, creditors, shareholders and the general public alike appreciated the measures taken by SEBI and the Ministry of Commerce in regulating corporates.

Legislative Changes

In the present global scenario, India's corporate sector has not only to compete with business worldwide but also has to achieve levels of management and governance that inspire confidence in investors—both domestic and foreign. The legal and regulatory framework must provide comfort to investors, especially foreign investors.

Keeping this in view, the Department of Company Affairs (DCA) has taken several initiatives in the recent past. These include legislative changes and modernisation of services with the help of technology. The DCA, in consultation with experts in the field, as also the stakeholders, has ushered in several changes in the corporate law. The Companies Act, 1956, has been amended thrice since 1999 and some further amendments are under consideration to give effect to policy liberalisation. An ordinance was promulgated on 23 October 2001, for easier terms and conditions for buy-back of shares by companies. This was done keeping in view the continuing depression in the share market and also the recent developments in the US and elsewhere.

The government constituted a high-level committee to examine and make recommendations for the legislative framework to enable formation and conversion of cooperative business into companies. Based on the recommendations of this committee, a bill was introduced in the Lok Sabha in August 2001, and passed by both the Houses of Parliament in December 2002. This legislation is intended to provide "primary producers" an option to have a new kind of business organisation (called a producer company) to produce and market products in a modern and professional manner at par with other companies. It may enhance their efficiency and competitiveness in the present liberalised and globalised market and help for the betterment of "primary producer".

Further, the government constituted a committee to examine the existing law relating to winding up of companies in order to remodel it in line with the latest developments and innovations in the corporate law and governance elsewhere.

On the basis of the recommendations of the committee, a bill was introduced in Lok Sabha in August 2001, and was passed by both the Houses of Parliament. This bill ushers in a new era of insolvency laws and provides for constitution of a Company Law Tribunal. The jurisdiction and powers presently conferred on the Company Law Board will be vested in the proposed national tribunal. This will result in the dissolution of the Company Law Board. It also envisages replacement of the Board for Industrial and Financial Reconstruction (BIFR) by repealing the Sick Industries (Special Provision) Act, 1985, for accelerating the pace of revival.

Introduction of Regulations

Governance initiatives through regulation have also made significant strides in the country. In consultation with the government, SEBI has initiated a number of steps to introduce improved practices and greater transparency in the capital markets in the interest of the investing public.

Governance initiatives through regulation have also made significant strides in the country. The Securities and Exchange Board of India (SEBI) has an ongoing programme of reforming the primary and secondary capital markets. SEBI was set up by the government in 1992 to counter the shortcomings found in the functioning of stock exchanges such as long delays, lack of transparency in procedures and vulnerability to price rigging and insider trading, and to regulate the capital market. SEBI, which has been made into a statutory body is authorised to regulate all merchant banks on issue activity, lay guidelines, supervise and regulate the working of mutual funds and oversee the working of stock exchanges in the country. In consultation with the government, SEBI has initiated a number of steps to introduce improved practices and greater transparency in the capital markets in the interest of the investing public. The stock exchanges in the country also mandate several salutary requirements through their listing agreements that every publicly traded company has to comply with. On the insistence of SEBI, stock exchanges have amended listing agreements to ensure that a listed company furnishes them annual statements showing the variations between financial projections and projected utilisation of funds, which would enable shareholders to make comparisons between promises and performance.

Among the professions, the Institute of Chartered Accountants of India has emerged as a responsible body regulating the profession of public auditors, and counts among its achievements the issue of a number of accounting and auditing standards. Constitution of an independent National Advisory Committee on accounting standards has been legislated by the amended Companies' Act of 1999. Other professional bodies such as the Institute of Cost and Works Accountants of India and the Institute of Company Secretaries of India have helped in promoting and regulating a well–trained and disciplined body of professionals who could add value to corporations in improving their management practices. The Institute of Company Secretaries of India has also taken a major initiative in constituting in 2001, a secretarial standards board comprising senior members of eminence to formulate secretarial standards and best secretarial practices and develop guidance notes in order to integrate, consolidate, harmonise and standardise the prevalent diverse practices with the ultimate objective of promoting better corporate practices and improved corporate governance. R. Ravi, the ICSI President, informed the press on 30 January 2005 that the institute has mooted a proposal to the government to make mandatory secretarial standards (SS) issued by it on the lines of accounting standards issued by the Institute of Charted Accountants of India. The ICSI has issued three SSs till now on board meetings, general meetings and payment of dividend, and one on registers and records is being finalised.

As mentioned earlier, with 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 (ASSOCHAM) and the Securities and Exchange Board of India (SEBI). The corporate governance Code in India was first promoted by the Confederation of Indian Industry. Further, the Securities and Exchange Board of India constituted the Kumar Mangalam Birla Committee and adopted its report in mid-2000.

The Kumar Mangalam Birla Committee confined itself to submitting recommendations for good corporate governance and left it to SEBI to decide on the penalty provisions for non-compliance. In the absence of suitable penalty provisions, it has been difficult for the market regulator to establish good corporate governance. Some of the penalty provisions are not sufficient enough to discipline the corporates. For example, the penalty for non-compliance of the stipulated minimum of 50% in respect of the number of directors in the board that should be non-executive directors is delisting of shares of the company. This would hardly serve the purpose. In fact, this would be detrimental to the interest of the investors and to the effective functioning of the capital market.

Similarly, an audit committee, which is subservient to the board, may serve no purpose at all; and one which is in perpetual conflict with the board, may result in stalemates to the detriment of the company. If a company is to function smoothly, it should be made clear that the findings and recommendations of the audit committee need not necessarily have to be accepted by the board which is accountable to the shareholders for its performance and which, under Section 291 of the Companies Act, is entitled to "exercise all such powers, and do all such things as the company is authorised to exercise and do".

However, some functional specialists are of the considered view that whenever there is a difference of opinion and the audit committee's advice is ignored or over-ruled, the board should be required to place the facts before the general body of shareholders at their next meeting.

Implementation of the Recommendations of Birla Committee Report

Clause 49 of the Listing Agreement

What is Clause 49?

The Securities and Exchange Board of India monitors and regulates corporate governance of listed companies in India through Clause 49.[2] This Clause is incorporated in the listing agreement (LA) of stock exchanges with companies and it is compulsory for them to comply with its provisions. Stock exchanges endeavour to bring in corporate governance standards among companies by the introduction of Clause 49 in the listing agreement they enter into with them before they are being listed. SEBI issued Clause 49 in February 2000. All group A companies had to comply with its provisions by 31 March 2001. All other listed companies with a minimum paid-up capital of Rs. 10 crore and networth of Rs. 25 crore had to comply with its provisions by 31 March 2002, and the remaining listed companies with a minimum paid-up capital of Rs. 3 crore or net worth of Rs. 25 crore had to comply with them by 31 March 2003.

SEBI monitors and regulates corporate governance of listed companies in India through Clause 49. This clause is incorporated in the listing agreement (LA) of stock exchanges with companies and it is compulsory for them to comply with its provisions.

Subsequently, on 29 October 2004, SEBI amended the original Clause 49 and issued a new Clause 49. All existing listed companies will have to comply with the provisions of the new clause by 1 April 2005. However, it has already come into force for companies that have been listed on the stock exchange after 29 October 2004.

Provisions and Requirements of Clause 49

1. **Composition of Board:** The board should be composed of in the following manner: In case of full time chairman, 50% non-executive directors and 50 percent executive directors.
2. **Constitution of the Audit Committee:** The audit committee should have 3 independent directors with the chairman having sound financial background. The finance director and the head of the internal audit should be special invitees and a minimum of three meetings should be convened every year.
3. **The Audit Committee:** The audit committee is responsible for review of financial performance on half-yearly/annual basis; appointment/removal/remuneration of auditors; review of internal control systems and its adequacy.
4. **Remuneration of Directors:** Remuneration of non-executive directors is to be decided by the board. Details of remuneration package, stock options, performance incentives of directors should be disclosed to the shareholders.
5. **Board procedures:** The board should have at least four meetings a year. A director should not be a member of more than 10 committees and chairman of more than 5 committees across all companies.
   Management discussion and analysis report should include the following points:
   (i) Industry structure and developments
   (ii) Opportunities and threats
   (iii) Segment-wise or product-wise performance
   (iv) Outlook on the business
   (v) Risks and concerns
   (vi) Internal control systems and its adequacy
   (vii) Discussion on financial performance
   (viii) Disclosure by directors on material, financial and commercial transactions with the company
6. **Shareholders information:** The company should provide a brief resume of new or reappointed directors. Quarterly results should be submitted to stock exchanges, placed on the company web site, and presented to analysts.

   The shareholders'/investors' grievance committee should have a minimum of 2 meetings a year, under the chairmanship of an independent director.

   A report on corporate governance and a certificate from auditors on compliance of provisions of corporate governance, as per Clause 49 in the listing agreement, should be provided.

Differences in the Key Provisions of the Original Clause and the New Clause

The new Clause 49 lays down tighter qualification criteria for independent directors. Unlike the original clause, the new clause disqualifies material suppliers and customers from being independent directors. It also disallows a shareholder with more than 2 percent stake in the company from being an independent director as well as a former executive who left the company less than 3 years ago.

Partners of current legal, audit, and consulting firms as well as partners of such firms that had worked in the company in the preceding 3 years, too, cannot be independent directors. A relative of a promoter, or an executive director or a senior executive one level below an executive director, too, cannot be an independent director.

Another important difference is that while the original clause gave the board freedom to decide whether a materially significant relationship between director and the company affected his independence, the new clause takes this discretionary power away from the board.

According to the original clause, the maximum time gap between two board meetings could be a maximum of 4 months. The new clause has reduced this time gap to 3 months.

The original clause had stipulated that the audit committee must meet at least three times a year and at least once every 6 months. The new clause makes it mandatory for the audit committee to meet a minimum of four times a year with a maximum time gap of 4 months.

Moreover, unlike the original clause which was silent on the qualifications of audit committee members, the new clause states that all members should be financially literate and at least one should have financial or accounting management expertise. The new clause gives a definition of “financially literate” and “accounting or related financial management expertise”. The new clause also strengthens and widens the role and responsibility of audit committees.

1. Nominee directors considered to be independent directors: Nominees of institutions that have invested in or lent to the company are deemed independent directors.

2. New provisions incorporated in the new Clause 49: The major new provisions included in the new Clause 49 are given below:

- The board will lay down a code of conduct for all board members and senior management of the company to follow compulsorily.
- The CEO and CFO will certify the financial statements and cash-flow statements of the company.
- At least one independent director of the holding company will be a member of the board of a material non-listed subsidiary.
- The audit committee of the listed company shall review the financial statements of the unlisted subsidiary, in particular its investments.

If while preparing financial statements, the company follows a treatment that is different from that prescribed in the accounting standards, it must disclose this in the financial statements, and the management should also provide an explanation for doing so in the corporate governance report of the annual report.

CEOs Accountable for Companies’ Risk Systems

Inspired by Sarbanes–Oxley Act, Clause 49 of listing agreement was scheduled to come into effect from 1 April 2005. However, bowing to general demand from corporates, SEBI decided in its board meet held on 23 March 2005, to defer the implementation of Clause 49 till 31 December to provide listed entities, including public sector companies, time to appoint adequate number of independent directors and comply with norms. No special concession is to be extended to state-owned enterprises which demanded exemption on this issue. SEBI felt that PSUs are not to be looked upon as special class of companies.

Under the new provisions, chief executive officers (CEOs) and chief financial officers (CFOs) in the country are preparing for a litmus test. Beginning 31 December 2005 all CEOs and CFOs embarked on massive documentation to meet the requirements of Clause 49 of SEBI’s listing agreement.

Rules of the Game

- CEOs and CFOs to be directly responsible for risk management (Provision 4C), internal control systems (Section 5)

- Clause 49 is largely derived from the Sarbanes–Oxley Act
- Companies seek legal advice, tap consultants to adopt new standards
- Want clarity on "material" association of independent directors
- Fear new norms will lead to shortage of independent directors
- Companies will have to spend more time and money on compliance.

"Being Done Too Fast"

As stated earlier, Clause 49 of the SEBI's listing agreement draws this provision from the Sarbanes–Oxley Act in its totality and makes the CEOs and CFOs accountable for putting in place, risk management and internal control systems in critical areas of operation for their companies. Corporate India is busy putting in place new systems. While corporates have welcomed the spirit of the move, some of them feel that it is premature in the country.

Mr. Arvind Parakh, Director (Finance), Jindal Stainless, opined: "While the direction is alright from a long term perspective, it is being done too fast and in a difficult manner. Indian companies have not reached a situation where this step is warranted. Companies are already adhering to corporate governance standards but to hold CEOs and CFOs responsible for every single mistake is not justified."

Provision 4C of Clause 49 deals with putting in place elaborate risk management and risk assessment processes and Section 5 relates to creating comprehensive internal control mechanisms.

CEOs and CFOs will not only certify these processes, but will also have to give an assurance to the company's audit committee, with two thirds independent directors, that everything is in place. According to Mr Richard Rekhi, a partner at KPMG, "The provision holding CEOs and CFOs accountable is taken from the Sarbanes–Oxley Act. It will certainly put a lot more responsibility on the two offices."[3]

Reserve Bank's and Other Regulations

The Reserve Bank of India (RBI) also constituted its own advisory group on corporate governance under the aegis of the standing committee on International Financial Standards and Codes to review and recommend norms of corporate governance from the perspective of the banking sector. Based on the suggestions received from these committees, the Department of Company Affairs amended the Companies Act in December 2000 to include corporate governance provisions, which would be applicable to all companies. These new provisions came into effect from 1 April 2001.

The regulatory move is extended to non-listed companies also. The Companies Act is applicable to all Indian companies—both listed and unlisted. It incorporates recommendations of the Birla Committee report, including those related to non-executive directors, independent directors, composition of related party disclosures, audit committees etc. The concept of "a deemed public company" has been eliminated from the Act and therefore, all companies now are either public or private. While most of the large companies are public, the committee's requirements are applicable only to companies with a share capital of over Rs. 5 crores. Also, only a 100 per cent subsidiary of a foreign company can seek exemptions as a private company. The Companies Act has reduced the number of companies a person can be a director from 20 to 15. The SEBI code also forbids them to sit on more than ten committees and to chair more than 5. The intent is to ensure that all directors fulfil their obligations and contribute in a greater measure towards the company affairs.

The Companies Act now allows shareholders to participate in critical company resolutions through postal ballot. Until now, special resolutions required at least 75 per cent of the shareholders present at the meeting to vote. Hence, if 200 of a

company's 1,000 shareholders were present at a meeting, 150 votes were sufficient to pass a resolution. Under the new provision, however, all shareholders will be able to participate in the voting process. Of late, postal ballot has become a common practice and stock exchanges are informed almost on a daily basis about an impending postal ballot by companies. Recently, Hindustan Lever got the approval of BSE to transfer its Sewri plant and one Sp. Polimer unit through postal ballot. Likewise, ITC got approval to amend its objects clause to start a new business. The ICICI Bank has sought approval for its ADS issue, while Blue Dart which wants to sell its subsidiary, ACC its Mancherial cement unit, Godrej Industries, Pantaloon, Reliance Energy and Glennmark have all sought this postal ballot route to seek their shareholders' approval.[4]

Self-regulation

Self-regulation has been somewhat lagging behind in the area of corporate governance in the country. The vast majority has been languishing with outdated practices nurtured during the years of insulated economic environment that obtained in the country for the better part of its post-independence history. The liberalisation initiatives of the nineties have exposed the inefficiencies of many of these organisations which are now trying to come to terms with the paradigm shift in doing business.

Self-regulation has been somewhat lagging behind in the area of corporate governance in the country. While admittedly some of the Indian companies compare most favourably with the best elsewhere in the world in the field of professional management and corporate governance, the vast majority has been languishing with outdated practices nurtured during the years of insulated economic environment that obtained in the country for the better part of its post-independence history. The liberalisation initiatives of the nineties have exposed the inefficiencies of many of these organisations which are now trying to come to terms with the paradigm shift in doing business.

Pioneers in Good Governance Practices

Industry Initiatives

Changing with the times, industry associations have taken the initiative to come up with guidelines for their member companies in the area of governance. A formal effort was initiated by the Confederation of Indian Industry when it produced in 1998, a document titled "Corporate Governance—A Desirable Code" through a Task Force headed by Rahul Bajaj, which for the first time formally recognised the obligation of listed corporations to create corporate wealth and distribute it among all their stakeholders. The need for transparency in reporting and the imperatives of having independent non-executive directors who could protect the interests of shareholders were clearly articulated. A similar initiative was mounted by SEBI with the constitution of a committee under the chairmanship of Kumar Mangalam Birla. Its report recommending guidelines on corporate governance published in February 2000 is a well balanced compendium of good practices that will stand corporates in good stead in their governance-improvement endeavours. These recommendations that have been categorised as mandatory, have since been incorporated in the listing agreements of the stock exchanges. To this extent, this initiative may be termed part-regulatory, part-voluntary.

As a service to the corporate sector, the CII is putting together a roster of independent directors from which companies can choose their non-executive directors while constituting their boards. The CII will provide the necessary guidelines to choose good directors, screen them, and continue to monitor and rate them. This will help companies overcome the difficulties they face in identifying professionally competent and ethically sound non-executive directors.

The existing diversity and complexity of forms and patterns of corporate governance will continue and, very probably, increase with time. Alternative governance will be needed to improve the effectiveness of governance, to influence the healthy development of corporate regulation, and to understand the reality of the political processes by which companies are governed, rather than the structures and mechanisms through which governance is exercised. In any development, it will be important to avoid the polarities of governance based on an expensive bureaucracy of regulation and the adversarial clash of vested interests.

Corporate Initiatives

Several studies have pointed out that the movement to introduce corporate governance practices in the country has achieved commendable progress. In fact, the country has evolved a system and structure of corporate governance considered to be one of the best among all developing countries. Unlike several other emerging markets, Indian companies maintain their shareholding patterns, making it possible to identify the ownership affiliation of each firm easily. "It is by and large a hybrid of the 'outsiders' systems' and "insiders systems' of corporate governance."

India has now evolved a system and structure of corporate governance considered to be one of the best among all developing countries. Unlike several other emerging markets, Indian companies maintain their shareholding patterns, making it possible to identify the ownership affiliation of each firm easily.

"The legal framework for all corporate activities including governance and administration of companies, disclosures, shareholders' rights, dividend announcements has been in place since the enactment of the Companies Act in 1956 and has been fairly stable. The listing agreements of stock exchanges have also been prescribing on-going conditions and continuous obligations to companies."

"India has a well-established regulatory framework for more than four decades, which forms the foundation of the corporate governance system in India. Numerous initiatives have been taken by the Securities and Exchange Board of India (SEBI) to enhance corporate governance practice, in fulfillment of the objectives: Investor protection and market development, for example, streamlining of the disclosure, investor protection guidelines, book building, entry norms, listing agreement, preferential allotment disclosures and lot more…. Accounting system in India is well-established and accounting standards are similar to those followed in most of the advanced economies (Khanna and Palepu, 2000).

According to a survey on corporate excellence carried out by Credit Lyonnais, three Indian companies—Infosys, Hindustan Lever Limited and Wipro are amongst Asia's top ten corporations in terms of good governance practices. Likewise, ICICI, Cummins India, HDFC, Ranbaxy, Dr. Reddy's Lab, Orchid Chemicals and several Tata group companies also share this honour.

The Birla Group has already adopted corporate governance provisions. Non-executive directors now dominate the group's company boards, and they have also constituted nomination, remuneration and audit committees.

Individual Initiatives

There were some outstanding initiatives in India from individual personalities even before the concept of corporate governance gained currency. J. R. D. Tata, from the time he took over the reins of the group till his death, ran the Tata industrial empire professionally, unlike other family-run businesses. Under his guidance, the Tata Group produced some outstanding CEOs. His belief in keeping business and politics separate did give the group a great deal of credibility and

brought him laurels, and won the trust of everybody. The man who believed in empowerment never craved for power, money or glory. He ensured that the House of Tatas followed corporate governance practices in all its forms, both in the letter and spirit. Tata was, and continues to be, a household name and his shareholders had always been happy with him.

Keshub Mahindra is another industrialist who like J. R. D. Tata runs his empire professionally. He kept his daughters and relatives out of the boardroom. He has ensured that it is Mahindra & Mahindra that is projected and not personalities. He has, like the Tatas, ensured that the business is divorced from politics. He has created a code of corproate governance for the company.

N. R. Narayanamurthy is the new icon and undisputed king of the new economy. He shook the corporate world by giving his employees a stock option scheme (ESOPS) that saw many corporates taking a leaf out of Infosys' book. Even before corporate governance became the buzzword, Infosys showed the way by giving detailed information and guidance reports in its 200 page plus annual report. So much so, that the SEC has been asking US companies to use the Infosys annual report as a model. The man who has created hundreds of millionaires within and at the bourses has set such high standards that Infosys keeps getting awards for being the best-run company, best at maintaining investor relations, best employer and so on. The ultimate tribute to Murthy was the government of India bestowing on Infosys the National Award for Excellence in Corporate Governance. By leveraging brainpower and sweat equity, Murthy has built a world-class software firm from the scratch.

Kumar Mangalam Birla who inherited a huge industrial empire challenged the conventional practices within the group companies when he took over in 1995. He has changed the culture of the group from being mainly a family-run enterprise of old-timers to one with professional ethos. His group companies have been making extensive disclosures. Impressed by this young Birla's initiative, the regulatory body, SEBI appointed him on a committee which is now known as the Kumar Mangalam Birla Committee on corproate governance.

Banks and Corporate Governance

Banks in India as corporates are as much required to be governed under corporate governance norms as other firms. Realising the importance of corporate governance to banks which are highly leveraged entities whose failures would pose large risks to the entire economic system, the Reserve Bank of India formed an advisory group on corporate governance that submitted its report in 2001 and another called the consultative group of directors of banks/financial Institutions (known as the Ganguly Committee) The RBI acted on their recommendations that have considerably strengthened corporate governance mechanism in banks.

Banks in India as corporates are as much required to be governed under corporate governance norms as other firms. Additionally, they are also covered under the internationally followed Basel Committee norms about which details are provided in the chapter on banking and corporate governance.

The Basel Committee norms relate only to commercial banks and financial institutions. Banking and financial institutions stand to benefit only if corporate governance is accepted universally by industry and business, whom banks and financial institutions have to interact and deal with. SEBI only partially attends to this need.

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Transparency in the Private Sector

The need for transparency, so far, appears to have been felt in the context of public authorities alone. Consequently, we have the Right to Information Act and a modification of the Official Secrets Act. While, there is no doubt that the government has to be completely transparent in its dealings since it deals with public money, privately managed companies also have a wide shareholder base. They also deal with large volumes of public money. The need for transparency in the private sector is, therefore, in no way less important than in the public sector.

However, private companies use "competitive advantage/company interests" as a pretext to hide essential information. Awarding of contracts, recruitments, transfer pricing (for instance, through under/over invoicing of goods in intra-company transfers) are the areas which require greater transparency. Environmental conservation, redressal of customer complaints and use of company resources for personal purposes are some of the other crucial areas, which call for greater disclosure. Relevant details about these must be available for public scrutiny. Fear of public scrutiny will ensure corporate governance on sound principles both in the public as well as the private sectors.

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Initiatives of the Department of Company Affairs

In May 2000, the Department of Company Affairs invited a group of leading industrialists, professionals and academics to study and recommend measures to enhance corporate excellence in India. This Study group in turn set up a Task Force under the chairmanship of Dr. P. L. Sanjeev Reddy, which examined the subject of "Corporate Excellence Through Sound Corporate Governance" and submitted its report in November 2000. The Task Force in its recommendations identified two classifications, namely, essential and desirable, with the former to be introduced immediately by legislation and the latter to be left to the discretion of companies and their shareholders. Some of the recommendations of the Task Force include the following:

- Greater role and influence for non-executive, independent directors
- Stringent punishment for executive directors for failing to comply with listing and other requirements
- Limitation on the nature and number of directorship of managing and full-time directors
- Proper disclosure to the shareholders and investing community
- Interested shareholders to abstain from voting on specified matters
- More meaningful and transparent accounting and reporting
- Tougher listing and compliance regimen through a centralised national listing authority
- Highest and toughest standards of corporate governance for listed companies
- A code of public behaviour for public sector units

Setting up of Centre for Corporate Excellence

The Government of India has set up the Centre for Corporate Excellence under the aegis of the Department of Company Affairs as an independent and autonomous body as recommended by the study group. The centre would undertake research on corporate governance; provide a scheme by which companies could rate themselves in terms of their corporate governance performance; promote corporate governance

through certifying companies who practise acceptable standards of corporate governance and by instituting annual awards for outstanding performance in this area. Government's initiative in promoting corporate excellence in the country by setting up such a centre is indeed a very important step in the right direction. It is likely to spread greater awareness among the corporate sector regarding matters relating to good corporate governance, motivating them to seek accreditation from this body. Cumulative effect of the companies achieving levels of corporate excellence would undoubtedly be visible in the form of much enhanced competitive strength of our country in the global market for goods and services.

National Award for Excellence in Corporate Governance

The national award for excellence in corporate governance, was instituted in 1999 by the Ministry of Finance. For the very first year, the award was presented to Infosys. For the year 2000, a panel chaired by Justice M.N. Venkatachaliah and comprising eminent persons unanimously selected The Tata Iron and Steel Limited (TISCO) for the award.

The national award for excellence in corporate governance, instituted in 1999 by the Ministry of Finance under the aegis of the Department of Company Affairs is sponsored by Unit Trust of India. For the very first year, the award was presented to Infosys. A panel chaired by Justice P. N. Bhagwati and comprising eminent persons unanimously selected Infosys Technologies (Limited) for the award for the year 1999. The panel commended the company thus: "Infosys is an ethical organisation whose value system ensures fairness, honesty, transparency, and courtesy to all its constituents and society at large." For the year 2000, a panel chaired by Justice M. N. Venkatachaliah and comprising eminent persons unanimously selected The Tata Iron and Steel Limited (TISCO) for the award. This prestigious award was given to the company's management for showing fairness, honesty, transparency and courtesy to all stakeholders and for its deep concern for the environment, pioneering social audit, taking good care of its employees and for driving change within the company in terms of knowledge management systems.

Corporate Restructuring

Besides, there are several substantive improvements in the law. It provides for initiation of restructuring of a corporate at a much earlier stage of financial sickness, thereby enhancing the possibility of its revival. It also provides for a safety net for the workers and the investors through better terms by setting up a rehabilitation fund and other allied measures. The jurisdiction and powers relating to winding up, presently vested with the High Courts, are also being shifted to the National Company Law Tribunal.

With globalisation and opening up of the economy, the need was felt that the Indian market should be geared to face competition not only from within the country, but from outside as well. Based on several recommendations, the Competition Bill was introduced in the Lok Sabha.

The Competition Bill, 2002, is a landmark development in economic legislation. The government had set up a high-level committee to examine the existing Monopolies and Restrictive Trade Practices (MRTP) Act, 1969, for shifting the focus of the law from curbing monopolies to promoting competition and to suggest a modern competition law in line with international developments to suit Indian conditions.

Best Practices

The law governing corporates has been fine-tuned by amending the Companies Act to create the right ambience for the corporate enterprises to function effectively in the era of liberalisation. With these amendments, corporates are now in a

position to adopt the best practices in corporate governance in vogue elsewhere in the world. The DCA has undertaken an ambitious programme to completely overhaul its services to the corporate sector by undertaking modernisation and placing the services on the Internet. This is being undertaken with a view to reducing the time and resources spent by corporates. The offices of the Registrar of Companies (ROC) curb malpractices that arise out of the situation and also tap the immense amount of economic data received through filing in ROC offices and through the cost audit branches in the DCA. Computerisation and modernisation is planned to be undertaken through private or public partnership.

As mentioned earlier, Naresh Chandra Committee was set up to look into issues relating to auditor-company relationship such as rotation of auditors/auditing partners, restrictions on non-audit work/fees, procedures for appointment of auditors, determination of audit fees, the role of independent directors and disciplinary procedures for accountants. The recommendations of the committee are expected to help improve the credibility of company accounts and the integrity of audit work. They would also help in strengthening the disciplinary mechanism against erring accountants.

Establishment of the Serious Fraud Office

The Department of Company Affairs has set up a Serious Fraud Office (SFO) as part of a new push to crack down on company fraud and improve corporate governance. The SFO will investigate economic crimes such as bribery by companies trying to win lucrative deals. The SFO which is to be part of the Department of Company Affairs will investigate company finances and prosecute them in cases where there has been violation of corporate laws.

The establishment of the SFO has come as part of a general climate of change in corporate governance in India. The government is contemplating to set up a National Centre for Corporate Governance as a joint initiative with the private sector. A committee is also recently commissioned to examine how to make the country's businesses more transparent. The SFO will pass the case on to other authorities if there is evidence that other laws, such as banking laws or tax laws, have been broken.[5]

Establishment of the National Foundation of Corporate Governance

To provide a platform to deliberate on issues relating to good corporate governance as key to sustainable wealth creation, the Indian government has taken a step forward in settingup the National Foundation for Corporate Governance (NFCG). In September 2003, the Union Cabinet had given its consent for setting up NFCG as a Trust. The Foundation has since been registered as a trust with the objective of promoting good corporate governance in India.[6] Managing the trust will be a three-tier body comprising a governing council, a board of trustees and an Executive directorate.

> To provide a platform to deliberate on issues relating to good corporate governance, the Indian government has taken a step forward in setting-up National Foundation for Corporate Governance (NFCG). The foundation has since been registered as a trust with the objective of promoting good corporate governance in India.

The foundation will work in synergy with the Investor Protection and Education Fund (IE&PF), a corpus used for investor awareness programmes on issues such as capacity building. Promoting investor associations will be a common activity between the two bodies.

Among the broad objectives of NFCG will be to provide research and training in the field of corporate governance. It would also be a source of financial or any other assistance for activities aimed at promoting corporate governance, including research and training. Besides, the US-based Global Corporate Governance Forum will also be supporting the India-centric activities taken up by various agencies.

Meanwhile, IE&PF on its part is setting up a prime database called 'Investor Watch out' on the lines of a similar concept in Europe that will help educate the investors and list the names of the erring companies.

In exercise of the powers conferred by Section 205C of the Companies Act, Department of Company Affairs has, in October 2001, established an Investor Education and Protection Fund(IE&PF), the one mentioned earlier in connection with NFCG. The Fund will get contributions from companies having unpaid dividend, matured deposits and debentures and share application money lying with them for more than seven years. The funds are to be utilised for promoting investors' awareness and protection of their interests. A committee to administer this fund has already been constituted by the DCA. Recognising the increasing concerns about the levels of corporate governance and ethical practices in the corporate sector, the DCA has undertaken active measures by promoting good corporate governance and enhancing the image of the corporate sector.

Need For Accounting Standards

There is another area, which needs to be attended to for bringing about further improvements in corporate governance in India. That is the introduction of internationally acceptable accounting standards. The ICAI has come out with a set of new accounting standards, which has now became mandatory.

Apart from these issues, there is another area, which needs to be attended to for bringing about further improvements in corporate governance in India. One such area is the introduction of internationally acceptable accounting standards. There are some gaps in accounting standards, which need to be closed or narrowed down for greater transparency.

One of the first and foremost demands of good corporate governance is to let investors know how their money has been used to further the interests of the company they have invested in.

The question that assumes importance in this context is, how effectively the resources of the company are utilised to strengthen the organisation. The only available source of information regarding the affairs of a company appears to be its balance sheet. Yet, for obvious reasons, the balance sheet remains the most abused statement of several companies. What is revealed by them may be significant, but what is hidden is vital.

The common methods by which companies hide their wrongful practices, which are all too well known, are to use legal jargon and accounting parlance, non-disclosure and selective adoption of only those policies that are mandatory in nature. It is only a handful of qualified persons, primarily the chartered accountants and the other knowledgeable people, who can get to the real picture behind the scenes and unmask the actual from the portrayed picture. It is in this context that the adoption of the US Generally Accepted Accounting Principles (GAAP), which provides for rigorous accounting standards and disclosures, assumes relevance.

The Institute of Chartered Accountants of India has come out with a set of new accounting standards, which became mandatory from 1 April 2001. These include standards regarding segmental reporting and related party transactions. Companies with subsidiaries will now have to present a consolidated financial statement for the entire group. Also, deferred tax payments will now have to be reflected in the current financial statements. Standards for triple bottom-line accounting, wherein companies will have to formally provide information regarding their social and environment related initiatives are likely to be introduced shortly.

As a result of the overall changes made by SEBI, the Department of Company Affairs and industry-based voluntary codes, Indian accounting and financial reporting standards are now at par with European standards, although they still significantly lag behind the generally accepted US accounting principles.

Indian companies with overseas interests find it easy to adopt international standards.

There are many areas such as consolidation of accounts, treatment of fixed assets, depreciation, R&D costs, etc. where Indian Accounting Standards (IAS) are at variance with the US GAAP. However, it is heartening to note that things appear to be changing for the better on the Indian turf thanks to the impetus towards a more transparent accounting system shown by market leaders. The Institute of Chartered Accountants of India (ICAI) has already issued the Accounting Standard 21 (AS-21) for consolidation of accounts whereby accounts of companies would be presented along with those of their subsidiaries. This would meet the long pending demand of investors on greater transparency and disclosure.

The move towards corporate governance, however, brings along some unusual risks. With most organisations moving at an extremely fast pace to be recognised as responsible corporate citizens, those who do not will witness an erosion of their reputations with corporate governance standards continuously evolving, auditors all over the world are still unclear on what exactly they have to report. This is a great challenge since operating processes and internal audit functions will have to be redefined to ensure compliance.

Corporate Governance Rating

The Department of Company Affairs has set up an institute to rate corporate excellence similar to credit rating agencies such as CRISIL. This institute will undertake research in the area of corporate governance to be able to improve the overall legal framework and to advise companies and directors on how they can take corporate excellence forward. Individual corporate excellence ratings will be made available to investors, lenders and the public. The institute will be funded from the penalties paid by companies for violating the provisions of the Companies Act.

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The Securities and Exchange Board of India has sought the services of two of the leading credit rating agencies in the country—Credit Rating Information Services of India Ltd. (CRISIL) and Investment Information and Credit Rating Agency (ICRA) to prepare a comprehensive instrument for rating the good corporate governance practices of listed companies. Besides these two, there are two other credit rating agencies (CRAs). These are CARE and FITCH India. According to the former SEBI Chairman, Mr. G. N. Bajpai, CRAs would enable the securities market regulator judge the compliance status of corporates on parameters such as effective creation, management and distribution of investors' wealth. CRAs are normally expected to carry out periodic reviews of the ratings given.

ICRA's Rating Methodology

Corporate governance rating is being done by ICRA, where assigning it is still very much a learning process.

In order to evaluate corporate governance, ICRA has decided to look at the following:

1. **Shareholding structure:** A transparent shareholding structure where the key shareholders are clearly identifiable and where an absence of opaque cross holdings is considered a positive feature.
2. **Governance structure and management process:** This focusses on the internal decision making process and the quality and nature of

information presented to a company's board. In looking at the decision making process, how responsibility is delegated and how accountability is ensured, a view is taken of not just what is laid down in procedures but what is actually practised. As to the quality of information submitted to the board, what is examined is whether it is told enough to know what is going on and whether its quality is satisfactory, are important. Emphasis is laid on matters such as inter-corporate loans, "related-party" transactions, large capital expenditure, diversification, and of course, mergers and acquisitions.

3. **Board structure and process:** The board structure and process of decision making is all very important. The bottomline is whether a company is board-managed or its board is a rubber stamping body whose members hold their positions at the pleasure of the effective owner. For this, the size of the board, selection criteria for directors, proportion of independent directors and the expertise they can command, compensation policy for directors, number and nature of board committees, attendance record of directors and frequency of board meetings are all taken into consideration.
4. **Examine stakeholder relations:** ICRA's methodology on this matter relates almost wholly to the rights of shareholders and the duty of the company to service them well. There is a passing reference to other financial stakeholders such as banks, financial institutions and fixed-deposit holders. But the whole idea of stakeholder is that it goes far beyond the shareholder and includes the workers, a company's customers and the society at large.
5. **Transparency and disclosures:** It is found that better-run companies disclose more than they are required by the law. But in assessing a company's performance in this regard, emphasis is laid on how materialistic the disclosures are and whether they really shed any light or hide more than they reveal.
6. **Financial discipline:** Considerations under this criterion would broadly overlap with the determinants governing financial rating. But it is emphasised that a financial rating says nothing about the nature of corporate governance prevailing in a company and similarly, a governance rating says nothing about the financial position of a company. The risk of governance failure will not be apparent from the financial rating of a company, but from its corporate governance rating. Here again, the conceptual scope of corporate governance and the way ICRA sees the idea may be a little divergent. While discussing financial discipline, it says that the ultimate objective of corporate governance is to maximise shareholder value to the extent that if the company goes down in its governance record, no matter how excellent otherwise, will mean nothing. But what if a company's shareholders are happy with it but its workers or society at large are not, then the conflict of interest needs to be dealt with and a mutually beneficial situation needs to be arrived at, but one should remember that shareholders are also members of the society.

Credit ratings for debt paper, which did not start off very well, later picked up, thanks to the pressures of the market which forced issuers of debt to get themselves rated in order to raise money. Similarly, market pressures will force more and more corporates in India to go in for corporate governance ratings. Eventually, SEBI, which can legitimately take credit for spearheading the movement for corporate governance ratings in India, must make such ratings mandatory for issuers of equity, so that investors have a comprehensive understanding of the companies where they are putting their money.

Corporate Governance in India—A Performance Appraisal

It is over a decade that the concept of corporate governance has become a passion with industry analysts in India. It has long passed the stage of being a fashion statement which was the case in early 1990s, as its ideals having been propagated as the be-all and end-all of all corporate endeavour in the aftermath of economic liberalisation in the country on one hand, and the then newly published Cadbury Report, on the other. All these got irretrievably intermixed to give the concept an aura and a halo. Now, after more than a decade down the line and with a lot of studies and in-depth research having been done by several committees, a reality check and analysis throw up a lot of somewhat unpalatable home truths.

Indian industry has come a long way since 1991. There has been a phenomenal growth both in the quality and number of corporates in the country. Some of them are implanting their footprints abroad and some worldwide objective research has shown that our corporates, *albeit* small in number, are second to none in terms of corporate governance standards. Companies like Infosys are on top of the heap. If the American capital market regulator, SEC, commend Infosys' balance sheet as a model to be emulated by US companies, it speaks volumes about our better-governed corporates.

In the table below a list of 63 companies that were shortlisted for the conferment of the Government of India's Award for Excellence in Corporate Governance

TABLE 19.1 Companies nominated for the consideration of the Award for Excellence in Corporate Governance (1999, 2000, 2001)

1.	Agervo (India) Ltd.	24.	GACL
2.	Archies Greetings and Gifts Ltd.	25.	Glaxo India Ltd.
3.	Asea Brown Boveri Ltd.	26.	Global Telesystem Ltd.
4.	Asian Paints Ltd.	27.	HCL Infosystems Ltd.
5.	Bajaj Auto Ltd.	28.	HCL Technologies Ltd.
6.	BFL Software Ltd.	29.	HDFC Bank Ltd.
7.	Bharat Forge Ltd.	30.	HDFC Ltd.
8.	BPCL	31.	Hero Honda Motors Ltd.
9.	Britannia Industries Ltd.	32.	Hindalco
10.	BSES Ltd.	33.	Hindustan Lever Ltd.
11.	Cadbury India Ltd.	34.	HPCL
12.	Castrol India Ltd.	35.	ICICI Ltd.
13.	Cipla Pharma	36.	Indian Hotels Company Ltd.
14.	Colgate India Ltd.	37.	Indian Oil Corporation
15.	Container Corporation of India Ltd.	38.	ITC Ltd.
16.	Corporation Bank	39.	Larsen & Toubro Ltd.
17.	CRISIL	40.	Lupin Laboratories Ltd.
18.	Dabur India Ltd.	42.	Mahindra & Mahindra
19.	Digital Equipment India Ltd.	43.	Mphasis BFL Ltd.
20.	Dr. Reddy's Laboratories Ltd.	43.	Motor Industries Company Ltd.
21.	E I H Ltd.	44.	MRF Ltd.
22.	Finolex Cables Ltd	45.	Nicholas Piramal India Ltd.
23.	Finolex Industries Ltd.	46.	NIIT Ltd.

47.	Novartis India Ltd.	56.	SmithKline Beecham India Ltd.
48.	ONGC	57.	State Bank of India
49.	Pidilite Industries Ltd.	58.	Sun Pharmaceuticals Ltd.
50.	Procter & Gamble India Ltd.	59.	Sundaram Fastners Ltd.
51.	Punjab Tractors Ltd.	60.	TVS Suzuki Ltd.
52.	Ranbaxy Laboratories Ltd.	61.	VSNL
53.	Reckitt & Coleman India Ltd.	62.	Wipro Ltd.
54.	Reliance Industries Ltd.	63.	Wockhardt Ltd.
55.	Satyam Computers Ltd.		

Source: Excellence in Corporate Governance (An exercise in assessment of corporate governance practices in the Indian Corporate Sector) by Dr. Jinesh N. Panchali, Indian Institute of Capital Markets.

for the period 1999–2001 is given. The list was prepared on the bases of certain corporate governance criteria such as (i) governance structure, which includes composition of the board and committees of the board; (ii) disclosures in the annual report, which covers statutory disclosures and non-statutory disclosures; (iii) timeliness and content of information to the investors and the public, which take into account compliance with the listing agreement with the concerned stock exchange, contents on website and grievance resolution ratio and (iv) enhancement of shareholder value determined on the bases of share prices and return on net worth. These 63 corporates that have been chosen for consideration of the topmost award for corporate governance standards they follow (Table 19.1), represent only a sample and not exhaustive enough to cover all companies that are worthy enough for being shortlisted. This implies that there are a sizeable number of corproates in the country that make serious efforts to adopt better corporate governance standards.

There is another perspective to the issue of the Indian corporate sector's earnest attempt to put in place corporate governance practices. According to Tata & Sons Executive Director, R. Gopalakrishnan, Indian firms have spent Rs. 800 crore so far on corporate governance. "In the last three years, the money paid to auditors has jumped to Rs. 800 crore from Rs. 400 crore. This, I would say, is arguably the cost of corporate governance." He pointed out that industry groups like the Tatas and Birlas believed in the trusteeship concept of wealth[7] which is one way of looking at corporate governance.

Viewed from another angle, if many Indian industries are recognised across the world, it is also due to the image they have been projecting as successful corporations with good governance systems. In that sense Indian industry seems to have arrived. Two Indian companies—Infosys and Reliance Industries—are among the 44 global strategic partners, which are contributing their expertise and resources to the organisation of the Annual Meeting of the World Economic Forum 2005. Infosys Chairman and Chief Mentor, N. R. Narayana Murthy is also one of the co-chairs in this prestigious annual event of the WEF held in Devos, Switzerland.[8]

A Report Card That Does Not Impress

However, the success of the Indian corporates in achieving good corporate governance seems to be only skin deep. Corporate governance seems to have favourably impacted only a handful of corporates whose leaders imbued with its lofty ideals, have taken them to such dizzy heights, while others have done nothing but cosmetic changes in the governance of their companies and seem to have satisfied themselves with their meagre attempts.

In early 2004, a corporate governance country assessment for India was carried out as part of the joint World Bank—IMF programme of report on the Observance of Standards and Codes. The objective was to benchmark the observance by Indian corporations against the OECD principles of corporate governance, which were originally framed in 1999, revised in early 2004 and are considered as benchmark on corporate governance by the World Bank.[9]

The report assesses India's compliance with each of the OECD principles of corporate governance. The compliance level has been classified into five categories, namely, (i) "observed", (ii) "largely observed", (iii) "partially observed", (iv) "materially not observed" and (v) "not observed". Out of 23 OECD principles, Indian corporations have been found to be observing 10, 6 were "largely observed", another 6 "partially observed" and 1 was "materially not observed".

Corporate governance in India seems to have favourably impacted only a handful of corporates whose leaders imbued with its lofty ideals have taken them to such heights, while others have done nothing but cosmetic changes in the governance of their companies and seem to have satisfied themselves with their meagre attempts.

The one category where the assessment team had found Indian corporates "materially not observing" concerns facilitating all shareholders, including institutional shareholders to exercise their voting rights. These principles call for institutional shareholders to disclose their voting policy and also to disclose when they act in a fiduciary capacity, how they manage material conflicts of interest that may affect exercise of their key ownership rights.

Table 19.2 presents the areas where the assessment team had found Indian corporations to be only "partially observant" of the OECD principles. The report has made several policy recommendations in the case of a principle which is less than fully observed. Some of the important policy recommendations are:

1. **Sanction and enforcement:** The existing provisions on sanctions in the Companies Act are considered inadequate, particularly the magnitude of fines. Stock Exchanges, at present, do not have power to impose fines. Sanction and enforcements should be credible deterrents for the corporates to carry out their business practices within the applicable laws and regulations. It should be such as to ensure that business practices are aligned with the legal and regulatory framework, in particular with regard to related party transactions and insider trading.

TABLE 19.2 Areas where Indian companies are "partially observant" of the OECD principles

Principles	*Comments*
All shareholders should be treated equally	While shareholders can approach SEBI, the company law board or the investors grievance committee of the concerned stock exchange for redress of grievances, doubts persist about the effectiveness of legal remedies.
Prohibition of insider trading	While insider trading is a criminal offence, the enforcement is weak and often ineffective.
Board/managers to disclose interests	It is reported that misuse of corporate assets and abuse in related party transactions remain a problem.
Redress for violation of stakeholders' rights	Redress can be sought through civil and high courts, but there are long delays and backlogs.
Annual independent audit	Auditors can provide consulting service to the auditee company to the extent of the level of audit fee, but disciplinary proceedings are lengthy.
The Board should be able to exercise objective judgement	As multiple board membership can interfere with performance of direction, the desirability of such a situation should be considered. Special training and certification programme for audit committee members should be considered.

Source: "Report card that does not Impress" by Dilip Kumar Sen, The Hindu, Business Line dated 27 January 2005.

2. **Necessity for clear demarcation of controls:** The current regulatory framework places the responsibility of oversight of listed companies partly with the Department of Company Affairs (DCA), SEBI and the stock exchanges. This multiplicity of regulators without clear demarcations leads to overlapping controls and enables violators go off the hook. The fragmented structure also gives rise to regulatory arbitrage and weaken enforcement. Keeping in view the enormous size of the country's equity market, there is a need to thoroughly review this three-tiered supervision system and clearly demarcate the responsibility of each regulator. This is the reason why the N. K. Mitra Committee recommended that SEBI alone should be the capital market regulator clothed with powers of investigation in the corporate governance mechanism obtained in India.
3. **Lack of professionalism of directors:** A key missing ingredient is a strong focus on professionalism of directors. Director training institutes can play a key capacity-building role and expand the pool of competent candidates on a priority basis. Directors should upgrade their knowledge and skill. If boards are not expected to simply "rubber stamping" the decisions of management or promoters, they must have a clear understanding of what is expected from them.
4. **Role of institutional investors:** Institutional investors acting in a fiduciary capacity should be encouraged to form a comprehensive corporate governance policy, including voting and Board representation. In addition to the above policy recommendations of the World Bank – IMF Team, there are other deficiencies in the country's capital market that need to be addressed effectively.
5. **Indian boards show poor professionalism:** The corporate governance reforms have been mostly on paper. The hollowness of the system is indicated by the fact that the "independent directors" are all nominated by the controlling group whom they are supposed to supervise!

   An analysis by L. C. Gupta and his team of researchers shows that a vast majority of the Indian listed companies have destroyed shareholder value. Whether or not a company has given proper attention to the interest of shareholders, would ordinarily get reflected in two indicators of shareholders' return, viz., dividends and capital appreciation.[10]

   - The study shows that the great majority of Indian listed companies have, in fact, destroyed shareholder value.
   - Instead of severely punishing the guilty corporate managements, the Indian authorities let them go scot free.

   Indian directors give only lip service to corporate governance practices, as pointed out by Dilip Kumar Sen in his article quoted above. In India, like in most developing, and to some extent, even in some developed countries, corporates are run like CEO's personal fiefdom. CEOs do not generally care for welfare of all stakeholders, but for the interest of the principal shareholders only. The majority of directors are unaware that they are agents of shareholders and that they hold a position of trust and faith. Participation of a non-executive director in meetings, whether of the board or its committees, is inversely proportional to the health of bottom line—better the bottom line, lesser the participation.

   Most directors of companies do not consider it necessary to update their knowledge and understanding on changes in laws and regulations or the business model of the company of which they are directors and which affect their duties and responsibilities as directors. So long as the performance of the company is satisfactory, which is judged by the health of bottom line, refusal to approve or object to any proposal of management is considered bad manners.

6. **Independent directors are not so independent:** Independence of independent directors seems to be only on paper. Most of the independent directors are hand-in-glove with the promoters. They rubber-stamp questionable decisions of promoters and ignore fund diversion and mismanagement in their companies. In several top companies, there are people who have remained as independent directors for as many as 20–30 years. In Reliance industries, for example, these directors remained silent when the company made massive investment in other unlisted companies. A SEBI panel tried to stop this practice and proposed a limit (9 years) on their tenure with a retrospective effect. But Indian corporate bigwigs "intervened" and lobbied for changes—finally, the limit is now with prospective effect.

   Sen continues to assert that non-executive directors do not consider themselves as watch-dogs of shareholders. Board rooms are invariably filled up with "yes" men who do not raise relevant questions and assent to all proposals put up by the management. A person is invited to become a non-executive director only if he/she enjoys the patronage of the chairman/CEO through old school connection or social circuit or golf club. Except during a crisis even nominee directors play a passive role at meetings. This has been demonstrated time and again, when an objective analysis of corporate failures is made. A general rule for the domestic corporate sector is that what you preach on corporate governance need not necessarily be practised in the company you manage. Same non-participating directors can become extremely vocal and inquisitive and raise uncomfortable questions the moment performance of the company becomes unsatisfactory. In India non-executive directorships are considered more as a symbol of social status and connections than as a position of responsibility.

   A couple of years after Indian corporates tom-tommed the virtues of good corporate governance practices, the revelations at Reliance, the country's largest private sector company, show that a lot still needs to be done. To be sure, corporate governance levels have improved in the last 5 years, but Indian industry still finds itself on the opposing side.[11]
7. **Whistle blower policy:** SEBI had proposed sometime ago that a whistle blower policy should be made mandatory. However, after stiff resistance from the industry, it asked the N. R. Narayana Murthy panel to rework the policy. Later, the whistleblower policy was made optional for companies.
8. **Unlisted investment companies:** This is the most confusing part of Indian industry and one that companies will protect tooth and nail. Companies and promoters have promoted thousands of unlisted subsidiaries. Many of them divert funds through these companies. The *modus operandi*: The listed company will give a loan (even interest-free) to these unlisted companies, which, in turn, will default repayment. A major chunk of these investment companies hold shares in their listed companies. In fact, promoters have floated several layers of such subsidiaries to hold their stakes in leading group companies. Most of corporate India including the Tatas, Birlas, and Reliance follow this practice.
9. **Accounting gimmicks:** While there are some gaps in financial statements, corporate sources claim, "We are now pretty close to the global best practices". But this has to be taken with a pinch of salt. For instance, a study by CRISIL in 2004 reclassified and sanitized the annual accounts of 616 manufacturing companies. It re-stated the accounts of 243 companies and showed that their actual profits are different from what they had reported. Simply put, their books were cooked.
10. **Poor shareholder participation:** Corporate misgovernance in India would not have gone thus far and promoter families would not have ruled the

roost this much, had there been a well-directed shareholder activism. The Indian investors, more than their counterparts elsewhere, are scattered, unorganised, ill-informed, mute and un-interested in the affairs of the company they have invested in, except for the dividends and other annual gifts doled out to them. They give their consent most obligingly enabling unscrupulous managements to perpetrate their dynastic rule with glee and making corporate democracy a sham. Voices of dissent are few and rarely recorded. The worst part of it is that even large institutional shareholders rarely record their dissent, and if they find board decisions and practices unacceptable they simply sell their securities and quit, rather than fight and help establish better governance practices. No wonder there has been a sizeable erosion of investor confidence in the Indian industry with scams coming to light almost every year in quick succession.

11. **Obliging auditors:** Another weak link in the wobbling chain of corporate governance in the country is that of the auditing profession. Obliging auditors help companies in window-dressing, manipulation of profit and loss accounts, hedging and fudging of unexplainable expenditures and resorting to continuous upward evaluation of assets to conceal poor performance. It is common knowledge that there is a dire need for independent auditors who are reputed and above board. Due to distrust in Indian auditors, most of the multinational companies in India have insisted on their parent companies' auditors to audit their subsidiaries in the country. Things have started improving with the Institute of Chartered Accountants of India insisting on the profession adopting improved accounting practices, but there is a lot to be achieved.[12]
12. **Other Problems:** There are of course, several other problems in the country's capital market that are responsible for the poor record of corporate governance in the country. It has been mentioned earlier and it requires repetition in this context. A soft state, a lethargic and slow-moving judicial system, a value system that is indifferent to moral turpitudes, an inefficient market regulator and poor enforcement of rules and regulations have all combined together to ensure that though the ideal of corporate governance is kept on a high pedestal, it is only occasionally put into practice.

The Future of Corporate Governance in India

Although India has a long way to go to be ranked among the best in the world in corporate governance, the driver is exactly right. A large number of CEOs now realise that their companies need financial and human capital in order to grow to scales necessary to survive international competition. They also understand that such capital will not be available in a non-transparent corporate regime that is bereft of international quality of disclosures and accountability. It is precisely this realisation which is driving the corporate governance movement in India and which, has greater chances of delivering substance rather than ticking mandated governance checklists.

> It is important to note that there are still some lacunae in different aspects of corporate governance: India still has poor bankruptcy laws and procedures (legal and procedural; barriers to good corporate governance); Indian accounting standards still do not mandate consolidation—although this is slated to change; Indian stock markets are still inefficiently run, and do have adequate depth or width to give shareholders greater comfort. The Indian bond market is in its infancy.

It is important to note that there are still some lacunae in different aspects of corporate governance.

- India still has poor bankruptcy laws and procedures (legal and procedural barriers to good corporate governance).
- Indian accounting standards still do not mandate consolidation—although this is slated to change.
- Indian stock markets are still inefficiently run, and do have adequate depth or width to give shareholders greater comfort.

- The Indian bond market is in its infancy. Pension funds need to invest much more in equity, and play an activist role. Mutual funds "need to walk the talk" in corporate governance.

Even so, it is necessary to recognise that corporate India has gone a long way in the business of governance, especially in the last 4 years—and more so given its legacy of the past.

Impetus for the Growth of Corporate Governance in India

Although corporate governance has been slow in making its mark in India, the next few years will see a flurry of activity. This will be driven by several factors:

The following factors augur well for better corporate governance in India in future. Competitive-driven; new players' professionalism; growth in market capitalization; foreign portfolio investors; media influences; influence of banks and financial institutions; realisation among Indian corporates of the benefits of corporate governance; impending full capital account convertability will exert its own pressure.

1. **Competition-driven:** Most important is the force of competition. With the dismantling of licences and controls, reduction of import tariffs and quotas, virtual elimination of public sector reservations, and a much more liberalised regime for foreign direct and portfolio investments, Indian companies have faced more competition in the second half of the 1990s than they did since Independence. Competition has forced companies to drastically restructure their ways of doing business.
2. **New players' professionalism:** Many companies and business groups that were on the top of the pecking order in 1991 have been relegated to the bottom. Simultaneously, new aggressive companies have clawed their way to the top. Therefore, they are more than willing to have professional boards and voluntarily follow disclosure standards that measure up to the best in the world.
3. **Growth in market capitalisation:** There has been a phenomenal growth in market capitalisation. This growth has triggered a fundamental change in mindset from the earlier one of appropriating larger slices of a small pie, to doing all that is needed to let the pie grow, even if it involves dilution in share ownership.
4. **Foreign portfolio investors:** One cannot exaggerate the impact of well-focussed, well-researched foreign portfolio investors. These investors have steadily raised their demands for better corporate governance, more transparency and greater disclosure. Over the last few years, they have systematically increased their exposure in well-governed firms at the expense of poorly run ones.
5. **Media Influences:** India has a strong financial press, which will get stronger with the years. In the last 5 years, the press and financial analysts have induced a level of disclosure that was inconceivable a decade ago. This will increase and force companies to become more transparent—not just in their financial statements but also in matters relating to internal governance.
6. **Influence of banks and financial institutions:** Despite serious lacunae in Indian bankruptcy provisions, neither banks nor financial institutions will continue to support managements irrespective of performance. Already, the more aggressive and market oriented FIs have started converting some of their outstanding debt to equity, and setting up merger and acquisition subsidiaries to sell their shares in under performing companies to more dynamic entrepreneurs and managerial groups. This will intensify over time, especially with the advent of universal banking.
7. **Realisation among Indian corporates of the benefits of corporate governance:** Ultimately, Indian corporations have appreciated the fact that good corporate governance and internationally accepted standards of accounting and

disclosure can help them access the US capital markets. Until 1998, this premise existed only in theory. It changed with Infosys making its highly successful NASDAQ issue in March 1998. This was followed by five more US depository issues—ICICI (which is listed on NYSE), Satyam, Infosys, Rediff and WIPRO. There are more and more companies gearing up to issue US depository receipts, and all of them will get listed either at NYSE or at NASDAQ. This trend has had two major beneficial effects. First, it has shown that good governance pays off, and allows companies to access the world's largest capital market. By the latest count, external commercial borrowings of Indian corporations (ECBs) during the financial year 2004–05 would top $10 billion, apart from an equivalent amount of FDI inflows.[13] Second, it has demonstrated that good corporate governance and disclosures are not difficult to implement—and Indian companies can do all that is needed to satisfy US investors and the SEC. The message is now clear: it makes good business sense to be a transparent, well governed company, incorporating internally acceptable accounting standards.

8. **Impending full capital account convertability will exert its own pressure:** Moreover, sooner than later India will move to full capital account convertibility. When that happens, an Indian investor will seriously consider whether to put his funds in an Indian company or to place it with a foreign mutual or pension fund. That kind of freedom will be the ultimate weapon in favour of good corporate governance. Thankfully for India, the companies that matter have already seen the writing on the wall. Thus, it may not be wrong to predict that in another couple of years India might have the largest concentration of well-governed companies in South and Southeast Asia.

CONCLUSION

Past experience on governance issues in the country has shown that none of the corporate governance principles can be cast in stone and laid to rest forever. There is an ongoing need for constant review and course corrections that would keep the country in the pink of health in terms of its corporate excellence. By a judicious mix of legislation, regulation, and suasion, this task needs to be constantly addressed. With growing maturity and competitive compulsions, it should be possible to gradually reduce legislative interventions and increase regulatory compliance with, and self-induced adherence to, the best practices in this field. Till then, however, legislation and regulation to ensure at least certain minimum standard is inevitable. To facilitate such a graduation into better governance practices, globalisation has opened up an array of opportunities to corporate India. To emerge successful in its new tryst with destiny, there are no soft options available and the Indian corporate sector must necessarily turn to good governance in its pursuit of competitive excellence in a challenging international business environment.

KEYWORDS

- A report card
- Accounting Standards
- Best practices
- Corporate governance rating
- Corporate initiatives
- Ethics and values
- Impetus for growth
- Individual initiatives
- Industry initiatives
- Legislative changes
- National Foundation for Corporate Governance
- Performance appraisal
- Rating methodology
- Reserve Bank of India
- Restructuring
- Self-regulation
- Serious Fraud Office
- The harbinger of corporate governance
- Transparency

DISCUSSION QUESTIONS

1. What do you understand by the term 'corporate governance'? Why is it important?
2. Elucidate the need for corporate governance in India.
3. What roles, values and ethics play in ensuring corporate governance?
4. What were the efforts initiated by India to ensure corporate governance in the country?
5. What do you understand by the term 'Listing Agreement'? In this context, explain Clause 49.
6. Discuss the extent to which efforts to ensure corporate governance has been effective in India.

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Case Study

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, Unilever 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 Unilever; 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.

20

The Corporation in a Global Society

CHAPTER OUTLINE

- Introduction
- Factors Facilitating Globalisation
- Role of Multinational Corporations
- Caux Round Table
- Key Global Issues for Business
- Corporate Governance, a Pre-requisite for Globalisation

With WTO playing an active role and its hundred and odd members opening up of their economies, globalisation is moving forward relentlessly, with freer movement of people, capital, jobs, trade and information. international business has become an important economic force. Today few, if any, countries can claim to be economically self-sufficient. Most business enterprises, are drawn to doing business across national borders today.

Introduction

With the World Trade Organisation (WTO) playing an active role and its hundred and odd members opening up their economies, globalisation is moving forward relentlessly, with freer movement of people, capital, jobs, trade and information. Global businesses operate in an essentially borderless society and have considerable power to effect change, while internationally the direct role of nation states is diminishing. In this fast changing scenario, there is an urgent need for a sustained dialogue, initially among senior business leaders from around the world, to define the critical role of the corporation in a global society.

Growth of Global Corporations

In the second half of the 20th Century, international business has become an important economic force. Today few, if any, countries can claim to be economically self-sufficient. Even India with its vast human and natural resources, cannot insulate herself from the world economy and though there was tremendous political opposition from within, she was constrained to open up her economy and join the WTO. In every country, developing or developed, international business touch people's lives daily.

Most business enterprises, big or small, are drawn to conduct business across national borders today. They may be purchasing raw materials from foreign suppliers, assembling products from components made in several countries, or selling finished goods or services to customers in other nations. With the passage of time and more and more countries removing or reducing trade barriers, the number of firms affected by international competition keeps on increasing every day. In our day-to-day life we consume goods and services that have an international character about them—clothes, books, CDs, computers and soft drinks. Many MNCs have subsidiaries, affiliates and joint venture partners in most of the developing countries so much so, in some cases, the number of foreign employees of these corporations may exceed that of the home country.

Factors Facilitating Globalisation

Many factors have come to play a facilitating role in recent times to promote and foster international trade. Many developing countries adopted protectionist policies and raised huge tariff barriers for decades to protect their vulnerable home industries from foreign goods. Global business opportunities were also limited by poor communication facilities, slow development of infrastructure, inordinate delays in travel and shipping and a host of non-tariff barriers raised by many countries. Today, people can reach any place on the globe in one day and international communication is instantaneous. "Business operations can be managed effectively simultaneously." Resources are sometimes more plentiful and less costly in other countries; labour may be cheaper; taxes may be lower. In some cases, it may be even beneficial if the weather is better."[1]

At the beginning of the 21st century, nations are most closely linked to one another than ever before through trade in goods and services, through flow of capital, through movement of labour—though to a limited extent—and through investments in each other's economies. There are several factors that have played a key role in promoting international trade in recent times. These are:

1. ***Falling trade barriers:*** Liberalisation of trade has been recently accelerated as a result of free trade agreements, emergence of trade blocs and the facilitating

role played by international organisations such as the World Trade Organisation, International Monetary Fund and the World Bank.

2. ***Political reforms have opened-up new frontiers:*** As pointed out by James Post et al (1999), the former communist nations of Eastern Europe are now open to doing business around the world. Millions of people in these countries are now able to take advantage of goods and services that global commerce provides in an open and free market place. There have been other factors such as the re-unification of East and West Germany, the enormous growth in global tourism and transport and communications have also added to this stupendous growth in world trade.
3. ***More developing nations joining the bandwagon of global business:*** Several countries such as Taiwan, Thailand, Malaysia, Singapore and Indonesia have been growing rapidly in recent years in addition to the industrial prowess of Japan and South Korea in the Asia Pacific region. Recently, China, India, Brazil and Russia have emerged as successful global players and in turn have invited business across the world to invest in them.
4. ***Emergence of new technologies and businesses spanning continents:*** New technologies and business based on them such as computer hardware and software, pharmaceuticals, communications that have worldwide investments and markets, have brought about a tremendous transformation in fostering world trade. Like wise, business process outsourcing (BPO) and several IT-enabled services have widened the horizons of international business opportunities.
5. ***Faster transport and communications:*** Thanks to the Open Air Policies adopted by many countries, distances have been reduced and movement of people and products has become much faster, thus catering to the whims and fancies of the modern consumers. Besides, faster transport and communication have quickened the processes of production by moving the factors to the centres that manufacture the finished products.
6. ***Special features of modern production:*** Modern production is such that various spares and components are produced in countries which enjoy economies of scale, division of labour and comparative cost advantage and then assembled at a location which enjoy cheap labour with great skill and expertise. In the case of watches, clocks and even diamonds this happens. This reduces cost, widens the market and promotes international business.

Doing Business in a Diverse World

Time was when corporations doing business in many countries considered the country of their origin as the major source of their capital, revenues and personnel. Under this *ethnocentric* perspective, the home country's laws were viewed as dominant but nowadays companies have understood that they should consider the entire world as their home and have to adopt their business practices to different environments and cultures while sticking to global identity and policies. Under this *geocentric* perspective, firms develop managers at all levels from a worldwide pool of talent and seek to use the best people for all jobs regardless of where they come from. In fact, in recent times transnational corporations which used to deploy men from their home countries in senior management positions in their subsidiaries in India and elsewhere, have started recruiting their future managers from topnotch Indian educational academies such as the IIMs and IITs to man their units worldwide. Banking companies like Citibank and Standard Chartered Bank and firms like Bata and Hindustan Lever Ltd. have a number of Indian managerial personnel

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not only manning their subdiaries, but even their parent organisations. In this context, James E. Post et al. have this to say: "Companies such as IBM, General Electric, and Exxon have long histories of bringing their managers from, around the world to meetings and workshops for the purpose of broadening everyone's understanding of the world in which their company operates. At Dow Chemical, technical specialists from plants around the world are connected by information technology and physically meet several times each year to discuss advances in science and technology. European firms such as Nestle (Switzerland), ABB (Asea, Brown, Boveri, a Swedish—Swiss company) and Unilever (Great Britain—Netherlands) have led the way towards internationally diverse corporate board membership."[2]

However, in the making of the *geocentric* outlook, it is not the size of the firm that matters, but the geographic location and awareness of the social and cultural characteristics of the firm's stakeholders that reinforce the importance of an open approach to cultural differences. "To be a global company in the modern economy is to build a geocentric perspective into the very fibre of the business organisation." (James E. Post *et al*.).

For instance, when Nestle and Unilever carry on business in the Indian subcontinent, they face different political systems: India has a vibrant democracy, Pakistan, most often a dictatorship and Bangladesh, a fledgling and brittle democracy. In terms of economic systems too, there are substantial variations which are reflected in the kinds of economic policies they pursue. Though all these countries are supposed to have a common culture, their divergent religious and linguistic affinities bring in considerable variations in the manner they live and consume things. With different socio-economic and political environment, legal framework, institutional set-up, fiscal, monetary and commercial policies, factor endowments, production techniques, nature of products and consumption habits, these companies will have to acclimatise themselves not only to the existing realities of each of these countries, but also to be prepared to fine-tune their policies and business strategies to the fast moving changes that occur in these dynamic societies. As commerce becomes more global, with customers, suppliers, and competitors from other nations and cultures, managers have to understand and appreciate how diverse socio-economic systems affect the markets and the socio-political environment of business and act accordingly, if they have to be successful in their global business.

Role of Multinational Corporations

Multinational corporations are business entities that operate in more than one country. The name multinational corporation is distinct from international corporation. The latter name was used in the 1960s to identify a company with a strong national identification. The home market was the company's primary focus. Overseas operations were usually carried out by wholly owned subsidiaries controlled by home country nationals. By the 1980s, international corporations had evolved into more globally oriented companies.

Businesses in the present global society are carried on by multinational or transnational corporations, most of which are based in developed countries. "multinational corporations" are business entities that operate in more than one country. The name "multinational corporation" is distinct from "international corporation". The latter name was used in the 1960s to identify a company with a strong national identification. The home market was the company's primary focus. Overseas operations were usually carried out by wholly owned subsidiaries controlled by home country nationals. By the 1980s, international corporations had evolved into more globally oriented companies. While still maintaining a domestic identity and a central office in the country where it was incorporated, a multinational corporation now aims to maximise its profits on a worldwide basis. The corporation is so large and extended that it may be outside the control of a single government. Besides subsidiaries, a multinational corporation may have joint ventures with individual companies, either in its home country or foreign countries.

Excessive Economic Clout

Global business does not function in a vacuum. It operates within the context of international and, where necessary, regional rules and regulations set up by appropriate governmental agents. Global business is dominated by multinational corporations that have their businesses spread across continents. According to a study conducted by Sarah Anderson and John Cavanagh for Corporate Watch 2000, the world's top 2000 corporates have combined sales that are far greater than a quarter of the world's economic activity and are bigger than the combined economies of all countries minus the biggest 9, i.e., they surpass the combined economies of 182 countries. The surprising thing about the inequities these corporations have brought about in the world economy is the fact that of the 100 largest economies in the world, 51 are global corporations; only 49 are countries. A study by the Institute for Policy Studies (IPS) indicates that 200 giant corporations, most of which are larger than many national economies, now control well over a quarter of the world's economic activity. For instance, Philip Morris is larger than New Zealand, and operates in 170 countries. Instead of creating an integrated global village, these firms are weaving webs of production, consumption, and finance that bring economic benefits to, at most, a third of the world's people. Two-thirds of the world (the bottom 20 per cent of the rich countries and the bottom 80 per cent of the poor countries) are either left out, marginalised or hurt by these webs of activity.[3]

Current Issues—Multinational Corporations

Multinational corporations face many of the same issues as domestic companies[2] such as maximising profits, meeting customer demands, and adapting to technological changes. In addition, multinational corporations must stay current with trends and events in the various countries where they operate. Political reforms in South Africa, economic liberalisation in India and social trends in Europe are examples of matters that are important to corporations operating in these countries.

Accountability is also an issue multinational corporations face. Because they are so large, multinational corporations can, and sometimes have, exerted questionable political and economic power in some countries. As a result, critics view multinational corporations suspiciously and sometimes seek to have host countries impose restrictions on them. They have also aroused intense distrust among socialist-oriented parties as exploiters of the wealth of the developing countries. Since almost all the MNCs are also incorporated in the US or countries in Europe which were once colonial powers that impoverished the colonies for centuries, the MNCs are considered as neo-colonial powers that continue to exploit these erstwhile colonies economically.

Caux Round Table

In the context of promoting world trade in a principled manner, the Caux Round Table (CRT) has done yeomen service. The CRT, an international network of principled business leaders working to promote a moral capitalism was founded in 1986 by Frederick Phillips, former President of Phillips Electronics and Oliver Giscard d'Estaing, former Vice-Chairman of INSEAD, as means of reducing escalating trade tensions. In due course of time, the CRT began focussing attention on the importance of global corporate social responsibility in reducing social and economic threats to world peace and stability.

CRT Principles for Business

Some commentators suggest that we are at a major turning point in history—a time that occurs only once every hundred years or so, when adequate vision is lacking, leadership is weak, new technology sweeps across nations, gaps widen between people, laws and institutions break down, values weaken, crime and corruption increase, and human relations falter. Such factors inherently threaten world peace, stability and prosperity, while business globalisation is accelerating in both the historically major economies and the strong new economies.

The CRT advocates implementation of its Principles for Business through which principled capitalism can flourish and sustainable and socially responsible prosperity can become the foundation for a fair, free and transparent global society. The CRT goal is sustained profitability within ethical framework of social responsibility.

At the company level, the Caux Round Table advocates implementation of the CRT Principles for Business as the cornerstone of principled business leadership. The CRT Principles apply fundamental ethical norms to business decision-making. A specially designed process for incorporating the CRT Principles into the culture of a corporation, the self-assessment and improvement process, is available for companies to use. Ethical training for corporate boards of directors and new ethics curriculum for business schools are being developed.

To promote better outcomes for globalisation, the Caux Round Table is working to raise the level of awareness of senior business leaders, and elite opinion around the world about new opportunities to attack global poverty. These include legal and regulatory changes in developing countries that will improve the environment for productive investment of foreign and domestic equity capital. The Caux Round Table is working in alliance with global business leaders, international institutions and policy makers to improve investment environments in selected developing countries by suggesting certain Principles for governments and the adoption of the 12 core "best practice" standards for transparent management of national financial institutions.

The CRT Principles for Business were formally launched in 1994, and presented at the United Nations World Summit on Social Development in 1995. The CRT principles for business articulate a comprehensive set of ethical norms for business operating internationally or across multiple cultures. The CRT principles for business emerged from a series of dialogues catalysed by the Caux Round Table during the late 1980s and early 1990s. They are the product of collaboration between executives from Europe, Japan and the United States, and were fashioned in a document called "The Minnesota Principles". The CRT principles for business are recognised by many as the most comprehensive statement of responsible business practice ever formulated by business leaders for business leaders.

The goal of the CRT is to diffuse its suggested principles, standards, benchmarks, management concepts and practices, and understanding of a moral capitalism as widely as possible.

The formation of the Caux Round Table was a significant step taken by senior business leaders to address global issues affected by the performance and conduct of international business. Deeply concerned with the issue of promoting solutions to the tensions arising from trade imbalances, the CRT has monitored the continuing changes in the economic and political landscape, and its influence has grown through the formulation and wide circulation of its principles for business. Global business stands at the crossroads of the fundamental changes taking place in the world. The CRT believes that business has a crucial role to play in helping to identify and promote solutions to issues that impede the development of a society that is more prosperous, sustainable and equitable. Globalisation facilitating free movement of people, capital, jobs, trade and information and businesses operate in a borderless manner and with the role of nation states becoming less important leads to the development of "soft" laws, i.e., the effect of international conventions and bilateral treaties being used by NGO's as representing society's expectations of conduct, in advance of their adoption into the laws of individual nation states. As reluctant as some corporations have traditionally been to go beyond their operational objectives, the time has come for the roles of corporations, governments and other institutions to be significantly redefined—a time for new partnerships and greater cooperation on a global level.

International Business Issues

Simultaneous efforts to promote free trade and protect domestic industry from foreign competition is one of the most pressing issues in international business today. Intellectual property rights is another important issue. International business is hindered when companies fear that their patents, trademarks and industrial secrets will be violated abroad. Countries which fail to protect these rights may be shunned, and consequently may suffer from lack of foreign investment and access to cutting edge technology. Efforts at environmental protection are another international business issue. In the business context, this issue centres, in part, on the extent natural resources in less-developed countries could be exploited for the benefit of developed countries. For example, should Filipino's forests be destroyed to satisfy the Japanese demand for lumber is a much debated issue. International business is business conducted across national boundaries. It is therefore concerned with political, economic, social and cultural conditions in a variety of countries. As technology improves international communications and transportation links, international business and international corporate activities will expand.

Simultaneous efforts to promote free trade and protect domestic industry from foreign competition is one of the most pressing issues in international business today. Intellectual property rights is another important issue. International business is hindered when companies fear that their patents, trademarks, and industrial secrets will be violated abroad. Countries which fail to protect these rights may be shunned, and consequently may suffer from lack of foreign investment and access to cutting edge technology. Efforts at environmental protection are another international business issue.

Need for Dialogue on the Role of the Corporation

With the onset of globalisation and the business corporation spreading its wings outside the home country, there is an urgent need for a sustained dialogue, initially among senior business leaders from around the world, and then including leaders of governments and other institutions, to define the critical role of the corporation in a global society. The rules of the game are fast changing. Whether in the physical, social or economic environment, business leaders can no longer rely solely on past traditions, established strategies or earlier expectations of society. For such a dialogue to be fruitful, it requires a common framework and guidelines. The following beliefs can be considered as a framework for that discussion:

- The primary responsibility of the corporation is to conduct its operations proficiently, i.e., to be technologically innovative, competitive and financially sound.
- Corporations must be increasingly responsive to issues affecting the physical, social and economic environments not only because of their impact on business performance but also out of a pro-active sense of responsibility to all constituencies served.
- Corporations need to consider the balance between the short-term interests of shareholders and the longer-term interests of the enterprise and its stakeholders.
- Meeting traditional objectives and performance criteria is not sufficient. Voluntary standards which exceed the requirements of prevailing law and regulations are necessary to the development of sustainable practices. Society's "license or franchise to operate" has to be earned.
- Corporations should lead by example through business practices that are ethical, transparent, and that reflect a commitment to human dignity, political, economic freedoms and preservation of the planet.
- Corporations cannot act alone but should seek to address key societal issues through cooperative efforts with governments, civil society including other institutions and local communities.

In such a dialogue, the following issues should be given precedence:

- The employment issue
- Sustainable practices and values
- Trust, honesty and transparency

- Collaboration and partnerships for action

These issues need to be examined in the context of the fundamental social, economic, political and technological changes taking place throughout the world today.

Global Economic and Political Environment

Some commentators suggest that we are at a major turning point in history—a time that occurs only once every hundred years or so, when adequate vision is lacking, leadership is weak, new technology sweeps across nations, gaps widen between people, laws and institutions break down, values weaken, crime and corruption increase, and human relations falter. Such factors inherently threaten world peace, stability and prosperity, while business globalisation is accelerating in both the historically major economies and the strong new economies. The period since the CRT was founded has encompassed the completion of the General Agreement on Tariffs and Trade (GATT) agreement, strongly endorsed by CRT participants, and the formation of the WTO. Other developments include the completion of the single European Market, the formation of North American Free Trade Agreement (NAFTA) and the Association of South East Asian Nations (ASEAN) agreements. The collapse of communism in central and eastern Europe has created both opportunities and challenges.

The emergence of India and China as major economies, together with the resurgent growth of the Tiger economies, has generated unprecedented prosperity and industrial muscle. The emergence of market economies challenges expanding global businesses to help enable those markets to reach their potential and to enhance the prosperity of their populations. Threats to a prosperous and sustainable society include the gulf between the rich and the poor, between the successfully industrialised nations and their less developed neighbours. Social unrest and discontent are increased by religious fanaticism and organised crime. Unlawful immigration is a destabilising influence as those without money, jobs, knowledge or opportunity are attracted to centres of prosperity. The flood of migration of Sikhs to the USA and UK in the aftermath of Blue Star Operations and later the Delhi riots following Indira Gandhi's assassination, and large-scale migration to Europe of Sri Lankan Tamils following the continued strife between the government and the LTTE are cases in point. Business leaders rightly see major opportunities for access to new markets, for the wider utilisation of intellectual property and technology, and for new investment. But they are also faced with formidable challenges to reduce the attendant risks.

Public Awareness and Scrutiny

At the same time, there has been a revolution in communication, itself the source of huge new global business operations. With easier and more immediate access to information, and the stimulus of media analysis, public interest in the conduct of business has intensified. Sophisticated media presentation focusses particular issues and heightens concern, especially where perceptions develop that the public interest is threatened or power is being abused. Demands increase for greater transparency and for effective public scrutiny. Society expects corporations to be accountable, not just in traditional areas of financial performance, but across all functions that have an impact on the physical, social and economic environments. Society's confidence is undermined by ignorance and suspicion but reinforced by information and understanding. Without confidence, society can be expected to review its "license" or "franchise" for business to operate. It exercises its sanction

through legislation and regulations, the facility of choice in the market place, actions of pressure groups, and corrosive public criticism of targeted sectors, corporations or key position holders.

Recent campaigns on top executive compensation, environmental performance, employment conditions, sale of arms, and customer service standards provide evidence of the potentially harmful effects of public alienation. Conversely, companies that have addressed the challenges openly have been able to win public support even while undertaking major changes involving restructuring, adoption of new technologies sometimes seen as threatening, and in resolving highly controversial issues such as disposal of toxic waste. Increasingly, competitive advantage and customer loyalty are achieved through providing access and dialogue and demonstrating genuine concern for the needs of communities and the public interest.

Technological Challenges and Opportunities

Never in the chequered history of the human race, has there been such an explosive growth of technology in such a short span of time as it is now. Technological innovations have brought in changes that are immense in manufacturing, transport and communications, information and knowledge management, pharmaceuticals and biotechnology, banking and financial management and in a host of other spheres. The impact of these innovations on business and industry, as in other walks of life, is immeasurable. Methods and processes of production have been shortened, distances reduced, time taken lessened in every human endeavour. Business and trade have become global. The world itself has become so small as to be called the "global village". In this fast-changing environment—social, political, economic and governmental—corporations have to adopt themselves faster, reckon competition and work out successful survival strategies. Even while they have to swim against the rising costs of technology-induced processes and changes, they have to acclimatise themselves to newly evolving corporate cultures and governance practices. Values keep changing and corproates have to be in the vanguard of these changes to succeed in their business. If challenges arising out of technological innovations are many, opportunities too are plentiful. An ever-increasing global market, large scale manufacturing with its attendant economies of scale and lowered costs, escalating profits and a chance of becoming transnational corporate players are not too small a gain for the corporates to ignore.

The Physical Environment

Business has increasingly faced several challenges with regard to its effects on the physical environment and its sustainability. It is in this area that issues have become most globalised and inter governmental conventions and NGOs have had significant influence. Increasing awareness on this issue has reshaped legislations around the world and has led to the formation of new international institutions, with a huge impact on the policies and practices of businesses and their representative organisations. There are few remaining international corporations that have not published statements of environmental, safety and health policies while significant sectors have adopted a coherent voluntary worldwide code of responsible practice. Considerable progress has been made in disclosure, and in introducing reporting and verification procedures. Although many aspects of environmental concern still await scientific verification, the concept of a voluntary precautionary approach has evolved, coupled with significant public commitments on performance goals. Science and emerging

technology have enabled business to take many beneficial initiatives in areas such as efficient agriculture, safe water and hygienic food processing. However, maturing public attitudes introduce new challenges in terms of what is acceptable in the public interest. The adoption of unfamiliar risks raises deep public concern. Important examples include the application of biotechnology and pesticides in agriculture and use of additives and radiation in food preservation. Business must make both practical and ethical decisions on the adoption of risk, its assessment and communication to its constituencies.

The Social Environment

Population growth, and consequent unemployment, increasing inequalities between the rich and the poor, public health, immigration flows and social disorder interact to affect the conditions in which business develops. The prevailing political framework determines whether the responses are subject to command economy rule, to free market economies or to what are called mixed economies. Education and training are the precursors to economic development, and most political regimes give these high priority. However, the resources required to ensure efficient delivery may be inadequate, depending upon the general economic climate and social infrastructure. A natural consequence of successful business activity is that employment opportunities and wealth are created, together with an increasingly cohesive and supportive social fabric. Successful business, however, depends upon its efficiency, competitiveness and its flexibility to adapt to changes in the marketplace. In the global market, even the most enduring businesses have to adapt, through measures affecting employment levels and disposition. Significant factors include changes in demand, new technology and the emergence of competition.

Key Global Issues for Business

Modern international corporations face dilemmas in the following fronts: The employment dilemma; sustainable practices and values; trust, honesty and transparency.

All of these developments have far-reaching consequences. Some favour business and others threaten it. But none can be ignored. The CRT affirms that the primary purpose of the corporation is to manage its business effectively. In doing so, however, global business cannot assert that "the only business of business is business". It should seize the opportunity to be an active participant in contributing to greater peace, stability and prosperity. Many business leaders have recognised the implications of globalisation for their corporations and have given increasing attention to the social concerns. A broadening consensus has developed that business has a responsibility towards the communities it serves and depends upon, to contribute beyond the strict requirements of the law, and beyond the needs of self-protection. Participants in the CRT affirm this perspective, and seek to define the responsibility of global corporations in relation to certain key issues.

1. **The employment dilemma:** The CRT has addressed the need for job creation regularly. It involves a complex set of issues with far-reaching implications both in industrialised and developing nations. Resolution of the global employment dilemma may be fundamental to reducing risks of social upheaval and to finding solutions to other key global issues. One of the greatest strengths of business has been and must continue to be job creation, even as restructuring of current activities continues. Country after country has decided that increased private sector employment is the linchpin to sustainable economic growth. Business has a responsibility to provide working conditions that respect each employee's health and dignity, and to provide jobs and compensation that improve the living

conditions of workers and their families. But some crucial questions must be answered:

- What can and should be the role of business in promoting job creation?
- What responsibility should business take for promoting flexibility and employability?
- What is its role in seeking to change regulations which inhibit change in employment practices or impose administrative burdens that threaten competitive employment?
- What steps must be taken to assist those without jobs?
- Is it true, as some suggest, that technological advances of recent years have eliminated more jobs than they have created? Or, on the contrary, does the problem lie in protectionism and resistance to change?
- What rectifying actions can be taken?

Within a wider social and economic context, business also needs to address questions such as:

- The gulf between the rich and the poor within nations and between successfully developed and less developed economies;
- The urgent need in developing nations for the rule of law, necessary infrastructure nurturing of a new work ethic and other measures to assure sustainable development of a market economy; and
- The impact of increased immigration and freer trade agreements upon all sectors of societies, both within developed and developing nations.

Global business leaders and their counterparts in governments must draw from past successes to develop policies that promote job creation, review regulatory constraints that inhibit job creation, and consider new risk-sharing between business and government. Above all, business leaders need to identify the factors which promote creativity and innovation and inspire confidence in enterprise rather than resorting to protectionism.

2. **Sustainable practices and values:** It is widely understood by people now that shorter-term performance criterion have to be balanced against longer-term considerations involving the effects of business on its environment and thus its sustainability. While laws and conventions focus particular provisions for the conduct of business, there is a growing consensus that attitudes, standards and practices must exceed legal requirements. Business needs to monitor the impact of its products and services and to stand for values with which society will identify. Extending the practice of many corporations which already publish their general principles for the conduct of their business, and of a large number which publish their policies and performance in areas of safety, health, the physical environment and energy efficiency, how should business define its role in areas such as:

- Resource management
- Technology transfer
- Human exploitation
- Employee development
- Illicit substances and their abuse
- The family
- Encouragement of sound values in society.

Business will have to determine the extent and scope of its responsibility in such sensitive areas, and find the right balance alongside other institutions involved.

3. **Trust, honesty and transparency:** It is the considered belief of CRT and other such similar organisations that business, as well as the professions, have a duty to the rest of society to be trustworthy, honest and transparent in their dealings. Public suspicion of business motives and behaviour is a negative influence which can lead to restrictive legislation and can threaten job creation and other potential benefits to society. A loss of trust may result in a virtual revocation of

business' "license" or "franchise" to operate in the public interest. Communications technology and the media intensify the call for information and explanation. To obtain trust worldwide business practices must satisfy the perceptions of society as to what is ethical. Global businesses should not participate in or condone bribery, money laundering or other corrupt practices but should cooperate with others to eliminate them. Some of the key questions to be addressed include the following:

- What are the practical obstacles to greater openness and transparency?
- What is a right balance between pro-active and reactive measures to achieve public understanding of the standards of business and its performance?
- How should business leaders approach the problem of corruption, given the diversity of cultures?
- How can business engage in sustained dialogue with all its constituencies to define shared responsibilities for resolving issues?

4. Collaboration and partnerships for action: The CRT believes that solutions to complex global issues require the cooperative efforts of business, government and other institutions. Working alone, these powerful players are likely to fail. Working together, they can apply local models to international situations and find multifaceted solutions to complex problems. The partnership developed in many cities where businesses collaborate with local authorities, central government, education, emergency services and special interest groups could be adapted to global initiatives. Although the difficulties in achieving effective collaboration are likely to be daunting, business needs to take the initiative and persevere in this process. Business needs to consider its role and approach in in the following aspects:

- Working out a coherent strategy for addressing global problems
- Establishing a constructive business network embracing its principal world centres
- Initiating dialogue with relevant public institutions
- Mounting and funding agreed initiatives and action programmes.
- Monitoring and reviewing progress and outcomes.

Corporate Governance—A Prerequisitie for Globalisation

If Indian companies want to be globally competitive in the new millennium, then good governance is an utmost necessity. The first requirement of corporate governance is professional management. Few companies will voluntarily adopt 'corporate governance codes' because in their perception these will add to their costs without bringing much tangible benefits and hence the government must regulate their adoption. Government must take the lead in this regard and enforce corporate governance through institutions. If the government fails to enforce governance codes, then businessmen must themselves take the initiative out of self-discipline. It will be best if private sector companies and public sector enterprises act in concert in this respect.

If India wants to ensure that as a crisis of the same proportion experienced by Southeast Asia never occurs here, and if Indian companies want to be globally competitive in the new millennium, then good governance is an utmost necessity. The East Asian crises occurred due to the lack of public governance and corporate governance. "Singapore suffered the least because it had good governance rules in place." Public governance involves setting up of regulatory bodies and a legal framework, the establishment of institutions that ensures transparency. Rule of law and a proper financial system are essential. The first requirement of corporate governance is professional management. Even in family-owned companies, where family members often hold the highest offices in companies, it is imperative that such family members are professionally qualified and competent for the office they hold.

Few companies will voluntarily adopt "corporate governance codes" because in their perception these will add to their costs without bringing much tangible benefits and hence the government must regulate their adoption. Government must take the lead in this regard and enforce corporate governance through institutions.

If the government fails to enforce governance codes, then businessmen must themselves take the initiative out of self-discipline. It will be best if private sector companies and public sector enterprises act in concert in this respect. Even if the government or public sector enterprises are not interested, private sector companies must adopt global corporate governance standards, because "globalisation demands good corporate governance." After all, globalisation is likely to benefit private sector corporations more than public sector enterprises.

Some analysts are very pessimistic and even suggest that Indian companies should not globalise until good governance rules are put in place, as otherwise India would go the East Asian way. In East Asia, all the good work built up over ten years and more was destroyed in a matter of weeks, simply because the necessary framework was not there. If Indian companies want to globalise, they must adopt good corporate governance standards. One reason why Indian infotech companies were able to raise funds in the markets abroad such as Nasdaq was because they had adopted global corporate governance standards that satisfied the American investors.

Another area of concern in the country as elsewhere is the lack of independent auditors. In the present times, it is imperative to have independent auditors who are reputed and above board. Due to the distrust in Indian auditors, most of the multinational companies have insisted that the parent company's auditor should also audit the subsidiary companies in India, often at much higher costs. One of the problems with corporate governance is the fact that different regions have different economic philosophies. "In the US, the only concern is increasing the shareholders' value, in Continental Europe it is creating employment, while in Japan, the companies worked in tandem with the government as per the national strategy. Thus, it is very difficult to have a universal governance code, but there are minimum standards that all companies worldwide can and must adopt."[4]

CONCLUSION

Global business opportunies have grown tremendously in recent times, thanks to the opening up of hitherto fettered markets of socialist and developing countries and the active role played by international organisations such as GATT, WTO, IMF and the World Bank. Stupendous growth in transport and communications and cutting edge technologies in IT and IT-enabled services have added their own dimensions to this growth process.

But if this process of global trade in goods and services is to continue and sustain itself, the important players in this game, namely, corporations, have to play their parts fairly and ethically. Corporations that are involved in the production and distribution of goods and services for a worldwide market should not only live by and exhibit ethical principles and good corporate governance practices, but also should be seen to be practising them. This alone will provide them a foothold in advanced as well as emerging markets. No corporation that is found to be unethical and wanting in terms of corporate governance will have a future. If transparency, honesty, fairness, integrity and ethical behaviour along with protection of the all stakeholders' interests are commendable virtues within a country, they are far more preferred outside. The wide popularity of CRT Principles of Business bears ample testimony to the fact that the world likes and prefers to deal with a good and reliable corporate than to do it otherwise. The growth or otherwise of corporations in a global society is very much dependent on how good they are and perceived to be so by all their stakeholders.

KEYWORDS

- Business issues
- Caux round table
- Diverse world
- Economic clout
- Economic environment
- Employment dilemma
- Facilitating globalisation
- Global corporations
- Multinational corporations
- Partnership for action
- Physical environment
- Political environment
- Prerequisite for globalisation
- Public awareness
- Scrutiny
- Social environment
- Sustainable practices
- Technological challenges

DISCUSSION QUESTIONS

1. What are the factors responsible for the emergence of global corporations?
2. What are the challenges and opportunities in doing business in a diverse world?
3. What role does multinational corporations play in the economies of low income countries?
4. Discuss briefly the emergence of the Caux Round Table and the CRT Principles for Business.
5. Justify the need for dialogue on the role of the corporation as a growing global society.
6. Discuss briefly the key global business issues and the means to address them effectively.

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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 under-takings 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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