LOVELY PROFESSIONAL UNIVERSITY

CORPORATE GOVERNANCE AND ETHICS

Edited By

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for
Lovely Professional University
Phagwara

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SYLLABUS

Corporate Governance and Ethics

Objectives: The course provides an insight into the corporate governance practices & codes to be followed by the company. Internal & external corporate governance practices & problem s faced by the stakeholders & company will be analysed.

S. No.	Description
1	Understanding corporate governance: Corporate governance – an overview, History of corporate governance
2	Concepts of corporate governance – Theory & practices of corporate governance, corporate governance mechanism and overview – land marks in emergence of corporate governance
3	Stakeholders: Rights and privileges; problems and protection, Corporate Governance and Other stakeholders
4	Board of Directors: A Powerful Instrument in Governance; Role and responsibilities of auditors
5	Development of codes and guidelines and summary of codes of best conduct, Banks and corporate governance; Ganguly committee's Recommendation
6	Business Ethics and Corporate Governance; Corporate Social Responsibility: Justification, Scope and Indian Corporations
7	Environmental Concerns and Corporations; Indian Environmental Policy, The Role of Media in Ensuring Corporate Governance; Ethics in Advertising
8	Monopoly, Competition and Corporate Governance; MRTP Act and Competition Act, The Role of Public Policies in Governing Business
9	The Indian Capital Market Regulator: SEBI, The Role Of Government in Developing and Transition Economics
10	Corporate Governance in Developing and Transition economies, Corporate governance: Indian scenario, The Corporation in a Global Society,

Unit 1: Understanding Corporate Governance

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Objectives

After studying this unit, you will be able to:

- Define corporate governance
- State the needa and importance of corporate governance
- Discuss the issues and benefits of corporate governance
- Know the history of corporate governance

Introduction

Corporate governance is a central and dynamic aspect of business. The term 'governance' is derived from the Latin word *gubernare*, meaning 'to steer', usually applying to the steering of a ship, which implies that corporate governance involves the function of direction rather than control. In fact, the significance of corporate governance for corporate success as well as for social welfare cannot be overstated. Recent examples of massive corporate collapse resulting from weak systems of corporate governance have highlighted the need to improve and reform corporate governance at international level. In the wake of Enron and other similar cases, countries around the world have reacted quickly by pre-empting similar events dramatically.

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"Capitalism with integrity outside the government is the only way forward to create jobs and solve the problem of poverty. We, the business leaders are the evangelists of capitalism with integrity. If the masses have to accept this we have to become credible and trustworthy. Thus we have to embrace the finest principles of corporate governance and walk and the talk." (Narayan Murthy)

Corporate governance has in recent years succeeded in attracting a good deal of public interest because of its apparent importance for the economic health of corporations and society in general. However, the concept of corporate governance is poorly defined because it potentially covers a large number of distinct economic phenomena. As a result, different individuals have come up with different definitions that basically reflect their special interest in the field. It is hard to see that this 'disorder' will be any different in the future so the best way to define the concept is perhaps to list a few of the different definitions.

1.1 Corporate Governance: An Overview

1.1.1 Definition of Corporate Governance

Corporate governance comprehends the framework of rules, relationships, systems and processes within and by which fiduciary authority is exercised and controlled in corporations. Relevant rules include applicable laws of the land as well as internal rules of a corporation. Relationships include those between all related parties, the most important of which are the owners, managers, directors of the board (when such entity exists), regulatory authorities and to a lesser extent, employees and the community at large. Systems and processes deal with matters such as delegation of authority, performance measures, assurance mechanisms, reporting requirements and accountabilities.

Standard and Poors defined corporate governance as "the way in which a company organizes and manages itself to ensure that all financial stakeholders receive their fair share of a company's earnings and assets" is increasingly a major factor in the investment decision-making process. Poor corporate governance is often cited as one of the main reasons why investors are reluctant, or unwilling, to invest in companies in certain markets.

Corporate Governance concerns with the exercise of power in corporate entities. The OECD provides a functional definition of corporate governance as:

"Corporate Governance is the system by which business corporations are directed and controlled. 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. 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."

The report of SEBI Committee on Corporate Governance gives the following definition of corporate governance.

"Corporate governance is the acceptance by management, of the inalienable rights of shareholders as the true owners of the corporation and of their own role as trustees on behalf of the shareholders. It is about commitment to values, about ethical business conduct and about making a distinction between personal and corporate funds in the management of a company".

The simplest definitions, is given by a Cadbury Report (UK). 'Corporate Governance is the system by which businesses are directed and controlled'.

The Cadbury Committee said, "The primary level is the company's responsibility to meet its material obligations to shareholders, employees, customer, suppliers, creditors, to pay its taxes and to meet its statutory duties. The next level of responsibility is the direct result of actions of companies in carrying out their primary task including making the most of the community's human resources and avoiding damage to the environment. Beyond these two levels, there is a much less well-defined area of responsibility, which involves in the interaction between business and society in a wider sense."

The ongoing nature of corporate governance indicates by the definition of the Commission on Global Governance (1995), 'A continuing process through which conflicting or diverse interests may be accommodated and co-operative action may be taken'.

1.1.2 Need of Corporate Governance

A corporation is a congregation of various stakeholders, namely customers, employees, investors, vendor partners, government and society. A corporation should be fair and transparent to its stakeholders in all its transactions. This has become imperative in today's globalized business world where corporations need to access global pools of capital, need to attract and retain the best human capital from various parts of the world, need to partner with vendors on mega collaborations and need to live in harmony with the community. Unless a corporation embraces and demonstrates ethical conduct, it will not be able to succeed. Corporate governance is about ethical conduct in business. Ethics is concerned with the code of values and principles that enable a person to choose between right and wrong and, therefore, select from alternative courses of action. Further, ethical dilemmas arise from conflicting interests of the parties involved. In this regard, managers make decisions based on a set of principles influenced by the values, context and culture of the organization. Ethical leadership is good for business as the organization is seen to conduct its business in line with the expectations of all stakeholders.

Corporate governance is beyond the realm of law. It stems from the culture and mindset of management and cannot be regulated by legislation alone. Corporate governance deals with conducting the affairs of a company such that there is fairness to all stakeholders and that its actions benefit the greatest number of stakeholders. It is about openness, integrity and accountability. What legislation can and should do is to lay down a common framework – the "form" to ensure standards. The "substance" will ultimately determine the credibility and integrity of the process. Substance is inexorably linked to the mindset and ethical standards of management. Corporations need to recognize that their growth requires the cooperation of all the stakeholders; and such cooperation is enhanced by the corporation adhering to the best corporate governance practices. In this regard, the management needs to act as trustees of the shareholders at large and prevent asymmetry of benefits between various sections of shareholders, especially between the owner-managers and the rest of the shareholders.

Notes Corporate governance is a key element in improving the economic efficiency of a firm. Good corporate governance also helps ensure that corporations take into account the interests of a wide range of constituencies, as well as of the communities within which they operate. Further, it ensures that their boards are accountable to the shareholders. This, in turn, helps assure that corporations operate for the benefit of society as a whole. While large profits can be made taking advantage of the asymmetry between stakeholders in the short-run, balancing the interests of all stakeholders alone will ensure survival and growth in the long-run. This includes, for instance, taking into account societal concerns about labor and the environment.

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1.1.3 Scope of Corporate Governance

Corporate governance covers the following functional areas of governance:

1. ***Preparation of company's financial statements:*** Financial disclosure is a very important and critical component of corporate governance. The company should implement procedures to independently verify and safeguard the integrity of the company's financial reporting. Disclosure of material matters concerning the organization should be timely and balanced to ensure that all investors have access to clear, factual information.

2. ***Internal controls and the independence of entity's auditors:*** Internal control is implemented by the board of directors, audit committee, management, and other personnel to provide assurance of the company achieving its objectives related to reliable financial reporting, operating efficiency, and compliance with laws and regulations. Internal auditors, who are given responsibility of testing the design and implementing the internal control procedures and the reliability of its financial reporting, should be allowed to work in an independent environment.

3. ***Review of compensation arrangements for chief executive officer and other senior executives:*** Performance-based remuneration is designed to relate some proportion of salary to individual performance. It may be in the form of cash or non-cash payments such as shares and share options, superannuation or other benefits. Such incentive schemes, however, are reactive in the sense that they provide no mechanism for preventing mistakes or opportunistic behaviour, and can elicit myopic behaviour.

4. ***The way in which individuals are nominated for the positions on the board:*** The Board of Directors have the power to hire, fire and compensate the top management. The owners of a business who have decision-making authority, voting authority, and specific responsibilities, which in each case is separate and distinct from the authority, and responsibilities of owners and managers of the business entity.

5. ***The resources made available to directors in carrying out their duties:*** The duties of the directors are the fiduciary duties similar to those of an agent or trustee. They are entrusted with adequate power to control the activities of the company.

6. ***Oversight and management of risk:*** It is important for the company to be fully aware of the risks facing the business and the shareholders should know that how the company is going to tackle the risks. Similarly the company should also be aware about the opportunities lying ahead.

Caselet

Should Corporate Governance be Voluntary or Mandatory

Today no one argues against the need for a system of good corporate governance to attract capital to the corporate sector. Regulators, which have the responsibility to protect the interest of shareholders, continuously endeavour to improve the standard of corporate governance. There is a trend towards the convergence of the Anglo-Saxon corporate governance model. The corporate governance structure, which requires a balanced board of directors with adequate number of independent directors, is widely accepted. It is also widely accepted that the role of the board of directors is to protect the

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interest of non-controlling shareholders through effective monitoring. But, in practice, companies do not prefer a monitoring board of directors.

They see value in having an advisory board of directors. This is so because companies do not see a business case for a board of directors, which effectively monitors the executive management. Although researchers argue that good and effective corporate governance system in a company reduces the cost of capital, their research findings do not provide conclusive evidence of reduced cost of capital. The argument is based on the principle that higher the risk, higher is the expected return. Therefore, if corporate governance reduces the total risk by reducing the risk of expropriation of shareholders' wealth by the executive management, the return expected by shareholders, which measures the cost of capital, should also reduce.

The logic is simple. But that may not work in practice. If corporate governance results in too much and too many controls, it kills the managerial entrepreneurship and innovation resulting in less than the optimal performance. Shareholders are not benefitted as both the expected return and actual return on investment are reduced. This is likely to happen if independent directors exercise too much control over the executive management. Performance of companies improve if, independent directors restrain themselves from imposing controls on the management and intervene when there are signs of mismanagement. Therefore, companies prefer advisory board of directors and shareholders do not resent to the same.

Shareholders are not too much bothered about the quality of corporate governance in a company because the quality of corporate governance is not observable. What is observable is the composition of board, qualifications of board of directors, number of meetings held, number of meetings attended by each board member, constitution of various board committees and number of meetings held by them and attendance members in those meetings. The board process is not observable to those who are not privy to board proceedings. Therefore, the adequacy of the corporate governance system can be observed but its effectiveness cannot be observed.

On the other hand, performance of the company is observable. Often, enterprise performance is used as a measure of the effectiveness of the corporate governance system. Capital flows to companies, have good track record of economic performance in terms of creating shareholders' wealth. In fact, shareholders have little to choose between companies in terms of the corporate governance system because the corporate governance system is uniform for all the companies.

The government has interest in reducing the cost of capital for companies. If the cost of capital can be reduced, some projects that are unviable will become viable with reduced cost of capital. Companies prefer to use effective supervisory board to improve performance rather than establishing an effective monitoring board. The alternative way of reducing the cost of capital is to reduce the information asymmetry between the executive management and the capital market and to reduce the chances of earnings management. These also strengthen the passive monitoring by capital mar-ket participants and others and enhance activities in the corporate control market. Quality of Accounting practices, disclosures in annual reports and in financial statements, disclosures to investors through stock exchanges and audit effectiveness reduces information asymmetry and chances of earnings management. Therefore, the government should focus on all those aspects.

Source: http://www.business-standard.com/india/news/should-corporate-governance-be-voluntary-or-mandatory/427488/

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1.1.4 Participants to Corporate Governance

Corporate governance is concerned with the governing or regulatory body (e.g. the SEBI), the CEO, the board of directors and management. Other stakeholders who take part include suppliers, employees, creditors, customers, and the community at large.

Shareholders delegate decision rights to the managers. Managers are expected to act in the interest of shareholders. This results in the loss of effective control by shareholders over managerial decisions. Thus, a system of corporate governance controls is implemented to assist in aligning the incentives of the managers with those of the shareholders in order to limit self-satisfying opportunities for managers.

The board of directors plays a key role in corporate governance. It is their responsibility to endorse the organisation's strategy, develop directional policy, appoint, supervise and remunerate senior executives and to ensure accountability of the organisation to its owners and authorities.

A key factor in an individual's decision to participate in an organisation (e.g. through providing financial capital or expertise or labour) is trust that they will receive a fair share of the organisational returns. If somebody receives more than their fair return (e.g. exorbitant executive remuneration), then the participants may choose not to continue participating, potentially leading to an organisational collapse (e.g. shareholders withdrawing their capital). Corporate governance is the key mechanism through which this trust is maintained across all stakeholders.

Task

Pick a few companies and find out the relationship between profit and corporate governance.

1.1.5 Importance and Benefits of Corporate Governance

Policy makers, practitioners and theorists have adopted the general stance that corporate governance reform is worth pursuing, supporting such initiatives as splitting the role of chairman/ chief executive, introducing non-executive directors to boards, curbing excessive executive performance-related remuneration, improving institutional investor relations, increasing the quality and quantity of corporate disclosure, inter alia. However, is there really evidence to support these initiatives? Do they really improve the effectiveness of corporations and their accountability? There are certainly those who are opposed to the ongoing process of corporate governance reform. Many company directors oppose the loss of individual decision-making power, which comes from the presence of non-executive directors and independent directors on their boards. They refute the growing pressure to communicate their strategies and policies to their primary institutional investors. They consider that the many initiatives aimed at 'improving' corporate governance in UK have simply slowed down decision-making and added an unnecessary level of the bureaucracy and red tape The Cadbury Report emphasized the importance of avoiding excessive control and recognized that no system of control can completely eliminate the risk of fraud (as in the case of Maxwell) without hindering companies' ability to compete in a free market. This is an important point, because human nature cannot be altered through regulation, checks and balances. Nevertheless, there is growing perception in the financial markets that good corporate governance is associated with prosperous companies. Institutional investment community considered both company directors and institutional investors welcomed corporate governance reform, viewing the reform process as a 'help rather than a hindrance'. Specifically, towards corporate governance reform.

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The findings of (Solomon J. and Solomon A., 1999) endorsed many of the issues relating to the agenda for corporate governance reform in UK. For example, they show, that institutional investors agreed strongly with the Hampel view that corporate governance is as important for small companies as for larger ones. The results also indicated significant support from the institutional investment community for the continuance of a voluntary environment for corporate governance. The respondents' agreement that there should be further reform in their investee companies also added support to the ongoing reform process. Lastly, the institutional investors perceived a role for themselves in corporate governance reform, as they agreed that the institutional investment community should adopt a more activist stance.

Benefits of Corporate Governance

The initiation of the process of corporate governance in PEs is likely to result into a series of important benefits. Firstly, the flip-flop about owning of the responsibility for low performance would perhaps come to an end. The owners will be on enterprise board. Secondly, goal and role clarity would improve. Enterprise would be mission – vision driven. Thirdly, opportunity for top management to create a cultural transformation from government entities to corporate entities, and from state-financed to self-sustaining ones.

1.1.6 Role of Corporate Governance

The role of effective corporate governance is of immense significance to the society as a whole. It can be summarised as follows:

1. Corporate governance ensures the efficient use of resources.
2. It makes the resources flow to those sectors or entities where there is efficient production of goods and services and the return is adequate enough to satisfy the demands of stakeholders.
3. It provides for choosing the best managers to administer scarce resources.
4. It helps managers remain focused on improving performance and making sure that they are replaced when they fail to do so.
5. It pressurises the organization to comply with the laws, regulations and expectations of society.
6. It assists the supervisor in regulating the entire economic sector without partiality and nepotism.
7. It increases the shareholders' value, which attracts more investors. Thus, corporate governance ensures easy access to capital.
8. As corporate governance leads to higher consumer satisfaction, it helps in increasing market share and sales. It also reduces advertising and promotion costs.
9. Employees are more satisfied in organizations that follow corporate governance policies. This reduces the employee turnover, which results in the reduction in the cost of human resource management. Only a satisfied employee can create a satisfied customer.
10. Corporate governance reduces the procurement and inventory cost. It helps in maintaining a good rapport with suppliers, which results in better and more economical inventory management system.
11. Corporate governance helps in establishi7ng good rapport with distributors providing not only better access to the market, but also reducing the cost of production.

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1.1.7 OECD Parameters and Principles

The Organisation for Economic Cooperation and Development (OECD) laid down some principles of corporate governance. Principles are intended to assist OECD and non-OECD 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.

Corporate governance is only part of the larger economic context in which firms operate that includes, for example, macroeconomic policies and the degree of competition in product and factor markets. The corporate governance framework also depends on the legal, regulatory, and institutional environment. In addition, factors such as business ethics and corporate awareness of the environmental and societal interests of the communities in which a company operates can also have an impact on its reputation and its long-term success. While a multiplicity of factors affect the governance and decision-making processes of firms, and are important to their long-term success, the Principles focus on governance problems that result from the separation of ownership and control. However, this is not simply an issue of the relationship between shareholders and management, although that is indeed the central element. In some jurisdictions, governance issues also arise from the power of certain controlling shareholders over minority shareholders. In other countries, employees have important legal rights irrespective of their ownership rights. The Principles therefore have to be complementary to a broader approach to the operation of checks and balances.

1.1.8 Issues involved in Corporate Governance

Corporate governance involves the following issues:

Internal Control

The Board of Directors should maintain a sound system of internal control to safeguard the investment of shareholders and the assets of the company, the board should conduct a review of the effectiveness of internal controls.

Correct Preparation of Financial Statements

The Board of Directors should present a balanced and understandable assessment of the company's position and future prospects. There should be a statement by the auditors about their reporting responsibilities.

Compensation of CEO and other Directors

There should be a formal and transparent procedure for developing policy on executive remuneration for CEO and other directors. No director should be in a position of deciding his or her own remuneration. The Board of Directors should establish a remuneration committee of at least three. This committee should have delegated responsibility for setting remuneration for all executive directors and the chairman, including pension rights and any other compensation.

Nomination of Members of the Board of Directors

Appointments to the Board of Directors should be made on merit. Adequate care should be taken to ensure that all the directors have enough time available to devote to the job. This criterion is more important in the case of chairman. The appointments to the board should be made in such a way so as to maintain an appropriate balance of skills and experience. There should be a nomination committee, which should process the appointments for the board and make recommendations. A majority of members of this nomination committee should be

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independent, non-executive directors so as to evaluate the balance of skills, knowledge and experience. For the purpose of the appointment of chairman, the nomination committee should prepare a job specification, time commitment expectation and crisis management abilities.

Disclosure Norms

The annual report should record:

1. How decisions are taken by the board;
2. The names of chairman, CEO and other directors;
3. The number of meetings and the individual attendance by directors;
4. How performance evaluation of the board has been made; and
5. The steps taken by the board to develop an understanding of the views of major shareholders about their company.

The annual report should also include the work of the nomination committee and the remuneration committee.

Rights of Corporation

A corporation is a legal entity with the following rights:

1. The ability to sue and be sued.
2. The ability to hold assets in its own name.
3. The ability to hire agents.
4. The ability to sign contracts.
5. The ability to make by-laws to govern its internal affairs.

1.2 Historical Perspective of Corporate Governance

Corporate ownership structure has been considered as having a strongest influence on systems of corporate governance, although many other factors affect corporate governance, including legal systems, cultural and religious traditions, political environments and economic events. All business enterprises need funding in order to grow, and it is the ways in which companies are financed which determines their ownership structures. It became clear centuries ago that individual entrepreneurs and their families could not provide the finance necessary to undertake developments required to fuel economic and industrial growth. The sale of company shares in order to raise the necessary capital was an innovation that has proved a cornerstone in the development of economists worldwide. However, the road towards the type of stock market seen in the UK and US today has been long and complicated. Listed companies in their present form originate from the earliest form of corporate entity, namely the sole trader. From the middle ages, such traders were regulated by merchant guilds, which over saw a diversity of trades. The internationalization of trade, with traders venturing overseas, led gradually to regulated companies arising from the medieval guild system. Members of these early companies could trade their own shares in the company, which lead ultimately to the formation of the joint stock companies.

The first company to combine incorporation, overseas trade and joint stock was the East India Company, which was granted a royal charter in 1600, for merchants of London trading into the East Indies. The early governance structures of this company were reminiscent of CG structures and mechanisms in today's companies (Farrar and Hannigan, 1998; Cadbury, 2002). International trade and interest in investment overseas led to the infamous South Sea Bubble of the 1720,

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where the general public in Britain, who had invested in "shares" in the company of merchants of Great Britain trading to the South Seas, realized they had lost their hard-earned money in the first stock market overvaluation and subsequent collapse. At one point during the bubble's growth the amount invested in companies involved in the South Seas reached £500 millions, double the value of all the land in England at the time. Investors did not realize the lack of solid foundation underlying their investment. The bubble in UK information technology stocks in the late 1990s was another example of investor irrationality and the ways in which the markets could be fooled. The Bubble Act, which followed the bursting of the South Sea Bubble, prevented companies from acting as a corporate body and from raising money by selling shares, without the legal authority of an act of parliament or royal charter. Inevitably, this halted the development of the Joint Stock Companies. It was the development of the railway network in Britain in the 1800s that again instigated at the development of the companies as we know them today, as they needed to attract funds to feed their growth.

A total of 910 companies were registered from the introduction of the first modern Joint Stock Company's Act in 1844 (Farrar and Hannigan, 1998). However, these companies were unlimited. This implied that their shareholders bore unlimited liability for their investee company's debts, and this was not an effective means of encouraging people to place their monies into the hands of Company Management. Greater enticement was required. This came with the Limited Liability Act of 1855. Limited liability implied that shareholders could only lose the amount they had invested in the company, rather than be liable for their entire wealth, as had been the case with the unlimited companies. These events represented a major breakthrough for the growth of capitalism. This was introduced as a progressive reform measure aimed at revitalizing British business, as at that time companies were seeking incorporation in the USA and France in preference to the UK, in order to obtain limited liability for their shareholders. The number of incorporations rose dramatically following these changes.

In the USA, the managerially controlled corporation evolved at a similar time, following the Civil War in the second half of the 19th century. It was from this time that the notorious 'divorce' of ownership and control began to emerge. This corporate malaise was first outlined in Berle and Means (1932) seminal work. The modern corporation and private property, which showed that the separation of ownership from control had engendered a situation where the true owners of companies, the shareholders, had little influence over company management and were rendered impotent by the wide dispersion of ownership and by a general apathy among shareholders towards the activities of investee company management. It was the dispersion of ownership that created the root of the problem rather than the separation per se. The influence of companies was growing at the time of Berle and Means' work and many feared the potential impact of their influence on society, unless their power was checked by their owners, the shareholders. They considered that companies were growing to such an extent that they were almost becoming 'social institutions'. Yet there was little incentive for shareholders to involve themselves in their investee companies. If they were dissatisfied with the companies' behaviour they could sell their shares. This approach to share ownership has been termed 'exit' as opposed to a more proactive approach of using their 'voice'. The 'problem' revealed in Berle and Means formed the basis of the 'agency problem', where shareholders (the principals) struggle to control and monitor the activities of managers (the agents) in order to align managerial interests and objectives with their own. An important implication of these observations was to focus increasing attention on the role of companies' boards of directors, as a mechanism for ensuring effective corporate governance.

Although the ownership structure underlying the traditional agency problem was prevalent in the USA, the situation was extremely similar in the UK, where share ownership flourished following the introduction of the Joint Stock Companies Act of 1844 and the Limited Liability

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Act of 1855. Problems arising from separation of ownership and control were recognized in Adam Smith's "The Wealth of Nations" (1838). In his discussion of joint stock companies, he explained that company directors were the managers of their shareholders' money, and not of their own. He considered it likely that these directors would be less concerned about someone else's investment than they would be about their own and that this situation could easily result in 'negligence and profusion' in the management of company affairs. Further, in his personal exposition of corporate governance, Sir Adrian Cadbury (2002) pointed out that there were allusions to the 'agency problem' in the UK that predated Berle and Means' writing. Indeed, Cadbury explained that in the Liberal Industrial Inquiry of 1926-1928 in the UK, a significant problem was detected because management and responsibility were in different hands from the provision of funds, the risk taking and the financial rewards. A study by Florence (1961), also suggested similarity between the UK system of corporate governance and that of the USA, as he showed that two-thirds of large companies were not controlled by their owners.

When companies within the capitalist system of the UK and the USA demonstrate effective systems of corporate governance, they can be productive and efficient, and can have a positive impact on society as a whole. Efficiently functioning capital markets can, theoretically at least, lead to efficient allocation of resources and a situation of optimal social welfare. However, ineffective, weak corporate governance can have the opposite result.

Did u know? The 'yin and yang' of the capitalist system are widely known. On the positive side, capitalism is associated with wealth production, economic prosperity and corporate success. On the negative side, capitalism is associated with greed, despotism, abuse of power, opaqueness, social inequality and unfair distribution of wealth.

It is the functioning of internal and external corporate governance that determines whether a company, or even a country, displays more of the negative or the positive aspects of the capitalist system. The level of inherent trust within the business sector and within society as a whole has been questioned in recent times, with a general acknowledgement by sociologists of a decline in social cohesion and community. Specifically, there has been a decline in society's confidence in institutions, such as corporations and institutional investment organizations.

The traditional Anglo-American system of corporate governance described above has not remained stable and has undergone dramatic changes in recent years. The main aspect of change has involved transformation of ownership structure in the UK and the USA. The rise of the global institutional investor as a powerful and dominant force in corporate governance has transformed the relationship between companies and their shareholders and has created a completely different system of corporate governance from that described above. Ownership structure is no longer widely dispersed, as in the model presented by Berle and Means, but is now concentrated in the hands of a few major institutional investors.

Task Find out the history of corporate governance in India.

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Case Study

"Big Bull" Harshad Mehta Scandal

Harshad Mehta was an Indian stock broker caught in a scandal beginning in 1992. He died of a massive heart attack in 2001, while the legal issues were still being litigated. Early life Harshad Shantilal Mehta was born in a Gujarati jain family of modest means. His father was a small businessman. His mother's name was Rasilaben Mehta. His early childhood was spent in the industrial city of Bombay. Due to indifferent health of Harshad's father in the humid environs of Bombay, the family shifted their residence in the mid1960s to Raipur, then in Madhya Pradesh and currently the capital of Chattisgarh state. An Amul advertisement of 1999 during the conterversy over MUL saying it as "The Big Bhool" (Bhool in Hindi means Blunder) He studied at the Holy Cross High School, located at Byron Bazaar. After completing his secondary education Harshad left for Bombay. While doing odd jobs he joined Lala Lajpat Rai College for a Bachelor's degree in Commerce.

After completing his graduation, Harshad Mehta started his working life as an employee of the New India Assurance Company. During this period his family relocated to Bombay and his brother Ashwin Mehta started to pursue graduation course in law at Lala Lajpat Rai College. His youngest brother Hitesh is a practising surgeon at the B.Y.L.Nair Hospital in Bombay. After his graduation Ashwin joined (ICICI) Industrial Credit and Investment Corporation of India. They had rented a small flat in Ghatkopar for living. In the late seventies every evening Harshad and Ashwin started to analyze tips generated from respective offices and from cyclostyled investment letters, which had made their appearance during that time. In the early eighties he quit his job and sought a job with stock broker P. Ambalal affiliated to Bombay Stock Exchange (BSE) before becoming a jobber on BSE for stock broker P.D. Shukla. In 1981 he became a subbroker for stock brokers J.L. Shah and Nandalal Sheth. After a while he was unable to sustain his overbought positions and decided to pay his dues by selling his house with consent of his mother Rasilaben and brother Ashwin. The next day Harshad went to his brokers and offered the papers of the house as guarantee. The brokers Shah and Sheth were moved by his gesture and gave him sufficient time to overcome his position. After he came out of this big struggle for survival he became stronger and his brother quit his job to team with Harshad to start their venture GrowMore Research and Asset Management Company Limited. While a brokers card at BSE was being auctioned, the company made a bid for the same with financial assistance from Shah and Sheth, who were Harshad's previous broker mentors. He rose and survived the bear runs, this earned him the nickname of the Big Bull of the trading floor, and his actions, actual or perceived, decided the course of the movement of the Sensex as well as scripspecific activities. By the end of eighties the media started projecting him as "Stock Market Success", "Story of Rags to Riches" and he too started to fuel his own publicity. He felt proud of this accomplishments and showed off his success to journalists through his mansion "Madhuli", which included a billiards room, mini theatre and nine hole golf course. His brand new Toyota Lexus and a fleet of cars gave credibility to his show off. This in no time made him the nondescript broker to super star of financial world. During his heyday, in the early 1990s, Harshad Mehta commanded a large resource of funds and finances as well as personal wealth.

The fall In April 1992, the Indian stock market crashed, and Harshad Mehta, the person who was all along considered as the architect of the bull run was blamed for the crash.

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It transpired that he had manipulated the Indian banking systems to siphon off the funds from the banking system, and used the liquidity to build large positions in a select group of stocks. When the scam broke out, he was called upon by the banks and the financial institutions to return the funds, which in turn set into motion a chain reaction, necessitating liquidating and exiting from the positions which he had built in various stocks. The panic reaction ensued, and the stock market reacted and crashed within days.He was arrested on June 5, 1992 for his role in the scam.

His favorite stocks included

1. ACC
2. Apollo Tyres
3. Reliance
4. Tata Iron and Steel Co. (TISCO)
5. BPL
6. Sterlite
7. Videocon.

The extent The Harshad Mehta induced security scam, as the media sometimes termed it, adversely affected at least 10 major commercial banks of India, a number of foreign banks operating in India, and the National Housing Bank, a subsidiary of the Reserve Bank of India, which is the central bank of India. As an aftermath of the shockwaves which engulfed the Indian financial sector, a number of people holding key positions in the India's financial sector were adversely affected, which included arrest and sacking of K.

M. Margabandhu, then CMD of the UCO Bank; removal from office of V. Mahadevan, one of the Managing Directors of India's largest bank, the State Bank of India. The end The Central Bureau of Investigation which is India's premier investigative agency, was entrusted with the task of deciphering the modus operandi and the ramifications of the scam. Harshad Mehta was arrested and investigations continued for a decade. During his judicial custody, while he was in Thane Prison, Mumbai, he complained of chest pain, and was moved to a hospital, where he died on 31st December 2001. His death remains a mystery. Some believe that he was murdered ruthlessly by an underworld nexus (spanning several South Asian countries including Pakistan). Rumour has it that they suspected that part of the huge wealth that Harshad Mehta commanded at the height of the 1992 scam was still in safe hiding and thought that the only way to extract their share of the 'loot' was to pressurise Harshad's family by threatening his very existence. In this context, it might be noteworthy that a certain criminal allegedly connected with this nexus had inexplicably surrendered just days after Harshad was moved to Thane Jail and landed up in imprisonment in the same jail, in the cell next to Harshad Mehta's.

Mumbai: Just as the year 2001 was coming to an end, Harshad Shantilal Mehta, boss of Growmore Research and Asset Management, died of a massive heart attack in a jail in Thane. And thus came to an end the life of a man who is probably the most famous character ever to have emerged from the Indian stock market. In the book, The Great Indian Scam: Story of the missing ₹ 4,000 crore, Samir K Barua and Jayanth R Varma explain how Harshad Mehta pulled off one of the most audacious scams in the history of the Indian stock market.

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Harshad Shantilal Mehta was born in a Gujarati Jain family of modest means. His early childhood was spent in Mumbai where his father was a smalltime businessman. Later, the family moved to Raipur in Madhya Pradesh after doctors advised his father to move to a drier place on account of his indifferent health. But Raipur could not hold back Mehta for long and he was back in the city after completing his schooling, much against his father's wishes. Mehta first started working as a dispatch clerk in the New India Assurance Company. Over the years, he got interested in the stock markets and along with brother Ashwin, who by then had left his job with the Industrial Credit and Investment Corporation of India, started investing heavily in the stock market. As they learnt the ropes of the trade, they went from boom to bust a couple of times and survived. Mehta gradually rose to become a stock broker on the Bombay Stock Exchange, who did very well for himself. At his peak, he lived almost like a movie star in a 15,000 square feet house, which had a swimming pool as well as a golf patch. He also had a taste for flashy cars, which ultimately led to his downfall.

Newsmakers of the week: View Slideshow "The year was 1990. Years had gone by and the driving ambitions of a young man in the faceless crowd had been realised. Harshad Mehta was making waves in the stock market. He had been buying shares heavily since the beginning of 1990. The shares which attracted attention were those of Associated Cement Company (ACC)," write the authors. The price of ACC was bid up to ₹ 10,000. For those who asked, Mehta had the replacement cost theory as an explanation. The theory basically argues that old companies should be valued on the basis of the amount of money which would be required to create another such company. Through the second half of 1991, Mehta was the darling of the business media and earned the sobriquet of the 'Big Bull', who was said to have started the bull run. But, where was Mehta getting his endless supply of money from? Nobody had a clue. On April 23, 1992, journalist Sucheta Dalal in a column in The Times of India, exposed the dubious ways of Harshad Metha. The broker was dipping illegally into the banking system to finance his buying. "In 1992, when I broke the story about the ₹ 600 crore that he had swiped from the State Bank of India, it was his visits to the bank's headquarters in a flashy Toyota Lexus that was the tipoff. Those days, the Lexus had just been launched in the international market and importing it cost a neat package," Dalal wrote in one of her columns later. The authors explain: "The crucial mechanism through which the scam was effected was the ready forward (RF) deal. The RF is in essence a secured shortterm (typically 15day) loan from one bank to another. Crudely put, the bank lends against government securities just as a pawnbroker lends against jewellery….The borrowing bank actually sells the securities to the lending bank and buys them back at the end of the period of the loan, typically at a slightly higher price." It was this ready forward deal that Harshad Mehta and his cronies used with great success to channel money from the banking system. A typical ready forward deal involved two banks brought together by a broker in lieu of a commission. The broker handles neither the cash nor the securities, though that wasn't the case in the leadup to the scam. "In this settlement process, deliveries of securities and payments were made through the broker. That is, the seller handed over the securities to the broker, who passed them to the buyer, while the buyer gave the cheque to the broker, who then made the payment to the seller. In this settlement process, the buyer and the seller might not even know whom they had traded with, either being know only to the broker." This the brokers could manage primarily because by now they had become market makers and had started trading on their account. To keep up a semblance of legality, they pretended to be undertaking the transactions on behalf of a bank. Another instrument used in a big way was the bank receipt (BR). In a ready forward deal, securities were not moved back and forth in actuality. Instead, the borrower, i.e. the seller of securities, gave the buyer of the securities a BR. As the authors

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write, a BR "confirms the sale of securities. It acts as a receipt for the money received by the selling bank. Hence the name bank receipt. It promises to deliver the securities to the buyer. It also states that in the mean time, the seller holds the securities in trust of the buyer." Having figured this out, Metha needed banks, which could issue fake BRs, or BRs not backed by any government securities. "Two small and little known banks the Bank of Karad (BOK) and the Metorpolitan Cooperative Bank (MCB) came in handy for this purpose. These banks were willing to issue BRs as and when required, for a fee," the authors point out. Once these fake BRs were issued, they were passed on to other banks and the banks in turn gave money to Mehta, obviously assuming that they were lending against government securities when this was not really the case. This money was used to drive up the prices of stocks in the stock market. When time came to return the money, the shares were sold for a profit and the BR was retired. The money due to the bank was returned.

The game went on as long as the stock prices kept going up, and no one had a clue about Mehta's modus operandi. Once the scam was exposed, though, a lot of banks were left holding BRs which did not have any value the banking system had been swindled of a whopping ₹ 4,000 crore. Mehta made a brief comeback as a stock market guru, giving tips on his own website as well as a weekly newspaper column. This time around, he was in cahoots with owners of a few companies and recommended only those shares. This game, too, did not last long. Interestingly, however, by the time he died, Mehta had been convicted in only one of the many cases filed against him.

Question

Comment on the role of banks and investors in the scandal. Do you think, they could have averted the scam?

Source: www.casestudy.co.in

1.3 Summary

- Corporate governance comprehends the framework of rules, relationships, systems and processes within and by which fiduciary authority is exercised and controlled in corporations.
- Corporate governance deals with conducting the affairs of a company such that there is fairness to all stakeholders and that its actions benefit the greatest number of stakeholders.
- The initiation of the process of corporate governance in PEs is likely to result into a series of important benefits.
- Corporate ownership structure has been considered as having a strongest influence on systems of corporate governance, although many other factors affect corporate governance, including legal systems, cultural and religious traditions, political environments and economic events.

1.4 Keywords

Corporate governance: It is the system by which businesses are directed and controlled.

Clause 49: A clause introduced by SEBI for the implementation of corporate governance.

Ethical conduct: It refers to the behaviour on standards of right and wrong.

Shareholder's Wealth: It is equal to the market price of his holdings in shares.

Stakeholders: Who has direct or indirect concerns in the organisation.

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1.5 Self Assessment

State whether the following statements are true or false:

1. Corporate governance is about ethical conduct in business.
2. The board of directors does not play important role in corporate governance.
3. Corporate governance pressurizes the organisation to comply with the laws, regulations and expectations of society.
4. Preparation of the organisation's financial statement is not the functional area of governance.
5. Shareholders delegate decision rights to the managers.
6. Organisations should develop a code of conduct for their directors and executives that promotes ethical and responsible decision-making.
7. Corporate governance ensures easy access to capital.
8. Enterprise doesn't need any mission or vision.
9. The institutional investors have no role to play in corporate governance.
10. All the stakeholders participate in corporate governance.

1.6 Review Questions

1. Define corporate governance. What do you understand by the term governance?
2. "Corporate governance is a continuous process". Give your views.
3. In the light of the dynamic business environment, discuss the need of corporate governance.
4. What functional areas does corporate governance cover?
5. Discuss the role of various stakeholders in the corporate governance process.
6. Discuss the benefits and importance of corporate governance.
7. Explain the role of corporate governance in modern business.
8. Give a brief outline of the history of corporate governance.
9. Do you think corporate governance is necessary? Give your own viewpoints.
10. "Corporate governance is beyond the realm of law". Analyse the statement.

Answers: Self Assessment

1.	True	2.	False
3.	True	4.	False
5.	True	6.	True
7.	True	8.	False
9.	False	10.	True

1.7 Further Readings

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Books

C V Baxi, *Corporate Governance.*

Geeta Rani, R K Mishra, *Corporate Governance: Theory and Practice*, Excel Books.

Mallin, Christine A., *Corporate Governance*, Oxford University Press, 2004.

S Singh, *Corporate Governance.*

Online links

en.wikipedia.org/wiki/Corporate_governance

www.corpgov.net/

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Unit 2: Concepts of Corporate Governance

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Objectives

After studying this unit, you will be able to:

- State basic concepts of corporate governance
- Explain theory and practices of corporate governance
- Realise the corporate governance mechanism
- Discuss the landmarks in emergence of corporate governance

Introduction

The concept of governance defined in the 1999 OECD Principles of Corporate Governance as: 'the system by which business corporations are directed and controlled.' The 'holy trinity' of good corporate governance has long been seen as shareholder rights, transparency and board accountability. While corporate governance is overtly concerned with board structure, executive compensation and shareholder reporting, the underlying assumption is that it is the board that is responsible for managing and controlling the business.

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2.1 Basic Concept of Corporate Governance

Corporate governance has become important topic of discussion of all segments of the corporate world. The corporate Governance has assumed greater significance in the light of series of corporate failings, both in public and private sectors. Corporate governance has now been recognized as a medium to provide the structure through which the objectives of the company are set, deciding on the means of attaining those objectives and monitoring performance. Thus, corporate governance consists of a system of structuring, operating and controlling a company in order to achieve objectives like fulfilling the strategic goals of the owners, taking care of the interests of employees, maintaining sound relations with customers and suppliers, taking account of community and environmental needs and also maintaining proper compliance with all applicable legal and regulatory requirements.

Corporate governance and the enterprise culture have become important for the survival of companies and indeed of national economies in the increasingly global economy. Having a good corporate governance is a necessity for all countries, both developed countries with highly sophisticated stock exchanges, and the developing countries which are anxious to attract international portfolio investment. Corporate governance and the enterprise culture are closely linked because they both directly relate to the leadership of enterprises.

There are various definitions of corporate governance – the Cadbury Report defined it as "the system by which companies are directed and controlled"; Professor Colin Tricker (who originally coined the term corporate governance back in 1984) made the important distinction between management and direction, stating "if management is about running business, governance is about seeing that it is run properly", which is the old distinction between doing things right and doing the right thing.

In the publication of the Principles for Corporate Governance in the Commonwealth by the Commonwealth Association for Corporate Governance, we find the description that "corporate governance is essentially about leadership; for efficiency, for probity, with responsibility, and leadership which is transparent and accountable".

From the aforesaid publication the corporate governance can be summarized to cover three essential areas; conformance, performance and consensus.

1. The conformance of company managers to high standards of transparency, probity, accountability and responsibility;
2. The performance of board directors in providing the strategic leadership which will sustain their companies' competitiveness locally and in the global market; and
3. The consensus (for want of a better term) which maintains the harmonious and productive relationships between the company and its host society.

The principles, structure and systems of corporate governance should be applied in a wide range of organisations – not just publicly listed joint stock companies, but also throughout the banking sector, in state enterprises, in co-operatives, in the ever-growing and increasingly important NGO sector, and in public services such as health and education boards.

Did u know? Dr. Cesar Saldana analysed the concept of corporate governance especially in the commercial context and identified three alternative systems of corporate governance. These are (i) the Equity Management System (EMS), (ii) the Bank Lend System (BLS), and (iii) the Family Based System (FBS).

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Principles of Corporate Governance

The OECD Principles of Corporate Governance were published in 1999 (and substantially revised in 2004), but it wasn't until after the Enron and WorldCom debacles, and the US Sarbanes Oxley response in 2002, that most other OECD countries made a determined effort to adopt codes of corporate governance. With the exception of the US, individual OECD countries have all adopted corporate governance codes that work on the 'comply or explain' principle. The US Sarbanes Oxley act ('SOX') works on the basis of 'comply or be punished.' One of the impacts of SOX is that companies that are directly affected by it are requiring their partners and suppliers to certify conformance to SOX because that gives them greater certainty of ongoing compliance themselves.

The requirement for all organizations to adopt best corporate governance practices, irrespective of their nationality or location, is - in spite of the resistance of many executives in many jurisdictions - growing stronger. The 'entry price' for access to western capital markets is, increasingly, acceptance of western accounting and corporate governance norms.

Key elements of good corporate governance principles include honesty, trust and integrity, openness, performance orientation, responsibility and accountability, mutual respect, and commitment to the organization. In particular, senior executives have responsibility to conduct the business honestly and ethically, especially concerning actual or apparent conflicts of interest, and disclosure in financial reports.

Generally the following are the commonly accepted principle of corporate governance.

Protection of shareholders rights: It is done through the equitable treatment of the shareholders. Organizations should respect the rights of shareholders and help shareholders to exercise those rights. They can help shareholders exercise their rights by effectively communicating information that is understandable and accessible and encouraging shareholders to participate in general meetings.

Interests of other stakeholders: Organizations should recognize that they have legal and other obligations to all legitimate stakeholders.

Role and responsibilities of the board: The board needs a range of skills and understanding to be able to deal with various business issues and have the ability to review and challenge management performance. It needs to be of sufficient size and have an appropriate level of commitment to fulfill its responsibilities and duties. There are issues about the appropriate mix of executive and non-executive directors. The board of directors may discharge their duty through different board committees as per the need.

Responsible and ethical behaviour: Ethical and responsible decision making is not only important for public relations, but it is also a necessary element in risk management and avoiding lawsuits. Organizations should develop a code of conduct for their directors and executives that promotes ethical and responsible decision making. It is important to understand, though, that reliance by a company on the integrity and ethics of individuals is bound to eventual failure. Because of this, many organizations establish Compliance and Ethics Programs to minimize the risk that the firm steps outside of ethical and legal boundaries.

Notes There are five principles of ethical power for organisations.

1. ***Purpose:*** The mission of our organisation is communicated from the top. Our organisation is guided by the values, hopes and a vision that helps us to determine what is acceptable and unacceptable behaviour.

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2. ***Pride:*** We feel proud of ourselves and of our organisation. We know that when we feel this way, we can resist temptations to behave unethically.
3. ***Patience:*** We believe that holding to our ethical values will lead us to success in the long term. This involves maintaining a balance between obtaining results and caring how we achieve these results.
4. ***Persistence:*** We have commitment to live by ethical principles. We are committed to our commitment. We make sure our actions are consistent with our purpose.
5. ***Perspective:*** Our managers and employees take time to pause and reflect, take stock of where we are, evaluate where we are going and determine how we are going to get there.

Kenneth Blanchard and Norman Vincent Peale, "THE POWER OF ETHICAL MANAGEMENT"

Disclosure and transparency in reporting: Organizations should clarify and make publicly known the roles and responsibilities of board and management to provide shareholders with a level of accountability. They should also implement procedures to independently verify and safeguard the integrity of the company's financial reporting. Disclosure of material matters concerning the organization should be timely and balanced to ensure that all investors have access to clear, factual information.

2.2 Theory and Practices of Corporate Governance

In order to appreciate how theories have tried to make sense of corporate governance issues, reference has been made to four widely discussed theories which are commonly used to understand how corporations are governed and how the system of corporate governance can be improved. The development of corporate governance is bound intimately with the economic development of industrial capitalism: different governance structures evolved with different corporate forms designed to pursue new economic opportunities or resolve new economic problems.

2.2.1 Shareholders Theory vs. Stakeholders Theory

Shareholder theory or agency theory asserts that shareholders advance capital to a company's managers, who are supposed to spend corporate funds only in ways that have been authorized by the shareholders.

The agency problem was effectively identified by Adam Smith when he argued that company directors were not likely to be as careful with other people's money as with their own. Agency theory offers shareholders a pre-eminent position in the firm legitimized not by the idea that they are the firm's owners, but instead its residual risk takers.

The agency view suggests that shareholders are the 'principals' in whose interest the corporation should be run even though they rely on others for the actual running of the corporation. It is claimed that shareholders have the right to residual claims because they are the residual risk bearers. Since other stakeholders in the corporation will receive the returns for which they have contracted, the maximization of shareholder value results in superior economic performance, not only for the particular corporation, but for the economy as a whole, it is held.

Since, the basis of agency theory is the self-interested utility-maximizing motivation of individual actors, it is assumed that the relationship between shareholders (principals) and managers

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(agents) will be problematic. Internal and external governance mechanisms help to bring the interests of managers in line with those of shareholders, including:

1. An effectively structured board;
2. Compensation contracts that encourage a shareholder orientation;
3. Concentrated ownership holdings that lead to active monitoring of executives;
4. The market for corporate control that is an external mechanism activated when internal mechanisms for controlling managerial opportunism or failure have not worked.

On the other hand, stakeholder theory asserts that managers have a duty to both the corporation's shareholders and "individuals and constituencies that contribute, either voluntarily or involuntarily, to a company's wealth-creating capacity and activities, and who are therefore its potential beneficiaries and/or risk bearers."

The firm is a system of stakeholders operating within the larger system of the host society that provides the necessary legal and market infrastructure for the firm's activities. The purpose of the firm is to create wealth or value for its stakeholders by converting their stakes into goods and services.

Freeman and Reed (1990) define organizations as multilateral agreements between the enterprise and its stakeholders. The relationship between the company and its internal stakeholders (employees, managers, owners) is defined by formal and informal rules developed through the history of the relationship. This institutional setting constrains and creates the strategic possibilities for the company. While management may receive finance from shareholders, they depend on employees to fulfill strategic intentions. External stakeholders are equally important and relationships with customers, suppliers, competitors, and special interest group are also constrained by formal and informal rules. Finally governments and local communities set the legal and formal rules within which business must operate. The conception of the company is a set of relationships rather than a series of transactions, in which managers adopt an inclusive concern for all stakeholders.

2.2.2 Stewardship Theory

Steward is a person who manages other's property or financial affairs and is entrusted with the responsibility of proper utilization and development of organization's resources.

According to stewardship theory, the behaviour of the steward is collective, because the steward seeks to attain the objectives of the organization. Given the potential multiplicity of shareholders' objectives, a steward's behaviour can be considered organizationally centered. Stewards in loosely coupled, heterogeneous organizations with competing stakeholders and competing shareholders objectives are motivated to make decisions that they perceive are in the best interests of the group.

Therefore, a pro-organizational steward is motivated to maximize organizational performance, thereby satisfying the competing interests of shareholders. This does not imply that stewards do not have necessary "survival" needs. Clearly, the steward must have an income to survive. The difference between the agent and the principal is how these needs are met. The steward realizes the trade off between personal needs and organizational objectives and believes that by working towards organizational and collective ends, personal needs are met.

Stewardship theorists argue that the performance of a stewardship is affected by whether the structural situation in which he or she is located facilitates effective action. If the executive's motivations fit the model of man underlying stewardship theory, empowering governance

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structures and mechanisms are appropriate. Thus, a steward's autonomy should be deliberately extended to maximize the benefits of a steward, because he or she can be trusted.

Table 2.1: Comparison of Agency Theory and Stewardship Theory

S. No.	Criteria	Agency Theory	Stewardship Theory
1.	Model of Man	Economic Man	Self-Actualizing Man
2.	Behaviour	Self-Serving	Collective Serving
3.	Motivation	Lower order/economic needs (physiological, security, economic)	Higher order needs (growth achievement, self-actualization)
4.	Social Comparison	Other Managers	Principal
5.	Identification	Low value commitment	High value commitment
6.	Power	Institutional (legitimate, coercive, reward)	Personal (expert, referent)
7.	Management Philosophy	Control oriented	Involvement oriented
8.	Risk Oriented	Control mechanisms	Trust
9.	Time Frame	Short-term	Long-term
10.	Objective	Cost control	Performance enhancement
11.	Cultural difference	Individualism	Collectivism
		High power distance	Low power distance

2.2.3 Property Rights Theory

In the new institutional economics, property rights are viewed simply as control rights over physical and human assets. More specifically, they are institutions (or sets of rules and enforcement attributes) that help people form reasonable expectations about control over assets. These institutions consist of laws, administrative arrangements, and social norms relating to the allocation and enforcement of control rights over assets.

Property rights shape corporate governance in two fundamental and related ways. *First*, they determine what types of firms will emerge in a given environment. Like all organizations, firms arise in response to the incentives and transaction costs generated by the existing institutional framework.

Example: Large public firms with dispersed shareholders are not prevalent in insecure property rights environments, because it is too costly to establish the required corporate control mechanisms.

Second, the specific governance mechanisms available to firms are constrained by existing property rights institutions, which specify the legitimate forms of control in any given community.

2.2.4 Popular Models for Governance

Corporate governance relates to the internal means by which corporations are operated and controlled. While government plays a central role in shaping the legal, institutional and regulatory climate within which individual corporate governance systems are developed, the main responsibility lies with the private sector.

Notes

The unique characteristics and distinctive features of four important models of corporate governance are detailed below:

1. ***The Anglo-American Model:*** In this model, the board appoints and supervises the managers who manage the day-to-day affairs of the corporation. While the legal system provides the structural framework, the stakeholders in the company will be suppliers, employees and creditors. However, creditors exercise their lien over the assets of the company. The policies are framed by the board of directors and implemented by the management. The board oversees the implementation through a well-designed information system. The board of directors, being responsible to their appointers – the shareholders – commits to them certain returns within the board contours of the market framework.

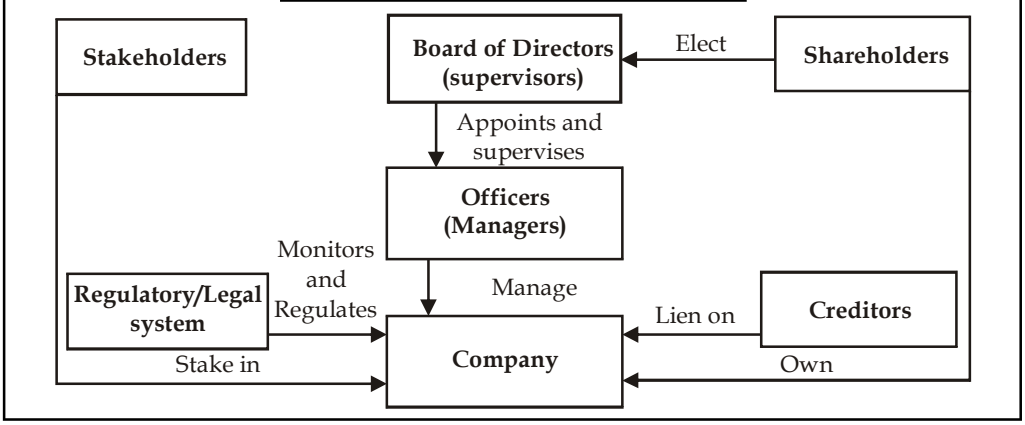
   It will ensure an efficient organization for production, exchange and performance monitoring. However, there is no agreement on the cost effectiveness or efficiency of the model (Macey, 1998). While Fischel and Easterbrook (1991) and (Romano, 1993) make a very optimistic assessment of the U.S. flawed. It will not be costless for the market to provide a greater supply of institutional investor monitoring.

   The distinctive features are:

   (a) Clear separation of ownership and management, which minimizes conflict of interests.

   (b) Companies are run by professional managers who have negligible ownership stakes linked to performance. CEO has a major role to play.

Figure 2.1: The Anglo-American Model



2. ***The German Model:*** In this model, although the shareholders own the company, they do not entirely dictate the governance mechanism. As shown, shareholders elect 50 per cent of members of supervisory board and the other half is appointed by labour unions. This ensures that employees and laborers 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 distinctive features are:

   (a) Banks and financial institutions have substantial stake in equity capital of companies.

   (b) Labour Relations Officer is represented in the management board. Worker participation in management is practiced.

   (c) Both shareholders and employees have equal say in selecting the members of the supervisory board.

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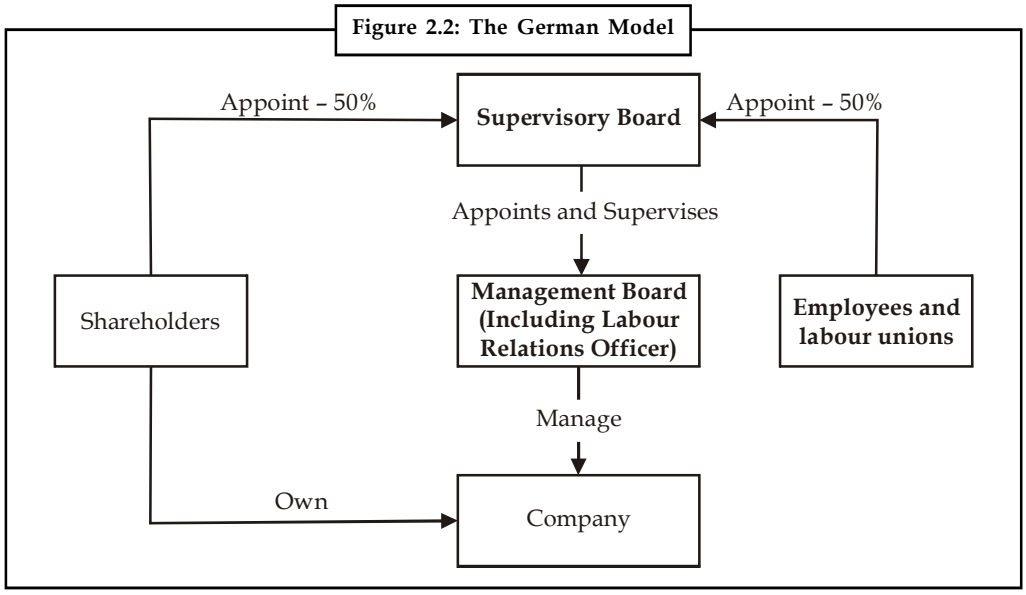
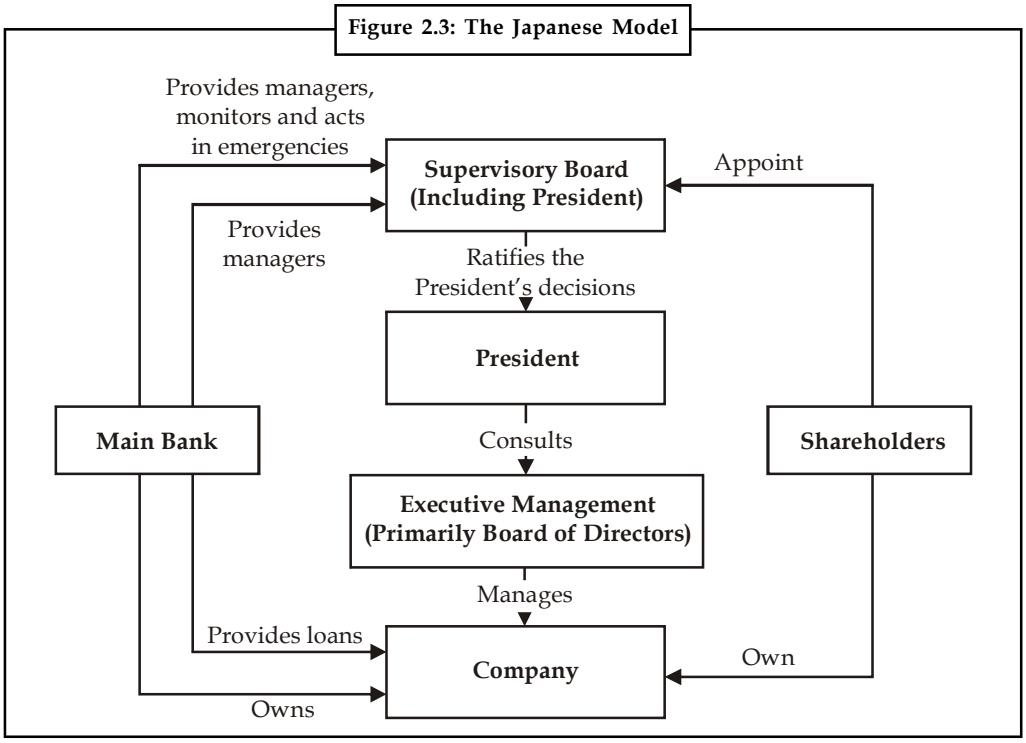
Figure 2.2: The German Model



3. ***The Japanese Model:*** In Japanese model, the financial institution has accrual role in governance. The shareholders and the bank together appoint board of directors and the president.

Figure 2.3: The Japanese Model



The distinctive features are:

(a) Inclusion of President who consults both the supervisory board and the executive management.

(b) Importance of the lending bank is highlighted.

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4. ***The Indian Perspective (Governance in the Public Sector):*** India in its own right has a unique and epochal background of governance. In the ancient times, the King was always considered the representative of the people. The wealth of the State was not the personal wealth of the king. The principle of trusteeship was also followed. Various modern authors have also taken tips on good governance from Kautilya's Arthasastra.

   The modern 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. In respect of public enterprises, central/state government forms the board. The hold of the government constitutes is to be dominant.

   The distinctive features are:

   (a) Equity shares are owned wholly or substantially (51 per cent or more) by the government.

   (b) Good deal of political and bureaucratic influence over the management.

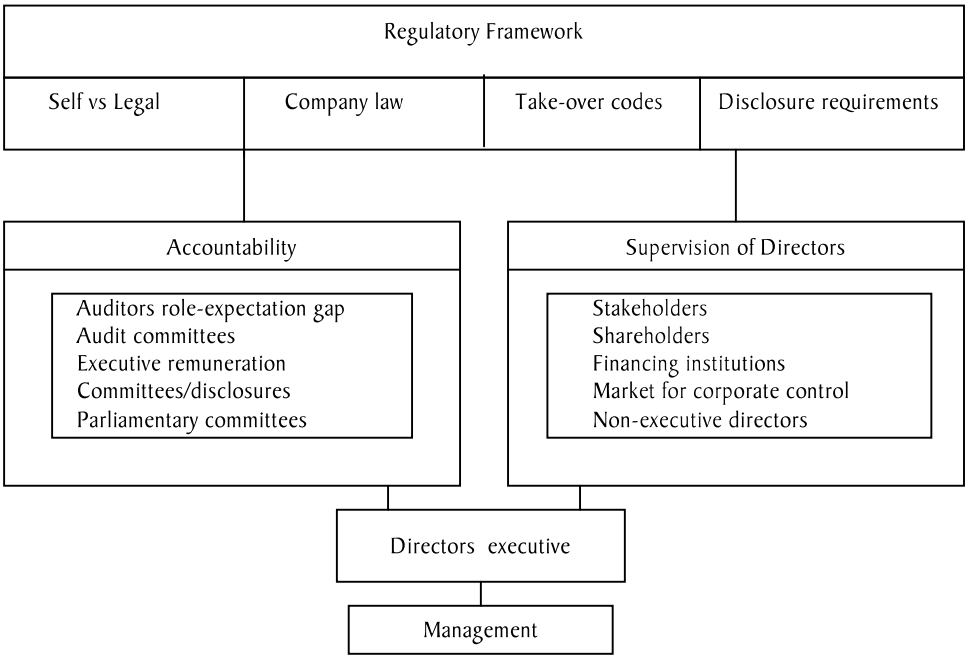
   (c) Organization often viewed as a social entity.

   (d) The board of directors are appointed by the controlling administrative ministry.

   (e) Excessive emphasis on observing rules, regulations and guidelines.

   (f) Efficiency and performance are sacrificed at the altar of propriety.

Figure 2.4: The Indian Perspective of Corporate Governance



2.3 Corporate Governance Mechanisms and Overview

Corporate governance in is a new phenomenon. In its ambit, the responsibilities of an enterprise to its customer, employees, society/government, suppliers and creditors are defined and a stocktaking is done at the end of a specified period to ensure whether such responsibilities have

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been fulfilled or not. The board of directors of the enterprise has to assume the responsibility of installing the systems of corporate governance in the enterprise and overseeing its effective implementation.

Corporate Governance and Board of Directors

The board of directors of an enterprise has to fulfill a number of responsibilities.

1. Creating conditions for developing a sound business strategy in consonance with national/ plan objectives.
2. Ensuring that the enterprise has a CEO of the highest caliber, and the certain senior managers are being groomed to assume the CEOs positions in future.
3. Creating systems of information, audit and control to oversee whether the enterprise is meeting objectives.
4. Ensuring that the enterprise complies with legal and ethical standards.
5. Ensuring that the enterprise is able to manage crisis and that its actions come in hardly in the prevention of crisis.

Example: Motorola, a US based multinational, evaluates its board of directors by asking questions about

1. The level of involvement of the board in CEO succession.
2. Sufficiency of information to board for CEO evaluation.
3. Appropriate processes to assess the CEOs.
4. CEOs' commitment in time spent with regard to the long-range future of the company.
5. Changes proposed by CEO with regard to company direction.
6. The CEOs' capability to formulate a vision and a mission.
7. The CEOs' efforts to put in place appropriate structures to evaluate the company's strategy and objectives and resolve to effectively inquire into major performance deficiencies.
8. The CEOs' capability to deal with unforeseen corporate crisis.

Against this backdrop, it is seen that most of boards do not contribute to business strategy development. A number of enterprises have been taken by surprise by the process adopted by the government of liberating the Indian economy from the shackles of controls, quotas, embargoes and protection. Many have turned sick, as their products have no appeal left for consumer.

PE boards have been an utter failure with regard to succession planning. No effort is made to groom people internally to succeed the CEO. Sometimes, boards just do not have an idea as to who could succeed the CEO in the event of his retirement or resignation, as they have had no time to observe the style and functioning of their immediate junior colleagues.

On the information side, boards fall short of expectations severely. Whereas in the case of boards of management of private enterprise, a number of sub-committees of the boards are appointed to look into major issues of audit, recruitment, purchases, exports, performance evaluation, joint ventures, etc. Boards have failed to notice this trend. Boards have spared little time for developing the enterprise business strategy. This has happened primarily because no clear vision exists. Therefore, boards have failed to comprehend changes in direction of the

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organization nor critically observed the contribution of the CEO in changing such direction. The contribution of boards in resolving corporate crisis is equally unsatisfactory as members are indifferent and do not feel the urgency to come forward and contribute their mute because they are neither brought to book or punished.

Despite non-performance on financial and physical fronts by companies, their boards have done little to remove the handicaps obstructing physical and financial performance on the whole, one has yet to come across a single instance in the history of boards where such entities have conceptualized schemes of their assessment and brought these schemes to the notice of their administrative ministries, let alone the common citizen. Corporate governance in the context of customers means ensuring satisfaction on quality, price, after-sales service, etc. Studies of such parameters point out that a lot requires to be done. One of the characteristics of a good brand is its export potential. Little thought to quality production, state-of-the art R&D, aggressive marketing, higher prices, among others, contribute to the sorry state of affairs.

Corporate Governance and Chief Executive Officer

The premise of effective corporate governance commences with questioning the effectiveness of the institution of board of directors, etc. In a recent study of corporate governance in US, there has been an evaluation of CEO, whole board, individual directors. The areas that were investigated in the study ranged from the ability of developing the annual strategic plan, shaping the organization's short-term and long-term objectives, performance of the stock price, lobbying efforts, involvement in trade associations, efforts at internal communication, leadership skills, success in managing labour relations, and succession, among others.

In US, a CEO is usually evaluated on five to ten objectives, at three levels of performance (Poor, Acceptable and Outstanding). These levels become the benchmarks for different pay packages. A CEO does his/her own self-assessment and presents it to the board. The self-assessment with regard to different parameters is done in quantitative terms as he is expected to translate the various objectives into a set of personal and performance targets. A committee of the board assesses the performance of the CEO, mostly on quarterly basis, and reports are placed before the full board. A composite evaluation takes place at the end fiscal year. Shifting this discussion to the Indian scenario, one finds that the boards do not normally assess the performance of the CEO. The absence of this practice does not stimulate the CEO to have his/her own mission and vision and by extension, reaching milestones during his/her tenure with the enterprise. This, in turn, results in lack of involvement and commitment on the part of the CEO sending unhealthy signals down the line in the organizational hierarchy.

Though there have been questions against the practice of self-assessment by CEOs, have not taken advantage of even this flexibility. This has created problems not only for the CEO but also for the rest of the staff of PE. This could be one of the reasons for the low salaries of the CEOs, managerial and non-managerial staff in their organizations. It also explains, to an extent, the lack of will of the board of directors to hold the CEO responsible for the performance of , and accounts for a reason why are seen as non-performing entities.

Nominee Directors

Nominee directors include government nominees and representatives of financial institutions on boards. In essence, these directors are a conduct between the enterprise and the government. They must, therefore, bring together with them the Government's thinking regarding the various issues for discussion at board meetings and in the case of financial institutions, the effective utilization of invested funds. It has been found that government nominees dominate board meetings and their contribution is not in proportion to their representation. Nominees of the

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financial institutions also act more often than not as a rubber-stamp and are indifferent to the proceedings taking place in the meetings.

The nominee directors should be clear about their dual role, i.e., safeguarding the interests of the government/institution and interests of the enterprises.

In playing the dual role, they must:

1. Approve the decisions of various matters discussed at board meetings keeping in view the interests of government/institutions on the one hand, and the enterprise policies and interests on the other in terms of growth, return and competitiveness.
2. Ensure that no dividends are paid to shareholders unless interest on loan capital has been paid to the government or financial institutions. In addition to this, they must ensure that statutory liabilities such as remission of provident fund contributions, payments to state electricity boards, contribution to gratuity fund, etc., have been taken care of prior to making funds for dividends.
3. Play a very active role in ensuring the leverage of the enterprise in favour of government institution and vice-versa.

Research has revealed that nominee directors:

1. Abstain from attending board meetings or send some junior officials to substitute for them. Attendance of government nominees is not up to the required mark. To secure good corporate governance such a practice should be discontinued.
2. Have been accused of being loners on boards and fail to play as teams.
3. Expertise in matters of finance and engineering is wide open to anybody's guess. That is as far as government is considered. Nominees of financial institutions are not very different. They take vary rigid postures on various issues, insisting only on matters dear to them.

Directors not conversant with the financial functioning of the business and different aspects of its operations must take time off and first get groomed in basics of financial management, company law, secretarial practice, costing, audit, engineering, etc. They must set self-assessment goals for themselves while they sit on boards in terms of their contribution to reduction in per unit cost, increase in labour productivity, sales return on investment, earnings per share, etc.

They would do well if they could set up similar benchmarks for enhancing the contribution of the enterprise to the people around it. An assessment of the role of the nominee directors on boards would squarely point out the great scope for improving their contribution.

Creditors, Suppliers and Corporate Governance

Boards have to play a critical role to fulfill conditions of sound corporate governance vis-à-vis creditors, as they are very important stakeholders. Creditors need financial information on the operations of the enterprise on a continuous basis (liquidity, solvency, debt-paying capacity, debt service coverage ratio, interest coverage ratio, value added to wages, growth of turnover, growth in market share, etc). By installing an effective system of financial disclosure, boards can ensure effective corporate governance.

There is no consistency in accounting policies followed in. They go on changing their depreciation policies and they sometimes do not differentiate between revenue and capital expenditure. They even club certain expenses to give erroneous picture about their efficiency and claim of fulfilling certain legal obligations. Some of these enterprises have fallen so short of expectations with regard to finalization and preparation of accounts that the Securities and Exchange Boards of India (SEBI) had to exempt them from filing quarterly profit and loss accounts and balance

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sheets. The disinvested enterprise had to be exempted even from filing the financial statement for the listing on Indian bourses, and was later asked to provide only summary details to fulfill the conditions.

Likewise, suppliers, especially in the case of manufacturing goods, where 60% of the cost relates to materials, are drawn into the system of corporate governance. The continuity of quality material supply ensures smooth production, helps cost reduction and maintain competitiveness, among others.

It is here that lay the problem. Past or even the present record of meeting payments of bills presented is slow and cumbersome. In the emerging system of strategic partnerships and zero inventories, competitive advantage lies in how materials issue, and thereby suppliers are managed in the current inventory of corporate governance.

Government, Employees and Corporate Governance

Government – central, state or municipal – is the external stakeholder. The government must, manage and control enterprises, through laws and regulations.

The Comptroller and Auditor General of India acts as the custodian of public funds invested in these enterprises. Questions know as starred and unstarred are constantly asked by elected representatives on the policies and performance of. More often than not replies made/tabled and discussions ranging from half-hour to two days and special debates are unsatisfactory. Parliamentarians and in the same manner legislators are very angry about the deployment of public funds.

The government machinery existing in the form of the DPE has contributed to a worsening of the situation. A recent study on its guidelines shows that out of the 892 it issued, 762 needed deletions, 25 required modifications and only 105 qualified for continuation. Failing to understand its own actions, the Government of India appointed a number of committees, notable of which was the Arjun Sengupta Committee on policy. The government later introduced the concept of Memorandum of Understanding in 1988 and disinvestment in 1991.

As an owner, the government certainly has the right to get dividends and ensure sound functioning of, but has no right to make them dysfunctional. In UK, the government opted for the right of self-denial and abolition of the select committee on nationalized industries. French have been more fortunate. They are called government enterprises without the government continuously watching their functioning. In our view, the government must resist the temptation to set up institutions under the influence of zealots who still dwell in the dark ages of command and control. Existing institutions like the Selection Board should be wound up. The application of Article 12 to should be stopped forthwith and should be allowed to draw up their own articles of association.

The organisation should fulfill their responsibilities to employees. No steps should be initiated to ensure free flow of information, maximize labour productivity potential, nurture and strengthen participatory systems, set-up sound systems of accountability or establish a proper relationship between productivity and reward.

Board Committees

Audit Committee: The Audit Committee is comprised of independent directors and meets on a regular basis. The Audit Committee oversees internal controls and disclosure controls and procedures for financial reporting. In addition, the Audit Committee is responsible for the appointment, compensation and oversight of the work of Sun's external auditors. Currently, all

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three members of the Audit Committee are "financial experts" (as determined in accordance with Securities and Exchange Commission rules).

Nominating Committee: The Corporate Governance and Nominating Committee (CGNC) is comprised of independent directors and its purpose is to ensure that Board of Directors is properly constituted to meet its fiduciary obligation to stockholders and follows appropriate governance standards.

Task

Select two companies and explain the mechanism of their corporate governance.

Caselet

Corporate Governance at Oracle Corporation

The Board of Oracle Corporation has throughout its history developed corporate governance practices to fulfill its responsibility to Oracle Corporation stockholders. Although recent events involving corporate accounting fraud has brought much attention to corporate governance principles, having good practices in place is not novel at Oracle. The composition and activities of the Company's Board of Directors, the approach to public disclosure and the availability of ethics and business conduct resources for employees exemplifies the Company's commitment to good corporate governance practices, including compliance with new standards.

As part of these practices, the Board has adopted the following Corporate Governance Guidelines to help ensure that it has the necessary authority and procedures in place to oversee the work of management and to exercise independence in evaluating Oracle Corporation's business operations. These guidelines allow the Board to align the interests of directors and management with those of Oracle Corporation's stockholders. These guidelines are subject to future refinement or changes as the Board may find necessary or advisable for Oracle Corporation in order to achieve the above objectives.

Oracle continually applies good corporate governance principles to multiple areas of the Company. In addition to these guidelines Oracle has had a Code of Ethics and Business Conduct since 1996, which was recently modified in 2001. The Board has also adopted charters for each of the following standing Board Committees: Finance and Audit Committee. Committee on Compensation and Management Development and Nomination and Governance Committee.

Under Section 16 of the Securities Exchange Act of 1934, Directors, Officers and 10 per cent or greater stockholders ("Section 16 Reporting Persons") are required to report changes in their stock ownership within two business days.

Oracle Corporation Corporate Governance Guidelines

Director Qualifications

A majority of the members of the Board of Directors (the "Board") must qualify as independent directors in accordance with the applicable provisions of the Securities Exchange Act of 1934, the rules promulgated there under and the applicable rules of the Nasdaq National Market (collectively, and "Independence Rules"). The Nomination and

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Governance Committee of the Board is responsible for reviewing with the Board the requisite skills and characteristics of new Board members as well as the composition of the Board as a whole. This assessment will include members' qualifications as "independent" under the Independence Rules as well as consideration of individual skills, experience and perspectives that will help create an outstanding, dynamic and effective Board. Nominees for Director will be selected each year by the Nomination and Governance Committee in accordance with the policies and principles in its charter.

The Board will periodically evaluate the appropriate size of the Board and make any changes it deems Appropriate. The Board does not believe that it should establish term limits for its members. While term limits could help insure that there are new ideas and viewpoints available to the Board, the Board recognises the value of continuity of Directors who have experience with the Company and who have gained over a period of time a level of understanding about the Company and its operations that enable the Director to make a significant contribution to the deliberations of the Board.

It is the responsibility of each Director to ensure that other commitments do not conflict or materially interfere with the director's responsibilities to the Company. If a Director has any concerns about whether serving as a Director of another company might conflict with his or her duties to the Company, the Director should consult the Chairman of the Board in advance of accepting an invitation to serve on the other company's Board and should inform the Nomination and Governance Committee in writing of the outcome.

Directors are expected to report changes in their primary business or professional status, including retirement, to the Chairman of the Board and the Chairman of the Nomination and Governance Committee.

Director Responsibilities

The basic responsibility of the Directors is to exercise their business judgement to act in a manner they reasonably believe is in the best interests of the Company and its stockholders and in a manner consistent with their fiduciary duties. In fulfilling that responsibility, Directors may ask such questions and conduct such investigations as they deem appropriate, and may reasonably rely on the information provided to them by the Company's senior executives and its outside advisors and auditors. The Directors shall be entitled to have the Company purchase Directors' and officers' liability insurance on their behalf and receive the benefits of indemnification and exculpation to the fullest extent permitted by law, the Company's charter and by-laws and any indemnification agreements, as applicable.

Directors are expected to regularly attend Board meetings and meetings of committees on which they serve, to spend the time needed in preparation for such meetings and to meet as frequently as they deem necessary to properly discharge their responsibilities. In addition, directors should stay abreast of the Company's business and markets, and as appropriate, meet with the Company's customers or attend events or take other actions they deem appropriate to enhance Oracle's business and their effectiveness as directors. Agenda and other information that are important to the Board's understanding of the business to be conducted at a Board or committee meeting should generally be distributed in writing to the directors at least two days before the meeting, and directors should review these materials in advance of the meeting. The non-management Directors (i.e., Directors who are not Company officers) will meet in regular executive sessions.

The Board has no policy mandating the separation of the offices of Chairman and the Chief Executive Officer (the "CEO"). The Board also has no policy providing for a lead director. The Board believes that a number of non-management Directors fulfill this role

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at various times depending upon the particular issues involved. The Board retains the discretion to consider these matters on a case-by-case basis.

The Chairman of the Board and the Secretary will establish and disseminate the agenda for each Board meeting. At the organizational meeting of the newly elected Board, the Secretary will present a schedule of agenda subjects to be discussed during the next twelve months (to the degree this can be foreseen). Each Board member is free to suggest the inclusion of items on the agenda. Each Board member is free to raise at any Board meeting subjects that are not on the agenda for that meeting. The Board will periodically review with the CEO the Company's long-term strategic plans.

The Board believes that management speaks for the Company. Individual Board members may, from time to time, expressly represent the Company in meetings or otherwise communicate with various third parties on the Company's behalf. It is expected that Board members will do this with the knowledge of the management and, unless warranted by unusual circumstances or as contemplated by the committee charters, only at the request of management. For communications with employees see "Director Access to Officers and Employees," below.

With respect to any matter under discussion by the Board, directors must disclose to the Board any potential conflicts of interest they may have and, if appropriate, refrain from voting on a matter in which they may have a conflict.

Board Committees

The board will have at all times a Finance and Audit Committee, a Compensation and Management Development Committee (the "Compensation Committee") and a Nomination and Governance Committee. All of the members of these committees will be "independent" Directors, as defined in the Independence Rules. Committee members and chairs will be appointed by the Board upon the recommendation of the Nomination and Governance Committee.

Each of the above standing committees will have its own written charter. The charters will set forth the purpose, authority and responsibilities of the committees as well as qualifications for committee membership, procedures for committee member appointment and removal, committee structure and operations and how the committee reports to the Board. The charters of each standing committee will be reviewed periodically with a view to delegating to the standing committees the full authority of the Board concerning specified matters appropriate to such committee.

The Chairman of each committee, in consultation with the committee members and senior management, will determine the frequency and length of the committee meetings consistent with any requirements set forth in the committee's charter. The Chairman of each committee, in consultation with the appropriate members of the committee and management, will develop the committee's agenda.

The Board may, from time to time, establish or maintain additional committees as it deems appropriate and delegate to such committees such authority permitted by applicable laws and the Company's by-laws as the Board sees fit.

The Board and each Board committee shall have the power to hire legal, accounting, financial or other advisors as they may deem necessary in their best judgement with due regard to cost, without the need to obtain the prior approval of any officer of the Company. The Secretary of the Company will arrange for payment of the invoices of any such third party.

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Director Access to Officers and Employees

Directors have full and free access to officers and employees of the Company. Any meetings or contacts that a Director wishes to initiate may be arranged Directly by the director or through the CEO or the Secretary. The Directors should seek to ensure that any such contact is not disruptive to the business operations of the Company and will, to the extent necessary and appropriate, inform the CEO of any communications between a Director and an officer or employee of the Company.

The Board or the CEO may request that certain members of senior management attend all or any portion of a Board meeting and will schedule presentations by managers who: (a) can provide additional insight into the items being discussed because of their personal involvement in these areas, or (b) have future senior management potential.

Director Compensation

The form and amount of Director compensation will be determined by the Compensation Committee in accordance with the policies and principles set forth in its charter, and the Compensation Committee will conduct an annual review of Director compensation.

Director Orientation and Continuing Education

The Board or the Company will establish, or identify and provide access to, appropriate orientation programmes, sessions or materials for newly elected directors of the Company for their benefit either prior to or within a reasonable period of time after their nomination or election as a Director. This orientation may include presentations by senior management to familiarise new directors with the Company's strategic plans, its significant financial, accounting and risk management issues, its Compliance Programme, its Code of Ethics and Business Conduct, its principal officers and its internal and independent auditors. In addition, the orientation will include visits to Company headquarters and, to the extent appropriate, other of the Company's significant facilities. All other Directors are also invited to attend the orientation. If and when continuing education rules are developed by the Nasdaq National Market, all Directors shall comply with those rules.

CEO Evaluation

The Compensation Committee will conduct an annual review of the CEO's performance and compensation, as set forth in its charter (and may, in its discretion, consult for this purpose with the Nomination and Governance Committee). The Board will review the Compensation Committee's report in order to ensure that the CEO is providing the best leadership for the Company in the long- and short-term.

Performance Evaluation

The Board, led by the Nomination and Governance Committee, will periodically conduct a self-evaluation to determine whether the Board and its committees are functioning effectively. The full Board will discuss the evaluation to determine what action, if any, could improve Board and committee performance. The Board, with the assistance of the Nomination and Governance Committee, as appropriate, shall periodically review these Corporate Governance Guidelines to determine whether any changes are appropriate.

Source: Dr. S. Singh, *Corporate Governance: Global Concepts and Practices*, First Edition, Excel Books, New Delhi, 2005

2.4 Landmarks in Emergence of Corporate Governance

The development of various committees that recommend the practices and policies of corporate governance serve as landmarks in emergence of corporate governance.

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Internationally, the following committees serve as the landmarks:

1. Cadbury Committee, 1992
2. Greenbury Committee, 1995
3. Hampel Committee, 1998
4. Turnbell Committee, 1999
5. Higgs Committee, 2003
6. Sarbanes-Oxley Act, 2002

Redraft of the Combined Code, 2003

All of these will be discussed in unit 6.

We will now discuss the emergence of corporate governance in India.

During the last decade, there has been significant revival of interest in corporate governance in various parts of the world. Among the major reasons for the revival has been a spate of corporate frauds and corporate failures. In the process a number of codes have been developed. In India, interest in corporate governance was revived with the onset of the process of economic reforms in 1991. Deregulation, privatisation, marketisation and globalisation trends unleashed in the process of reforms led to renewed interest and need for good governance in the country's corporate sector. There is a widely held belief that the standards of corporate governance must match with the spirit of the new economic policy and reforms so that the interests of the various stakeholder groups particularly the shareholders and lenders are adequately protected. A number of established and progressive companies maintain their voluntary codes of governance.

Companies Act 1956 is the principal legal instrument which contains provisions with regard to the role and functioning of the board of directors and the governance of companies. Development of the governance codes in other countries, rising expectations of the various stakeholder groups and rising incidence of corporate frauds have mounted pressure in the country for the development of a governance code which could serve as a model for adoption by Indian corporate sector or against which their actual standards of performance could be judged. In this circumstance, three codes have been recently evolved viz.:

1. Desirable Corporate Government in India-A code, by Confederation of Indian Industry (CII), 1997.
2. Kumar Mangalam Committee Report on Corporate Government (appointed by SEBI under the Chairmanship of Kumar Mangalam Birla, 1999
3. Naresh Chandra Committee on Corporate Governance

2.4.1 The CII Code

As mentioned above, the CII code was brought out in 1997. It made as many as 17 specific recommendations. The main recommendations of the code are as follows:

1. A single well performing board is desirable. The full board should meet at least 6 times a year preferably at an interval of 2 months.
2. A listed company with annual turnover of ₹ 100 crore and above should have professionally competent and acclaimed non-executive directors. Such directors should constitute at least 30 per cent of the board if the chairman of the company is a non-executive director and at least 50 per cent if the chairman and the managing director is the same person. Non-

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executive directors should play an active role in boards, have clearly defined responsibilities and have adequate knowledge of accounting and finance.

3. No single person should hold directorship in more than 10 companies. The limit excludes directorship in subsidiaries where the group has at least 50 per cent equity stake or associate companies where the group has 25-50 per cent equity stake.

4. In order to get better inputs from non-executive directors they should be paid a commission over and above sitting fees for their professional services. The present rates of commission are adequate. The commission can be appropriately combined with stock options for a better package of compensation.

5. While reappointing members of a board, companies should furnish attendance record of directors. As a general practices, a non-executive director should not be reappointed if he did not have the time even to attend 50 per cent of the meetings.

6. Listed companies with a turnover of ₹ 100 crore and above or a paid up capital of ₹ 20 crore, whichever is less, should set up Audit Committees within 2 years. An audit committee should have at least 3 members, all non–executive directors, having adequate knowledge of finance, accounts and company law. The committee should assist the board in fulfilling its functions relating to corporate accounting, reporting practices, financial and accounting controls and financial statements and proposals. The committee should have periodical interaction with statutory auditors and internal auditors for quality and credibility of company's accounts. For effective functioning of the committee, the management must make available financial data of the company and associated companies, particularly relating to investments, debt, contingent liabilities, current liabilities and debt. Lastly, listed companies (turnover above ₹ 100 crore or paid up capital of ₹ 20 crore whichever is less) should maintain a strong internal audit department or keep a external auditor to do internal audit.

7. Under its standard disclosure practice, a listed public company provides additional information to its shareholders. The information should give data on high and low monthly averages of share price in all the stock exchanges where the company is listed, for the representing year, a statement on value added and fuller details on business segments and divisions. Consolidation of group accounts should be optional and subject to the permission of the financial institutions for allowing a company to leverage on the basis of group assets and of the income tax department using the group concept in assessing corporate income tax.

8. Major Indian stock exchanges should insist on a compliance certificate (signed by CEO and CFO) stating that:

   (a) The management is responsible for the preparations, integrity and fair presentation of financial statements and other information contained in the Annual Report.

   (b) The company will continue business in the following year.

   (c) The accounting policies and principles conform to standard practices and that the board has overseen the company's system of internal accounting and administrative control system either directly or through audit committees.

9. For listed companies with paid-up capital to ₹ 20 crore or above, the quality and quantity of disclosure that accompanies a GDR (Global Depository Receipts) issue should also be the norm for a domestic issue.

10. The government must permit greater funding to the corporate sector against shares and other papers.

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11. It would be desirable if financial institutions as pure creditors rewrite their covenants to eliminate the provision of having nominee directors, except in cases of serious debt default and when the company does not provide requisite periodic operation data to the lending institution as per contract. The Institutions should withdraw from company boards where equity holding is 5 per cent less or where total holding is less than 10 per cent.
12. If a company gets its bonds, debentures or equity issues rated by more than one rating agency, then the rating information along with relative rating on the full rating scale should be given in the prospectus and the issue documents. In case of foreign and domestic issues, similar disclosure norms should be followed.
13. Companies defaulting on fixed deposits should not be allowed to accept further deposits and make inter-corporate loans and investments till the default is made good. It should further be disallowed to declare dividend till default is removed.

2.4.2 Kumar Mangalam Birla Report

Kumar Mangalam Birla Committee appointed by the Securities and Exchange Board of India (SEBI) dwelt on the various aspects of corporate governance. A number of recommendation made by the Committee are common or similar to the CII Code described above, but in certain respects it has given more specific recommendations. However, in basic spirits both the reports are quite similar. In accordance with its terms of reference, the task of the committee was to suggest:

1. Amendment to listing agreement and other measures to improve the standard of corporate governance;
2. A code of corporate best practices; and
3. Safeguards to deal with insider trading.

The report lays down that its recommendations should be made applicable to all listed companies including their directors, managements, employees and professionals associated with the company. The committee identifies shareholders, board of directors and management as the three constituents of corporate governance and identifies rights, roles, responsibility and accountability of these constituents. The committee before making recommendations examined the current status of governance standards and the provisions of existing laws, rules and regulations. The committee also considered certain critical issues relating to the quality of financial reporting, including consolidation of the accounts of subsidiaries, segment reporting when a company has multiple lines of business, disclosure and treatment of related party transactions and treatment of deferred taxation. Some of these issues were addressed by CII as well while formulating its governance code. The Committee has divided its measures into mandatory and recommendatory categories and regards its code as the first formal and comprehensive attempt in corporate governance.

The major recommendations of the committee are as follows.

Board of Directors

1. The board of a company should have an optimum combination of executive and non-executive directors with 50 per cent of the board consisting of non-executive directors. The number of independent directors would depend upon the Chairman of the board. In case of non-executive chairman, at least one-third of the board should comprise of independent directors. In case of an executive chairman, at least 50 per cent of the board should be independent. The tenure of the directors should be as per Companies Act.

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2. Financial institutions should have no direct role in managing the company and should normally not have nominees on the board merely by virtue of their financial exposure in the company. However, a nominee director would be justified in case of loan default (actual or potential) or for protecting their interest as shareholders. Such decisions should be left to the lending institutions themselves.
3. Chairman's role in principle should be different from that of the chief executive. A non-executive chairman should be entitled to maintain a chairman's office at the company's expense.
4. A director should not be a member in more than ten committees or act an chairman of more than five committees across all companies in which he is a director.

Audit Committee

1. Standards of government applicable to the full board should be applicable to the audit committee as well. The board of a company should set up a qualified and independent audit committee to enhance the credibility of the financial disclosures of the company.
2. The composition of the Audit Committee should be as follows:
   (a) At least three non-executive directors as members (majority being independent and at least one having financial and accounting knowledge).
   (b) One of the independent directors as Chairman.
   (c) The finance director, head of the internal audit and a representative of external auditor as invitees at the meetings of the audit committee.
   (d) The company secretary as the secretary of the committee.
3. The committee should meet at least thrice in a year. One meeting must be held before finalisation of annual accounts and one necessarily after 6 months.
4. The Committee must have the power to seek information from any employee, obtain outside legal or other professional advice and secure attendance of outsiders with relevant expertise, if necessary.

Director's Remuneration

1. The remuneration of the non-executive directors should be decided by the entire board.
2. Shareholders should be fully informed about the remuneration of directors. The following disclosures must be made in the section on corporate governance of the annual report of the company.
   (a) All the elements of remuneration package (like salary, benefits, bonus, stock option, pension etc.)
   (b) Details of fixed component of remuneration and performance linked incentives (including performance criteria).
   (c) Service contract details.
   (d) Stock option details, if any.

Notes

Accounting Standards and Financial Reporting

The companies should be required to give consolidated accounts in respect of all of its subsidiaries in which they hold 51 per cent or more share capital. Further, to obtain an overall financial position of the company, financial reporting for each product segment should be available to the shareholders and the market.

The committee refrained from making recommendations in areas, which were already being considered by SEBI or the Institute of Chartered Accountants of India. The areas included, among others, matters pertaining to related-party transactions and deferred taxation.

Company Management

1. The board must clearly define the role of the management. Management is defined to comprise the Chief executive, executive directors and the key managers of the company, involved in the day-in-day activities of the company
2. The management must disclose to the board all material financial and commercial transactions where they have personal interest, that may have a potential conflict with the interest of the company (e.g. dealing in company shares, transactions with organisations which have shareholding of the management or their relatives etc.).
3. As a part of management disclosure, in addition to the Director's Report, Management Discussion and Analysis Report (MDAR) should form a part of the annual report to the shareholders. MDAR should include the following:
   (a) Industry structure and developments;
   (b) Opportunities and threat, risks and concerns;
   (c) Segment-wise or product-wise performance;
   (d) Adequacy of internal control system;
   (e) Financial performance vis-à-vis operational performance; and
   (f) Material development in human resources and industrial relations.

Notes **Functions of Management as Recommended by KM Birla Committee Report**

The distinction between the functions of board of directors and company management (consisting of Chief Executive, Executive Directors and key managers) lies at the heart of corporate governance. The committee recommends that the following main function should be carried out by the management.

1. Assisting the board in its decision-making process for formulating the company's strategy, policies, code of conduct and performance targets and in the implementation of the same by managing the day-to-day affairs of the company. The management must attempt at maximisation of shareholder value.
2. Providing all material and substantial financial and operating information in a timely and accurate manner to the board of directors.
3. Ensuring compliance to all regulations, laws of the government and the code of ethics laid down by the board.

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4. Maintaining effective internal control system commensurate with business requirements.
5. Providing efficient and timely service to shareholders and to protect their rights and interests.
6. Facilitating efficient working of board committees

Shareholders

1. In case of appointment or re-appointment of a director, shareholders must be provided with a brief resume of the person concerned, his expertise in specific functional areas, names of the companies in which he holds the directorship and the names of the board committees of which he is a member.
2. Shareholders should have right to participate in and have sufficient information on :
   (a) Decisions concerning basic corporate changes;
   (b) Takeovers, sale of assets or division of the company.
   (c) Changes in capital structure which has the potential to bring about a change in control of the company.
3. Half-yearly declaration of financial performance and summary of significant developments in the company over the last six month period should be sent to each shareholder.
4. A separate board committee should be set up under the chairmanship of a non-executive director to take care of the shareholders complaints relating to transfer of shares, non-receipt of balance-sheet, declared dividend etc. To expedite the process of share transfer, the board of the company should delegate the power of share transfer to the registrars and share transfer agents.

2.4.3 Naresh Chandra Committee Report, 2002

The committee was appointed by the Securities and Exchange Board of India (SEBI) to make recommendations on the representation of independent directors on company boards and the composition of audit committees. The Committee in his report submitted in December 2002, has taken forward some of the recommendations of the Kumar Mangalam Birla committee .

The major highlights and recommendations of the committee report are as follows.

1. It makes no distraction between a board with an executive Chairman and a non-executive chairman.
2. It is sufficient to have compulsory rotation of audit partners in every five years.
3. Independent directors should play a larger role to ensure that corporate governance practices are improved and that the interests of stakeholders other than promoters are protected.
4. There should be increased level of disclosure by a company and its auditors. The disciplinary mechanism for audit and related professionals should be overhauled.
5. At least 50 per cent of the directors on the board of any listed company and unlisted public limited company with paid-up share capital and free reserves of ₹ 10 crore or more or turnover of Rs 50 crore or more should be independent. The boards of these companies should have atleast independent four independent. Audit committees of these companies should be made up entirely of independent directors.

Notes

Task

Pick an organisation and analyse its board structure for conformance of code of practices as given by the two committees discussed in section 2.4.

Case Study

Enron—A SAGA of Boom and Bust—United States

Background

Enron was formed from the merger in 1985 of Houston Natural Gas and Inter-north. In just over 15 years, it transformed itself from a regulated natural gas company into one of the world's largest energy traders. With more than 21,000 employees around the world, its revenues were over $ 100bn in 2000. Enron grew rapidly, containing three businesses - energy, wholesale and global services. The size of dealings made Enron briefly one of the biggest energy companies in the world, with sale of $ 101bn in 2000, rivalling venerable names such as Shell and Exxon.

Enron's prominence came not only from the key role it played in world energy markets but also because under President Bush, the US administration depend on its chairman Kenneth Lay for advice on energy. By some estimates, it had many lakhs of investors through the holdings of pension funds across the US.

Enron established itself in the UK at the first signs of energy liberalization, becoming the first company to begin construction of a power plant after the electric industry was privatized. For a decade or so, Enron's revolutionary approach was universally applauded.

Innovation

The genius behind Enron was the realisation that energy, water, and even obscure products such as telecom bandwidth were essentially commodities that could be bought, sold and hedged just like shares and bonds. Enron was a huge "market-maker" in the US; it acted as the main broker in energy products. Among its innovations, it has prized open the German power and gas markets, created a virtual gas storage facility in the UK, and pioneered the world's largest online commodity trading site.

Earned Eminensee and Awards

As recently as 14th August 2001, Fortune magazine tipped the firm as one of the 10 growth stocks to last the decade. The company has won a string of awards, including Fortune "America's most innovative company" award for an unprecedented six years between 1996 and 2001. In 2000, it won the Financial Times' "energy company of the year" award and "boldest successful investment decision".

Biggest Corporate Failure

Enron has filed for chapter 11 bankruptcy – which allows a company to continue trading while seeking protection from its creditors. The firm had already confessed to having inflated its profits. It leaves debts behind of about $ 15 bn. The collapse of Enron is the biggest corporate failure in US history.

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Major Exposure Reported so Far

JP Morgan: $90m, Citigroup: up to $800m, Credit Lyonnais: $25m, Dynergy: $75m, Mirant up to $60m, American Electric Power: up to $50m, El Paso: up to $50m, Centrica: $43m, TotalFinaElf:$25m

The biggest exposures admitted so far come from the banking sector. Citigroup and JP Morgan reportedly have combined exposure of up to $1.7 bn, although about half of that is secured on Enron's assets. France's Credit Lyonnais has admitted to $250m, part of a structured finance deal. But the banking-sector exposure is in effect much higher. Not yet included in the mounting total is $3bn lent by a banking consortium to finance Enron's power generation project in India. And banks around the world hold Enron bonds, which were downgraded to "junk" status. The only significant admission on this front so far has been from Japan's Nikko Cordial, which has over $ 200m in Enron bonds.

How the Collapse Happened?

When the firm reported its third quarter results in October, 2001 it revealed a large, unexplained hole that sent its share price tumbling. The US financial regulator – the Securities Exchange Commission (SEC) launched an investigation into the firm and its results. Enron then admitted it had inflated its profits, sending shares even lower.

A potential buyer for Enron, shied away from the company, leaving it no choice but to file for bankruptcy on 2nd, December, 2001.

What Went Wrong?

Enron's trading operations relied heavily on exceptionally complicated financial transactions, some relating to deals many years in the future. Auditing this sort of business is never easy, but it seems the situation at Enron was exacerbated either by incompetence or criminality among certain senior managers. No one, it seems, really understands what Enron has been doing these past few years. The revenues have largely been obscured by the accounting tricks, which have seen it become the subject of US investigations and a takeover for a much smaller company. At the end of February 2001, accounting giant Arthur Andersen gave its official seal of approval to Enron's annual report. The auditors' statement was clear: the energy firm's accounts presented "fairly, in all material aspects, the financial position of Enron Corp and subsidiaries."

Nine months later, Enron admitted that its accounts for that year, and for the three previous years, had been more or less fictional – an admission that culminated in the firm's messy bankruptcy.

One potential problem here is that most energy markets are informally run, and only lightly regulated.

Unlike stock markets, for example, where clear procedures exist in case of counterparty default, a big dispute in the energy markets could take years of legal wrangling to resolve. The firm's Enron Online trading system acted as the unofficial exchange for the vast majority of energy trading in the US, but lacked the sort of safeguards seen on the New York Stock Exchange.

Chronology

The following are key dates of rise and fall in the history of energy trading giant Enron:

January 25, 2002: Death of Cliff Baxter, Former Vice Chairman of Enron Corporation

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Notes

January 23, 2002: Kenneth Lay the chairman and chief executive officer resigned from the company, but will remain on the company board.

January 18, 2002: A Texas judge orders accountancy firm Andersen to stop destroying documents relating to its auditing of Enron.

January 17, 2002: Enron fired accounting firm Andersen on 17th blaming the auditor for destroying Enron documents government investigators were seeking for a probe in the fallen energy trader's aggressive and murky book keeping.

As auditors, Andersen had to sign off on Enron's accounting practices, many of which contributed to a loss of shareholder confidence that sent the one-time Wall Street darling into the largest Chapter 11 bankruptcy in history. Enron' s aggressive bookkeeping hid billions of debt off the balance sheet, and later led to a reduction of four years' worth of earnings to the tune of some $600 million.

Andersen confirmed that senior Andersen executives knew of crucial issues surrounding Enron's debt-laden off-balance sheet partnerships last February. The company confirmed the existence of a February 6 memo recounting the meeting, which it described as an annual review at which the auditor decides whether to keep its clients.

Enron said it has started looking for a new external auditor

Andersen mounts an advertising campaign to salvage its reputation.

January 15, 2002: Enron's stock begins trading over-the-counter after the New York Stock Exchange moves to delist its shares. Enron last traded on the NYSE at 67 cents on January 10. Accounting firm Andersen says its lead partner involved in the Enron audit, David Duncan, ordered documents destroyed after learning federal regulators wanted to see them. Andersen says it will fire the partner and placed three other partners responsible for the Enron work on, leave

January 11, 2002: Swiss bank UBS reaches an agreement to take control of Enron's main energy trading business.

January 10, 2002: Andersen admits employees disposed of documents relating to Enron's audit.

The White House reveals that Lay called treasury secretary Paul O'Neill and Commerce Secretary Don Evans in the autumn to warn them of Enron's mounting financial problems. Bush, who received major campaign contributions from Lay, orders a review headed by O'Neill of US pension and disclosure rules.

Dec. 13, 2001: Andersen executives tell Congress they warned Enron about possible illegal acts after it failed to provide their firm with crucial data about its finances.

Dec. 12, 2001: Congressional hearings begin on Enron's collapse. Enron unveils plans to raise up to $6 billion by selling assets.

Dec. 4, 2001: Enron secures $1.5 billion in emergency financing from major creditors JP Morgan Chase and Citigroup, so that it can run a skeleton operation.

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Dec. 3, 2001:	Enron fires 4,000 employees, while Dynergy counter-sues for control of the northern Natural Gas Pipeline.
Dec. 2, 2001:	Enron files for Chapter 11 bankruptcy and hits Dynergy with a $ 10- billion breach of contract law-suit
Nov. 2, 2001:	Major credit rating agencies downgrade Enron's bonds to "junk" status. Dynergy terminates its deal to buy Enron. Enron temporarily suspends all payments, other than those necessary to maintain core operations.
Nov. 9, 2001:	Enron agrees to be acquired by smaller rival Dynergy for $9 billion in stock. Under the terms, Chevron Texaco agrees to inject $ 1.5 billion in fresh capital.
Nov. 8, 2001:	Enron says it overstated earnings dating back to 1997 by almost $600 million.
Nov. 1, 2001:	JP Morgan and Salomon Smith Barney agree to provide an additional $ 1 billion in secured credit.
October 24, 2001:	Andrew Fastow is replaced as chief financial officer by Jeff McMahon.
October 17, 2001:	Criticism of Enron mounts after a Wall Street Journal report discloses that Enron took $1.2-billion charge against share holders' equity relating to dealings with partnerships run by CFO Andrew Fastow.
October 16, 2001:	Enron reports its first quarterly loss in over four years taking charges of $ billion on poorly performing businesses.
August 14, 2001 :	Jeff Skilling resigns as Enron president and chief executive officer, citing personal reasons. Ken Lay returns to chief executive job.
May 29, 2001:	The Maharashtra State Electricity Board, Dabhol power plant's sole customer, stops buying power. The US energy giant Enron is set to exit from India's biggest foreign investment project in the western state of Maharashtra. Enron's Indian subsidiary, Dabhol Power Company, has served a notice to transfer its assets to the Maharashtra State Electricity Board (MSEB). The notice served by Enron to MSEB formally sets in motion the process of calculating Dabhol's assets. This is linked to the termination of the power purchase agreement signed between the Dabhol Power Company and MSEB.

The notice also clears the way for a final termination notice to the Indian authorities. Enron officials still maintain that they would prefer settling the dispute amicably through a negotiated purchase of their stake by the Indian Government or any other Indian financial institution.

February 12, 2001:	Jeff Skilling becomes president and chief executive officer.
August 2000:	Enron's stock hits an all-time high of $ 90.56.

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July 2000:	Enron and Blockbuster announce 20 year deal to provide video-on-demand service over high speed internet lines.
October 1999:	Enron announces launch of Enron Online, its internet-based system for wholesale energy trading.
August 1999:	Enron exits oil and gas production by divesting its stake in subsidiary Enron Oil & Gas which is renamed EOG Resources.
1986:	Ken Lay is appointed as chairman after Enron is formed from the merger.

Outcome of Enron Failure

1. The fallout is immense. Enron has left behind $ 15 bn of debts. And many banks around the world are exposed to the firm, from lending it money and trading with it. Amongst others, JP Morgan has admitted to $900m of exposure, the Citigroup to up to $800m. Some banks are already proceeding with legal action, and the New York based Amalgamated Bank is suing Enron top executives for $15 bn. It seems likely that a few smaller firms that dealt extensively with Enron could go bust soon, too. On an individual level, many employees have lost their jobs and seen the value of their pensions – which had been invested heavily in Enron's own stock-wiped away. And Enron's shareholders have seen shares which were worth $85 just a year ago become virtually worthless.
2. In the longer term, the failure of Enron makes all-out market deregulation look a lot less attractive. Policy-makers used to be keen on the idea of applying Wall Street techniques to energy markets, hoping that it might result in greater efficiency and cheaper prices. Until recently, that hope seemed to be coming true. Now investors will also be more cautious about putting their money into companies that they do not understand.
3. As criminal investigation has been launched, it is a possibility their senior executives at the firm were involved in fraud. In order to fiddle its balance sheets, the firm used complex financial partnership in order to conceal debt. And many of the company's executives allegedly raked in massive profits, selling their shares before the stock collapsed. But Enron's 20,000 employees lost billions of dollars in their pension plans, after they were barred by the company from selling shares when their value plummeted.
4. The last potential exposure is the thousands of investors who own Enron shares, which have fallen from a high of over $90 last year to around 67 cents. Enron's shares are widely held among pension funds and other big investors, but also used to be popular among the general public, as the firm received years of favourable press coverage.
5. The collapse of Enron entangled the Bush Administration on Thursday as the White House said two Cabinet officers were warned of its looming financial crisis and Attorney-General John Ashcroft rescued himself from the criminal probe into the energy trading giant. President George W Bush ordered a review headed by Treasury Secretary Paul O'Neill of US pension and corporate disclosure rules. The review aims to avoid a repeat of the Enron collapse, in which thousands of employees lost their pension savings and the company filed the largest bankruptcy in US history.

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Bush's team has close ties to Enron and its Chairman, Kenneth Lay, a major Bush campaign contributor.

Bush, who worked in the oil industry, has known Enron's chairman since he was governor of Texas. Enron has been a major donor to Bush over the course of his political career, the Center for Public Integrity said. He said the first review, by the Treasury, Commerce and Labour departments, would analyze pension and 401 (k) rules and recommend ways to reform them so that "people are not exposed to losing their life savings as a result of a bankruptcy." Enron and its workers have contributed almost $ 4.5m to Republican candidates in US political campaigns.

6. Enron collapse may spur analyst reforms, as less than two months before Enron's spectacular collapse, Goldman Sachs stock analysis informed investors that they considered the energy trading company to be "still the best of the best." Most of Wall Street was bullish on the company. In the Enron case, the Wall Street analysts, whose job it is to recommend stocks for investors to buy and sell - were holding their bullish view all the while the stock fell from its peak at about $ 90 a share to its level of around 60 cents. Even when the company appeared to be in trouble, Wall Street clung to its rosy outlook. In late October, after Enron management held a conference call to discuss investor concerns over murky off-balance sheet deals that would later trigger the company's downfall, Goldman still say only "limited risk in (Enron) shares", which it had given its top "Recommended List" rating.

   Goldman wasn't alone in giving sinking Enron the thumbs up. At the start of November, UBS Warburg declared that Enron shares, then trading at $14, had "the potential for a doubling or greater over the intermediate to long-term."

   Even in the final few days before Enron's Dec. 1 bankruptcy filing, eight of 16 Wall Street analysts still rated its shares "strong buy" or "buy", while six held the "hold" rating. Just two listed it as a "sell."

7. The failure of analysts or even debt rating agencies such as Moody's or Standard & Poor to provide adequate warning of Enron's problems will attract regulatory interest. Efforts at reform, for now, remain in the hands of self-regulatory and nonprofit organizations such as the National Association of Securities Dealers, which oversees the Nasdaq Stock Market, and the Association for Investment Management Research, which awards the Certified Financial Analyst designation.

Regulators have started to take action, too. The American Institute of Certified Public Accountants (AICPA), which issues auditing standards through its Auditing Standards Board, said it would propose a new auditing standard early next year for detecting fraud.

The AICPA plans to issue guidance for company management and audit committees, as well as revised auditor standards on the review of quarterly financial statements. It also said it would make recommendations to the SEC on disclosing special purpose entities, complex financial vehicles often kept off a firm's balance sheet – precisely the sort of structure that may have played a role in Enron's downfall. Now, the accounting industry is taking a long hard look at itself.

Some More Facts

1. The real accounting scandal is not that handful of over-ambitious companies like Enron, WorldCom, Parmalat, etc. broke accounting rules to inflate their earnings, but that a majority of companies are inflating their accounting profit by window

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dressing the figure one way or the other, which is now popularly known as 'creative accounting'.

2. Many companies in almost all the countries do indulge in window dressing their figures by inflating incomes or deflating expenses to beef up profit. But those businesses which do so during depression phase of business cycle, with no intention to cheat but to remain a float in the eyes of people is different from those which indulge in creative accounting by deflating expenses (under provisioning) or inflating incomes when their is none. When accountants start doing the latter, it becomes accounting myth or financial scandal.

3. Consider one of the actions relating to Enron. In June 1999, some top executives at investment bank Credit Suisse First Boston (CSFB) discussed a controversial investment proposal with Enron. Andrew Fastow, the chief financial officer of the Houston-based energy company, had approached CSFB about joining hands with him in a new off balance sheet partnership known as LMJI that was intended to hedge the value of Enron's investment in an internet company.

Any deal that offered a chance to come closer to Mr. Fastow and Enron was intriguing. The company was one of 'Wall Streets' cash cows when it came to investment banking fees. But at least one investment CSFB banker was alarmed. Robert Jeffe, a managing director, later told the investigators that he was extremely upset that Mr. Fastow would represent both Enron and LJMI in future dealings as there will definitely be conflict of interest. Mr. Jeffe also saw that Mr. Fastow would earn more than $ 20 million from this arrangement. He further said that "This was something that I would never do even if I have approval from the President of the United States or the Supreme Court." Despite this, a group of CSFB executives including Chuck Ward, the former head of investment banking, Mark Paterson, former head of Leveraged Finance, and Richard Thornburgh, the former Chief Financial Officer, signed off on the deal. They were, it seems, persuaded by assurances from Enron's Board and opinions from its lowers and accountants. On 26 November, 2003, the Bankruptcy examiner, Neal Batson, concluded that SFB's participation in LJMI enabled Enron to book $ 95 million of questionable profits, forming 10% of total profit, while allowing improper profit of $ 40 million to themselves.

This myth was exposed by a very bold lady employee (Watkin) who worked directly under the Chief Financial officer Mr. Fastow, and the call partnership firm 'LMJI' was really owned by him only. For details, please refer to chapter - 12 of this book captioned "Whistle Blowing office helps governance the company".

Similarly, Enron managed billions of dollars of debt that JP Morgan and Citigroup helped Enron disguise as commodity trades.

Mr. Batson also got evidence that Royal Bank of Scotland and Toronto Dominion "aided and abetted" Enron's improprieties, listing a catalogue of abuses. CSFB enjoyed for long an unusually close relationship with Enron. In 1999, it received from Enron about $ 23 million as fee, which was the highest paid to any bank. Two years later, CSFB was rated Enron's "best bank" in North America. CSFB helped the company undertake a variety of transactions - from loans and commercial debt and equity undertakings to more exotic pieces of work. Mr. Batson said that CSFB knew, for instance, that Enron carried about $ 4.5 billion of off-balance sheet debt and company was in dire need of cash. The bank also knew that many of Enron assets in Latin America and elsewhere were less valuable than advertised as CSFB was given the job of finding buyers. Another finding is that CSFB may have recovered its dues at the cost of other investors, because of its closeness and better

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inside knowledge about Enron. By 2001, CSFB had reduced its credit exposure to Enron from more than $ 600 million to about $ 167 m. In fact one of CSFB employees, Ms Sakol was persuaded by her superior in the equity research department not to give negative rating to Enron stocks; which it rightly deserved.

Mr. Batson also concluded from some other deals in which CSFB knew that Enron's transactions had no legitimate business purpose and that its financial statements were misleading.

The most notable deal that CSFB did for Enron was LJMI. It was presented by Mr. Fastow as a way for Enron to lock in the value of a $ 10 million investment in a technology company Rythms that had soared to more than $ 250 million by late 1999.

In an other messy transaction, Enron contributed $ 276 million in its own stock to LJMI as collateral for the hedge. Mr. Faslow, who had invested $ 1 million in LJMI, would become Managing partner, while entities controlled by CSFB and RBS each contributed $ 7.5 million and became limited partners.

The Enron saga, thus, can be described as one which was based on falsehood, deceit, cheating, self seeking, unethical decisions, kite flying, messy transactions, which together led to its rapid boom and bust. Enron CEO suddenly resigned after sensing danger. By October, 2001, Enron shocked Wall Street by announcing a loss of $ 618 million. What is more, Enron announced that it was reducing stockholders' equity by $ 1.2 billion. There was now nothing to stop the deluge.

In November, the Company reduced earnings by another $ 600 million for 1997-2001 and added $ 2.5 billion as debt to the company's books. In December 2001, it called it a day by filing for bankruptcy protection.

One can imagine the resultant plight of lenders, suppliers, clients, and other stakeholders. Thousands lost their jobs. Stock was worth a pittance. Retirement savings went up in smoke. One may like to ask what did the auditors Arthor Andersen do in bringing Enron to this pass? Did they aid and abet this huge financial swindle? Was there a new economy in the making or a plain and simple fraud ? There are perhaps no answers to these questions. It is now an open story of corruption in high places, as without the shelter of "big shots" it was not possible to pull off this shenanigan.

Professor Paul Krugman said Enron would be a greater disaster for America than September 11.

The lesson for all of us in general and corporates and regulators in particular from the Enron saga is: some controls are necessary to check creative accounting, as there are many creative minds in corporates who are prepared to take the investors for a ride. Another important lesson for the government and regulators of all the countries is - (i) Pack the corporate Boards with independent directors and (ii) Every company with a paid-up capital and free reserves exceeding ₹ 10 crores and turnover per annum exceeding ₹ 50 crores must have (a) Nomination Committee, (b) Remuneration Committee and (c) Audit Committees (all 3 committees), without exception.

Questions

1. What do you think are the reasons for the sudden collapse of Enron?
2. Was Enron having proper corporate governance in place? If not, what precisely was lacking?
3. What lessons can be learned from the Enron saga?

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4. Comment on the risks involved in "related party transitions" and "collusion" of CEO, CFO, Banks and Auditors from the experiences learned from "Enron Episode".
5. Had there been more than fifty percent independent directors on the Board of Enron, and a reasonably strong "Audit Committee" in place, could the fate of the company have been different?

2.5 Summary

- Corporate governance has now been recognized as a medium to provide the structure through which the objectives of the company are set, deciding on the means of attaining those objectives and monitoring performance.
- Corporate governance and the enterprise culture have become important for the survival of companies and indeed of national economies in the increasingly global economy.
- As per the agency theory the shareholders are the 'principals' in whose interest the corporation should be run even though they rely on others for the actual running of the corporation.
- According to stewardship theory, the behaviour of the steward is collective, because the steward seeks to attain the objectives of the organization.
- All firms are adaptations to property rights institutions. In every economy, control rights over firms are allocated between political and private actors.
- There are four popular models of corporate governance related to different countries.
- The mechanism of corporate governance includes structure of boards its functioning responsibilities and its committees through which it discharges its duties.
- Key elements of good corporate governance principles include honesty, trust and integrity, openness, performance orientation, responsibility and accountability, mutual respect, and commitment to the organization.
- During the last seven years, there has been increasing concern for corporate governance. The issue of governance heats up particularly at times when corporate frauds are detected and reported.

2.6 Keywords

Agency theory: It suggests that shareholders are the 'principals' I whose interest corporation should be run.

Financial Disclosure: Reporting of financial facts and figures

Nominee Directors: They include government nominees and representatives of financial institutions.

OECD: Organisation for Economic Co-operation and Development

Stakeholder theory: The purpose of the firm is to create wealth for its stakeholders.

SOX: US Sarbanes Oxley Act

Stewardship theory: According to this theory, the behaviour of steward is collective, because the steward seeks to attain the objectives of the organisation.

Notes

2.7 Self Assessment

Fill in the blanks:

1. Nominee Directors include representatives of financial institutions and .....
2. Corporate governance and the ..... are closely linked.
3. Creditors need financial information on the operations of the enterprise on a .....basis.
4. OECD: Organisation of ..... Cooperation and Development.
5. Property rights are viewed simply as ..... over physical and human assets.
6. The agency problem was effectively identified by .....
7. In Japanese model, the financial institution has ..... role in governance.
8. In German model, the supervisory board is elected by .....
9. CII developed code of corporate governance in .....
10. ..... committee took forward the recommendations of KM Birla Committee.

2.8 Review Questions

1. "If management is about running business, governance is about seeing that it is run properly". In the light of this statement, discuss the idea of corporate governance.
2. Nominee Directors play a dual role. Explain
3. Analyse the role of government in corporate governance.
4. Do you think corporate governance has become more relevant after some big corporate failure worldwide? Give reasons.
5. Is an effective financial disclosure system important? Why?
6. Discuss the Audit and Nominating Committees.
7. "Organizations are multilateral agreements between the enterprise and its stakeholders". Explain the statement.
8. Distinguish between the Anglo-American Model and the German Model.
9. Based on your understanding of corporate governance, which is the best model? Give reasons.
10. Discuss the major recommendations of the KM Birla Committee on Corporate Governance.

Answers: Self Assessment

1.	Government nominees	2.	enterprise culture
3.	continuous	4.	Economic
5.	control rights	6.	Adam Smith
7.	Accrual	8.	shareholders and labour unions
9.	1997	10.	Naresh Chandra

2.9 Further Readings

Notes

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Unit 3: Corporate Governance and Stakeholders

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3.8 Further Readings

Objectives

After studying this unit, you will be able to:

- Know the rights and privileges of stakeholder especially shareholders
- State the SEBI' s guidelines for the protection of shareholders rights
- Explain the corporate governance mechanism and control, internal and external control

Introduction

The conception of the company is a set of relationship rather than a series of transaction, In which managers adopt an inclusive concern of all stakeholders. It represents a sense of corporate citizenship that view an organisation with a mature appreciation of its rights and responsibilities toward its stakeholders. Corporate governance incorporates the interests of all stakeholders and presents codes guidelines and system of control to take care the concerns of different stakeholders.

Difference between Shareholders and Stakeholders

Stakeholders are the ones who affect or get affected by the actions of the company. Customers, employees, suppliers, government are all examples of stakeholders of a company.

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Shareholders are individuals or companies that legally own shares of stock of a joint stock company. They jointly own the company. They can be considered as a partial subset of stakeholders. They have some rights which are exclusive to them and are not available to any other stakeholder.

3.1 Stakeholders: Rights and Privileges

The different stakeholders in corporate governance include the regulatory body (e.g., the chief executive officer, the board of directors, management and shareholders). The other stakeholders are suppliers, employees, creditors, customers, and the community at large. Because there are so many parties concerned with a corporation's goals and results, corporate governance systems need to be streamlined, rigidly structured, and as transparent as possible to its stakeholders. Corporate governance monitors whether outcomes are consistent with goals, and motivates the corporation to maintain its direction or alter it to better adhere to goals. Thus, the primary function of corporate governance is to bring all its stakeholder to align their behaviors with the corporation's goals and ideals.

Relationships among all parties involved in the governance of a corporation needs to be managed. This is not limited to the internal stakeholders such as owners, board of directors, and employees, but extended to include regulatory agencies and the community at large. With well-defined relationships, a company can easily manages and governs its communications both internally and externally that helps in encouraging relatively un-involved people to share in the corporate goals.

Directors and manager need to be aware of the interests of stakeholders in governance, however their responsibility towards them is judged. Governance reports have emphasized the role of institutional investors (insurance companies, pension funds, investment houses) in directing companies towards good corporate governance.

Stakeholders are any entity (person, group or possibly non-human entity) that can affect or can be affected by the actions or policies of an organization. It is a bi-directional relationship. Each stakeholder group has different expectations about what it wants and different claims upon the organization.

In this regard stakeholders' theory proposes corporate accountability to a broad range of stakeholders. It is based on companies being so large, and their impact on society being so significant that they cannot just be irresponsible to their stakeholders. Several committees regulations and laws have presents rights of different stakeholders and measures to protect their interest. One of the major stakeholder is the share holders of the firm. We shall discuss their rights here.

To the Customers

1. To ensure high quality product at affordable and fair prices or free.
2. To ensure good service, ethical conduct and courtesy to the customers.

To the Society

1. To ensure contribution to the society in most deserving areas.
2. To ensure fairness in all dealings through careful assessment and scrutiny and professional service.
3. To ensure maintenance as well as continuous improvement.

Notes

To the Employees

1. To provide all employees opportunity for meaningful work and adequate facilities for development of their abilities and potential through proper training.
2. To ensure acknowledgement and appreciation for good work.
3. To encourage and facilitate increased association of the employees in decisions related to their work spheres.
4. To provide best possible conditions of employment through fair wages and working environment.

To the Governing Body

1. To provide thorough and adequate information regarding the operations of the organization.
2. To ensure economic viability of the operations through sound financial policies.
3. To ensure continuation and growth of the operations through investing funds in essential facilities and infrastructure for the operations.

3.1.1 Rights of Shareholders

The corporate governance framework should protect shareholders' rights and facilitate the exercise of shareholder rights.

1. Basic shareholder rights include the right to
   (a) *Secure methods of ownership registration:* The Central Depository Services Ltd. (CDSL), which maintains high standards of safety and efficiency Registration in depository and the unique account number is proof of ownership for the shareholders.
   (b) *Convey or transfer shares:* There are no restrictions on the transferability of shares, except in the case where the Board may, subject to the right of appeal conferred by section 111 of the Companies Act.
   (c) *Obtain relevant information on the corporation on a timely and regular basis:* Most of the financial and non-financial information on the companies is available on their websites or other commercial websites free of cost. Apart from this regular filings with Stock Exchanges, SEBI and DCA are also available for shareholders' scrutiny free of cost or at a nominal cost.
   (d) *Participate and vote in general shareholder meetings:* Board of directors are entrusted with the duty of convening the Annual General Meeting and Extra Ordinary General Meeting.

Did u know? ***Requisition Committee:*** Shareholders may ask the board of directors to hold an Extra Ordinary General Meeting. This is usually known as Requisition Meeting.

Resolutions that are required to be passed in the general meeting requisitioned by the members have to be circulated in advance by the members.

   (e) *Elect and remove members of the board:* Section 257 of the Companies Act, 1956, enables shareholders to elect members of the Board of Directors. Section 284 of the Companies Act enables a company to remove a director through an ordinary resolution.

Notes

(f) *Share in the profits of the corporation:* A company can declare dividends only out of current profits after providing for depreciation; or out of undistributed profits of previous years after providing for depreciation; or out of monies provided by the Central or State Government for the payment of dividend in pursuance to a guarantee given by that Government.

2. Shareholders should have the right to participate in, and to be sufficiently informed on, decisions concerning fundamental corporate changes such as:

   (a) Amendments to the statutes, or articles of incorporation or similar governing documents of the company.

   (b) The authorization of additional shares.

   (c) Extraordinary transactions including the transfer of all or substantially all assets, that in effect result in the sale of the company.

3. Shareholders should have the opportunity to participate effectively and vote in general shareholder meetings and should be informed of the rules, including voting procedures that govern general shareholder meetings.

   (a) Shareholders should be furnished with sufficient and timely information concerning the date, location and agenda of general meetings, as well as full and timely information regarding the issues to be decided at the meeting.

   (b) Opportunity should be provided for shareholders to ask questions of the board, including questions related to the annual external audit, to place items on the agenda of general meetings, and to propose resolutions subject to reasonable limitations.

   (c) Effective shareholder participation in key corporate governance decisions, such as the nomination of and election of board members, should be facilitated. Shareholders should be able to make their views known on the remuneration policy for board members and key executives. The equity component of compensation schemes for board members and employees should be subject to shareholder approval.

4. Shareholders should be able to vote in person or in absentia, and equal effect should be given to votes whether cast in person or in absentia.

3.1.2 Privileges of the Shareholders

Shareholders enjoy the following privileges:

1. Capital structures and arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership should be disclosed.

2. Markets for corporate control should be allowed to function in an efficient and transparent manner.

3. The rules and procedures governing the acquisition of corporate control in the capital markets, and extraordinary transactions such as mergers, and sales of substantial portions of corporate assets, should be clearly articulated and disclosed so that investors understand their rights and interest.

The exercise of ownership rights by all shareholders, including institutional investors, should be facilitated.

Task

Visit the website of National Grid and find out the initiatives taken by them to manage their stakeholders.

Notes

Caselet

Governance and Stakeholders at National Grid

There is a continuing debate about the US model of Corporate Governance versus the one in the UK. Some think that the US model is stricter … well, don't tell that to UK based National Grid. Their comprehensive treatment of Governance and stakeholders could just be the envy of firms across the pond.

National Grid operates a Shareholder Networking programme, the aim of which is to allow shareholders to gain a better understanding of the Company. The programme, which is normally run twice a year in June and during early December over two days, includes visits to operational sites and presentations by senior managers and employees. Participants also have the opportunity to meet and question Directors.

Source: www.corporate-eye.com

3.2 Problems and Protection

SEBI has provided the guidelines to protect the interest of shareholders. These protections are given in the light of problems faced by shareholders.

1. ***Disclosure:*** Any person or body corporate whose shareholding crosses the 5% threshold has to publicly disclose this to the relevant stock exchange and to SEBI.
2. ***Trigger:*** SEBI initially specified a 10% trigger. If an acquirer's shareholding crossed 10%, he (person or body corporate) had to make an open offer for at least an extra 20% of the shares.
3. ***Minimum offer price:*** Any such public offer must carry a minimum price which is the average of the market price for the last six months.
4. ***Creeping acquisition:*** Existing management is allowed to consolidate its holdings through the secondary market so long as such acquisition does not annually exceed 2% of the shares.
5. ***Escrow:*** To ensure that the takeover bids are serious, there has to be an escrow account to which the acquirer has to deposit 25% of the value of his total bid.

For mergers and de-mergers, the companies concerned must go through the following steps:

1. Secure approval of their respective board of directors.
2. Appoint valuers for doing the valuation and, hence, the share-swap ratio.
3. Secure approval from shareholders in a shareholders' meeting.
4. Get cavlion K approval from the High Court about the arrangement of merger or demerger.

Caution Anti-take-over devices should not be used to shield management from accountability.

Notes

3.2.1 Equitable Treatment of Shareholders

The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.

1. All shareholders of the same class should be treated equally.

   (a) Within any class, all shareholders should have the same voting rights. All investors should be able to obtain information about the rights attached to all series and classes of shares before they purchase. Any changes in voting rights should be subject to approval by those classes of shares, which are negatively affected.

   (b) Minority shareholders should be protected from abusive actions by, or in the interest of, controlling shareholders, acting either directly or indirectly, and should have effective means of redress.

   (c) Votes should be cast by custodians or nominees in a manner agreed upon with the beneficial owner of the shares.

   (d) Processes and procedures for general shareholder meetings should allow for equitable treatment of all shareholders. Company procedures should not make it unduly difficult or expensive to cast votes.

2. Insider trading and abusive self-dealing should be prohibited. While insider-trading regulations were framed in 1992, it was felt that there was no framework for prevention of insider trading. Consequently, The Insider Trading (Amendment) Regulations were notified on February 20, 2002. The following changes have been made through these amendment regulations:

   (a) *Strengthening Existing Provisions:* These includes changes in the definition of connected person, broadening the meaning of dealing in securities, redefining the term 'deemed to be connected', re-framing the term 'unpublished price sensitive information', and amendments to the procedure of investigations, etc.

   (b) *Incorporation of disclosure requirements by insiders such as directors and large shareholders:* A new regulation has been included providing for initial and continual disclosure of shareholding by directors or officers and substantial shareholders (holding more than 5 per cent shares/voting rights) of listed companies.

   (c) *Creation of preventive framework consisting of code of conduct for listed companies and other entities associated with securities markets:* This is to create a preventive framework to stop insider trading, all listed companies and other entities associated with securities market are now required to adopt a code of conduct on the lines of the model code specified in the regulations.

   (d) *Creation of a code of corporate disclosure practices for listed companies:* Listed companies are now required to adopt a code for corporate disclosure to improve transparency in the market and fairness in the dissemination of information by corporate to the market.

   (e) *Dissemination off price sensitive information to public:* To have a proper method for dissemination of price sensitive and other important information relating to companies and market to the public, the stock exchanges have been advised to display such information on their terminals in the quickest possible manner.

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(f) *Dealing with market rumours:* Companies are required to designate compliance officers who can be contacted by the stock exchanges whenever such verification is needed. Exchanges are required to take up quick verification of rumours and ensure proper dissemination of the relevant information.

(g) *Co-ordination and sharing of information:* The exchange has to designate a senior level official handling surveillance function to co-ordinate with other exchanges on surveillance matters.

3. Members of the board and key executives should be required to disclose to the board whether they, directly, indirectly, or on behalf of third parties, have a material interest in any transactions or matter directly affecting the corporation.

3.2.2 Nature of Complaints by Shareholders

1. ***Non receipt of Dividend:*** A common complaint put by the companies' shareholders is the non-receipt of dividend. According to the AGM details issued by ITC ltd. for the financial 2005, 50% shareholders put the complaint for the non receipt of dividend.

2. ***Change of Address:*** Shareholders are required to inform the company in writing of any change in their address quoting their folio number. The Shareholders who hold share certificates in physical form are requested to intimate their change of address duly signed by all holders to the Registrar along with the following :

   (a) The old address

   (b) The detailed New address along with the pin code

   (c) Telephone no. / other contact no. / Email address

   (d) The signature on the request of change of address should tally as per the specimen signature recorded with the Company / Registrar.

   (e) A Copy of Telephone bill / Electricity Bill / any other document evidencing the new address should form as enclosure of the request of change of address.

   The shareholders who hold shares in electronic form, are requested to intimate their change of address to the depository participant with whom they maintain their demat account and not to the company or the share transfer agent. If any shareholder wants to change the current address, he or she needs to put a complaint with all the details given above.

3. ***Non receipt of Share Certificate:*** Complaints for the share certificate can be for the issue of original share certificate or in case if you have lost the original certificate you can put a complaint to issue a duplicate share certificate. In case of torn, mutilated or lost share certificates, the shareholders are eligible to receive duplicate share certificates in lieu of the same. The shareholders have to surrender their original torn or mutilated share certificates to the Company, along with a request for issue of duplicate share certificates.

4. ***Transmission of Shares:*** The Word "Transmission" means transfer by operation of law i.e. devolution of title to shares. This would include devolution by operation of law, death, bankruptcy, marriage.

   If the shares were held in single name, the successors or beneficiaries under a Will executed by the deceased would be the persons in whose favour the shares would be transmitted. In order to expedite transmission of shares, please submit all the share certificates along with any one of the following documents, viz. Succession Certificate or Probate of the

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Will or Letter of Administration or Legal Heir Certificate / Survival Certificate issued by competent authorities of the Government

If the shares are held in joint name(s), please submit a certified copy of the Death Certificate of the deceased shareholder along with all the relevant share certificates so that the name deceased could be deleted from records as well as the certificates.

5. ***Transposition of Shares:*** Transposition of names of shareholders i.e. change in the order of names does not require any Transfer Deed or Share Transfer Stamps. Transposition would be done of the entire holing in any folio.

   Such request has to be submitted duly signed by all shareholders and submitted along with all the original share certificates.

   Share certificates along with a request letter duly signed by all the joint holders may be sent to the Company's R&TA for change in order of names

   Transposition can be done only for the entire holdings under a folio and therefore, requests for transposition of part holding cannot be accepted by the Company / R&TA.

6. ***Other Complaints:*** The key other complaints are relating to change in bank address, transfer of shares, non receipt of financial statements etc.

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Financial Reporting and Disclosures

Financial disclosure is a critical component of effective corporate governance. SEBI set up an Accounting Standards Committee, as a Standing Committee, under the chairmanship of Shri Y.H. Malegam with the following objectives:

1. To review the continuous disclosure requirements under the listing agreement for listed companies;
2. To provide input to the Institute of Chartered Accountants of India (ICAI) for introducing new accounting standards in India; and
3. To review existing Indian accounting standards, where required and to harmonize these accounting standards and financial disclosures on par with international practices.

SEBI has interacted with the ICAI on a continuous basis in the issuance of recent Indian accounting standards on areas including segment reporting, related party disclosures, consolidated financial statements, earnings per share, accounting for taxes on income, accounting for investments in associates in consolidated financial statements, discontinuing operations, interim financial reporting, intangible assets, financial reporting of interests in joint ventures and impairment of assets. With the introduction of these recent Indian accounting standards, financial reporting practices in India are almost on par with International Accounting Standards.

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Case Study

Satyam: The Rise and Fall of Ramalinga Raju

Satyam Computer Services, Ltd. was a rising star in the Indian outsourced IT services industry. The company was formed in 1987 in Hyderbad, India by B. Ramalinga Raju. The firm began with twenty employees and grew rapidly as a global business. It offers information technology (IT) and business process outsourcing (BPO) services spanning various sectorsx, including: aerospace and defense, banking and financial services, energy and utilities, life sciences and healthcare, manufacturing and diversified industrials, public services and education, retail, telecommunications and travel.

The Satyam scandal is a classic case of negligence of fiduciary duties, total collapse of ethical standards, and a lack of corporate social responsibility. It is human greed and desire that led to fraud. This type of behavior can be traced to: greed overshadowing the responsibility to meet fiduciary duties; fierce competition and the need to impress stakeholders especially investors, analysts, shareholders, and the stock market; low ethical and moral standards by top management; and, greater emphasis on short-term performance.

Greed for money, power, competition, success and prestige compelled Mr. Raju to "ride the tiger," which led to violation of all duties imposed on them as fiduciaries - the duty of care, the duty of negligence, the duty of loyalty, the duty of disclosure towards the stakeholders. According to CBI, the Indian crime investigation agency, the fraud activity dates back from April 1999, when the company embarked on a road to double-digit annual growth. As of December 2008, Satyam had a total market capitalization of $3.2 billion dollars.

Satyam planned to acquire a fifty-one percent stake in Maytas Infrastructure, a leading Infrastructure Development, Construction and Project Management Company, for $300 million. The Rajus's had a 37% stake. The total turnover was $350 million and a net profit of$20 million. Raju's also had a 35% share in Maytas Properties, another real estate investment firm. Satyam revenues exceeded $1 billion in 2006.

In April, 2008 Satyam became the first Indian company to publish IFRS audited financials. On December 16, 2008, the Satyam board, including its five independent directors had approved the founder's proposal to buy the stake in Maytas Infrastructure and all of Maytas Properties, which were owned by family members of Satyam's Chairman, B Ramalinga Raju, as fully owned subsidiary for $1.6B.

Without shareholder approval, the directors went ahead with the management's decision. The decision of acquisition was, however, reversed twelve hours after investors sold Satyam's stock and threatened action against the management. ii This was followed by the lawsuits filed in the US contesting Maytas deal. The World Bank banned Satyam from conducting business for 8 years due to inappropriate payments to staff and inability to provide information sought on invoices.xxix Four independent directors quit the Satyam board and SEBI ordered promoters to disclose pledged shares to stock exchange.

Investment bank DSP Merrill Lynch, which was appointed by Satyam to look for a partner or buyer for the company, ultimately blew the whistle and terminated its engagement with the company soon after it found financial irregularities. On 7th January 2009, Saytam's previous Chairman, Ramalinga Raju , resigned after notifying board members and the Securities and Exchange Board of India (SEBI) that Satyam's accounts had been falsified.

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Raju confessed that Satyam's balance sheet of September 30, 2008, contained the following irregularies:

1. Inflated figures for cash and bank balances of US$1.04 billion vs. US$1.1 billion reflected in the books;
2. An accrued interest of US$77.46 million which was non-existent;
3. An understated liability of US$253.38 million on account of funds was arranged by himself;
4. An overstated debtors' position of US$100.94 million vs. US$546.11 million in the books.

Raju claimed in the same letter that neither he nor the managing director had benefited financially from the inflated revenues. He claimed that none of the board members had any knowledge of the situation in which the company was placed. The fraud took place to divert company funds into real estate investment, keep high earnings per share, raise executive compensation and make huge profits by selling stake at inflated price.

The gap in the balance sheet had arisen purely on account of inflated profits over a period that lasted several years starting in April 1999. "What accounted as a marginal gap between actual operating profit and the one reflected in the books of accounts continued to grow over the years," Ragu explained in his letter to the board and shareholders. He went on to explain, "This gap reached unmanageable proportions as company operations grew significantly." Every attempt to eliminate the gap failed, and the aborted Maytas acquisition deal was the last attempt to fill the fictitious assets with real ones. But the investors thought it was a brazen attempt to siphon cash out of Satyam, in which the Raju family held a small stake, into firms the family held tightly. The following chart depicts the Satyam's fabricated income statement. It shows the difference between actual and reported finances:

Fabricated Income Statements of Satyam

Fudging Numbers- as of Sept 30, 2008

(Rs. Cr)

	Actual	Reported	Difference
Cash and Bank Balances	321	5,361	5,040
Accrued Interest on bank FDs	Nil	376.5	376
Understated Liability	1,230	None	1,230
Overstated debtors	2,161	2,651	490
Total	-	-	7,136
Revenues (Q2FY09)	2,112	2,700	588
Operating Profits	61	649	588

The Satyam deal with Matyas was salvageable. It could have been saved only if "the deal had been allowed to go through, as Satyam would have been able to use Maytas' assets to shore up its own books. Raju, who showed artificial cash on his books, had planned to use this nonexistent cash to acquire the two Maytas companies. Given the stake the Rajus held in Matyas, pursuing the deal would not have been terribly difficult from the perspective of the Raju family.

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The auditors, bankers, and SEBI, the market watchdog, were all blamed for their role in the accounting fraud. To what extent did the fraud take place - and who else was involved? It is likely the fraud extended beyond Raju to other top mananagers. The fraud itself, however, was enough.

Factors Contributing to Fraud

Numerous factored contributed to the Satyam fraud. "The independent board members of Satyam (including the dean of the Indian School of Business, a Harvard Business School professor, and an erstwhile star at Intel), the institutional investor community, the SEBI, retail investors, and the external auditor – none of them, including professional investors with detailed information and models available to them, detected the malfeasance." The following is a list of factors that contributed to the fraud:

1. Greed
2. Ambitious corporate growth
3. Deceptive reporting practices-lack of transparency
4. Excessive interest in maintaining stock prices
5. Executive incentives
6. Stock market expectations
7. Nature of accounting rules
8. ESOPs issued to those who prepared fake bills
9. High risk deals that went sour
10. Audit failures – Internal & External
11. Aggressiveness of investment banks, commercial banks,
12. Rating agencies & investors
13. Weak Independent directors and Audit committee
14. Whistle blower policy not being effective

Aftermath of Satyam Scandal

Immediately following the news of the fraud, Merrill Lynch terminated its engagement with Saytam, Credit Suisse suspended its coverage of Satyam, and PricewaterhouseCoopers came under intense scrutiny and its license to operate may be revoked. Coveted awards won by Satyam and its executive management, such as Golden Peacock Award for Corporate Governance under Risk Management and Compliance Issues, SAP Pinnacle Award, E & Y Entrepreneur Award etc, were stripped from the company. Satyam's shares fell to 11.50 rupees on January 10, 2009, their lowest level since March 1998, compared to a high of 544 rupees in 2008. In the New York Stock Exchange, Satyam shares peaked in 2008 at US$ 29.10; by March 2009 they were trading around US $1.80. Investors lost $2.82 billion in Satyam. Criminal charges were brought against Mr. Raju, including: criminal conspiracy, breach of trust, and forgery. After the Satyam fiasco and the role played by PwC, investors became wary of those companies who are clients of PwC, which resulted in fall in share prices of around 100 companies varying between 5-15%.

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Victims of Fraud

Employees of Satyam spent anxious moments and sleepless nights as they faced non-payment of salaries, project cancellations, layoffs and equally bleak prospects of outside employment. "They were stranded in many ways - morally, financially, legally, and socially."

Clients of Satyam expressed loss of trust and reviewed their contracts preferring to go with other competitors. Cisco, Telstra and World Bank cancelled contracts with Satyam. "Customers were shocked and worried about the project continuity, confidentiality, and cost overrun."

Shareholders lost their valuable investments and there was doubt about revival of India as a preferred investment destination. The VC and MD of Mahindra, in a statement, said that the development had "resulted in incalculable and unjustifiable damage to Brand India and Brand It in particular."

Bankers were concerned about recovery of financial and nonfinancial exposure and recalled facilities.

Indian Government was worried about its image of the Nation & IT Sector affecting faith to invest or to do business in the county.

Corporate Governance issues at Satyam

Jagdish Sheth, executive director of the India, China and American Institute and Professor of Marketing at Emroy University, stated: "Indian business culture puts a premium on favors, friendship, and clanship. The Western concept of conflict of interest does not always mesh well with the Indian value of loyalty. People believe that they have to cheat to win. They believe that nice guys finish last."

On a quarterly basis, Satyam's earnings grew. Mr. Raju admitted that the fraud which he committed amounted to nearly $276 million. In the process, Satyam grossly violated all rules of corporate governance. The Satyam scam had been the example for following poor governance practices. It had failed to show good relation with the shareholders and employees. Governance issue at Satyam arose because of non fulfillment of obligation of the company towards the various stakeholders. Of specific interest are the following: distinguishing the roles of board and management; separation of the roles of the CEO and chairman; appointment to the board; directors and executive compensation; protection of shareholders rights and their executives.

Shareholders never had the opportunity to give their consent prior to the announcement of the Matyas deal. Falsified documents with grossly inflated financial reports were delivered to them. Ultimately, shareholders were at a loss - and, cheated. Surely, questions about management's credibility were raised in addition to the non-payment of advance taxes to the government. Together, these raise questions about Satyam's financial health.

Lessons Learned

Satyam's fraud spurred the government of India to tighten corporate norms to prevent recurrence of similar frauds in future. The government took action to protect the interest of the investors and safeguard the credibility of India and the nation's image across the world. It has forced the government to re-write corporate governance rules and tighten the norms for chartered accountants. Some of the regulations include promotion of shareholders' democracy with protection of rights of minority shareholders, responsible

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self-regulation with adequate disclosure and accountability and lesser government control over internal corporate processes, voluntary corporate governance code, certificate of independence for independent directors, an institution of mechanism for whistle blowers, and a cap at 10 percent on the revenues coming from a single client to an audit firm. Promoters should be prohibited from interfering in the recruitment of independent directors. Independent directors should have challenging, skilled ID's, who have time to devote to the business, rather than well known faces. Additional lessons include having an effective 'whistle blower policy' in place, education on ethical values, criteria for remuneration to key personnel, and strengthening of quality review.

Questions

1. Comment on the position of shareholders after the scan came into linelight.
2. How did Satyam fiasco affect Brand India's image?

Source: Christina Caraballo, Anil Cheerla and Omeed Jafari, The George Washington University

3.3 Corporate Governance and other Stakeholders

Corporate governance mechanisms and controls are designed to reduce the inefficiency that might be occurred due to certain moral ambiguities and wrong selections. For example, to monitor managers' behaviour, an independent third party (the external auditor) attests the accuracy of information provided by management to investors. An ideal control system should regulate both motivation and ability. An effective system of corporate governance has both internal and external aspects that have to be sufficiently responsive if governance is to succeed Internal aspects include ownership structure, the board of directors and committees, internal control, risk management, transparency and financial reporting. External aspects can either be market-oriented, or can take the form of credit ranking, and/or social requirements.

3.3.1 Internal Corporate Governance Controls

Internal corporate governance controls and monitors activities and take corrective action to achieve organisational goals. These internal controls may be:

1. ***Monitoring by the board of directors:*** The board of directors, with its legal authority to hire, fire and compensate top management, safeguards invested capital. It is done through by holding regular meetings so that potential problems to be identified, discussed and eliminated. Whilst non-executive directors are thought to be more independent, they may not always result in more effective corporate governance and may not increase performance. Due to the differing nature of the firms or companies different board structures are optimal for different firms. Moreover, the ability of the board to monitor the firm's executives is a function of its access to information. Access to information plays an important role in the fiunctioning of the BOD. The Executive directors possess superior knowledge of the decision-making process and therefore evaluate top management on the basis of the quality of its decisions that lead to financial performance outcomes
2. ***Internal control procedures and internal auditors:*** It is done through different board committees such as audit committtee, management committee and recruitment committee. Internal control procedures are policies implemented by an entity's board of directors. It monitors financial reporting, operating efficiency, and compliance with laws and regulations. Internal auditors are personnel within an organization who test the design and implementation of the entity's internal control procedures and the reliability of its financial reporting.

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3. ***Balance of power:*** It incorporates the theory of seperation of power. It entails that the President be a different person from the Treasurer. This application of separation of power is further developed in companies where separate divisions check and balance each other's actions. One group may propose company-wide administrative changes, another group review and can veto the changes, and a third group check that the interests of people (customers, shareholders, employees) outside the three groups are being met.

4. ***Remuneration:*** Performance-based remuneration is designed to relate some proportion of salary to individual performance. It may be in the form of cash or non-cash payments such as shares and share options, superannuation or other benefits. Such incentive schemes, however, are reactive in the sense that they provide no mechanism for preventing mistakes or opportunistic behaviour, and can elicit short sighted behaviour.

3.3.2 External Corporate Governance Controls

External corporate governance controls encompass the controls of external stakeholders exercise over the organisation. External controls can be:

1. ***Competition:*** Competition can come in various forms like direct competition, indirect competition, internal competition, cost competition, quality competition etc. They keep the organization on the right track and on the way to achieve their goals.

2. ***Debt covenants:*** Both the debtors and the creditors help keep a check on the organization's activities. The lenders will trade off the cost/benefits of a loan as per the risk and interest. Along with hem there are some protective covenants added in the agreement that allow the lender some control.

3. ***Demand for and assessment of performance information:*** The shareholders have the right to know the exact financial position of the company. They have right to go through the financial reports of the company for their personal assessment.

4. ***Government regulations:*** For any company to work smoothly and legally, it must obey the rules of the local government. The government keeps a tab on the organisations so that they adhere to the laws.

5. ***Managerial labour market:*** Managerial labour markets or trade unions have adequate power to control the activities of the company. They have certain demands and have their preset way of functioning. They have the power to negotiate with the management.

6. ***Media pressure:*** Media is the bridge between the corporates and the general public. Hey showcase the position of the company to the people across the globe.

7. ***Takeovers:*** It is purchase of one company (target) by another (acquirer). Both the target and the acquirer have the right to know about all the aspects related to each other's business.

Task

Take examples of Indian companies and show the need of good corporate governance in protecting the interest of different stakeholders.

Notes

Case Study

Polly Peck's Early Years

In 1980 Restro Investments, a private company controlled by Nadir and based in the tax haven of Jersey, made a cash offer for Polly Peck, a small company which had been quoted on the London Stock Exchange for a number of years. Polly Peck was also in the clothing industry, but its profitability had not been remarkable. Restro Investments acquired 58 per cent of the share capital of Polly Peck at a cost of £ 270,000. Over the next ten years, Polly Peck was to experience unprecedented growth under Nadir's management, so that ten years later that 58 per cent share of Polly Peck was worth just over £ lbn (Hindle, 1993). Small wonder if that shareholders who remained loyal to Polly Peck during the first half of the 1980s were so positive about the company's financial performance.

The stock market began to notice the positive effect that Asil Nadir had on company share prices, and market sentiment seemed to work in his favour. In July 1980, Polly Peck raised £ 1.5m in a rights issue, the new capital being required to purchase Uni-Pac, a company already owned by Nadir, which began packaging fruit in northern Cyprus. The Turkish Cypriot government, under its President Rauf Denktash, was keen to encourage inward investment into the economy, although there were no doubt concerns by investors about the status of the Turkish Cypriot economy and about potential difficulties in remitting cash from northern Cyprus.

Moving away from clothing, an industry, which Nadir was experienced and familiar with, and diversifying into fruit packaging represented a risk. Polly Peck then acquired another small listed company, Cornell Dresses. Shortly after acquiring control, the share price of Cornell Dresses increased by approximately 400 per cent, which seems to have been related once again to positive market sentiment connected with Asil Nadir's business reputation.

Nadir then turned his attention to the Turkish mainland. He decided to set up a water-bottling plant at Niksar in 1982 and was expecting to sell bottled mineral water to Middle Eastern countries, a potentially lucrative market. In 1983 Nadir picked-up another company in Turkey, involved in fruit packing and processing. That same year, he entered into a joint venture (Vestel) with the UK firm Thorn-EMI. Vestel would manufacture televisions and video-cassette recorders and was to prove a particularly profitable part of the Polly Peck group. Although many of Polly Peck's business ventures were ultimately profitable, some of them took time to come on stream, yet the stock market always seemed to have particularly optimistic expectations about the future profitability of these deals—perhaps unrealistically high expectations.

In the early 1980s, some financial journalists began to question the quality of information in Polly Peck's financial statements about current operations. Hindle refers to articles in The Observer in 1983 on the slow progress of the water-bottling plant at Niksar, and about the profit projections for the Thorn-EMI electronics venture. Michael Gillard, an Observer journalist, had questioned whether Polly Peck's UK auditors, Stoy Hayward, were carrying out proper checks on the Cypriot accounts, which were being audited by a local Cypriot firm. And why was there no geographical breakdown of profit and turnover in the accounts? The London Stock Exchange's rules demanded that quoted companies give such a breakdown, but Polly Peck had obtained a special exemption from the Stock Exchange

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on the grounds that giving such information would be 'commercially damaging'. This vacuum, said the Observer, 'only serves to encourage speculation, if not suspicion'. Mr Nadir did not help his case by refusing to meet Mr Gillard and put across his point of view (Hindle, 1993).

However, such negative comments seemed to have little impact on the share performance of Asil Nadir's companies. One explanation that has been offered is that the 1980s witnessed an era of increasing entrepreneurship engendered by the values of the Conservative government under Prime Minister Margaret Thatcher, who came to power in 1979. Also, Asil Nadir seemed to find little difficulty in raising the necessary finance for his projects from UK banks.

It is quite likely that the Conservative privatizations of the early 1980s influenced market sentiment. The privatizations of state-owned enterprises such as British Telecommunications had created a wider spread of share ownership, which gave an almost assured capital gain to those who subscribed for the shares. In this environment, Polly Peck was perhaps seen by many investors as a stock that could be relied on to produce above-normal profits well into the future. During the 1980s it was also perceived by some observers that Polly Peck's operations in Cyprus might be at risk from political uncertainties. Asil Nadir had been able to negotiate some privileges for his companies' operations in northern Cyprus with the Turkish Cypriot President Rauf Denktash but there was always a danger that reunification of the island could end these favorable conditions. But in the first half of the 1980s it appeared that some of Polly Peck's projects – the water-bottling plant in Turkey and the Vestel electronics plant – were taking longer to deliver revenues than had been anticipated. Nevertheless, Polly Peck had a tendency to continually announce new and exciting ventures and this seemed to support investors' confidence in the shares and hence the share price.

Polly Peck Expands Abroad

By 1985, Cornell Dresses and Wearwell had been incorporated in the Polly Peck Group, whose name was changed to Polly Peck International. Headquarters were established in Berkeley Square, an exclusive part of Mayfair in London. By 1986 Polly Peck shares could be traded in the USA and positive market sentiment there appears to have been partly responsible for a substantial rise in the Polly Peck share price in 1987.

Towards the end of 1987, Polly Peck was raising loan finance in Swiss francs for investment in countries such as Turkey. This did not appear to be a sound policy, raising finance in a stable currency to invest in a weak currency area. One of the problems with trying to interpret Polly Peck's financial position was the fact that a large part of its revenue was received in Turkey and northern Cyprus, where the local currency was the Turkish lira.

During 1988, Polly Peck began to buy companies or establish joint ventures in various countries, including the Netherlands, Spain, Hong Kong and the United States. In addition, Polly Peck was buying stakes in UK companies such as Borthwicks, involved in food processing. Polly Peck had also invested in shipping and by 1988 operated 10 ships with cargo and refrigeration facilities. As a result of organic growth combined with company takeovers, the group virtually doubled in size between 1987 and 1988. There was a danger that Polly Peck was overreaching itself and would not be able to properly control so many diverse operations.

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Even though he was both chairman and chief executive of Polly Peck International, Asil Nadir could not always persuade his board to agree to his corporate purchases and, instead, bought some operations (such as newspaper publishers in Turkey) from his own private resources.

In 1989, Del Monte, which processed tinned fruit and sold fresh fruit came on to the market. The previous year, RJR Nabisco had been the subject of a leveraged buy-out, which had left the company with a substantial amount of debt to service. RJR Nabisco decided to sell Del Monte to reduce its debt. Polly Peck decided to bid for the fresh fruit business and paid $ 875m. As a result of this deal, Polly Peck's share price increased by over 20 per cent. This increase in market capitalization helped to push Polly Peck into the FTSE 100 index. The purchase of Del Monte was paid for partly through a rights issue and partly through debt, the major part being debt. In addition, the Del Monte brand was included on the Polly Peck balance sheet.

In 1989, Polly Peck acquired a 51 per cent stake in Sansui, a Japanese electronics company quoted on the Tokyo Stock Exchange. This purchase also increased Polly Peck's debt. In order to reduce debt, Polly Peck began to sell some operations that had formed the core of its business, and attempted to get Del Monte a quote on the New York Stock Exchange (NYSE), but was not successful. This would have raised additional equity for the Polly Peck group of companies and helped to reduce its overall level of debt.

Nadir tries to take Polly Peck Private

In August 1990, an indication of Asil Nadir's management style came in an announcement that he would bid for Polly Peck International with the aim of converting it into a private group. On Friday 10th August, 1990, Asil Nadir summoned the board of directors of Polly Peck to an extraordinary meeting two days later. After five hours of boardroom discussion, Polly Peck's finance director, David Fawcus, announced the possibility of a bid by Asil Nadir to take the group private. It appeared that Nadir was becoming frustrated by his conviction that the group's shares were 'undervalued' in the stock market.

For a long time Asil Nadir had felt that the group's price-earnings ratio was too low. The price-earnings ratio expresses the relationship between a company's share price and its earnings (essentially, reported profits before payment of dividends). Companies which operate in a relatively 'safe' economic environment tend to have higher price-earnings ratios compared to companies whose earnings are more volatile and perhaps seen as 'risky'. In August 1990, the price-earnings ratio of Polly Peck was about 8. Because a large part of Polly Peck's revenues were generated in northern Cyprus, whose international status was unclear, it was likely that the stock market would mark down the shares to some extent. But in 1990 there was an additional element of risk. On 2nd August, 1990, Iraqi armed forces invaded Kuwait, bringing instability to the Middle East and much of Polly Peck's revenue was generated in Turkey, which shared a border with Iraq.

A report, shortly after Asil Nadir announced that he wanted to take Polly Peck private, stated:

The precise fashion in which the group achieved its extraordinary profitability has never been fully apparent then or now. In the City doubts began to circulate, fanned, most Turks believe, by Mr Nadir's enemies among the Greek Cypriots who were not unnaturally resentful of his success in making profits out of their former orange groves. Rumours that the Turkish Cypriot authorities were about to withdraw tax concessions helped fuel a

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market panic and a plunge in the share price. Distrust of Mr Nadir was exacerbated by a campaign against him by some British papers (Financial Times, 14 August, 1990: 15).

At first, commentators appeared to be generally sympathetic to Asil Nadir's move to take Polly Peck private. While Turkey and northern Cyprus were important to Polly Peck's operations, together revenues generated in the Eastern Mediterranean comprised only about 30 per cent of the group total. Nadir's frustration with what he viewed as a low stock market valuation seemed to be a reasonable justification for him to want to take the group private. However, five days after announcing his intention to take the group private, Asil Nadir abruptly changed his mind, and announced that he was dropping the plan. This abrupt change on Nadir's part did not go down well in the market. The share price fell substantially over the course of one week. Before the announcement, the share price stood at 393p, equivalent to a market capitalization of £ 1.9bn. After Asil Nadir announced that he would not take the group private, the share price fell to 307p, equivalent to a market capitalization of £1.3bn. In the course of a week, approximately £ 600m had been wiped off the equity value of the group. This event seemed to be a turning point in Polly Peck's fortunes.

The Stock Exchange Investigates

Nadir alleged that he had dropped his plans to take the company private after receiving approaches from 'significant institutional and private shareholders' who wanted Polly Peck to remain public. The London Stock Exchange was keen to investigate quickly the circumstances surrounding the two announcements by Asil Nadir, particularly in view of the fluctuations in the share price. He had claimed that there was no doubt as to the availability of finance to make an offer for the company. His private shareholdings in Polly Peck amounted to 26 per cent and he would need acceptances from other shareholders of 64 per cent to arrive at the critical level of 90 per cent of the group's shares. A statement issued by the Stock Exchange, following the investigation, noted a lack of preparation to normal standards by Mr Nadir before he notified the board of his intention to make an offer for Polly Peck. It also referred to the fact that Mr Nadir convened an emergency board meeting for Sunday 12th August, 1990 at very short notice and this contributed to the fact that only seven of the thirteen directors were able to attend. Also, given the short notice, the board did not have access to adequate professional advice on a suitable response to Mr Nadir's approach. Somewhat ominously, the Stock Exchange reported that it had conveyed its findings and the supporting papers to the relevant authorities. There is little doubt that a main concern of the Stock Exchange was that anyone with privileged information on the announcements could have exploited the opportunity to benefit financially from the share price fluctuations.

But, by early September 1990, Polly Peck appeared to have put the August controversy behind it and announced on 3rd September, 1990 financial results for the first half of the financial year: they were better than market forecasts had suggested. Polly Peck also announced a 21 per cent increase in its interim dividend, but at a meeting with analysts, in answer to a question, Asil Nadir was forced to issue a categorical denial that he was under investigation. Then on 20th September, 1990, Asil Nadir was interviewed by the Serious Fraud Office (SFO) and questioned for several hours. On 19th September the Metropolitan Police had searched the offices of South Audley Management, a property company indirectly linked to Nadir. It appeared that South Audley Management and a former director had been investigated by the Stock Exchange insider dealing group.

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It was also reported that the Turkish Government had made representations to the UK Prime Minister concerning what it believed to be a campaign against Nadir, manipulated by Greek Cypriots. On Thursday 20th September, 1990, the share price of Polly Peck had collapsed and trading was suspended at a price of 108p. The falling share price coincided with Asil Nadir's questioning by the Serious Fraud Office. The fall in share price left Polly Peck with a market capitalization of £ 468m, about a quarter of what it had been two months earlier.

On 23rd September, 1990 the Sunday Times published a lengthy article which alleged that there had been irregularities in share dealings in Polly Peck shares. The article cited Jason Davies, a broker based in Switzerland who worked for Asil Nadir's private companies. The article went on to explain:

For some weeks, well before the SFO entered the scene, the Sunday Times Insight team had been investigating Nadir, Davies and their associates. It has uncovered how: for months Davies and others ran a share-buying operation to bolster the fortune and reputation of both Nadir and Polly Peck; a complex network of letter-box companies and foreign bank accounts was used to disguise the scheme and hide it from the prying eyes of City regulators (Sunday Times, 23rd September, 1990, Business Section).

The Sunday Times article also referred to an incident in May 1989. David Fawcus, finance director of Polly Peck, and Tony Reading, managing director, were surprised to learn that a number of key staff had suddenly been dismissed by Asil Nadir. The dismissed staff included Martin Helme, finance director of Sunzest (a Polly Peck subsidiary); Vi Jensen, financial controller; Martin Brown, another Sunzest executive; and even David Fawcus's own secretary. When the news reached the stock market, Polly Peck's shares dropped by 10 per cent amid fears that Tony Reading might resign. In the event Tony Reading did resign a month later, although David Fawcus stayed on and did not resign until early 1991, by which time administrators had been appointed to manage Polly Peck.

The Sunday Times article of 23rd September, 1990 raised the possibility that Polly Peck money might have been used to buy Polly Peck shares. 'If they did so, it would send misleading signals to the market. Pension funds and trusts, which look after the savings of millions of ordinary people, as well as private investors and speculators, rely on share prices to guide their investment decisions. They assume that price reflects thousands of independent decisions to buy, hold or sell. Financial assistance by a company for the acquisition of its own shares is therefore outlawed'.

By Monday 24th September, 1990, it was being reported that some financial institutions were calling for the appointment of an independent chairman. There were also requests that independent reporting accountants be brought in alongside Polly Peck's established auditors, Stoy Hayward. On Wednesday 26th September, 1990, it was revealed that the Takeover Panel had uncovered trades in shares of Polly Peck International worth nearly £ 2m, which were undisclosed for six weeks in breach of the Takeover Code. It was reported that sales of Polly Peck shares at 417p and 410p were made near the top of the market following Asil Nadir's announcement to buyout the company. It was also stated that rule 8.3 of the Takeover Code requires all deals by any shareholder controlling more than 1 per cent of any company to be disclosed by noon the day after they were carried out, once a formal bid period has begun. The shares in question had been sold two days after the Polly Peck board announced the approach by Asil Nadir to buyout the remaining Polly Peck shares.

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Polly Peck's Liquidity Problems

On Monday 1st October, 1990, Polly Peck International delivered a statement on the crisis which had overtaken the company since Asil Nadir had proposed to buyout the remaining Polly Peck shareholders on 12th August, 1990. It stated that the share price collapse and associated negative publicity had precipitated liquidity problems for the parent company. The board emphasized that these liquidity problems related to the parent company rather than to operating subsidiaries which they claimed had a very successful trading record. The board went on to say that one of its most urgent tasks was to see a restoration of confidence in the company. In addition Mr Nadir had informed the board that he denied all allegations of impropriety and he had commenced proceedings for libel against the Sunday Times and Observer newspapers.

In early October 1990, The Guardian reported that Asil Nadir was jetting around the world struggling to save his corporate empire and that the financial chaos surrounding Polly Peck threatened to spread to other companies built up and dominated by charismatic individuals. In an interesting article, Roger Cowe referred also to Rupert Murdoch and Robert Maxwell as striving to avoid joining the list of debt-bound businesses whose extraordinary growth during the 1980s was in danger of being followed by dramatic collapse in the 1990s. This was a particularly insightful comment given that the Maxwell empire collapsed just over a year later under a mountain of debt. Cowe was particularly concerned about independent scrutiny of chairmen who dominated their boards of directors in quoted companies. 'Look in vain for strong directors, executive or non-executive, who can stand up to the charismatic boss, not merely to verify transactions with private interests, but also to challenge their whims.'

The reason for the collapse in the share price became clearer some two weeks later. It was reported that banks that were holding Polly Peck 1 shares, as collateral against loans advanced to Asil Nadir, dumped 10m shares on the market on 20th September, 1990 and this precipitated a collapse in the company's share price. Once the share price fell, the shares Nadir had it pledged as collateral would be insufficient and he would need to increase the collateral. On 21st September, 1990 the Zurich office of Warburg's sold a further 2.6m shares. In total over 16m shares were sold by financial institutions before the share price suspension, the largest single sale being 7.9m shares sold by Citicorp investment bank on 20th September, 1990.

On 3rd October, 1990, Polly Peck announced that it had halted payments to creditors. An adviser to Asil Nadir claimed that Polly Peck's liquidity problems had arisen because the Sheraton Voyager Hotel, which had been built in the Turkish coastal resort of Antalya at a cost of £ 70m, had been financed not by an increase in debt but out of the group's cash flow. A meeting with its banks was scheduled for 5th October and there was some expectation that Turkish financial institutions would be willing to provide financial assistance to Polly Peck during its liquidity crisis. It was learned that Polly Peck was facing difficulties remitting cash from northern Cyprus.

On 4th October, 1990 Asil Nadir appeared to be confident about his financial position and claimed that his personal wealth was eight to ten times the value of his 24 per cent holding in Polly Peck. However, it was not known to what extent this holding was pledged against bank loans. At the suspension price, this made his personal wealth worth about £1 bn. He claimed that he had substantial assets in Turkey and northern Cyprus. By 8th October it seemed unlikely that the Turkish President, Turgut Ozal, would be willing to mount a rescue operation for Polly Peck, but Nadir hoped to gain a standstill on interest payments

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and a rollover of short-term debt. He stated that he was negotiating to dispose off assets and reduce the company's gearing.

On 10th October, 1990, Asil Nadir flew to Turkey to begin negotiations with government officials, banks and businesses in order to try to resolve Polly Peck's financial crisis. Speaking from Turkey on 11th October, Nadir claimed that he would be able to offer serious evidence of good amounts of remittances from Turkey and Cyprus. He needed to provide solid evidence to the creditors of Polly Peck that he could produce cash to persuade the banks to roll over the existing loans. Asil Nadir was desperate to dispose of assets in Turkey and northern Cyprus, but appeared to be facing difficulties in getting potential purchasers interested in bidding for Polly Peck's businesses in the eastern Mediterranean.

By 23rd October, one banker in Istanbul was quoted as saying 'Mr Nadir is not succeeding in selling anything here, including his personal assets, and he has no way out now'. Already, Polly Peck had made more than 100 employees redundant in Cyprus and it was feared that there would be further job losses, given that Polly Peck was the largest employer in northern Cyprus with 8,000 employees.

The Court Appoints Administrators

Polly Peck was placed into administration on 25th October, 1990 after the company was unable to satisfy its bankers that it would be able to reduce its debts. In addition, Asil Nadir himself faced personal bankruptcy when Barclays de Zoete Wedd attempted to serve a personal bankruptcy petition against him for £ 3.6m unpaid debt relating to Polly Peck shares purchased the previous month.

The descent from being one of the UK's thirty-six wealthiest individuals to defendant in a bankruptcy action had occurred over just a few weeks, and could have easily been avoided. It was the result of his repeated purchases of Polly Peck shares during the autumn as the share price tumbled. Taken all together, his last-ditch purchases totaled between £ 40 million and £ 50 million, and on top of this were liabilities to the Inland Revenue believed to be about £ 20 million. If it seems remarkable that Asil Nadir would have made purchases on this scale while his empire was tottering around him, it may seem even more astonishing that the securities houses with whom he traded allowed themselves to become involved in risky transactions on this scale when a moment's reflection would have warned them of what might lie ahead (Barchard, 1992).

On 30th October, the Serious Fraud Office (SFO) arranged for police and accountants to search the London headquarters of Polly Peck and it was reported that debts owing to creditors exceeded £ 1.3bn. Matters went from bad to worse when, on 17th December, 1990, Asil Nadir was charged with 18 offences of theft and false accounting. He had been arrested on 15th December at Heathrow Airport, London, when he had returned from a month's visit to Turkey and northern Cyprus in an attempt to dispose off assets and raise cash.

There appeared to be differences between administrators and the SFO. The administrators had reportedly warned that Nadir's arrest might hinder their work. They had previously complained of disruption when the SFO searched Polly Peck's London headquarters at Berkeley Square on 30th October and removed papers from the building.

After Nadir's arrest on 15th December, 1990, bail was set at £ 3.5m and Nadir was forced to spend several days in Brixton jail while the bail conditions were met. In addition, Nadir had to surrender his passports. The bail conditions appeared to some observers to be quite severe. In November 1991, Asil Nadir had been made personally bankrupt which meant

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that he had to give up his UK company directorships, including chairman and chief executive of Polly Peck. In February 1992, Nadir was committed for trial at the Old Bailey.

At first, the administrators had decided to co-operate with Asil Nadir, since they believed that the shareholders and creditors would ultimately receive more through co-operation than through legal action, but in October 1991 the administrators sued him for damages. In May 1991, the administrators had predicted that the shareholders and creditors would receive 52 pence for every £1 they had lost. By 1993, it seemed that the creditors would receive only 4 pence in the pound. By June 1991, the administrators' costs amounted to £ 8 Am.

At the end of the day, administrators are judged by what they can retrieve for creditors and shareholders. If in Polly Peck's case this turns out to be less than they earn in fees for themselves it will not be the first time in British corporate history that the process of administration has been a complete fiasco (Hindle, 1993).

Asil Nadir Flees to Cyprus

In May 1993, Asil Nadir decided to break his bail conditions and escape to northern Cyprus. Shortly after his escape to Cyprus, The Independent speculated that Asil Nadir had decided to 'jump bail' because four applications for a relaxation of his bail conditions had already been rejected by the UK courts. In addition, he may have suspected that he would be charged with conspiring to pervert the course of justice (by withholding information), which could mean that his bail would be revoked. IS Apart from the criminal prosecution, Nadir was being sued for £ 378m in the civil courts by the Polly Peck administrators, and creditors were claiming a further £ 80m from him.

Nadir has effectively been in exile in northern Cyprus since May 1993 and, given the particular international legal status of northern Cyprus, has managed to avoid extradition to face the courts in the UK. Although in 2003 Nadir suggested that he wanted to return to the UK to face the courts and clear his name, the SFO stated that he still faced 66 counts of theft. From Nadir's point of view he would probably face arrest as soon as he set foot in the UK. At the time of writing, unless Nadir does decide to return voluntarily to the UK, his trial is likely to resume only if northern Cyprus becomes part of the European Union. Until that time and the resumption of the court proceedings, many questions related to this case are unlikely to be resolved.

Could, or should, the events which overtook Polly Peck in 1990 have been foreseen? With hindsight it is possible to argue that the stock market was fixated on the remarkable share price performance of Polly Peck during the 1980s. Stock market sentiment may have been placing unreasonable expectations on the future profits that Polly Peck would be able to deliver.

Although some were critical of the basis for Polly Peck's share price movements, critics – especially during Polly Peck's heyday – seemed to be in a small minority. Barchard (1992) refers to one Swiss shareholder in Polly Peck who recalled being laughed down by other investors when he questioned the treatment of foreign exchange losses at an annual general meeting.

Gwilliam and Russell believe that financial analysts were insufficiently critical of Polly Peck's financial statements and argue (1991) that 'a significant proportion of analysts either did not dig sufficiently deep into the disclosed information or failed to understand its importance'. They comment on the fact that Polly Peck held monetary assets in Turkey and northern Cyprus in a depreciating currency, the Turkish lira. In this situation, holdings

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in the local currency would be subject to exchange losses over time as the Turkish lira depreciated against the pound sterling. However, a depreciating currency, by its very nature, will also be associated with high levels of interest on deposits (as compensation for the depreciating currency).

Gwilliam and Russell also refer to the fact that in 1989 Polly Peck's interest received was greater than interest payable, a surprising result since at the beginning and end of the financial year monetary liabilities exceeded monetary assets.

The relevant UK accounting standard, SSAP 20, Foreign Currency Translation (ASB) allowed foreign exchange losses to be taken to reserves, rather than be deducted from profit in the profit-and-loss account. But a case could be made for charging foreign exchange losses directly to the profit-and-loss account. Nevertheless, full information was provided in Polly Peck's accounts through the notes. As Gwilliam and Russell (1991) state, 'Polly Peck's accounts were full of danger signs. So why did the analysts still say "buy"?'

The fact that Asil Nadir was both chairman and chief executive of Polly Peck was also a cause for concern. The concentration of too much power in the hands of one individual may have meant that important decisions were not fully discussed by the board of directors. Hindle (1993) states that in 1990:

The reality was that Mr Nadir was juggling with so many balls at the time that he did not have the capacity to watch them all with his usual intensity. Superior information and a hands-on will to succeed had always been at the heart of his commercial successes. Now he was some times not getting the information, or not absorbing what he was getting.

In February 1991, an auction of furnishings at the London headquarters of Polly Peck, in Berkeley Square, raised about £ 3m. It was reported that Nadir had invested heavily in 18th century English furniture and had spent about £ 7m on the Polly Peck corporate collection. It has to be wondered whether such expenditures were of benefit to Polly Peck. Could they have been used more profitably elsewhere in the group?

Finally, concerns have been expressed in the medial about the legal process following Asil Nadir's arrest in December 1990 and the length of time it took for the UK authorities to bring the case to trial. Initially, Nadir was charged with 59 counts of theft and false accounting, but in 1992 a judge threw out 46 charges, leaving charges relating to £ 31m. When Nadir fled in May 1993, two and a half years after Polly Peck collapsed, the trial had not yet started and Nadir was under quite restrictive bail conditions. It is perhaps not surprising that he became impatient with the delays in the legal process. What is clear is that until the legal process can resume, there will be no definitive answer to many of the issues surrounding this complex affair.

Questions

1. Trace the expansion path of Polly Peck.
2. Why did the Stock Exchange intervene in the matters of Polly Peck?
3. Nadir was the only one responsible for company's downfall. Do you agree? Give reasons for your answer.

Source: D Geeta Rani and R K Mishra, *Corporate Governance: Theory and Practice*, First Edition, Excel Books, New Delhi, 2008.

Notes

3.4 Summary

- Stakeholders are any entity, person, group or possibly non-human entity, that can affect or can be affected by the actions or policies of an organization.
- In this regard stakeholders' theory proposes corporate accountability to a broad range of stakeholders.
- Corporate governance mechanisms and controls are designed to reduce the inefficiency that might be occurred due to certain moral ambiguities and wrong selections.
- An effective system of corporate governance has both internal and external aspects that have to be sufficiently responsive if governance is to succeed .
- Internal control includes, monitoring by the board of directors, internal control procedures and internal auditors, balance of power and remuneration.
- External control relates to the governmental control, labor markets, debt covenants etc.
- Bankruptcy not only affect the creditors but also affect suppliers of goods and services, banks, financial institutions, and so on. That is why there is a need to frame a code for protecting the different interest groups from the damage of their economic interest.
- India does not have a clear and comprehensive law on corporate bankruptcy. In fact, there is even significant confusion in the meaning of the terms bankruptcy, insolvency, liquidation and dissolution.

3.5 Keywords

BIFR: Board of Industrial and Financial Reconstruction

External Control: These are external to the organisation such as governmental regulations.

Internal Control: These controls are exercised internally by the organisation.

SICA: Sick Industrial Companies (Special Provisions) Act, 1985

Stakeholders: Any entity which can affect or be affected by the organisation.

3.6 Self Assessment

State whether the following statements are true or false:

1. Monitoring by the board of directors is one of the external control.
2. Bankruptcy only affect the creditors.
3. Shareholders are one of the important stakeholders in an organisation.
4. Equitable treatment of shareholders is made for the protection of the shareholders rights.
5. Minimum offer price is the market price of the share.
6. A common complaint by shareholders is delay in issuance of share certificates.
7. Shareholders have rights to elect and remove members on the board.
8. Government is entrusted with the responsibility of convening the Annual General Meetings of the companies.
9. To ensure that takeover bids are serious, there has to be an escrow account.
10. Competition is an external corporate governance control.

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3.7 Review Questions

1. What are basic responsibilities of an organization towards its stakeholders?
2. What are the rights of the shareholders? Discuss.
3. An organization should take care of its shareholders. How does SEBI ensure this?
4. Do you think shareholders deserve an equitable treatment? Give reasons.
5. Compare the internal and external corporate governance controls.
6. Discuss the nature of complaints put forward by the shareholders of a company. Why do you think it is important for the company to study the nature of the complaints?
7. Take an example of a company and discuss its policies towards its different stakeholders.
8. "Media acts an important external control in today's scenario." Comment
9. Organization and society go hand in hand. Do you agree? Give reasons.
10. Do you think that the bankruptcy system in India is good enough?

Answers: Self Assessment

1.	False	2.	False
3.	True	4.	True
5.	False	6.	True
7.	True	8.	False
9.	True	10.	True

3.8 Further Readings

Books

C V Baxi, *Corporate Governance.*

Geeta Rani, R K Mishra, *Corporate Governance: Theory and Practice*, Excel Books.

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Online links

en.wikipedia.org/wiki/Corporate_governance

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Unit 4: Board of Directors: A Powerful Instrument in Governance

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Objectives

After studying this unit, you will be able to:

- Discuss the type of power, liabilities and duties of directors
- Explain the role of board of directors
- Know the board's committees

Introduction

Shareholders are the owners of the company but they don't run it. That job is given to the directors. All limited companies must have at least one director. Directors have many business responsibilities for ensuring the success of their company, in areas such as health and safety, employment law and tax. A board of directors is a body of elected or appointed members who jointly oversee the activities of a company or organisation. A board's activities are determined by the powers, duties, and responsibilities delegated to it or conferred on it by an authority outside itself. These matters are given in the organisation's bylaws. The bylaws commonly specify the number of members of the board, their selection criteria and the number of times they are supposed to meet. In an organisation which is having shareholders, the board acts on behalf of the shareholders. They are also chosen by the shareholders themselves and is the highest authority in the management of the corporation.

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4.1 Meaning of Directors

In general terms, a director is someone appointed to take responsibility for the policy formation and control of a company because of particular ability and expertise in an industry. Directors advise management of the company on behalf of the shareholders (the owners of the company). However, the exact position of 'director' is hard to define, as no formal definition, either statutory or judicial, of the term has been given. The judicial pronouncements have described them as (i) agents, (ii) trustees, or (iii) managing partners.

The directors act as agents of the company and the ordinary rules of agency apply. They exercise the powers and are subject to duties within the framework of the company's Articles, and the Act. For instance, they may make contracts on behalf of the company and they will not be personally liable as long as they act within the scope of their authority. But if they contract in their own name, or fail to exclude personal liability, they also will be liable. If the directors exceed their authority, the same act may be ratified by the company. But if they do something beyond the objects clause of the company, then the act is ultra vires and the company cannot ratify the same. But directors are not agents for the individual shareholders, they are the agents of the company-the artificial person.

The directors have also been described as trustees. But they are not trustees in the full sense of the term in as much as no proprietary rights of the company's property are transferred to them and, therefore, they enter into contracts on behalf of the company and in the name of the company. On the other hand, in the case of a trust, the legal ownership of the trust property is transferred to the trustee and therefore, he can enter into contract in his own name, but whatever he does, he does for the benefit of the beneficiaries.

The directors are also sometimes described as managing partners. They manage the affairs of the company on their own behalf and on behalf of other shareholders who elect them.

4.2 Types of Directors

Various types of directors that can exist in a company are:

1. ***Ordinary Directors:*** Ordinary directors are also referred to as simple directors who attends Board meeting of a company and participate in the matters put before the Board. These directors are neither whole time directors nor managing directors.

2. ***Managing Director:*** Managing Director is a director who, by virtue of an agreement with the company or of a resolution passed by the company in general meeting or by its Board of directors or, by virtue of its Memorandum or Articles of Association, is entrusted with substantial powers of management which would not otherwise be exercisable by him, and includes a director occupying the position of a managing director, by whatever name called.

3. ***Executive Directors:*** An executive director is a director who performs a specific role in a company under a service contract which requires a regular, possibly daily, involvement in management.

   Such a director may also be an employee of the company. This fact may create a potential conflict of interest which in principle a director is required to avoid.

   To allow an individual to be both a director and employee the articles usually make express provision for it, but prohibit the director from voting at a board meeting on the terms of their own employment.

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4. ***Non-executive Directors:*** A non-executive director does not have a function to perform in a company's management but is involved in its governance. They are subject to the same legal duties as executive directors. In listed companies, corporate governance codes state that boards of directors are more likely to be fully effective if they comprise both executive directors and strong, independent non-executive directors.

5. ***Shadow Directors:*** According to company law, a director is a person who is responsible for the overall direction of the company's affairs. This means any person occupying the position of director, by whatever name they are called. A shadow director has also been defined as any person in accordance with whose instructions the directors are accustomed to act. However this does not include professionals such as accountants or solicitors.

   A person might seek to control a company as a director but avoid the legal responsibilities of being a director. The law seeks to prevent this by extending several statutory rules to shadow directors. Shadow directors are directors for legal purposes if the board-of-directors is accustomed to act in accordance with their directions and instructions.

6. ***Additional Directors:*** Additional Directors are appointed by the Board between the two annual general meetings subject to the provisions of the Articles of Association of a company. Additional directors shall hold office only up to the date of the next annual general meeting of the company. Number of the directors and additional directors together shall not exceed the maximum strength fixed for the Board by the Articles.

7. ***Alternate Director:*** An Alternate Director is a person appointed by the Board if so authorised by the Articles or by a resolution passed by the company in the general meeting to act for a director called "the original director" during his absence for a period of not less than three months from the State in which meetings of the Board are ordinarily held. Generally, the alternate directors are appointed for a person who is Non-resident Indian or for foreign collaborators of a company.

8. ***Professional Directors:*** Any director possessing professional qualifications and do not have any pecuniary interest in the company are called as "Professional Directors". In big size companies, sometimes the Board appoints professionals of different fields as directors to utilise their expertise in the management of the company.

9. ***Nominee Directors:*** The banks and financial institutions which grant financial assistance to a company generally impose a condition as to appointment of their representative on the Board of the concerned company. These nominated persons are called as nominee directors.

10. ***Independent Directors:*** As per the definition of independent director in the code of Corporate Governance, an independent director should not have any pecuniary relations or transactions with the company or its promoters; his decisions should be independent of those who have controlling stake in a company and be in the overall interest of the company and its stakeholders.

4.3 Power and Liabilities of Directors

A board of directors is a group of people elected by the owners of a business entity or shareholders who have decision-making authority, voting authority, and specific responsibilities which in each case is separate and distinct from the authority and responsibilities of owners and managers of the business entity. Directors are the members of the board of directors. The members of the board can be insider or outsider. Insiders are those who are somehow related to the corporation and may be referred to as executive directors. Outsiders are not related to the company, they may be referred as non executive directors or the independent directors. The legal responsibilities of boards and board members vary with the nature of the organisation, and with the jurisdiction

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within which it operates. For public corporations, these responsibilities are typically much more rigorous and complex than for those of other types.

The power and associated liabilities of a board of directors depend upon the nature and type of business organisation and the laws applying to the organisation.

Example: The business entity may be a public company or a private, limited or closely held company, owned by family members. There are numerous types of business entities available throughout the world such as a corporation, limited liability company, cooperative, business trust, partnership, private limited company, and public limited company.

Directors' powers and financial liabilities vary with the nature of the company. The company's Memorandum and Articles of Association limit what directors can do. The directors' liabilities emerge from the power and responsibility they shoulder. Typically these includes: monitoring the business activities, treating all shareholders equally, avoiding conflicts of interest, not making personal profits at the company's expense, not accepting benefits from third parties, must confined within the legal and regulatory framework, reporting and disclosure of financial statements and required reports.

The board of directors exercises their power usually in board meetings. Most legal systems provide that sufficient notice has to be given to all directors of these meetings, and that a quorum must be present before any business may be conducted. Here board has a power to accept any new business proposal or giving up any loss making activity. Directors also decide major policy changes in the business plan, selection or rejection of CEO etc. The powers of the board are vested in the board as a whole, and not in the individual directors.

4.4 Duties of Directors

Duties of directors may be divided under two heads:

1. Statutory duties
2. Duties of a general nature

4.4.1 Statutory Duties

The statutory duties are the duties and obligations imposed by the Companies Act. These have been discussed at appropriate places. Important among them are:

To file return of allotments: Section 75 charges a company to file with the registrar, within a period of 30 days, a return of the allotments stating the specified particulars. Failure to file such return shall make directors liable as 'officer in default'. A fine upto ₹ 500 per day till the default continues may be levied.

Not to issue irredeemable preferences shares or shares redeemable after 10 years: Section 80, forbids a company to issue irredeemable preference shares or preference shares redeemable beyond 10 years. Directors making any such issue may be held liable as 'officer in default' and may be subject to fine upto ₹ 1,000.

To disclose interest [Ss.299-300]: A director who is interested in a transaction of the company must disclose his interest, to the Board. The disclosure must be made at the first meeting of the Board held after he has become interested. This is because a director stands in a fiduciary capacity with the company and therefore, he must not place himself in a position in which his personal interest conflicts with his duty. Interest should be such which conflicts with the duties of the director towards the company.

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Notice, however, that the Companies Act does not debar a company from entering into a contract in which a director is interested. It only requires that such interest be disclosed. An interested director should not take part in the discussion on the matter of his interest. His presence shall not be counted for the purpose of quorum. He shall not vote on that matter. If he does vote, his vote shall be void. Non-disclosure of interest makes the contract voidable and not void. Where the whole body of directors is aware of the facts, a formal disclosure is not necessary (Venkatachalapathi v. Guntur Mills). In this case a loan was advanced by the wife of a director creating a mortgage on the property of the company. The director did not disclose his interest and he even voted on the matter. The company later sued to have mortgage set aside. Held, the fact was known to all directors and a formal disclosure was not necessary. As regards voting by the interested director, it was held that the voting would not render the contract void or voidable unless in the absence of that vote, there would have been no quorum qualified to contract.

To disclose receipt from transferee of property: Section 319 provides that any money received by the directors from the transferee in connection with the transfer of the company's property or undertaking must be disclosed to the members of the company and approved by the company in general meeting. Otherwise the amount shall be held by the directors in trust for the company. This money may be in the name of compensation for loss of office but in essence may be on account of transfer of control of the company. But if it is bona fide payment of damages of the breach of contract, then it is protected by s.321(3).

To disclose receipt of compensation from tranferee of shares: If the loss of office results from the transfer (under certain conditions) of all of the shares of the company, its directors would not receive any compensation from the transferee unless the same has been approved by the company in general meeting before the transfer takes place (s.320). If the approval is not sought or the proposal is not approved, any money received by the directors shall be held in trust for the shareholders who have sold their shares.

Section 320 further provides that in pursuance of any agreement relating to any of the above transfers, if the directors receive any payment from the transferee within one year before or within 2 years after the transfer, it shall be accounted for to the company unless the director proves that it is not by way of compensation for loss of office.

Section 321 further provides that if the price paid to a retiring director for his shares in the company is in excess of the price paid to other shareholders or any other valuable consideration has been given to him, it shall also be regarded as compensation and should be disclosed to the shareholders.

Some other statutory duties are: to attend Board meetings; to convene and hold general meetings; to prepare and place before AGM financial accounts; to make declaration of solvency.

4.4.2 General Duties

The general duties of directors are as follows:

Duty of good faith: The directors must act in the best interest of the company. Interest of the company implies the interests of present and future members of the company on the footing that the company would be continued as a going concern.

A director should not make any secret profits. He should also not exploit to his own use the corporate opportunities. In Cook v. Deeks (1916) AC 554, it was observed that "Men who assume complete control of a company's business must remember that they are not at liberty to sacrifice the interest which they are bound to protect and while ostensibly acting for the company, direct in their own favour business which should properly belong to the company they represent." In this case there was an offer of a contract to the company. Directors who were the holders of

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shares of 3/4 of the votes resolved that the company had no interest in the contract and later entered the contract by themselves. Held, the benefit of the contract belonged in equity to the company.

Duty of care: A director must display care in performance of the work assigned to him. He is, however, not expected to display an extraordinary care but that much care only which an ordinary prudent man would take in his own case. Justice Romer in Re City Equitable Fire Insurance Company observed, "His (director's) duties will depend upon the nature of the company's business, the manner in which the work of the company is distributed between the directors and other officials of the company. In discharging these duties a director must exercise some degree of skill and diligence. But he does not owe to his company the duty to take all possible care or to act with best care. Indeed, he need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience. It is, therefore, perhaps, another way of stating the same proposition that directors are not liable for mere errors of judgement."

Similar view was expressed in Langunas Nitrate Co. v. Lagunas Nitrate Syndicate (1899) 2 Chi. 392, in the following words: "If directors act within their powers, if they act with such care as is to be reasonably expected of them having regard to their knowledge and experience and if they act honestly for the benefit of the company they discharge both their equitable as well as legal duty to the company."

Section 201 states that a provision in the company's Articles or in any agreement that excludes the liability of the directors for negligence, default, misfeasance, breach of duty or breach of duty or breach of trust, is void. The company cannot even indemnify the directors against such liability. But if a director has been acquitted against such charges, the company may indemnify him against costs incurred in defense. Section 633 further states that where a director may be liable in respect of the negligence, default, breach of duty, misfeasance or breach of trust but if he has acted honestly and reasonably and having regard to all the circumstances of the case, he ought fairly to be excused, the court may relieve him either wholly or partly from his liability on such terms as it may think fit.

Duty to attend board meetings: A number of powers of the company are exercised by the Board of Directors in their meetings held from time to time. Although a director is not expected to attend all the meetings but if he fails to attend three consecutive meetings or all meetings for a period of three months, whichever is longer, without permission, his office shall automatically fall vacant.

Duty not to delegate: Director being an agent is bound by maxim 'delegatus non protest delegate' which means a delegate cannot further delegate. Thus, a director must perform his functions personally. A director may, however, delegate in the following cases: (a) where permitted by the Companies Act or articles of the company; (b) Having regard to the exigencies of business certain functions may be delegated to other officials of the company.

Some other duties are: to convene statutory, annual general meeting and also extraordinary general meeting general meeting when required by the shareholders of the company; to prepare and place at the AGM along with the balance sheet and profit and loss account a report on the company's affairs; to make a declaration of solvency in the case of a Member's voluntary winding up.

The duties of the directors are usually regulated by the company's articles. While performing their duties, they must display reasonable care, honesty, good faith, skill and diligence. As they stand in a fiduciary relationship to the company and they are agents and trustees in certain respects, they are bound to exercise in the performance of their duties a reasonable degree of skill and care.

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Did u know? In the United Kingdom, the Companies Act 2006, not yet in force, will require a director of a UK company "to promote the success of the company for the benefit of its members as a whole", but sets out six factors to which a director must have regards in fulfilling the duty to promote success. These are:

1. the likely consequences of any decision in the long term
2. the interests of the company's employees
3. the need to foster the company's business relationships with suppliers, customers and others
4. the impact of the company's operations on the community and the environment
5. the desirability of the company maintaining a reputation for high standards of business conduct, and
6. the need to act fairly as between members of a company

This represents a considerable departure from the traditional notion that directors' duties are owed only to the company. As it is clear that the primary responsibility of boards is to ensure that the corporation's management is performing its job correctly but in practice it is very difficult because of the reason that boards largely rely on management for the information which can be twisted easily by the management. Another reason is that boards of directors are part-time bodies, whose members meet only occasionally. This makes it difficult for board members to question management. In some cases CEOs are accused of exercising too much influence over the company's board. Some times directors may not have the time or the skills required to understand the details of corporate business, allowing management to obscure problems. Yet another problem is that directors often feel that a judgement of a manager, particularly one who has performed well in the past, should be respected. This can be quite legitimate, but poses problems if the manager's judgement is indeed flawed. Because of this, the role of boards in corporate governance, and how to improve their oversight capability, has been examined carefully in recent years, and new legislation in a number of jurisdictions, and an increased focus on the topic by boards themselves, has seen changes implemented to try and improve their performance.

4.5 Role of Board of Directors

The principal role of the board of directors - as representatives of the shareholders, is to oversee the function of the organization and ensure that it continues to operate in the best interests of all stakeholders. Given the complexity of today's organizations, that is no simple or straightforward task. Today, board effectiveness is a key performance driver of the Indian companies.

With expectations of them continuing to increase, boards can take several actions to govern more effectively. Indian boards must move away from being a rubber stamp to being a strategic asset for the company. They need to set the tone from top in promoting a transparent culture that promotes effective dialogues among the directors, senior management, and various function and risk managers. Boards should look beyond the 'old boy network' and select directors with individual areas of expertise, and invest on an ongoing basis on their formal and informal education. Independent directors should significantly contribute to the functioning of the board through requisite understanding of the company and the business. Boards must take a hard look at its own performance evaluation and enable continuous feedback and communication cycle.

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Effective boards build capabilities within themselves and their organizations that allow them to do both, protect existing assets (compliance role), as well as, manage threats to future growth (strategy oversight role).

Socio-Political-Legal aspects of Board's Responsibility

In the more recent context, all over the world, there is a serious debate on the board's role in articulating and maintaining ethical standards. These standards are related with the other aspects of the boards' responsibilities. These are not directly related to the financial well being of the company.

The board is going to be increasingly judged in terms of ethical criteria. In the UK, consequent upon the Nolan Committee Report, there has been a lot of debate on formulating a code of ethics as a self governance model and the role of the board in maintaining ethical conduct in the business transactions of the company. The ethical conduct denotes the inclusion of socio-cultural and environmental responsibilities. There is one more aspect that has to be addressed by the board is the political implications. The problems of board performance in many a country situations can be traced to the social and professional background of the project promoters, their business antecedents, cultural profile, nature and quality of information flows to the board and degree of openness and transparency in the board processes. These socio-cultural and ethical responsibilities should be taken care of as the business contribution to our sustainable development goals. Essentially it is about how business takes account of its economic, social and environmental impacts in the way it operates – maximising the benefits and minimising the downsides. Specifically, these are the voluntary actions that business can take, over and above compliance with minimum legal requirements, to address both its own competitive interests and the interests of wider society. These responsibilities are 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. If we look at these aspects , then this is the responsibility of the board to assure company's commitment to operating in an economically, socially and environmentally sustainable manner whilst balancing the interests of diverse stakeholders.

The question of social responsibilities and ethics arises in the context of India, in terms of the business practices, long history of regimes of economic controls, business culture, trading and commercial milieu, the social response to these practices, the legal and institutional framework, etc. The boards often distance themselves from the organisation and various stakeholders. The concept of social responsibility came into existence in India, but it took some time for the Indian Companies to understand their role towards society.

Example: Tata Group has helped many underprivileged in India from the inception of TATA Steel in Jamshedpur but there was never any strategic planning process in any organisation to help the Indian society. It was only in late nineties that few companies (esp. those which are in IT industry) had came forward with a proper guideline to show their seriousness towards these issues. The board of directors is very much concerned with the reputation of their company and it is their responsibility to enhance the reputation. Now they take socio-political aspect very seriously in fact it becomes a new business strategy to reduce investment risks and maximise profits by taking all the key stake-holders into confidence. The proponents of this perspective often include corporate social responsibility in their advertising and social marketing initiatives. The proponents of this perspective are the new generation of corporations and the new-economy entrepreneurs who created a tremendous amount of wealth in a relatively short span of time. They recognise the fact that social and environmental stability and sustainability are two important prerequisites for the sustainability of the market in the long run. They also recognise

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the fact that increasing poverty can lead to social and political instability. Such socio-political instability can, in turn, be detrimental to business, which operates from a variety of socio-political and cultural backgrounds. Consumers, employees, affected communities and shareholders have a right to know about corporations and their business. Corporations are private initiatives, true, but increasingly they are becoming public institutions whose survival depends on the consumers who buy their products and shareholders who invest in their stocks. This perspective stresses accountability, transparency and social and environmental investment as the key aspects of board responsibilities.

Earlier the boards operated as remote part of companies entirely unconnected and unconcerned with their environment. Managers are disillusioned as a result of role and social distance resulting from the board behaviour and the external constituencies are unhappy as they do not know how the board is functioning and the quality of the board deliberations and processes. To be effective, the board must, demonstrate willingness and capacity to narrow down the artificial social distance developed over time, and interact more freely with the organisation and external environment. If they do not do this, how are they going to inspire confidence in the potential groups of would be directors in the future times.

Caselet

What happens when board members don't understand their role?

When board members are unclear about their responsibilities to the organisation, they typically either become under-involved in governance or attempt to micromanage operational activities.

Under-involvement: Without guidance, some board members become unenthusiastic and perform only the minimum requirements of their position. They may miss meetings or fail to participate in discussions. They may also resist engaging in fundraising activities.

Micromanagement: Armed with a desire to make a difference and without an understanding of boundaries that separate board members from staff members, some board members will inject themselves into all avenues of operations. Bypassing the executive director, these board members will contact staff directly with requests. They may also seek direct involvement in project development and planning activities. Busy with operational tasks, they may neglect their fundamental board responsibilities.

Source: www.idea.org

4.6 Board's Committee

Perhaps in conformity with nature, all living creatures, including human beings are self-serving. It is, thus, hardly surprising to find that financially powerful business magnates who own and control the companies, both in India and abroad, were found to follow certain business practices universally. To mention a few of them that should not surprise anyone:

1. Promoter shareholders, by virtue of promoting the company and owning shares to the extent of 40 per cent to 80-90 per cent, self appoint themselves as Chairman and Managing Director (CEO) of the company.
2. After his death his crown is inherited by the sons, the eldest one particularly. For example, after the sad demise of Sri Dhirubhai Ambani, both his sons have become Chairman and Vice-Chairman respectively.

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3. The companies pack their boards with their blood relations, other relations and friends, so as to run it as their personal estate.
4. Retail shareholders who contribute their life savings and invest in corporate shares are left at the mercy of company management. Mostly the business is run to the detriment of ordinary shareholders.
5. Banks and financial institutions, who financially assist the companies by way of project loan-cum-working capital assistance look after their sectional interest by making corporates agree for reserving berth of "Nominee" Directors on the Boards of the assisted companies.
6. Government appointed auditors in case of public sector companies and qualified auditors, i.e., Chartered accountants in case of private companies, cease to remain independent auditors' due to many benefits like tax advisory or audit jobs of subsidiaries that can be awarded by the company chairman to them with a view to win them over, as these assignments carry attractive compensations.

The above mentioned practices are some management tricks which tend to make independent Board members and auditors biased in their favour so that they may run the company in a self-serving way instead of promoting the shareholders' and other stakeholders' interests, whose loyalty and confidence is sine qua non for the long-run survival and the growth of the businesses.

Due to above stated reasons, the issues of corporate governance that emanated primarily from the Cadbury Committee Report (Cadbury, 1996), U.K. found favour in other countries as well. Cadbury committee clearly mentioned that corporate governance has three important pillars. These are: Nomination Committee; Remuneration Committee and the Audit Committee.

In fact, all the Committees, both foreign and Indian, highlighted the criticality and importance of these three committees. The nomination committee, for example, plays a vital role in selecting independent non-executive Directors to the Board. Similarly, the remuneration committee decides the remuneration to be paid to the non-executive Directors and the audit committee ensures that the company accounts exhibit the true and fair position of the company's financial health.

It may be useful to devote some time on studying the composition, aims and modus operandi of these three committees in order to ensure satisfactory corporate governance.

4.6.1 Nomination Committee

Most of the committees on corporate governance in India and abroad have suggested appointment of independent Directors on the Boards of companies. They have also defined the term "Independent". But who will identify this person known as "Independent"? As there cannot be plants without seeds, or progeny without parents, similarly, there cannot be independent Directors on the Boards of the companies, unless there is a professional independent body known as Nomination Committee. Hence to constitute an effective, impartial and just Board, we need a committee of three to five outstanding personalities in the field of law, business management, economics, accountancy or any sister discipline, to constitute the Nomination Committee of the Board. In a nutshell, the job of this committee would be to search, locate and appoint independent Directors on the Board of public limited companies lying within their jurisdiction.

This committee should be formed by inviting nominations from the ordinary shareholders, excluding the promoters, through postal ballot. To facilitate smooth nomination, all the non--executive directors should short-list a panel for forming the "Nomination Committee". A nominating committee is appointed by the board of directors. Contemporary research results suggest that the nomination committee cannot influence the number of outside directors. The strength of outside directors is exogenously determined. One possibility is that outside

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participation is determined by the distribution of voting power in the firm. The nominating committee can, however, influence the independence of outside directors by selecting grey directors. This evidence is partly consistent with better boards forming nomination committees or, alternatively, with the use of nomination committees improving board quality. Nomination committee is fully responsible for the recruitment and selection of the members of remuneration committee and audit committee.

In a significant number of companies the requirements of a minimum number of independent directors is not fulfilled and hence the nomination committee itself does not contain all the three independent directors. Even in the audit committee (which is mandatory under section 292 A of the company's Act 1956), there are instances of the audit committee not having all three independent directors (though they may, in the case of public enterprises, consist of the administrator nominees of the controlling Ministries' non-executive directors).

The other limitation of the nomination committee is the role and function itself. The main task of the Nomination Committee is to propose candidates for election to the Board of Directors, including the chairman. The Nomination Committee must take into consideration the various rules on independence of the Board in relation to the Company, its senior management and major shareholders, in accordance with the requirements of Code of Corporate Governance. But it suffers from some limitations, for instance, if the role is defined in terms of 'assessing board membership needs', it is indeed a formidable task since no prior formal practice of determining membership needs is available. It is the function of the committee to assess the needs in terms of the board composition that corresponds with the changing business environments. As per the ongoing practice in some organisation the board restructuring is not done frequently, it may indicate *status quo* position and in this sense, composition is static. It depends on how the committee's members visualise the change in business environments and assess, as also agree on, the emerging profile and competencies of the potential directors. Another function after deciding about the change in board structure is evaluating the selection process and use the information of past selection procedure to eliminate unfavourable things. This is also the task of the nomination committee to build up capacity in terms of training and development of intellectual capital. It may be the function of the nomination committee in some organisations to maintain corporate governance process of the company. As the nomination committees are charged with the wholesome responsibility of enhancing and developing the intellectual capital of the companies, this extra function is more challenging task before the committee.

It is known that the committee is also responsible to assist the board in forming other board committees and identifying one of the independent directors in each of the committees as the Chairman of a committee. Generally, there is no practice of maintaining records of the circumstances for the resignation of the previous directors, an additional role of the nomination committee could be to ascertain the reasons and analyse the impact on the board composition and on the share markets. Likewise, forced CEO turnover may also be analysed and brief reports compiled for the board. In the long run such a practice will help in highlighting the specific factors affecting the board composition and restructuring, and creating more efficient selection and recruitment procedure for the directors.

One of the important tasks of tasks assigned nomination committees is to evaluate performance of the committee members. In other words, if there are three committees, then half the board members are covered in such an appraisal process. The appraisal process is implicit in the committee's functions since it selects and recommends to the board the appointment of these directors to the separate committees and it has to ensure that each committee carries out the designated tasks. Since the performance evaluation is not formalised, it is assumed that such a process remains informal which may or may not really be adequate to form sound basis of transparent and accountable decision making by the board.

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From the above discussion of the committee's function we can make out the basic philosophy behind the functioning of the nomination committee. It is that committee's philosophy of working is to create and build up human capital in alignment with the mission and objectives of the organisation which are embedded in the code of corporate governance of the organisation.

Task Visit the website of any one Indian MNC and find out the structure and role of its nomination committee.

4.6.2 Remuneration Committee

The remuneration committee is another important committee of the board. The structure of this committee is related to the structure of the ownership regarding the presence of insiders. The listing rules of NYSE and NASDAQ create the specific requirement for the independence of the remuneration committee. These requirements cannot be tested as the exclusive test of independence. For determining the independence of the director certain factors must be taken into account such as the prior association with the company, any relation with owners etc.

As far as the function of the committee is concerned it should shield executive compensation from the effect of restructuring changes, including earnings. Schedule XII to the Companies Act suggests a maximum ceiling of managerial remuneration with reference to the effective capital in case of companies having no profit or inadequate profit; and as per cent of profit in case of companies having profits. . What seems to have been ignored in deciding upper ceiling of the managerial remuneration is that whether the company has earned adequate profit with reference to the cost of capital in terms of economic profit, which is now popularly known as Economic Value Addition (EVA). The basic purpose of forming the remuneration committee is to establish a pay-performance relationship. In other words, the best formula for executive compensation plan must comprise a fixed component and a variable element linked to performance parameters like turnover or EVA or profit sharing or stock option scheme. An integral element of variable portion of executive compensation is bonus (cash or stock) or any variant of the same.

After the emergence of EVA concept courtesy Stewart in 1990, many US-based companies linked their bonuses to EVA, But it is not an accounting measure at all. In fact, it is mainly influenced by market return which in turn influences the cost of capital.

Caution Regarding composition of the remuneration committee, the SEBI Committee-I (KM Birla) recommends as follows: "to avoid conflicts of interest, the remuneration packages of the executive directors should be decided by a committee comprising a minimum of three non-executive directors, the Chairman of the committee being an independent director". In India, the company law has been indicating the upper limit of executive compensation, which perhaps not serving the real purpose of "rewarding in accordance with contribution", as far as the executives are concerned.

Remuneration committee membership is significantly related to director type, length of board tenure, and the number of other directorships held. In addition, committee membership depends upon director age, and the number of other committee membership. In contrast to the agency theory, that committee membership is only marginally related to director affiliations and unrelated to outside director stock ownership.

For the make up of the remuneration committee we have to analysed the impact of the firm's ownership structure for deciding on the inclusion of the insider in the committee. If we look at some organisation, it is evident that the ownership structure of the firm influences the composition

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of the remuneration committee in terms of insiders and outsiders. Most companies have remuneration committees, whose size varies with market capitalisation; few companies have insiders on the committee. There is some evidence that when insiders are members of the remuneration committee, it may lead to higher compensation. The percentage of the share ownership of the CEO influences the inclusion of the insider in the remuneration committee.

The period of tenure of the CEO provides time to build influences within firms and secure compensation close to their preferences over a period of time. The CEO can circumvent monitoring of incentive alignment mechanisms and strengthen his position vis-à-vis those of stockholders. Thus the relationship between remuneration and stock returns predicted by the agency theory looses hold as CEO tenure extends.

Another factor that influences the CEO remuneration is the relation between insider and outsider. If there is relatively short back-door distance between inside and outside directors or between the CEO and the members of the remuneration committee, CEO's remuneration is higher. The other reason to have the insiders in the committee is to avoid the unnecessary public attention in their practices.

The CEOs who are in more favourable positions, are able to negotiate agency contracts with more generous terms, regardless of whether the CEO sterns from a lack of ownership control or from other sources, such as CEO duality. Contracts appear to provide different ways to reduce employment subject to factors like ownership or management control, CEO duality, etc. CEOs in management controlled firms have more say in the matter of compensation and pay risk than these in owner controlled firms.

(***Note:*** Audit committee is also part of Board's committee, which we will discuss in the next unit.)

Task

Collect information about the committees of Directors, the Board of HDFC Bank has constituted to take informed decisions in the best interest of the Bank.

Case Study

Microsoft Corporation
Corporate Governance Guidelines

Over the course of Microsoft's history, the Board has developed corporate governance practices to help it fulfill its responsibilities to shareholders to oversee the work of management and the Company's business results. The governance practices are memorialised in these guidelines to assure that the Board will have the necessary authority and practices in place to review and evaluate the Company's business operations as needed and to make decisions that are independent of the Company's management. The guidelines are also intended to align the interests of directors and management with those of Microsoft's shareholders.

The guidelines are subject to future refinement or changes as the Board may find necessary or advisable for Microsoft in order to achieve these objectives.

Board Composition and Selection: Independent Directors

1. ***Board Size:*** The Board believes 8 to 10 is an appropriate size based on the Company's present circumstances. The Board periodically evaluates whether a larger or smaller slate of directors would be preferable.

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2. ***Selection of Board Members:*** All Board members are elected annually by the Company's shareholders, except as noted below with respect to vacancies. Each year at the Company's annual meeting, the Board recommends a slate of directors for election by shareholders. The Board's recommendations are based on its determination (using advice and information supplied by the Governance and Nominating Committee) as to the suitability of each individual, and the slate as a whole, to serve as Directors of the Company, taking into account the membership criteria discussed below. The Board's recommendations must be approved by a majority of the independent directors.

   The Board may fill vacancies in existing or new director positions. Such Directors elected by the Board serve only until the next election of Directors unless elected by the shareholders to a further term at that time.

3. ***Board Membership Criteria:*** The Governance and Nominating Committee works with the Board on an annual basis to determine the appropriate characteristics, skills and experience for the Board as a whole and its individual members. In evaluating the suitability of individual Board members, the Board takes into account many factors including general understanding of marketing, finance and other disciplines relevant to the success of a large publicly-traded company in today's business environment; understanding of Microsoft's business on a technical level; and educational and professional background. The Board evaluates each individuals in the context of the Board as a whole, with the objective of recommending a group that can best perpetuate the success of the business and represent shareholder interests through the exercise of sound judgement, using its diversity of experience. In determining whether to recommend a Director for re-election, the Governance and Nominating Committee also considers the director's past attendance at meetings, participation in and contributions to the activities of the Board.

4. ***Board Composition:*** Mix of Management and Independent Directors. The Board believes that, except during periods of temporary vacancies, a majority of its Directors must be independent. In determining the independence of a Director, the Board will apply the definition of "independent director" in the listing standards of the NASDAQ Stock Market and applicable laws and regulations.

5. ***Term Limits:*** The Board does not believe it should limit the number of terms for which an individual may serve as a Director. Directors who have served on the Board for an extended period of time are able to provide valuable insight into the operations and future of the Company based on their experience with and understanding of the Company's history, policies and objectives. The Board believes that, as an alternative to term limits, it can ensure that the Board continues to evolve and adopt new viewpoints through the evaluation and nomination process described in these guidelines.

6. ***Retirement Policy:*** The Board believes that 75 is an appropriate retirement age for outside Directors.

7. ***Directors with Significant Job Changes:*** The Board believes that any Director who retires from his or her present employment, or who materially changes his or her position, should tender resignation to the Board. The Board, and specifically the Governance and Nominating Committee, would then evaluate whether the Board should accept the resignation based on a review of whether the individual continues to satisfy the Board's membership criteria in the light of his or her new occupational status.

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8. ***Selection of CEO and Chairman:*** The Board selects the Company's CEO and Chairman in the manner that it determines to be in the best interests of the Company's shareholders.

9. ***No Specific Limitation on Other Board Service:*** The Board does not believe that its members should be prohibited from serving on Boards and/or committees of other organizations, and the Board has not adopted any guidelines limiting such activities. However, the Governance and Nominating Committee and the Board will take into account the nature of and time involved in a Director's service on other boards in evaluating the suitability of individual Directors and making its recommendations to Company shareholders. Service on Boards and/or committees of other organizations should be consistent with the Company's conflict of interest policies.

Board Meetings: Involvement of Senior Management

10. ***Board Meetings - Agenda:*** The Chairman of the Board and CEO, taking into account suggestions from other members of the Board, will set the agenda for each Board meeting, and will distribute this agenda in advance to each Director.

11. ***Advance Distribution of Materials:*** All information relevant to the Board's understanding of matters to be discussed at an upcoming Board meeting should be distributed in writing or electronically to all members in advance, whenever feasible and appropriate. This will help facilitate the efficient use of meeting time. In preparing this information, management should ensure that the materials distributed are as concise as possible, yet give directors sufficient information to make informed decisions. The Board acknowledges that certain items to be discussed at Board meetings are of an extremely sensitive nature and that the distribution of materials on these matters prior to Board meetings may not be appropriate.

12. ***Access to Employees:*** The Board should have access to Company employees in order to ensure that Directors can ask all questions and glean all information necessary to fulfill their duties. The Board may specify a protocol for making such inquiries. Management is encouraged to invite Company personnel to any Board meeting at which their presence and expertise would help the Board have a full understanding of matters being considered.

13. ***Executive Sessions of Independent Directors:*** The independent Directors of the Company will meet regularly in executive session, i.e., with no management Directors or management present, at least three times each fiscal year. Executive sessions of the independent Directors will be called and chaired by the chairperson of the Governance and Nominating Committee. These executive session discussions may include such topics as the independent Directors may determine.

Performance Evaluation: Succession Planning

14. ***Annual CEO Evaluation:*** The chair of the Governance and Nominating Committee leads the independent Directors in conducting a review at least annually of the performance of the CEO and communicates the results of the review to the CEO. The independent Directors establish the evaluation process and determine the specific criteria on which the performance of the CEO is evaluated.

15. ***Succession Planning:*** As part of the annual officer evaluation process, the Compensation Committee works with the CEO to plan for CEO succession, as well as to develop plans for interim succession for the CEO in the event of an unexpected occurrence. Succession planning may be reviewed more frequently by the Board as it deems warranted.

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16. ***Board Self-evaluation:*** The Governance and Nominating Committee is responsible for conducting an annual evaluation of the performance of the full Board and reports its conclusions to the Board. The Governance and Nominating Committee's report should generally include an assessment of the Board's compliance with the principles set forth in these guidelines, as well as identification of areas in which the Board could improve its performance.

Compensation

17. ***Board Compensation Review:*** Company management should report to the Board on an annual basis as to how the Company's Director compensation practices compare with those of other large public corporations. The Board should make changes in its Director compensation practices only upon the recommendation of the Governance and Nominating Committee, and following discussion and unanimous concurrence by the Board.

18. ***Director Stock Ownership:*** The Board believes that, in order to align the interests of directors and shareholders, directors should have a significant financial stake in the Company. Each director who has served on the Board for at least 3 years should own a minimum of 4,000 shares of common stock. The Board will evaluate whether exceptions should be made for any director on whom this requirement would impose a financial hardship.

Committees

19. ***Number and Type of Committees:*** The Board has 5 committees—an Audit Committee, a Compensation Committee, a Governance and Nominating Committee, a Finance Committee, and an Antitrust Compliance Committee. The Board may add new committees or remove existing committees as it deems advisable in the fulfillment of its primary responsibilities. Each committee will perform its duties as assigned by the Board of Directors in compliance with Company bylaws and the Committee's charter. Committee duties may be described briefly as follows:

    (a) *Audit Committee:* The Audit Committee reviews the work of the Company's internal accounting and audit processes. The committee is directly responsible for the appointment, compensation, retention and oversight of the Company's independent auditors.

    (b) *Compensation Committee:* The Compensation Committee stays informed as to market levels of compensation and, based on evaluations, recommends compensation levels and systems to the Board. Compensation of the Chief Executive Officer will be determined by the Compensation Committee or by a majority of the independent directors.

    (c) *Governance and Nominating Committee:* The Governance and Nominating Committee is responsible for recommending to the Board individuals to be nominated as Directors. The committee evaluates new candidates and current Directors, and performs other duties as described elsewhere in these guidelines.

    (d) *Finance Committee:* The Finance Committee monitors the present and future capital requirements and opportunities pertaining to the Company's business and provides guidance with respect to major financial policies of the Company.

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20. ***Composition of Committees:*** Committee Chairpersons. The Audit, Compensation, Governance and Nominating and Antitrust Compliance Committees consist solely of independent Directors. The Board is responsible for the appointment of committee members and committee chairpersons according to criteria that it determines to be in the best interest of the Company and its shareholders.

21. ***Committee Meetings and Agenda:*** The chairperson of each committee is responsible for developing, together with relevant Company managers, the committee's general agenda and objectives and for setting the specific agenda for committee meetings. The Chairperson and committee members will determine the frequency and length of committee meetings consistent with the committee's charter.

Miscellaneous

22. ***Review of Governance Guidelines:*** The practices memorialised in these guidelines have developed over a period of years. The Board expects to review these guidelines at least every two years as appropriate.

Question

Comment on the corporate governance framework of Microsoft.

4.7 Summary

- Directors have many business responsibilities for ensuring the success of their company. A board of directors is a body of elected or appointed members who jointly oversee the activities of a company or organisation. A board's activities are determined by the powers, duties, and responsibilities delegated to it or conferred on it by an authority outside itself.
- Directors are the members of the board of directors. The members of the board can be insider or outsider. Insiders are those who are somehow related to the corporation and may be referred to as executive directors.
- Outsiders are not related to the company, they may be referred as non executive directors or the independent directors.
- The legal responsibilities of boards and board members vary with the nature of the organisation, and with the jurisdiction within which it operates. For public corporations, these responsibilities are typically much more rigorous and complex than for those of other types.
- In fact, all the Committees, both foreign and Indian, highlighted the criticality and importance of these three committees. The nomination committee, for example, plays a vital role in selecting independent non-executive Directors to the Board.
- Similarly, the remuneration committee decides the remuneration to be paid to the non-executive Directors and the audit committee ensures that the company accounts exhibit the true and fair position of the company's financial health.

4.8 Keywords

Articles of Association: A document that specifies the regulations for a company's operations

Board of Directors: A group of persons chosen to govern the affairs of a corporation or other large institution.

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Memorandum of Association: Document that regulates a firm's external activities and must be drawn up on the formation of a registered or incorporated firm.

Nomination committee: A committee that acts under the corporate governance area of an organisation.

Shareholders: Any person, company, or other institution that owns at least one share in a company

4.9 Self Assessment

Fill in the blanks:

1. The powers and responsibilities of the Board of Directors is mentioned in……..
2. Individuals on the Board who are not a part of the company are referred to as……directors.
3. The ethical conduct of board of directors denotes the insertion of ……..and ……. responsibilities.
4. ……committee plays a vital role in selecting independent non-executive Directors to the Board.
5. Nomination committee is appointed by the …….
6. ……..suggests a maximum ceiling of managerial remuneration.
7. The main purpose of forming the remuneration committee is to establish a ……. relationship.
8. The SEBI Committee-I was presided by……..
9. The percentage of the share ownership of the …… influences the inclusion of the insider in the remuneration committee.
10. The profit earned by the company with reference to the cost of capital in terms of economic profit is referred to as…….

4.10 Review Questions

1. Discuss the power and liabilities of the directors.
2. Analyse the position of Board of Directors in an organisation.
3. "Directors must exercise their powers for a proper purpose". Comment
4. Examine the relevance of fulfilling social obligations for the Board of Directors.
5. "Directors cannot use their discretion recklessly." Elaborate
6. Critically evaluate socio-political-legal aspects of boards' responsibilities.
7. Discuss the different board's committees? Explain their role and functions.
8. Critically analyse the purpose of forming the nomination committee.
9. "A limitation of the nomination committee is the role and function itself". Discuss
10. Discuss the concept of EVA and deciding an upper ceiling in connection with the remuneration of the Board of Directors.

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Answers: Self Assessment

1.	organisation bylaws	2.	non-executive/independent
3.	socio-cultural, environmental	4.	Nomination
5.	Board of Directors	6.	Schedule XII of Companies Act
7.	pay-performance	8.	KM Birla
9.	CEO	10.	Economic Value Added

4.11 Further Readings

Books

A C Fernando, *Corporate Governance-Policies, Principles and Practices*, Pearson

D Geeta Rani and R K Mishra, *Corporate Governance-Theory and Practice*, Excel Books

Dr. S Singh, *Corporate Governance: Global Concepts and Practices*, Excel Books

Online links

en.wikipedia.org/wiki/Nominating_committee

www.governance.umicore.com/en/boardDirectors/

www.gt.co.za/Publications/...directors.../directors_duties.asp

www.oecd.org/dataoecd/21/30/1857291.pdf

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Unit 5: Role and Responsibilities of Auditors

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Objectives

After studying this unit, you will be able to:

- Identify the types of auditors and audits
- State the duties and responsibilities of an auditor in the context of corporate governance
- Explain the constitution of audit committee–its function accountability to its various stakeholders

Introduction

In the words of Professor Kenneth Scott of Stanford Law School, "Corporate governance, *inter-alia*, includes not only the control rights of stockholders, but also the contractual covenants and insolvency powers of the debt-holders, the commitments towards employees, customer and suppliers, the regulations and the statutes". In addition, a firm's decisions are greatly affected by the competitive conditions in which it is operating. Good corporate governance is, therefore, about maximizing shareholder value subject to meeting all social and contractual obligations. Corporate governance may be visualized as a tool for value enhancement of a company for its shareholders and all other stakeholders. It includes the debate on the appropriate management and control structures of a company and the rules relating to the power relations between owners, board of directors, management, auditors and the stakeholders such as employees, suppliers, customers and public at large. It addresses topics such as improving the publication of important information, the protection of shareholders' rights, promotion of balance of interests between managers, shareholders and other stakeholders; the independence of the board of directors, internal control systems and the function of audit.

5.1 Basic Concept of Auditing

The American Accounting Association defines auditing as a systematic process of objectively obtaining and evaluating the accounts or financial records of a governmental, business, or other entity based on established criteria. While auditing focuses largely on financial information, the process also may involve examination of nonfinancial documents that reveal information about a business's conduct.

Who are Auditors?

Auditors are persons lawfully appointed to examine and digest accounts referred to them, take down the evidence in writing, which may be lawfully offered in relation to such accounts, and prepare materials on which a decree or judgment may be made; and to report the whole, together with their opinion, to the, court in which such accounts originated.

5.1.1 Types of Auditors

There are four types of auditors:

1. ***Internal:*** Internal auditors are hired by a company to work for that company. They examine only internal financial documents relating to their employer. Internal auditors help the company increase the accuracy of their financial data and avoid any legal or monetary problems. They serve as quality control for the financial processes of the company.
2. ***External:*** While internal auditors can be useful, especially to larger companies, they are not always unbiased and smaller companies often cannot afford to hire a permanent

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auditor. External auditors do the same sort of document checking and analysis, but companies only hire them for a specific project. These auditors work for firms that specialize in selling auditing services to companies.

3. ***Government:*** Government auditors are specialists in tax and disclosure regulations. They inspect both businesses and individuals to determine precisely what regulations they fall under and if they are following these regulations properly. Government auditors help clear up confusion and investigate suspicious activity for government entities.

4. ***Forensic:*** Forensic auditors specialize in crimes and are used by law enforcement organizations when financial documents are involved in a crime. This does not necessarily mean the crime was financial (although this can be the case) but rather that the law enforcement organization needs to track money used to find out where it began or ended up.

5.1.2 Internal Audit

Internal auditing is a tool and technique for a periodical review of organizational systems and procedures arising out of activities within the organisation to ensure overall efficiency.

Internal auditing is the study of accounting and financial aspects directed towards compliance with accounting manual, correctness in accounting data and detection of fraud. Internal auditing is complementary to statutory auditing.

Internal Audit – Objectives and Scope

1. Adequacy and reliability of management information and control system. The internal auditor's role will be to evaluate as to the extent the various types and levels of communication are effective and a motivating force for all the people in the organisation.
2. Adequacy, accuracy and effectiveness of internal control systems in relation to operational activities.
3. Appraisal, review and evaluation of the adequacy and on-time financial accounting and reporting.
4. Achievement of management objectives through performance appraisal.
5. Safeguarding assets, utilization and accounting.
6. To ensure that all facilities (other than assets) are properly utilized and safeguarded.
7. Ascertaining the extent of compliance with management plans, policies, systems and procedures.
8. Appraising the systems and procedures.
9. Compliance with statutory laws and rules.
10. Prevention and detection of fraud, defalcation, misappropriation and embezzlement.

Basic Principles of Audit

1. Integrity, objectivity and independence
2. Confidentiality
3. Skill and competence. These are acquired through a combination of general education, technical education and practical experience

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4. Documentation
5. Planning
6. Evidence
7. Conclusion and reporting

Form of Internal Audit Report

It is not possible to generalize on the form and content of internal audit reporting. The format of presentation can be set out under the following heads:

1. ***Terms of reference:*** This is particularly applicable in case of directive from management for a special aspect of audit.
2. ***Purpose, scope and limitation of appraisal:*** A snap-shot of observations and recommendations.
3. Contents of the report.
4. Follow up of last audit report.
5. Significant facts or highlights of the main points (to be given before detailed report starts).
6. Detailed reports: the details can be set out by classifying into findings, observations and recommendations.
7. Exhibits, statistics and graphic presentation, etc.
8. The report may contain additional loose sheets of the report for the purpose of comments from management at plants/unit/location as well as for the purpose of follow up.
9. Under each aspect or subject of reporting, the findings, observations and recommendations should be set out in proper order.

5.1.3 Cost Audit

In the terminology published by the ICMA London, Cost Audit has been defined as "The verification of cost accounts and a check on adherence to cost accounting plan." In Cost Audit in Industry published by the ICWA of India, Cost Audit has been defined as "an audit of efficiency, of minute details of expenditure while the work is in progress and not a post-mortem examination."

The important aspects of cost audit are:

1. ***Property audit:*** It is the audit of executive action and plans bearing on the finance and expenditure of the company. The function of the cost auditor is advisory, but he is also to make his own judgement as to:
   (a) Whether the planned expenditure would give optimum results;
   (b) Whether the size and channels of expenditure were designed to produce the best results; and
   (c) Whether the return from expenditure on capital as well as current operations could have been bettered by some alternative plan of action.
2. ***Efficiency audit:*** It ensures the application of basic economic principles so that resources may flow into the most remunerative channels. The main purpose of efficiency audit is to ensure that:
   (a) Every rupee invested in capital or in other fields gives the optimum return.

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(b) The balancing of investment between different functions and aspects is designed to yield the optimum results.

Objective and Scope of Cost Audit

Objective and scope of cost audit may be stated as:

1. Verification of cost accounts and to see that the cost accounting plan has been adhered to.
2. Comparison of historical costs with those attainable under efficiency standards.
3. Isolation of abnormal costs with a view to highlight them.
4. Development of a reasonable degree of cost consciousness and establishment of social justice to the community in a controlled and scarce economy.
5. Examination of variances and their correct interpretation to the management.
6. Examination of the operating efficiencies or inefficiencies of an enterprise and optimization of the use of resources.
7. Analysis of the methods applied for allocation of overheads, examination of system of valuation of stock etc. with a view to eliminating the malpractices causing harm to the community at large.
8. Making an inter-firm and intra-firm comparison of costs.
9. Fixation of selling price of goods of national importance and
10. Investigation of Cost Structure of industries approaching the government for tariff protection etc.

5.1.4 Quality Audit

A quality audit is a review in which an auditor analyzes and verifies various records and processes relating to a company's quality program. In general, the purpose of a quality examination is to determine whether the company is complying with its quality program or whether it needs to make changes to its business practices. A company may also perform a quality audit in order to determine whether it is complying with certain quality standards, like those set by the International Organization for Standardization (ISO) 9000. Simply put, the ISO 9000 is a certification that a company is following formal business procedures.

Usually, a quality audit is an external audit, meaning it is conducted by an independent auditor or team of auditors who have expertise in the area. A company may also elect to perform an internal audit of its quality control systems on a periodic basis. Members of the audit team are typically professionals who have extensive knowledge about auditing standards, procedures, nd principles. In addition, auditors should have hands-on experience with examining, evaluating, and reporting on whether each aspect of a quality system is deficient or satisfactory.

5.2 Duties and Responsibilities of an Auditor

Corporate financial reporting and financial auditing is of immense importance to shareholders, investors and analysts. Moreover, these functions support the corporate governance system. So, it is relevant here to discuss the duties and responsibilities of an auditor in the context of corporate governance. An auditor has an important role regarding the financial well-being of a company or corporation. Auditor has to perform a wide variety of duties and tasks related to the financial matters of an entity. The general responsibilities of an auditor, is related to ensure

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financial compliance. The auditors collect and examine financial records to ensure that they are up to date and to make sure that the organisation abides by pertinent laws and regulations with regard to their finances. In addition, this is the responsibility of the auditors to prepare reports relating to their findings with regard to the financial status of the company and proper accounting procedures.

According to Prof. S. Sabir A. Jaffery, *"Auditing and governing are two separate functions. But, these are not mutually exclusive. Neither are they independent; nor interdependent. Rather, one reinforces the other."*

Auditing is obtaining and evaluating evidences regarding assertions about economic actions and events to ascertain the extent to which they correspond with the established criteria, and to communicating the result to the interested users. Thus, auditing encompasses investigation process, attestation process, and the reporting process, pertaining to economic actions and events. While discharging these duties auditors have the some points into its consideration. These are: compliance with legislative or regulatory requirements; adequacy of accounting and control systems; viability of economic activities, programmes, and projects. The above description of auditors' duty specifies the role of an auditor in relation to corporate governance. There are two ways in which we can see the role of the auditors in the light of corporate governance. The functions of the auditor are confined to economic actions and events. Good corporate governance is the outcome of the vast range of managerial functions. As we have said earlier that audit provides a support system to the corporate governance, so, auditors may look forward to bring about the desired level of improvement in the corporate governance. Auditors should play a more vital and direct role in establishing good governance. For this, they have an alternative, which is to perform their function in more dutiful and effective manner. Another way of doing this is to, as suggested by International Auditing Standards (IAS) that the matters that may be relevant to the governance of any business entity may be broader than those that form the subject matter of IAS, which are directly related to the audit of financial statements. IAS 260 categorically requires the auditors to communicate with the officials charged with the governance of an entity the matters arising from the audit of financial statements. They will not be required, the IAS continues, "to design procedure for the specific purpose of identifying matters of governance interest". The Code of Good Corporate Governance has taken to this phenomenon. It prohibits any such act on the part of the auditors.

"No listed company shall appoint its auditors to provide services in addition to audit except in accordance with the regulations and shall require the auditors to observe applicable IFAC (International Federation of Accountants) guidelines in this regard and shall ensure that the auditors do not perform management functions or make management decisions, responsibility for which remains with the Board of directors and management of the listed company. "

From the above discussion it is evident that auditors do not need to cross their area of operation. They are expected to contribute towards corporate governance from within their range of activities. It is their quality of work which is needed for being the support system to the corporate governance. The question of quality stressed on the auditor's responsibility for negligence. It would be presented in more clear form with the help of an example.

Example: PricewaterhouseCoopers, auditors of BCCI, was in the news for quite some time in past during the preceding century for their reportedly inappropriate behaviour leading to the collapse of the Bank. Thus, the auditing requires imagination and careful thought throughout the procedure. It is highly demanding and is often described as a very onerous

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responsibility. Auditors should have discharged their duty with utmost care. The general responsibilities of an auditor are given as under:

5.2.1 General Responsibilities and Duties

1. To manage the Internal Audit function.
2. To develop and maintain a procedure for the Internal Audit function which reflects the Office's responsibilities, authority, and reporting relationships.
3. To perform individual audits according to the Standards.
4. To maintain personal proficiency and that of staff auditors.
5. To supervise staff auditors by assigning them to jobs which match their abilities, reviewing their work, and appraising their performance.
6. To provide a liaison with all external audit authorities.
7. To conduct scheduled and special audits and make recommendations for improvement.
8. To continue to assess professional development and take advantage of opportunities to improve skills.
9. To keep themselves abreast of current trends in accounting and auditing.

Preparing Audit Procedure

1. Develop and discuss audit objectives.
2. Perform a field survey on the sites to provide exposure to the operations
3. Develop an audit program which will provide a thorough review of operations.

Conducting the Audit

1. Perform the audit in a professional manner and in accordance with the approved audit program.
2. Revise audit programs to make adjustments that apply to the audit to be performed.
3. To justify the application of audit principles and procedures.
4. To develop more detailed audit techniques and procedures for specific areas assigned if necessary.
5. To prepare neat, legible, and accurate work papers. Indicate the source of information and purpose of the work done.
6. To maintain an amicable relationship with auditee personnel.
7. To safeguard work papers and do not disclose matters of a confidential nature.
8. To keep auditee personnel aware of audit findings and recommendations so required improvements might be started as soon as possible.
9. Filing the audit report.

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5.2.2 Responsibilities and the Duties of External Auditors

If corporate governance is to work effectively, both internal and external auditors have critical roles to play. Each must provide assurance to directors and management on the integrity of financial statements and the adequacy of internal controls. To be effective, the auditors must maintain their independence.

The external auditor's report in corporate financial statements is seen as providing key assurance to the shareholders' interests. Steps are taken to ensure that information is accurate and free from management influence. The U.S. Sarbanes-Oxley Act of 2002 made the audit committee the body that appoints and compensates the external auditor. In addition, the external auditor's lead partner must rotate after five years to avoid becoming too close to management at a personal level and dependent on the company and the audit fees for advancement within the firm.

Caution Similar protection has not been granted to internal auditors. Although there is a clear and satisfying trend for internal auditors to report to the audit committee—more often than not, functionally to the audit committee and administratively to the chief financial officer (CFO) many continue to report directly to the CFO or other senior management.

The CFO has the power to hire and fire the chief audit executive (CAE) based on internal auditing's intrusive audits or unwelcome opinions. In addition, the CFO determines the CAE's compensation and has a tremendous influence on his or her career within the company. After all, many CAEs aspire to senior finance management positions. Finally, the CFO can restrict the resources provided to internal auditing through budget management.

Although external auditors' independence is protected to some degree, they still face many issues as internal auditors when it comes to undue management influence. The issues related to the internal and external auditors functioning.

Reporting

The audit report and opinion must be free of any bias or influence and reflect the professional assessment of the auditor, whether internal or external. Several professional organizations have addressed this point very clearly in their professional standards and guidance. The external auditor's management letter on internal controls rarely is as strong in its opinion and wording when it is published as when it is first reviewed with management. The points or suggestions are made soft and twisted in the final reporting comparing to what have been given by the auditors at first instance. Similarly, many internal auditors have been known to back down from strong adverse opinions in an effort to effect change, which is best achieved from a position of partnership rather than from conflict. Thus, the financial and audit report being generated were "report convolutions."

Regardless of the integrity of the internal and external auditors, the fact remains that management continues to have great influence on the compensation and retention of both parties. Audit committees typically rely on the advice of senior management in evaluating the audit team's performance. Frankly, it is difficult to do otherwise, as the directors interact more often with the executives and rely on them to run the corporation.

Area and Scope of Work

Management can influence the scope of work of both internal and external auditors. The CFO is the executive responsible for managing costs, especially administrative costs, within an

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organization. It is therefore understandable that CFOs feel the need to pressure internal and external auditors to contain their costs, as they don't want to be seen as making an exception for the functions for which they are responsible. However, if auditors are to be effective, they must have the resources necessary to do their jobs. In theory, the audit committee usually approves the internal audit budget, but few auditors are able to overcome objections from either the CFO or CEO to audit cost increases when they are trying to improve corporate profits.

Caselet

SEBI bans 3 Independent Directors of Pyramid Saimira

Marker regulator SEBI today barred three independent directors and members of audit committee of Pyramid Saimira from holding a similar position in any listed company for two years for giving false and misleading statements.

These independent directors are K S Kasiraman, K Natarahjan and G Ramakrishnan.

"(SEBI) restrains KS Kasiraman, K Natarahjan and G Ramakrishnan from being an independent director or a member of audit committee of any listed company for a period of two years from the date of this order," the market regulator said.

Last year, SEBI in a show cause notice alleged that Pyramid Saimira Theatre Ltd (PSTL) inflated its revenues and profits by fictitious entries in its accounts.

It disclosed the same in quarterly and annual accounts for the financial year 2007-08 and thereby misled the public in their investment decisions.

"It is also alleged that PSTL made false disclosures to stock exchanges on January 30, 2009 that it had entered into agreement with 802 theatres as on June 30, 2008," it added.

SEBI said these three people have failed in their duty as independent directors.

"They failed to review, as members of the audit committee, the internal control systems, which generated misleading financial statements," it added.

It further said they facilitated the company to make false and misleading disclosures and thereby created artificial prices and volumes in the securities of PSTL in the market, to the detriment of innocent investors.

"...the charge of disclosure of false and misleading statements, as alleged in the SCN against the noticees, is established," it added.

SEBI further said such conduct on the part of the noticees is disgrace to the institutions of independent directors and the audit committee of a listed company.

"This cannot be viewed lightly and warrants regulatory intervention," it added.

Source: www.articles.economictimes.indiatimes.com

5.3 Audit Committee

Transparency of accounts inspires confidence of market, stakeholders and prospective investors, the Government and the society at large. To ensure this, it is necessary to get the annual financial accounts audited by independent qualified auditors. But who is an independent auditor? Which agency to decide whether the auditor is independent or not; and what should be their fair

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remuneration? These are some of the burning issues facing the corporate sector all over the world.

The Cadbury Committee Report in UK (1996), then Hampel Committee Report in UK (1997), the OECD Principles (1998), the Blue Ribbon Committee Report in US (1998) and as many as Five Committees on corporate governance in India, namely (i) Committee on Corporate Governance of CII 1992, (ii) Ganguly Committee of Reserve Bank of India, (iii) K.M. Birla Committee (SEBI), (iv) Murthy Committee (SEBI), 1993, and (v) Naresh Chandra Committee (Government of India) examined these and many more vital aspects of corporate governance. All of them without exception suggested the constitution of at least audit committee for ensuring transparency in corporate accounts. In fact, the Cadbury Committee (UK) was the first to suggest creation of three strong pillars of corporate governance, in the form of three Committees as the nomination committee, remuneration committee and the audit committee. The Blue Ribbon Committee in the US has identified certain restrictions to the meaning of independent directors who can serve in the audit committee for adoption of both NYSE and NASD for listed Companies with a market capitalization of $200 million (or a more appropriate measure for identifying smaller-sized Companies as determined jointly by NYSE and NASD). Members of the audit committee shall be considered independent if they have no relationship to the corporation that may interfere with the exercise of their independence from management and the corporation. The examples of such relationship are:

1. A Director being employed by the corporation or any of its affiliates for current year or any of the past five years.
2. A Director accepting any compensation from the corporation or any of its affiliates other than compensation for board service or benefits under a tax-qualified retirement plan.
3. A Director being the member of the immediate family of an individual who is, or has been in any of the past five years, employed by the corporation or any of its affiliates as an executive officer.
4. A Director being a partner in, or a controlling shareholder or an executive officer of, any for profit business organization to which the corporate made—or from which the corporation received—payment that are or have been significant to the corporation or business organization in any of the past 5 years.
5. A Director being employed as an executive of another company where any of the corporation's executives served on that company's compensation committee.

The Blue Ribbon Committee recommends that in addition to adopting the definition of independence set forth, the NYSE and the National Association of Securities Dealers (NASD) require that the listed companies with a market capitalisation above $200 million have an audit committee comprised solely of independent Directors.

In contrast to the above views, the Kumar Mangalam Birla Committee–the 1st SEBI committee–opined that (i) non-executive directors, majority being independent, with at least one director having financial and accounting knowledge and (ii) the Chairman of the committee should be an independent director. As against this, as per Blue Ribbon Committee the audit committee should have at least three directors and each of them should be financially literate or become so within a reasonable period of time after his or her appointment to the audit committee. Further, at least one member of the committee should have accounting or financial management expertise.

5.3.1 Views of Blue Ribbon Committee regarding Audit Committee

The Blue Ribbon Committee also suggested the following other measures for improving efficacy of the audit:

1. Adoption of a written charter of activities approved by a full board specifying responsibilities of the audit committee.

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2. Annual public disclosure of activities carried out by the audit committee.
3. Audit committee as the representative of the shareholders should have the authority to propose appointment and replacement of the outside auditors.
4. Audit committee should enjoy the full authority of carrying out discussion with the auditors and the board should ensure complete independence of the outside auditors. This should form part of the listing agreement.
5. The Generally Accepted Auditing Standards (GAAS) in the USA require that a company's outside auditor discuss with the audit committee the auditor's judgements about the quality, not just the acceptability, of the company's accounting principles as applied in its financial reporting; the discussion should include such issues as the clarity of the company's financial disclosures and degree of aggressiveness or conservatism of the company's accounting principles and underlying estimates and other significant decisions made by management in preparing the financial disclosures and reviewed by the outside auditors. This should form part of the required ambience to encourage frank discussion.
6. The Committee recommends that the SEC require all reporting companies to include a letter from the audit committee in the company's annual report to shareholders and Form 10-K Annual Report disclosing whether or not, with respect to the prior fiscal year: (i) management has reviewed the audited financial statements with the audit committee, including a discussion of the quality of the accounting principles as applied and significant judgements affecting the company's financial statements; (ii) the outside auditors have discussed with the audit committee the outside auditor's judgements of the quality of those principles; (iii) the members of the audit committee have discussed among themselves, without management or the outside auditors present, the information disclosed to the audit committee, and (iv) the audit committee believes that the company's financial statements are fairly presented in conformity with Generally Accepted Accounting Principles (GAAP) in all material respects.
7. The Committee recommends that the SEC require that a reporting company's outside auditor conduct an SAS 71 Interim Financial Review prior to the company's filing of its Form 10-Q return.

5.3.2 Views of the Kumar Mangalam Birla Committee on Audit Committee

The audit committee should review important accounting policies, internal control system of the company, going concern assumption, related party transactions, risk management policies etc. However, in view of the present legal framework as regards appointment of the auditors, their involvement in various other consultancy jobs in the company like taxation matters, company law matters etc. and continuity of the audit function with same client, the committee felt the need for considering following basic issues:

1. That the auditors should be appointed by the shareholders in the general meeting on recommendation of the audit committee;
2. Time frame for the statutory audit to be conducted by the external auditors should be set out while entering into an audit contract;
3. Appointment of the outside auditors should be for a period of three years which will give them a better time-frame to understand the accounting environment of the company. It is a better alternative than the present system of annual appointment of the auditors. On the other hand, an auditor should get a maximum of two terms for external audit, i.e., for a period of maximum six years;
4. Audit committee should liaison between the external auditors and the management.

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5.3.3 Audit Committee as per Section 292-A of the Indian Companies Act

All public companies having paid up capital of not less than five crores of rupees shall constitute a committee of the Board to be termed as "Audit Committee". The audit committee "shall consist of not less than three directors and such number of other directors as the Board may determine of which two-thirds of the total number of members shall be directors, other than managing or whole time director".

1. The terms of reference of the audit committee shall be specified by the Board in writing;
2. The members of the audit committee shall elect a chairman from amongst themselves;
3. The annual report of the company shall disclose composition of the audit committee;
4. The auditor, the internal auditor (if any) and director in charge of finance, shall attend the meeting of the audit committee but they do not have any voting right;
5. The audit committee should have discussion with the auditors periodically about (a) the internal control system, (b) scope of audit including observations of the auditors, and (c) review of the half-yearly and annual financial statement before submission to the Board;
6. The audit committee shall ensure compliance with the internal control system;
7. The audit committee shall enjoy authority to carry out investigation into any matter specified in the proposed section 292A and for that purpose it shall enjoy full access to the information contained in the records of the company and it can also take external advice;
8. The recommendations on any matter relating to financial management, including the audit report shall be binding on the Board;
9. If the board does not accept any recommendation of the audit committee, it should communicate the reason thereof to the shareholders.
10. The chairman of the audit committee shall attend the annual general meeting for providing clarification matters relating to audit;
11. The default in complying with the provisions of this section is punishable with imprisonment which may extend up to one year or with fine which may extend up to fifty thousand rupees.

Task

Consider any one Indian firm and analyse the structure and role of its audit committee.

5.3.4 SEBI Guidelines in regard to Audit Committee

1. The audit committee shall have minimum three members, all being non-executive directors, with the majority of them being independent, and with at least one director having financial and accounting knowledge. The chairman of the committee can also invite finance director, representative of the external auditors, etc., in its meeting. The Company Secretary should be the secretary to the audit committee.
2. The audit committee shall meet at least thrice a year. One meeting shall be held before finalization of annual accounts and one every six months. The quorum shall be either two members or one-third of the members of the audit committee, whichever is higher and minimum of two independent directors.

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3. It has power to obtain information from the management on various accounting issues, internal control and internal audit system.

5.3.5 Views of Naresh Chandra Committee

Audit Committee and its Independence

Audit Committees are now mandatory under the Companies Act as well as Clause 49 of the listing agreement. Moreover, over three closely typed pages. Clause 49 exhaustively sets out the role, composition, functions and powers of such a committee, which are in line with some of the most stringent international standards — itself a testimony of the SEBI's and DCA's commitment to corporate governance. The law can hardly be bettered. And the Committee sees no reason to reproduce in this report the mandated Audit Committee guidelines in Clause 49 of the listing agreement.

One area, however, requires some legislative change. Clause 49 says that the Audit Committee of listed companies must consist exclusively of non-executive directors, of whom the majority must be independent. The Committee felt that this needed some improvement and tightening. There were doubts on the advisability of excluding nominee directors of financial institutions from audit committees. The Committee preferred to be consistent in not considering directors with a certain mandate to be really independent.

Independent Directors on Audit Committees of Listed Companies

Audit Committees of all listed companies, as well as unlisted public limited companies with a paid-up share capital and free reserves of Rs.10 crore and above, or turnover of Rs.500crore and above, should consist exclusively of independent directors, as defined in Recommendation 4.1.

However, this will not apply to: (1) unlisted public companies, which have no more than 50 shareholders and which are without debt of any kind from the public, banks, or financial institutions, as long as they do not change their character, (2) unlisted subsidiaries of listed companies.

No doubt, all Audit Committees claim to do what is mandated. It is, however, moot whether Audit Committees of most listed and unlisted public limited companies have the capability or inclination to follow the spirit of the law. There are four major reasons why many Audit Committees are not functioning as well as they should.

First, there are skill gaps. While one member of the committee may be positioned as the one having "financial and accounting knowledge", it is worth asking how deep that knowledge is, especially given the new accounting standards and complexities. Incidentally, this is not a unique Indian problem. Many audit Committees of Fortune 1000 US corporations face similar problems.

Secondly, it takes a considerable amount of additional time for an Audit Committee to successfully discharge its obligations in letter and spirit. The members have to review internal audit processes, have detailed discussions with internal as well as statutory auditors, independently meet the CFO and the finance team, examine audit plans, review the adequacy of internal control systems, follow up on fraud or irregularities, if any, evaluate the company's risk management policies, get a fix on all materially significant legal agreements, look into all key aspects of the financial reporting process, ensure compliance with financial, accounting and stock exchange standards, and much more. These have to be done every quarter and much more intensively before adopting the annual audited accounts.

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Such tasks are quite substantial even for Audit Committees of companies known for their excellent financial housekeeping. They are monumental for others. In the early stages—the 12-to 18-month period that is needed for well intentioned companies to get their financial hygiene in order—it can take an Audit Committee five to seven additional working days per year for it to dutifully discharge its obligations. Few, if any, Audit Committee members are willing to commit to this extra time.

Thirdly, inadequate remuneration of directors compounds the problem. Very few companies offer commissions on profits to the independent directors. And loss making companies — where Audit Committee tasks are all the more critical—can offer no commission whatsoever. Naturally, nobody except one who is steeped in altruism will want to spend an extra five to seven days doing Audit Committee work, all for a sitting fee of ₹ 5,000. So they don't.

Fourthly, there is the issue of selective monitoring by regulators. All companies faithfully report the composition of their Audit Committees and frequency of such meetings, and synopsis their role and functions. More often than not, that is what constitutes the typical annual report disclosure. And the regulators and stock exchanges accept these 'reports' as such. Indeed, it could be argued that what is perhaps the most important statutory reform in corporate governance has not been adequately monitored by the SEBI, DCA or the relevant stock exchanges.

In the present circumstances—lack of skill, the extra time dimension, paltry compensation for directors, and inadequate regulatory oversight — it would be heroic to assume that most Audit Committees would immediately tone up their act and become best-in-class overnight. That would require significant upward revision of independent directors' remuneration going hand-in-hand with some additional disclosures. However, it is also true that the process of change has definitely begun. At least two dozen Group A and a dozen Group B 1 companies are now reported to have good Audit Committees — a significant improvement compared to five years ago. If we get the compensation, additional disclosures right and mitigate some of the unnecessary liabilities of independent directors, we should be able to have, in the next three to five years, well performing Audit Committees for companies that together represent at least 75 per cent of India's market capitalization.

In what remains of this section, we set out recommendations of desirability of having Audit Committee charters, and on a set of disclosures that ought to be mandatory for such committees.

Recommendation: Audit Committee Charter

1. In addition to disclosing the names of members of the Audit Committee and the dates and frequency of meetings, the Chairman of the Audit Committee must annually certify whether and to what extent each of the functions listed in the Audit Committee Charter were discharged in the course of the year. This will serve as the Committee's 'action taken' report to the shareholders.
2. This disclosure shall also give a succinct but accurate report of the tasks performed by the Audit Committee, which would include, among others, the Audit Committee's views on the adequacy of internal control systems, perceptions of risks and, in the event of any qualifications, why the Audit Committee accepted and recommended the financial statements with qualifications. The statement should also certify whether the Audit Committee met with the statutory and internal auditors of the company without the presence of management, and whether such meetings revealed materially significant issues of risks.

We now move on to three key issues: remuneration of independent directors, legal liabilities of non-executive and independent directors, except from the class of retired people and those who feel important by claiming that they are on many boards.

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Some might argue that sitting fees underestimate independent directors' pay. Profit-making companies are permitted to pay up to 1 per cent of their net profits as commission to independent directors, and this could be quite a handsome amount in the Indian context. The argument is flawed logically and empirically. A look at the annual reports of the 3,723 companies belonging to Groups A, B1 and B2 of the BSE will reveal that no more than 5 per cent of this sample pay a commission on profits. To give an example, neither banks nor public sector enterprises can pay commissions to their independent directors.

The logical flaw is more severe. The need of the day is to get independent directors of the highest standards of skill and probity to discharge critical oversight functions for loss-making companies and help them to turn around.

Example: Consider two examples : one of a company whose profits have reduced from Rs.100 crore to Rs.10 crore over three years and another of a company whose losses have been brought down from ₹ 100 crore to ₹ 10 crore over the same period. The independent directors of the former — who have presided over the decline in national wealth-can, in addition to their sitting fees, still share a commission of ₹ 10 lakh. Their counterparts in the latter—who have supervised the re-building of national wealth — can only get their sitting fees.

In such a context, it is not surprising that no-profit making companies cannot get the services of the best independent directors, even though these are precisely the entities where such services are most needed. The Committee believes that we as a nation cannot hope to get the best talent into the boardrooms of corporate India with such remuneration structures. It is time for a major revamp.

5.3.6 Constitution of Audit Committee

Today, the audit committee is known as board committee. In a publicly-held company, an audit committee is an operating committee of the Board of Directors with responsibilities related to financial reporting as well as monitoring disclosure and corporate reporting. An audit committee is composed of the members drawn from the board of director with a Chairperson selected from among the members. In USA audit committee is composed of independent directors referred as non executive directors.

In India, The Companies (Amendment) Act (2000), among other things, provides for the formation and functioning of audit committees (section 292A). Similar requirements for audit committees are prescribed under clause 49 of the Listing Agreement issued by SEBI. In India, perhaps the 1992 stock market scam and liberalisation of the economy contributed to the introduction of these requirements. Be that as it may, scams and corporate failures have shaken investors' confidence and the whole world is watching intently the steps being undertaken by the various statutory authorities in this respect.

Section 292A applies to all pubic companies with a paid-up capital of Rs 5 crore or more. Clause 49 of the Listing Agreement covers most of the listed companies. The provisions of the SOX Act are applicable to 'issuers' as defined under the Securities Exchange Act. These provisions are also applicable to non-US domiciled corporations that have securities listed on the US bourses. This means that this Act also impacts the functioning of audit committees of Indian companies listed in the US.

Regarding the constitution and independence of the audit committee Section 292A requires that the audit committee shall consist of not less than three directors and such number of other directors as the board may determine. Two-thirds of the total number of the audit committee shall be directors other than the managing or whole-time directors. Clause 49 requires a minimum of three members, all being non-executive directors, with the majority of them being independent

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directors, with at least one director having financial and accounting knowledge. In USA the SOX Act defines the audit committee as a committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and the audit of the financial statements of the issuer. If no such committee exists, the entire board of directors shall be considered the audit committee. Further, each member of the audit committee of the issuer shall be independent.

Regarding independence of audit committee members, Clause 49 defines 'independent directors' as directors who, apart from receiving directors' remuneration, do not have any other material pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries, which in the board's view may affect their independent judgment.

For effectively discharging its duty the Audit Committee shall meet at least four times per year, or more frequently if required. The Audit Committee reports regularly to the Board and keeps written minutes of its meetings. Minutes of the meeting are maintained with the books and records of the Board. The person who is selected by the members of the audit committee chairs the meeting of the audit committee. A majority of the members of the audit committee present in person or by means of any communication equipment by means of which all persons participating in the meeting constitute a quorum. Periodically, the audit committee shall meet with the company's management, members of the company's internal corporate audit staff, if any, and with the independent auditor in separate sessions.

5.3.7 Role and Function of the Audit Committee

It is important to consider the audit committee's role in the context of the corporate governance process of the corporation. The audit committee is a board's committee so it must carry out its duties within the framework of the governance principles and practices established by the board of directors. Generally the role of the audit committee includes:

1. Oversight of the company's financial reporting process and the disclosure of its financial information to ensure the financial statement is correct and credible;
2. Recommending to the board, the appointment, re-appointment and, if required, the replacement or removal of the statutory auditor and the fixation of audit fees;
3. Reviewing, with the management, performance of statutory and internal auditors, adequacy of the internal control systems;
4. Reporting structure coverage and frequency of internal audit.

5.3.8 Responsibilities of an Audit Committee

The board of directors is related to the monitoring of the business activities, they are not involved in the execution of the business activities. Their prime responsibility is to monitor the business and take care of the interests of different stakeholders. For this, the board has to shoulder the responsibilities of overseeing the financial reporting and disclosure process, monitoring choice of accounting policies and principles, overseeing hiring, performance and independence of the external auditors, oversight of regulatory compliance, ethics, and whistleblower hotlines. Monitoring the internal control process, overseeing the performance of

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the internal audit function, discussing risk management policies and practices with management. The following may be the general responsibilities of the board of the directors:

Monitoring Financial Activities

The main responsibility of the audit committee is to review the financial reports quarterly and annually in publicly-traded companies. In this process, it is also involved in discussing complex accounting estimates and decisions and adoption or deletion of certain accounting principles or procedures. It regularly interacts with senior financial management such as the CFO and Controller and is in a position to comment on the capabilities of these managers. External auditors are also required to report to the committee on a variety of matters. It may be their views on management's selection of accounting principles, accounting adjustments arising from their audits, any disagreement or difficulties in working with management, and or in case of any identified illegal acts, or suspicion of fraud.

Responsibility towards External Auditor

This is the responsibility of the audit committee to approve selection of the external auditor. The external auditor reviews the entity's financial statements quarterly and issues an opinion on the accuracy of the entity's annual financial statements. If a change in external auditor is needed then audit committee's approval is required. Audit committees also ensure that external auditor is independent, meaning thereby, no conflicts of interest exist that may interfere with the auditor's job in presenting his version of financial statements.

Overseeing the Internal Control Process

It is related with policies and practices for controlling operations, accounting, and regulatory compliance of the entity. In this regard management, internal auditing function and external auditors provide report to the audit committee for keeping the effectiveness and efficiency of internal control.

Responsibility for Regulatory Compliance

Audit committees have to oversee any litigation or regulatory compliance risks, through the discussion with management. It is generally done through briefings or reports from the General Counsel, the top lawyer in the organisation.

Oversight of Risk Management

Risk can be defined as anything that may put constraints for a company from achieving its objectives. Certain types of risks are inherent in doing business. For the audit committee, risk can fall into two general categories: financial reporting risk and non-financial risk. Financial risks are related with accounting judgments and estimates, whereas non-financial reporting risks with possible financial reporting implications, such as a supply chain problem, product recall, or a marketing practice affecting revenue recognition. The company's efforts towards risk are important to the audit committee. It identifies financial reporting risks and non-financial risks that may have financial reporting implications and ensures that regarding those risks:

1. The company has appropriate internal controls
2. Internal and external audit plans appropriately addressing the risk
3. Management makes appropriate disclosures considering the risk involved
4. The impact of risk on financial statement financial statement is properly recorded

Notes

The following may be the types of risks about which the audit committee should be aware of:

1. ***External conditions:***
   (a) Technological changes
   (b) Fluctuations in the industry
   (c) Unrealistic earnings expectations by analysts
2. ***Operating conditions:***
   (a) Organizational changes including frequent change of key personnel.
   (b) Complex organizational structures.
   (c) Inexperienced management.
   (d) complex transactions
   (e) Excessive or inappropriate performance-based compensation.
   (f) Interest rate or currency exposures.
   (g) Abnormal trends or financial results compared to comparable companies.
3. ***Financial information systems and internal controls condition:***
   (a) Inappropriate control environment
   (b) Lack of management oversight.
   (c) Inappropriate management attitude towards existing controls.
   (d) Untimely reporting.

5.3.9 Accountability of Audit Committee to its various Stakeholders

The audit committee focuses primarily on legal relationships between auditors, directors and shareholders. There is an explicit relationship among these parties, but there are other people who are seen as stakeholders who have expectations to the audit in the organisation. The audit has a clear purpose which is to provide independent, true and fair opinion to the shareholders on the financial statements that are prepared by the board of directors. The independent opinion enhances the confidence of shareholders in using financial statements to assess the performance of directors. However, organisations have a variety of stakeholders and these stakeholders have certain expectations from the auditors. Audit committees have played a valuable role in ensuring that auditors understand who their clients are. Audit committee has different stakeholders:

Shareholders

Going by agency theory shareholders are directly related to the organisation through the board of directors. They are the owners of the company in all the terms. So, they are the most concerned with the financial statements of the company. It is the responsibility of audit committee to present a true and fair picture of the organisation before shareholders. It is one of the important function of the audit committee is to bridge the gap between the auditors, management & the stakeholders. Bridging the gap means that the stakeholders cannot have regular interface with the management. Audit Committee, by discharging its function of overall monitoring, helps to present a true picture of the organisation to the stakeholders. It not only points out the numerical accuracy but reflects the health of the organisation.

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Directors

Audit committee is the committee of the board of directors. So directors want audit committee to help and support them in discharging their responsibilities. While approving or disapproving any matter related to the financial activities of the organisation board of directors are dependent on the information provided by the audit committee. As well as in the matter of compliance concerning rules and regulations, is taken care by the audit committee. In this way audit committee is accountable to the directors or the board of directors.

Management

Managers may want committee to understand their organisations and add value by providing business advice and helping them to access finance at reduced cost. Management seeks audit committee input in advance of key decisions.

Audit Regulators

The audit regulating authority may want auditors to be accountable for meeting clear standards of performance and maintaining audit quality. Audit committee is accountable to the regulatory authorities for its true and fair practice in discharging of responsibility.

Creditors and Lenders

Creditors and lenders want a clear picture of the financial health of the organisation, as they want the security of their finance made to the given organisation. They see the audit as providing comfort that organisations will continue to be able to pay for goods and services or finance.

Employees

Employees may want the audit to provide some comfort about job security and the future direction of the organisation. The audit might be seen as one way of seeking some comfort over this.

Task

Make a list of the highest paid officials in the country. Do they deserve the kind of remuneration they get?

5.4 Audit Failure

Audit failure occurs when an audit (an official examination of a company's financial records) does not find things which it should, meaning that there could be fraud. In most cases, an audit failure leads to corporate scams. The Satyam fiasco was supposedly a result of audit failure.

Audit failure occurs when there is a serious distortion of the financial statements that is not reflected in the audit report, and the auditor has made a serious error in the conduct of the audit. Audit failure does not occur if the auditor has followed Generally Accepted Auditing Standards, regardless of the fairness and accuracy of the financial statements. A properly done audit does not guarantee that serious distortions of the financial statements have not occurred. However, a properly done audit does make serious distortions unlikely. Thus, audit failure cannot occur unless there is serious auditor error or misjudgment.

Notes

In current economic environment, business risks result from intensified market competition may force the dishonest management of the entity to commit financial fraud. Such risks may arise from: (1) Industry developments and consequent potential business risks that entity does not have the personnel and expertise to deal with the changes in the industry; (2) New products and services, and consequent potential business risks that there is increased product liability; (3) Expansion of the business, and consequent potential business risks that the demand has not been accurately estimated; (4) Current and prospective financing requirements, and consequent potential business risks on loss of financing due to the entity's inability to meet requirements, etc.

Recent years saw lots of financial frauds which have led to huge losses borne by innocent investors, creditors, employees, and others. Enron, WorldCom, etc. provide vivid examples of how internal control breakdowns and flawed and dishonest management and auditing can result in misstated financial statements that ultimately do great harm to national economy.

Audit failures meant that the accounting profession is confronted with a crisis of confidence and credibility. Criticism of the profession is widespread and harsh in the changing economic, social and regulatory climate in which the profession at present functions. Audit failures will endanger the existence of the profession and its development in the long run.

Notes

Companies (Auditor's Report) Order, 2003

Applicability (Any of the Following)

1. Paid - up capital and reserves of more than 50 Lacs.
2. Has accepted any public deposit.
3. Turnover exceeding ` 5 Crores.
4. Outstanding Loans of ` 10 Lacs or more from bank(s) and financial institution(s).

Reserve: The following explanations are important in this regard:

1. Reserve shall include both capital as well as revenue reserves
2. Revaluation reserve should also be taken into consideration while determining the figure of reserves.
3. The credit balance of Profit & Loss Account should also be considered as a part of reserve and the debit balance of P & L A/c should be reduced from the figure of revenue reserves. However, miscellaneous expenditure to the extent not written off should not be deducted as such.

Turnover: shall mean as the aggregate amount for which sales are effected by the company. The term "sales effected" would include sale of goods as well as services rendered by the company.

Compliance Note of CARO, 2003

1. **FIXED ASSETS**
   - (a) Check whether the Register of Fixed Assets has been maintained or not.
   - (b) Check whether the necessary entries have been duly incorporated in the said register or not.

Contd...

Notes

(c) Disclosure in the CARO in regard to disposal of fixed assets substantially, during the year.

(d) Compliance of section 293(1) (a) of the Companies Act, 1956 in case of Limited Companies.

(e) Minutes of the Board and General Meeting (in compliance of section 293).

2. **LOANS - UNDER SECTION 301 OF THE COMPANIES ACT, 1956**

(a) Loan includes Secured or Unsecured, taken or granted (u/s 301).

(b) Check whether the Register of Contracts or Arrangements / Interest or Concern u/s 301, made or not.

(c) Check whether the necessary entries have been duly incorporate in the said register or not.

(d) Checklist of Relatives and Form No. 24AA by all the Directors.

(e) Disclosure in the CARO in regard to the following:

(i) Number of parties

(ii) Maximum amount during the year.

(iii) Amount involved at the end of the year.

(iv) Transactions squared during the year and amount involved.

(v) Rate of Interest for such loans.

(vi) Whether prejudicial to the interests of the company or not.

(vii) Payment of Loans / Interest as per Schedule.

(viii) Disclosure in relation to recovery / payment of overdue amount, if the same is more than ₹ 1 Lac and action thereof.

(f) Details of transactions with related parties u/s 301, if the value of such transactions, exceed ₹ 5 Lacs in respect of any party and in any one financial year.

(g) Compliance of section 297 and 299 of the Act.

(h) Minutes of the Board and General Meetings in this regard.

3. **PUBLIC DEPOSITS - UNDER SECTION 58A OF THE COMPANIES ACT, 1956**

(a) List of persons from whom unsecured loans has been taken during the year and nature of relationship of such persons, e.g. whether Shareholder, Director, their Relatives or Inter corporate.

(b) The following details in connection of the above:

(i) Maximum amount during the year.

(ii) Amount involved at the end of the year.

(iii) Transactions squared during the year and amount involved.

(iv) Rate of Interest for such loans.

(c) Minutes of the Board Meetings in this regard.

Contd...

Notes

4. **INTERNAL AUDIT LIMIT UNDER CARO**

   (a) Increased from ` 25 Lacs to ` 50 Lacs linked to Paid-up Capital and Free Reserves.

   (b) Increased from ` 2 Crores to ` 5 Crores linked to Turnover.

   (c) Minutes of the Board Meetings in this regard.

5. **DETAILS OF SHARE APPLICATION**

   (a) Amount received as Share Application during the year and date of receipt.

   (b) Whether pending for allotment or not.

   (c) Whether interest being paid or not on such share application.

   (d) Details of refund of share application during the year.

   (e) Any amount whether due for transfer to Investor Education and Protection Fund being due for payment for more than 7 years.

6. **STATEMENT OF ARREARS OF STATUTORY DUES**

   (a) Arrears of statutory dues for more than 6 months.

   (b) When such dues should be deposited with the concerned authorities.

   (c) Details of delay exceeding 30 days in case of Provident Fund Dues.

   (d) Reasons for delay.

7. **DETAILS IN TERMS OF SICK COMPANIES**

   (a) Whether the company is registered for more than 5 years.

   (b) Accumulated losses being not less than 50% of its net worth-disclosure in CARO.

   (c) Disclosure in CARO Reporting in relation to cash losses for the current year and previous year after making adjustments of items of non-cash nature.

8. **PAYMENT OF LOANS TO BANKS / FINANCIAL INSTITUTIONS**

   (a) Whether there is any default in repayment of loans / interests to any bank or financial institutions during the year.

   (b) Necessary disclosure in relation to Amount of such default and period involved.

9. **DEALING / TRADING IN SHARES OR SECURITIES**

   (a) Applies to companies, involved in dealing and trading of shares and securities.

   (b) Necessary entries in the Register of Investments in case of other companies.

   (c) Compliance of Section 372A of the Companies Act, 1956 in case of Limited Companies.

   (d) Necessary disclosures in Minutes.

10. **DETAILS OF GUARANTEE**

    (a) Details of Guarantees given by the Company.

Contd...

Notes

(b) Compliance of Section 295, 372A of the Companies Act, 1956 in case of Limited Company.

(c) Necessary disclosure in Minutes.

11. **PREFERENTIAL ALLOTMENT OF SHARES**

(a) Details of preferential allotment to parties and companies covered in the register maintained u/s 301 of the Act.

(b) Disclosure in relation to pricing of such preferential allotment and concern / interest of the company in this regard. Determination of price based on earnings, dividends, assets value, goodwill etc.

(c) Compliance of SEBI Guidelines, in case of Listed Company.

(d) Compliance of provisions of section 81(1A) of the Companies Act, 1956 in case of Limited Company.

Further, the following disclosures are also important:

1. Compliance of special statute, if any, applicable in case of companies having specific nature of activity e.g. compliance of RBI Guidelines and Prudential Norms in case of NBFC Company.

2. Notice or report of any fraud on or by the company during the year, if any, the nature and the amount involved thereunder.

Caution The order places a considerable responsibility on the auditor. If he is to discharge his duties under the order properly, he should obtain, on the one hand, the co-operation of the management and on the other, the respect and confidence of the members to whom he is reporting. The auditor may be liable, however, if it is found that he expressed his opinion without the exercise of reasonable care and skill, or without applying his mind to the facts, or if he expressed his opinion in complete disregard of the facts.

Source: www.vmandaonline.com

5.5 Bankruptcy System in India

In eighties when the country's industrial arena is marked by industrial sickness, the Government of India set up in 1981, a Committee of Experts under the Chairmanship of Shri T.Tiwari to examine the matter and recommend suitable remedies therefor. Based on the recommendations of the Committee, the Government of India enacted a special legislation namely, the Sick Industrial Companies (Special Provisions) Act, 1985 commonly known as the SICA.

The main objective of SICA is to determine sickness and expedite the revival of potentially viable units or closure of unviable units (unit here in refers to a Sick Industrial Company). It was expected that by revival, idle investments in sick units will become productive and by closure, the locked up investments in unviable units would get released for productive use elsewhere.

The widespread abuse of Sections 22(1) and 22(5) of the Sick Industrial Companies (Special Provisions) Act, 1985, has become a point for discussion, that these sections should either be scrapped or modified significantly if thousands of crores of rupees worth of assets are to be restored to productive deployment.

Notes

Having started the liberalisation regime, Government has sought to introduce radical changes in the legislative environment in which commercial enterprises function. However, these changes focuses more on the established businesses with very little attention being paid to the liberation, rehabilitation and management of the value locked up in insolvent concerns. Firms take on debt for a variety of reasons. In certain cases, they prove unable to pay their debts. These firms then become bankrupt. In this situation if any law does not exist and the creditor(s) and debtor(s) are pretty much left to themselves to sort out problems arising from bankruptcy. Then they have only two options left to them:

In the case of secured loans, they can seize the collateralised assets.

In the case of unsecured loans, the creditors can call upon a third party or an arbitrator to sell some of the debtor's assets.

That is fine with the condition when assets can cover the claims of the debtors. But what happens if the creditors are numerous and the debtor's assets do not cover all the liabilities. In such cases, the creditors will mess up and dispose of the debtor's assets, inevitably resulting in a steep decrease in the value of these assets and a consequent loss to the creditors.

Bankruptcy not only affect the creditors but also affect suppliers of goods and services, banks, financial institutions, and so on. That is why there is a need to frame a code for protecting the different interest groups from the damage of their economic interest. Thus, the insolvency system must be governed by efficiency, equity and transparency in all terms..

There are certain characteristics of a good bankruptcy procedure.

A good bankruptcy procedure should preserve the bonding role of debt by penalising managers and shareholders equally. It works on precautionary basis. The decision making authority should be accountable while deciding on any commitment for future cash flow. And if this commitment is not met the decision making authority should be penalised.

A good bankruptcy procedure should decide and protect the preserve the absolute priority of claims. This system has various advantages.

First, it helps to ensure that creditors receive a reasonable return in bankruptcy states which encourages them to lend.

Second, it means that bankruptcy and non-bankruptcy states are not treated as fundamentally different.

5.6 Bankruptcy Law in India

The other countries in Asia have successfully developed and implemented insolvency regimes. But India is lagged behind due to indecision and bureaucratic hurdles.

India does not have a clear and comprehensive law on corporate bankruptcy. In fact, there is even significant confusion in the meaning of the terms bankruptcy, insolvency, liquidation and dissolution.

Insolvency is a condition when a person is unable to meet in entirety their liabilities from the realisation of assets and is determined by a balance sheet test. There is no regulation or statute legislated upon bankruptcy which denotes a condition of inability to meet a demand of a creditor.

Companies Act, 1956 through insertion of Chapter VI A to deal with the Revival and Rehabilitation of Sick Industrial Companies. This amendment also allows for the setting up of the National Company Law Tribunal (NCLT). But it is still pending. This state shows the uncertain development of insolvency legislation in India and the uncertainty faced by lenders and investors seeking to rely on the law.

Notes

The existing legislation, SICA, provides for a supervisory restructuring at the behest of The Board of Industrial and Financial Reconstruction ("BIFR") which restricted to the industrial companies only, in cases where the net worth of the company has fully eroded. The BIFR appoints an operating agency which is generally a Public Financial Institution, State Level Institution or a Scheduled Bank. However, the winding up of companies continues to be the jurisdiction of the Indian Courts which can take a decade even after the Company has actually been declared sick and reference has been made to BIFR under SICA.

This dualistic legal system is largely responsible for delays at various stages which defeat the real objective of maximising value of assets through facilitated restructuring.

Case Study

Audit Committee's Authority and Responsibilities at Dow

The Audit Committee shall perform the duties assigned to it by Section 4.2 of the Company's Bylaws and by the Board of Directors. The Audit Committee serves a board level oversight role where it oversees the relationship with the independent auditors, as set forth in this charter, and receives information and provides advice and general direction, as it deems appropriate, to management and the independent auditors, taking into account the information it receives and discussions with the independent auditors. Management is responsible for the preparation, presentation, and integrity of the Company's financial statements; accounting and financial reporting principles; internal controls; and procedures designed to reasonably assure compliance with accounting standards, applicable laws, and regulations, and the Company's internal audit department is responsible for objectively reviewing and evaluating the adequacy, effectiveness, and quality of the Company's system of internal controls. The independent auditor is responsible for performing an independent audit of the Company's consolidated financial statements in accordance with generally accepted auditing standards and expressing an opinion on the effectiveness of the Company's internal control over financial reporting.

The Audit Committee shall have the sole authority to appoint or replace the independent auditors (although it may submit any such action to shareholder ratification). The Audit Committee shall be directly responsible for the compensation and oversight of the work of the independent auditors (including resolution of disagreements between management and the independent auditors regarding financial reporting) for the purpose of preparing or issuing an audit report or related work. The independent auditors shall report directly to the Audit Committee.

The Audit Committee shall preapprove all auditing services and permitted non-audit services (including the fees and terms thereof) to be performed for the Company by its independent auditors, subject to the de minimis exceptions for non-audit services described in Section 10A(i)(1)(B) of the Exchange Act, which should be approved by the Audit Committee prior to the completion of the audit. The Audit Committee may form and delegate authority to subcommittees consisting of one or more members when appropriate, including the authority to grant preapprovals of audit and permitted non-audit services, provided that decisions of such subcommittee to grant preapprovals shall be presented to the full Audit Committee at its next scheduled meeting.

The Audit Committee shall have the authority and responsibility to take the actions set forth below as it determines necessary or appropriate and to perform such other duties

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and responsibilities as may be assigned to the Audit Committee, from time to time, by the Board of Directors of the Company, and / or the Chairman of the Board of Directors:

As to Financial Statement and Disclosure Matters:

1. Review and discuss with management and the independent auditors the annual audited financial statements, including disclosures made in management's discussion and analysis, and recommend to the Board whether the audited financial statements should be included in the Company's Form 10-K.
2. Review and discuss with management and the independent auditors the Company's quarterly financial statements prior to the filing of its Form 10-Q, including the results of the independent auditors' review of the quarterly financial statements.
3. Discuss with management and the independent auditors significant financial reporting issues and judgments made in connection with the preparation of the Company's financial statements, including any significant changes in the Company's selection or application of accounting principles, any major issues as to the adequacy of the Company's internal controls and any special steps adopted in light of significant control deficiencies.
4. ***Review and discuss quarterly reports from the independent auditors on:***
   a. All critical accounting policies and practices to be used.
   b. All alternative treatments of financial information within generally accepted accounting principles that have been discussed with management, ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the independent auditors.
   c. Other material written communications between the independent auditors and management, such as any management letter or schedule of unadjusted differences.
5. Discuss with management the Company's earnings press releases, including the use of non-GAAP information, as well as financial information and earnings guidance provided to analysts and rating agencies, which may include . discussing the types of information to be disclosed and the types of presentations to be made.
6. Discuss with management and the independent auditors the effect of applicable regulations and accounting profession initiatives as well as off-balance sheet structures on the Company's financial statements.
7. Discuss with management the Company's major financial risk exposures and oversee the steps management takes to monitor and control such exposures and to implement and follow the Company's risk assessment and risk management policies, and coordinate the reviews and results of reviews by the other Committees and the full board of Directors in their respective risk areas.
8. Discuss with the independent auditors the matters required to be discussed by applicable rules and professional standards, including any difficulties encountered in the course of the audit work, any restrictions on the scope of activities or access to requested information, and any significant disagreements with management.
9. Receive reports from the independent auditors and management and review disclosures made to the Audit Committee by the Company's CEO and CFO during their certification process for the Form 10-K and Form 10-Qs regarding any significant

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deficiencies in the design or operation of internal controls or material weaknesses therein and any fraud involving management or other employees who have a significant role in the Company's internal controls.

As to Oversight of the Company's Relationship with the Independent Auditors

10. At least annually, consider the independence of the independent auditors, and, consistent with rules of the Public Company Accounting Oversight Board, obtain and review a report by the independent auditors describing any relationships between the independent auditors, and the Company or individuals in financial reporting oversight roles at the Company, that may reasonably be thought to bear on the independent auditors' independence and discuss with the independent auditors the potential effects of any such relationships on independence.
11. Review and evaluate the lead partner of the independent auditors' team.
12. Obtain and review a report from the independent auditors at least annually regarding (a) the independent auditors' internal quality-control procedures, (b) any material issues raised by the most recent internal quality-control review, or peer review, of the firm, or by any inquiry or investigation by governmental or professional authorities within the preceding five years respecting one or more independent audits carried out by the firm, and (c) any steps taken to deal with any such issues.
13. Ensure the rotation of the lead (or coordinating) audit partner having primary responsibility for the audit and the audit partner responsible for reviewing the audit as required by law.
14. Recommend to the Board policies for the Company's hiring of employees or former employees of the independent auditors who participated in any capacity in the audit of the Company.
15. Discuss with the independent auditors matters of audit quality and consistency and any significant auditing or accounting issues presented by the audit engagement on which the audit team has consulted with their national office.
16. Meet with the independent auditors prior to the audit to discuss the planning and staffing of the audit.

As to Oversight of the Company's Internal Audit Function

17. Approve the appointment and removal of the senior internal audit executive as well as approve the senior internal audit executive's performance evaluation and compensation decisions. The senior audit executive reports functionally to the Audit Committee.
18. Review the significant issues raised in reports to management prepared by the internal auditing department and management's responses.
19. Review at least annually the internal audit department and its charter, mission, and responsibilities, independence, budget and staffing; specific risks, functions, and businesses in its planned scope; performance measurement goals and results; and quality program results.

As to Compliance Oversight Responsibilities

20. Obtain from the independent auditors assurance that Section 10A(b) of the Exchange Act has not been implicated. Section 10A(b) relates to illegal acts that have come to the attention of the independent auditors during the course of the audit.

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21. Obtain reports from management, the Company's senior internal auditing executive and the independent auditors concerning whether the Company and its subsidiary/ foreign affiliated entities are in conformity with applicable legal requirements and the Company's Code of Business Conduct and Code of Financial Ethics.
22. In conjunction with the Governance Committee, oversee the Company's policies and procedures regarding compliance with applicable laws and regulations and with the Company's Code of Business Conduct and Code of Financial Ethics, including reviewing and recommending to the Board of Directors any amendments to such codes. The Audit Committee shall review and recommend to the Board any waivers of such codes with respect to any employees or executives as it determines appropriate.
23. Oversee the Company's compliance programs, including the Company's Code of Business Conduct and Code of Financial Ethics, and, at least annually, meet to review the implementation and effectiveness of the Company's legal and ethical compliance programs with the chief compliance officer, who shall have the authority to communicate promptly and directly to the Audit Committee about any matters involving criminal or potential criminal conduct.
24. Establish and implement procedures for the receipt, retention and treatment of complaints received by the Company regarding accounting, internal accounting controls or auditing matters, and the confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters.
25. Discuss with management and the independent auditors any correspondence with regulators or governmental agencies and any published reports which raise material issues regarding the Company's financial statements or accounting policies.
26. Discuss with the Company's General Counsel legal matters that may have a material impact on the financial statements or the Company's compliance policies.

Question

Comment on the role of the audit committee in corporate governance at Dow Chemicals.

Source: www.dow.com

5.7 Summary

- In recent times our understanding of corporate governance has changed considerably. Traditionally the corporate governance was seen as a system that ensures that the manager does not take decision for private gains and does not expropriate shareholders' wealth. But now the perception is changed, and the corporate governance is taken in a broader sense.
- It is now perceived as a system that ensures optimal utilisation of resources for the benefit of shareholders while meeting societal expectations.
- It addresses topics such as improving the publication of important information, the protection of shareholders' rights, promotion of balance of interests between managers, shareholders and other stakeholders; the independence of the board of directors, internal control systems and the function of audit.
- An auditor has an important role regarding the financial well-being of a company or corporation. Auditor has to perform a wide variety of duties and tasks related to the financial matters of an entity.

Notes

- The general responsibilities of an auditor, is related to ensure financial compliance. The auditors collect and examine financial records to ensure that they are up to date and to make sure that the organisation abides by pertinent laws and regulations with regard to their finances.

5.8 Keywords

Audit: Examination and verification of a company's financial and accounting records and supporting documents by a professional

Audit Committee: Operating committee of the Board of Directors charged with oversight of financial reporting and disclosure.

External Auditors: Independent public accountant (not an employee of the company) who examines a business entity's books.

Generally Accepted Auditing Standards: Sets of standards against which the quality of audits is performed and may be judged.

Generally Accepted Accounting Principles: Common set of accounting principles, standards and procedures that companies use to compile their financial statements.

5.9 Self Assessment

Fill in the blanks:

1. Auditing and……are two different function but they reinforce each other.
2. Auditing includes investigation, …….and reporting of economic events.
3. Both……...and……..auditors need to play a vital role to ensure proper corporate governance.
4. ……of the company has the power to hire or fire the Chief Audit Executive.
5. ……. opined that the Chairman of the audit committee should be an independent director.
6. The set of standards for practices in auditing are …….
7. As per the SEBI guidelines, the audit committee shall meet at least …… a year.
8. Audit committee is a committee of the……..
9. The audit committee should ensure that the external auditors are……
10. An audit committee should be aware of technological changes, which is ……risk/ condition.

5.10 Review Questions

1. Analyse how the audit committee live up to its significant governance responsibilities and meet the high expectations of shareholders and other stakeholders?
2. Discuss the duties and responsibilities of an auditor in the context of corporate governance.
3. Explain the constitution and function of the audit committee.
4. In what ways an auditor of the company is concerned with the corporate social responsibility?

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5. Bring out the difference between duties and responsibilities of internal and external auditors.
6. "Auditing and governing are not mutually exclusive." Comment
7. Compare and contrast the views of Blue Ribbon Committee and KM Birla Committee regarding auditing function.
8. Discuss the views of Naresh Chandra Committee regarding the audit function.
9. Why is the auditing committee also called the board committee?
10. Draw a relationship between the work of the directors/auditors and their remuneration.

Answers: Self Assessment

1.	governing	2.	attestation
3.	external, internal	4.	Chief Financial Officer
5.	KM Birla Committee	6.	Generally Accepting Audit Standards
7.	thrice	8.	Board
9.	independent	10.	external

5.11 Further Readings

Books

Christine A., *Corporate Governance*, Oxford University Press, 2004.

Geeta Rani, R K Mishra, *Corporate Governance: Theory and Practice*, Excel Books

Parthasarthy, *Corporate Governance: Principles, Mechanisms and Practices*, Biztantra

Online links

en.wikipedia.org/wiki/External_**auditor**

http://www.boardsource.org/Knowledge.asp?ID=3.385

www.eib.org/about/structure/governance/**audit_committee**

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Unit 6: Codes and Guidelines of Corporate Governance

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Objectives

After studying this unit, you will be able to:

- Discuss development of codes and guidelines
- Describe corporate governance in banks
- State the Ganguly Committee's recommendations

Introduction

In the changing global scenario, it has become necessary to bring in effective governance practices in the corporate sector. Various important and valuable lessons have been learned from the series of corporate collapses that occurred in different parts of the world. Accordingly, several codes, guidelines and principles have been made and implemented covering varied aspects of corporate governance. They were introduced in order to restore investors' confidence as well as to enhance corporate transparency and accountability. They seek to establish the accountability standards of Directors and CEOs; as well as define the roles and responsibilities of the Board of Directors and stakeholders in the company.

6.1 Development of Codes and Guidelines

This unit presents an overview of some of the codes and regulations designed to improve corporate governance in UK, US and India. It reviews the recommendations of the various committees that were formed to intensify the practices of corporate governance.

The process of development of codes and guidelines is started with the setting up of different committees on corporate governance.

6.1.1 The Cadbury Report 1992

The Cadbury Report and its accompanying Code covered three general areas, namely: the board of directors, auditing and shareholders. The Cadbury Report focused attention on the board of directors as being the most important corporate governance mechanisms, requiring constant monitoring and assessment. However, the accounting and auditing function were also shown to play an essential role in good corporate governance, emphasising the importance of the corporate transparency and communication with shareholders and other stakeholders. Lastly, Cadbury's focus on the importance of the institutional investors as the largest and most influential group of shareholders has had a lasting impact. This more than any other initiative in corporate governance reform has led to the shift of directors' dialogue towards greater accountability and engagement with shareholders. Further, we consider that this move to greater shareholder engagement has generated the more significant metamorphosis of corporate responsibilities towards a range of stakeholders, encouraging greater corporate social responsibility in general. There is no denying about the substantial impact that the Cadbury Code has had on corporate Britain and, indeed, on companies around the world. By the late 1990s there was strong evidence to show a high level of compliance with the Cadbury Code's recommendations (see Conyon and Mallin, 1997), partly due to the UK's comply or explain approach. Central to the final report's recommendations was that boards of all listed companies registered in the UK should comply with the Code of Best Practice as set out in the report.

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6.1.2 The Greenbury Report 1995

The committee published its report on 17th July 1995 and its key themes were: 'accountability, responsibility, full disclosure, alignment of Director and shareholder interests, and improved company performance' (Directors' Remuneration: Greenbury 1995). The Greenbury Committee was formed after widespread public concern over what were seen as excessive amounts of remuneration paid to directors of quoted companies and newly privatised companies. 'Recent concerns about executive remuneration have centered above all on some large pay increases and large gains from share options in the recently privatised utility industries. These increases have sometimes coincided with staff reductions, pay restraints for other staff and price increases… there have also been concerns about the amounts of compensation paid to some departing directors' (Greenbury Report, 1995:9). The Greenbury Committee were keen to ensure that directors' remuneration was linked to company performance, and the committee did not seem to see a problem with high levels of pay per se, as long as they were justified on the basis of the company's financial results.

A key concern should be to ensure, through the remuneration system, that director's share the interest of shareholders in making the company successful. Performance-related remuneration can be highly effective in aligning interest in this way. In many companies, therefore, there will be a case for a high gearing of performance-related to fixed pay. But there are two constraints on this. First, there will usually be a level of basic salary below which it will not be practicable to go. Second, the requirements and priorities of companies vary. The gearing, which suits one company, may be quite unsuitable for another (Greenbury Report 1995, 38).

The Greenbury Report also addressed the problem of departing directors whose performance had not been noticeably successful, but who still manage to live the company with generous compensation for loss of office.

Compensation payments to directors on loss of office have been a cause of public and shareholders concern in recent times. Criticism has been directed at the scale of some of the payments made and at their apparent lack of justification in terms of performance. Some payments have been described as 'rewards for failure' (Greenbury Report, 1995, 45). When the Greenbury Report was published in 1995 it dealt specifically with the question of directors' remuneration and many of its recommendations were developed from the earlier Cadbury Report. The Greenbury Report recommended that the remuneration committee should consist exclusively of non-executive directors (the Cadbury Report had recommended wholly or mainly non-executive directors). These non-executive directors should have no personal financial interest, no potential conflicts of interest arising from cross-directorships and no day-to-day involvement in running the business.

6.1.3 The Hampel Report 1998

The Hampel Committee was created in 1995 to review implementation of the findings of the Cadbury and Greenbury Committees. The Hampel Committee published its report in 1998. Most of the recommendations in the earlier reports were then published in 1998 by the London Stock Exchange as *The Combined Code: Principles of Good Governance and Code of Best Practice*. The Combined Code (although redrafted since its original publication) is the currently applicable code of best corporate governance practice for UK listed companies. The recommendations of Hampel were along similar lines and on similar issues to Cadbury.

An important contribution made by the Hampel Report was the emphasis attributed to avoiding a prescriptive approach to corporate governance improvements and recommendations. The Cadbury Report highlighted the importance of focusing on the spirit of corporate governance reform, and Hampel reinforced this by stipulating that companies and shareholders needed to

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avoid a 'box-ticking' approach to corporate governance. The Hampel Report emphasised the need to maintain principles-based, voluntary approach to corporate governance rather than a more regulated and possibly superficial approach. This is typical of the UK approach to corporate governance and accounting as opposed to the US style of legislation, the rules-based approach.

In some ways (such as the role of institutional investors in corporate governance) Hampel could be interpreted as being less demanding than Cadbury. Indeed, there is a widely held perception that the report represented the interest of the company directors more than those of shareholders and that much of the positive impact from the Cadbury Report was diluted by the Hampel Report. Certainly, in the area of corporate social responsibility and corporate accountability to a broad range of stakeholders, there was a significant change in fact between the Cadbury Report and the Hampel Report. The Hampel Report clearly felt the need to redress the balance between shareholders and stakeholders and made strong statements on these issues.

An important contribution made by the Hampel Report related to pension fund trustees, as pension funds are the largest group of investors. Pension fund trustees were targeted by the report as a group who needed to take their corporate governance responsibilities more seriously. In particular, pension funds (and their trustees) were encouraged by the Hampel Committee to adopt a more long-term approach to institutional investment, in order to avoid short-termism for which UK companies are notorious. Pension funds were highlighted as the main culprits in placing short-term pressure on their investing companies.

6.1.4 The Turnbull Report 1999

The Combined Code (1998) dealt with internal control in Provisions D.2.1 and D.2.2. In these provisions the Code stated that company directors should conduct a review of the effectiveness of the internal control systems and should report this information to shareholders. The Turnbull Committee was established specifically to address the issue of internal control and to respond to these provisions in the Combined Code. The report provided an overview of the systems of internal control in existence in UK companies and made clear recommendations for improvements, without taking a prescriptive approach. The Turnbull Report was revolutionary in terms of corporate governance reform. It represented an attempt to formalise an explicit framework for internal control in companies. The aim was to provide companies with general guidance on how to develop and maintain their internal control systems and not to specify the details of such a system.

6.1.5 The Higgs Report 2003

Although the Cadbury Report and the Hampel Report stimulated substantial improvements in corporate governance in UK listed companies, certain areas have been highlighted for further examination. The fall of Enron spurred the UK and other countries into re-evaluating corporate governance issues, such as the role and effectiveness of non-executive directors.

As evidenced from the Enron case, the non-executive directors were ineffective in performing their corporate governance role of monitoring the company's directors and were subject to conflicts of interest. Even though the emphasis on non-executive directors in the UK has represented an improvement in UK corporate governance, the UK government post-Enron felt obliged to set up an enquiry to examine their effectiveness.

The Higgs Report dealt specifically with the role and effectiveness of non-executive directors, making recommendations for changes to the Combined Code.

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6.1.6 The Sarbanes-Oxley Act, 2002

In 2002 Paul Sarbanes, a Democrat Senator, and Michael Oxley, a Republican Congressman, were responsible for a radical piece of corporate legislation, the Sarbanes-Oxley Act. The Sarbanes-Oxley Act introduced sweeping corporate law changes relating to financial reporting, internal accounting controls, and personal loans from companies to their directors, whistle blowing and destruction of documents. In addition, Sarbanes-Oxley severely restricts the range of additional services that an audit firm can provide to a client. There are increased penalties for directors and professionals who have conspired to commit fraud. Some examples follow of its provisions. Section 906 of the Act requires that all periodic reports containing financial statements by the Chief Executive Officer (CEO) and Chief Financial Officer (CFO) of the company, certifying that the report fully complies with the Securities Exchange Act and fairly present, in all material respects, the financial condition and results of operations. The penalties for knowingly certifying a statement, which does not comply with the requirements, can be severe: up to $1 million in fines and/or up to ten years' imprisonment. Section 1102 provides that 'knowing and willful' destruction of any record or document with intent to impair an official proceeding carries fines and/or imprisonment up to 20 years. Section 806 provides protection for employees who provide evidence of fraud. There is also protection for 'whistleblowers' in publicly traded corporations. No company, officer or employee may threaten or harass an employee who reasonably believes that a criminal offence has been committed. Section 501 of the legislation also aimed to promote rules to address conflicts of interest where analysts recommend securities when their companies are involved in investment banking activities.

The Sarbanes-Oxley legislation also established a Public Company Accounting Oversight Board (PCAOB) to be responsible to the Securities and Exchange Commission (SEC) for the regulation of auditing in US companies, inspection of accounting firms and disciplinary proceedings. As a result of the Sarbanes-Oxley legislation, some companies felt that the burden of compliance was too high in relation to the perceived benefits.

6.1.7 Redraft of the Combined Code 2003

In July 2003 the Financial Reporting Council approved a new draft of the Combined Code, as intended from the Higgs Report in January 2003. It was referred to as, 'the biggest shake-up of board room culture in more than a decade' (Tassel, 2003). Although the redrafted code was not as prescriptive as Higgs original recommendations, it retained much of the flavour of his concerns. Indeed, the redrafting was welcomed by both the corporate and institutional investment communities, despite their initial reactions to the Higgs Report. The revised code in fact retained almost all of the fifty recommendations contained in Higgs' original report. The language, and the message were altered.

Summary of Codes of Best Conduct

Code of best practices given by Cadbury committee are as follows:

The code recommendations consist of 19 points set out under the headings of: (1) The Board of Directors; (2) Non-Executive Directors; (3) Executive Directors; and (4) Reporting and Controls. The main points are summarised as follows:

Board of Directors

1. The board should meet regularly, retain full and effective control over the company and monitor the executive management.

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2. 'There should be a clearly accepted division of responsibilities at the head of the company, which will ensure a balance of power and authority, such that no one individual has unfettered powers of decision.' Ideally the roles of Chairman and Chief Executive should be separated, although this may not always be practical, in which case there 'should be a strong and independent element on the board'.
3. The board should include non-executive director's 'sufficient caliber and number for their views to carry significant weight in the board's decisions'.

Non-executive Directors

1. Non-executive or 'outside' directors as the committee's chairman preferred to call them, should 'bring an independent judgment to bear on issues of strategy, performance, resources, including key appointments and standards of conduct'.
2. The majority of non-executive directors should be 'independent' of 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.
3. Non-executive directors should be appointed by a formal process and their appointment should be a matter for the board as whole. Appointments should be for specified terms and re-appointment should not be automatic.

Executive Directors

1. Directors' service contracts should not exceed three years without shareholders' approval.
2. Directors' pay and emoluments, including pension contributions and stock options and the amount and the basis for any performance-related element, should be fully disclosed and subject to the recommendations of a remuneration committees consisting mainly or wholly of non-executive directors and preferably chaired by a non-executive director.

Reporting and Controls

1. It is the board's duty to present a balanced and understandable assessment of the company's position.
2. The board should ensure that an objective and professional relationship is maintained with the auditors.
3. The board should establish an audit committee which should consist of at least three non-executive directors. Originally the committee referred to the annual audit as 'one of the cornerstones of corporate governance'.
4. The directors should report on the effectiveness of the company's system of internal control.
5. The directors should report that the business is a going concern, with supporting assumption or qualifications necessary.

In the Greenbury Report the key elements of best code of conduct are summarised below:

1. Remuneration Committees should consist only of non-executive directors. This should avoid pay being determined by directors with a direct financial interest. Remuneration committees should:
   (a) Publish an annual report giving full disclosure of all the elements (basic pay, bonuses, share options, pensions and so on);

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(b) Relate incentives to demanding performance targets, in order to 'align directors' and shareholders' interests';

(c) Explain pay policy to shareholders and justify any unusual or exceptional awards;

(d) Have the committee chairman attend AGM to respond to shareholders questions.

2. Long-term incentive schemes to be approved by shareholders.

3. Discounted share options. No longer should directors be awarded share options at a discount to the prevailing market price.

The Hample Committee made important contribution for the functioning of pension funds. It has developed codes specially in the area of investors relations and shareholders activism.

The Turnbull Committee was established specifically to address the issue of internal control and to respond to these provisions in the Combined Code. It represented an attempt to formalise an explicit framework for internal control in companies.

Higgs Recommendation included specification for the place of non-executive director. It says that a greater proportion of non-executive directors should be there and one of the director should assume chief responsibility as a champion of shareholders interest.

The new code under redraft of the combined code included the following:

1. At least half the board of directors should comprise independent non-executive directors.

2. A company's chief executive should not become chairman of the same company, except in exceptional circumstances.

3. The board's chairman should be independent at appointment.

4. A senior independent director should be appointed to be available to the company's shareholders, if they have unresolved concerns.

5. Boards should undertake a formal and rigorous evaluation of their own performance, considering especially the performance and effectiveness of its committees and individual directors.

6. Institutional investors should avoid box ticking when assessing investee companies' corporate governance.

7. Companies should adopt rigorous, formal and transparent procedures when recruiting new directors.

8. Non-executive Directors should only be reappointed after six years service, following 'a particular rigorous review'.

9. Non-executive Directors can only continue after nine years service following annual re-elections and should be considered no longer independent.

10. Boards should not agree to a full-time executive director accepting more than one non-executive directorship, or chairmanship in a top hundred company.

The Sarbanes-Oxley Act introduced changes relating to financial reporting, internal accounting controls, and personal loans from companies to their directors, whistle blowing and destruction of documents.

(To see latest code of conduct of Satyam, visit- http://www.mahindrasatyam.com/corporate/policies.asp)

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Task

Pick an organisation and analyse its board structure for conformance of code of best practices.

Caselet

Bank of Baroda's Philosophy on Code of Governance

The Bank shall continue its endeavour to enhance its shareholders' value by protecting their interest by ensuring performance at all levels, and maximising returns with optimal use of resources in its pursuit of excellence. The Bank shall comply with not only the statutory requirements, but also voluntarily formulate and adhere to a set of strong Corporate Governance practices. The Bank believes in setting high standards of ethical values, transparency and a disciplined approach to achieve excellence in all its sphere of activities. The Bank is also committed to follow the best international practices. The Bank shall strive hard to best serve the interests of its stakeholders comprising shareholders, customers, Government and society at large.

The Bank is a listed entity, which is not a company but body corporate under the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 and is regulated by Reserve Bank of India. Therefore the Bank shall comply with the provisions of Revised Clause 49 of the Listing Agreement entered into with Stock Exchanges to the extent it does not violate the provisions of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 and the Guidelines issued by Reserve Bank of India in this regard.

Source: www.bankofbaroda.com

6.2 Banks and Corporate Governance

Corporate Governance in Banks is a process which enhances the corporate image in the eyes of their stakeholders such as share owners, debt-paper holders, regulators, Government and the society at large, including present and potential customers. The subject has assumed added importance in India during the past one decade i.e. since mid-nineties, when Indian economy changed gear from a controlled economy to a free economy with systematic policy of deregulation, liberalisation and globalisation. The economy thus got integrated with the global markets of the world. This means the Indian corporate and business houses have to compete with the strongest firms of the world in each segment of market, products and services. They would no longer enjoy the fruits of a protected market as earlier and have to now compete with the best in the world in their respective fields of operations. But this is not possible unless following conditions are fully satisfied:

1. Products quality are standardised and are comparable with the best, both in quality and prices.
2. All the stake holders feel satisfied with the firms product quality, pricing and services rendered.
3. Shareholders are kept fully satisfied in terms of dividend and other services rendered from time to time.
4. Entire country, society and international community look at the firms product quality, its pricing and services with appreciation.
5. It should be looked at by the society as a socially responsible entity.

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The Basel Committee Recommendations

The Basel Committee published a paper for banking organisations in September 1999. The Committee suggested that it is the responsibility of the banking supervisors to ensure that there is effective corporate governance in the banking industry. It also highlighted 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.

Did u know? Efforts were taken for several years to remedy the deficiencies of Basel I norm and Basel committee came out with modified approach in June 2004. The final version of the Accord titled "International Convergence of Capital Measurement And Capital Standards-A- Revised Framework" was released by BIS. This is popularly known as New Basel Accord of simply Basel II. Base II seeks to rectify most of the defects of Basel l Accord. The objectives of Basel II are the following:

1. To promote adequate capitalisation of banks.
2. To ensure better risk management and
3. To strengthen the stability of banking system.

Essentials of Accord of Basel II

1. ***Capital Adequacy:*** Basel II intends to replace the existing approach by a system that would use external credit assessments for determining risk weights. It is intended that such an approach will also apply either directly or indirectly and in varying degrees to the risk weighting of exposure of banks to corporate and securities firms. The result will be reduced risk weights for high quality corporate credits and introduction of more than 100% risk weight for low quality exposures.
2. ***Risk Based Supervision:*** This ensures that a bank's capital position is consistent with overall risk profile and strategy thus encouraging early supervisory intervention. The new framework lays accent on bank managements developing internal assessment processes and setting targets for capital that are commensurate with bank' particular risk profile and control environment. This internal assessment then would be subjected to supervisory review and intervention by RBI.
3. ***Market Disclosures:*** The strategy of market disclosure will encourage high disclosure standards and enhance the role of market participants in encouraging banks to hold and maintain adequate capital.

6.3 Ganguly Committee's Recommendations

With a view to improving the financial health of the banks further, and make the Indian banking system world class, the Reserve Bank of India, in consultation with Indian Banks Association (IBA), appointed a committee known as the consultative Group of Directors of banks and financial institutions, with the following terms of reference:

1. To review the supervisory role of Boards of banks and financial institutions and to get feedback on the functioning of the Board vis-à-vis compliance, transparency' disclosures, audit committees etc.
2. To study the system prevalent in banks/financial institutions for monitoring by the Board, the implementation of the policies laid down by it.

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3. To make recommendations for making the role of Board of Directors more effective with a view to minimising risks and over-exposure.

4. To consider any other matter relevant to the subject.

With a view to getting certain expert opinion in the area of its study, the Group discussed various issues with known specialists in the field. The following experts and professional bodies held discussions/made presentation before the Group:

1. Institute of Company Secretaries of India, New Delhi

2. Dr. Y.R.K. Reddy of Yoga Consulting Pvt. Ltd, Hyderabad.

3. ConsIndia HR Services Pvt. Ltd., Mumbai

The Group held four meetings, including the presentations by the expert Groups. It also met a representative group of banks in a separate meeting on 8th March 2002 to elicit feedback on the draft recommendations of the Group.

The recommendations of the group concern the areas, as discussed in following subsections.

6.3.1 Constitution of the Board of Directors

The Board of Directors has important fiduciary responsibilities to the shareholders of the company. The Board is responsible for the overall management and effective functioning of the bank. As Banks are corporate entities, the Board of a bank is responsible to the shareholders. Further, banks being important participants in the payment systems, it is enjoined upon the Boards to safeguard the interests of the depositors and other stakeholders. The Board, however, cannot be expected to supervise the day-to-day operations of the bank and it, therefore, delegates and entrusts appropriate authority to the various functionaries, via the whole-time directors of the Board such as Chairman, Managing Director and Executive Directors. This makes each whole-time director, individually, and the Board, collectively, responsible for the performance of the bank.

The challenge facing Indian banking has been getting the board of directors to shape strategy and monitor performance without encroaching on management terrain or becoming too involved in the bank's day-to-day operations.

The Group notes that the statutes governing public sector banks vest powers with the Central Government to appoint whole-time directors as also majority of the independent/non-executive directors. The Boards of public sector banks (barring State Bank of India) comprise presently, two whole-time directors (one Chairman & Managing Director and one Executive Director). Considering the fact that banking is becoming more complex, the Group is of the view that one more whole-time director should be appointed on the Boards of large-sized nationalised banks, who could provide undivided attention to critical areas like risk management systems, human resource management, etc.

The eligibility criteria normally followed for nomination of independent directors to the Boards of public sector banks are the following:

1. The candidate should normally be a graduate (which can be relaxed while selecting directors for the categories of farmers, depositors, artisans, etc.)

2. He/She would be between 35 and 65 years of age.

3. He/She should not be a Member of Parliament/Member of Legislative Assembly/Member of Legislative Council

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The Group is of the view that the above criteria needs to be revised in view of challenges facing the banking sector.

Presently, the due diligence is done, to a limited extent, by the Reserve Bank of India for the candidates considered for independent/non-executive directorship in public sector banks. The due diligence by RBI is, however, confined to verifying whether the names forwarded by the Government of India figure in the Defaulters' List or not. This due diligence process does not assess either the ability, professional qualification or the technical competence of the candidates being considered for directorship to fulfil the fiduciary responsibilities expected of them.

In the case of independent/non-executive directors of private sector banks, since they are appointed by the Board, the due diligence exercise is not done by RBI. Such directors are appointed by the Board keeping in view the requirement of giving representation to the specified sectors, as enshrined in the Banking Regulation Act, 1949.

The Group recommends that the criteria followed by the Government of India for nominating directors to the Boards of public sector banks and the due diligence followed for them should be made applicable to independent/non-executive directors of other banks as well.

The Group is of the view that due diligence of the directors of all banks - be they in public sector or private sector should be done in regard to their suitability for the post by way of qualifications and technical expertise. The Group strongly feels that involvement of Nomination Committee of the Board in such an exercise should be seriously considered as a formal process. The final decision in respect of appointment of independent/non-executive directors should be that of the Board with the Nomination Committee presenting its recommendations highlighting both positive and negative aspects of each recommended candidate, for consideration of the Board.

While the desirable international practice of the Board members being nominated by the Nomination Committee from a list of qualified, experienced professionals would require amendments to the banking laws, the Group recommends that the Government while nominating directors on the Boards of public sector banks should be guided by certain broad "fit and proper" norms for the directors. The Group recommends the criteria suggested by the BIS to consider "fit and proper" for bank directors:

1. Competence of the individual directors as assessed in terms of formal qualifications, previous experience and track record.
2. Integrity of the candidates.

For assessing integrity and suitability, features like criminal records, financial position, civil actions undertaken to pursue personal debts, refusal of admission to, or expulsion from professional bodies, sanctions applied by regulators or similar bodies, and previous questionable business practices, etc. should be considered. (of, "Supervision of Financial Conglomerates", 1998, BCBS). The Group recommends that these criteria should also be made applicable to nomination of independent directors of private sector banks.

The Group recommends that a pool of professional and talented people should be built up for consideration of nomination as independent/non-executive directors to the Boards of banks and financial institutions. The list of such eligible directors should be assembled by RBI from independent sources after proper due diligence and such a list should be put on the RBI's website for access by all concerned. The Group is of the view that appointment/nomination of independent/non-executive directors to the Boards of banks (both public sector and private sector) should be from this list. Any deviation from this procedure by any bank, according to the Group, should be with the prior approval of RBI. RBI may also establish procedures for regularly updating the list through additions and deletions from time to time.

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6.3.2 Composition of the Board

The Group examined the structure and the composition of the Boards of banks. It is noted that composition of the Boards of banks is more regulation-based rather than need-based. As per the regulation applicable to banks, the Board of Directors of a bank is required to have representation from specific sectors like agriculture and rural economy, co-operation, SSI, law, etc., The Group is of the view that in the context of banking becoming more complex and competitive, the composition of the Board should be left to the business needs of banks. Composition of the Board (by way of representation of various sectors) should be so as to reflect the business strategy and its vision for the future.

The Group is of the view that in the present context when banking is becoming more complex and knowledge-based, there is an urgent need for making the Boards of banks more contemporarily professional, by inducting technical and specially qualified personnel. The earlier requirement of ensuring representation on the Boards of banks for areas like agricultural sector, law, co-operation, small-scale industry, etc. which were relevant in the immediate post-nationalisation era, in the Group's view, have not to be supplemented by other emerging priorities. The Group feels that instead of attempting to wholly change sectional representation, efforts should be aimed at bringing about a blend of 'historical skills' set (that is, regulation-based representation of sectors like agriculture, SSI, co-operation, etc.) and the 'new skills' set (that is, need-based representation of skills such as, marketing, technology, and systems, risk management, strategic planning, treasury operations, credit recovery, etc.).

It recognised that agriculture still contributes a significant share of GDP and representation to agriculture and SSI, etc., sectors have to be continued. With increased de-regulation and the structural changes that have taken place in the economy and in the banking sector, the Group is of the view that the Boards of banks should have representation in the following areas:

1. Finance
2. Information Technology
3. Human Resources Development
4. Persons with good track record of experience in managing/advising industrial enterprises
5. Economics

6.3.3 Independent/Non-executive Directors

The independent/non-executive directors in any organisation have a constructive role to play both on-and-off-the Board because of their knowledge and professional objectivity. Within the existing legal framework, the Group is of the view that independent/non- executive directors must play a more pro-active role by exercising their independence of judgement, practical experience, specialised knowledge, etc., to the deliberations of the Board. The independent/ non-executive directors have a prominent role in introducing and sustaining a pro-active governance framework in banks and financial institutions. The independent/non-executive directors, according to the Group, should provide constructive inputs regarding the business strategy, performance of the bank, etc. They should act as the catalyst for focused discussions on issues brought to the Board and subjects of critical importance to the bank during the meetings of the Board. These directors, being independent, are expected to be free from any organisational affiliation and should seek all information which are relevant to monitor the performance of the bank, the overall risk profile of its credit and investment portfolios, cases of over-exposure to one or a particular group of borrowers or entities related/associated with the promoter directors,

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etc. According to the Group, the independent/non-executive directors should raise in the meetings of the Board, critical questions relating to:

1. Business strategy, including loans and recovery policy
2. House keeping and internal control system
3. Record of exposure to various sectors/industries by way of both credit and investments, etc.
4. Risk management systems
5. Internal audit
6. Accounting policy
7. Senior management development
8. Other aspects of the functioning of the bank, and
9. Investor relations.

The independent/non-executive directors need to ensure that the vital issues raised by them are addressed by the bank to the full satisfaction of the Board. While making the above recommendations, the Group is guided by the fact that good corporate governance in banks will be sustained by a knowledgeable, skilful and well informed Board of Directors with a correct blend of expertise/professionalism, independence and involvement.

In the case of private sector banks where promoter directors may act in concert, the independent /non-executive directors should provide effective checks and balances ensuring that the bank does not build up exposures to entities connected with the promoters or their associates. They should also seek through the Board, all information relating to critical areas like connected lending, investments, exposure to entities/associates related to the promoters/large shareholders. The independent/non-executive directors should provide effective checks and balances, particularly in widely held and closely controlled banking organisations.

6.3.4 Commonality of Directors of Banks and NBFCs

In regard to the existing regulatory prohibition on directors of NBFCs becoming independent/ non-executive directors on the boards of banks, the Group is of the view that it would not be proper to debar a professional director on the board of an NBFC from becoming a director on the board of a bank. It needs to be noted that as per the existing policy, NBFCs satisfying certain criteria (such as, AAA rating, minimum net worth of ₹ 200 crore, CRR of not less than 12%, net NPA not more than 5%, etc) are allowed to be converted to a bank. In view of the above policy stance, the Group feels that it would not be fair to debar directors on the boards of NBFCs becoming independent/non-executive directors on the boards of banks.

Caution In order to avoid any likely conflict of interest, the Group recommends that a director on the board of a NBFC could be considered for appointment as director on the board of a bank if:

1. He/She is not the owner of the NBFC, [holdings (single or jointly with relatives, associates, etc.) exceeding 50%] or
2. He/She is not related to the promoter of the NBFC, or
3. He/She is not full-time employee in the NBFC.

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In regard to full-time employees of NBFCs, the Group feels that the Reserve Bank of India as the regulator, should have the discretion for considering such person for directorship in a bank, keeping in view the specific circumstances, merits, etc., of each case.

6.3.5 Responsibilities of Directors

A strong corporate board performs four major roles: over-seeing the risk profile of a company, monitoring the integrity of its business and control mechanisms, ensuring that expert management is in place and maximising the interests of its stakeholders. Such a board has regular and close contact with the organisation and can detect and correct any abnormal behaviour quickly. Such a board is also able to play a crucial role in hiring and retaining sound managers. The Group is of the view that banks being pivotal for the country's financial system, the boards of banks should fulfil all these four roles.

The Board of Directors of banks and financial institutions have, besides fiduciary obligations, as above, important social responsibilities, and the responsibilities to ensure compliance with the regulatory framework. These would include compliance with the directions/policy of the Government etc. In their fiduciary capacity, the Boards of directors should receive regular reports from their management committees, auditors and audit committee, formulate clear written policies in regard to various business strategies and policies (credit, investments, etc.), performance parameters for the bank and ensure that the bank's affairs are conducted in accordance with the stated policies/regulatory requirements. The Board should formulate policies relating to credit dispensation particularly in regard to exposures to various productive sectors, geographical areas, investments, exposures to sensitive sectors such as capital market, strategies for recovery of loans and status of progress with respect to investments, risk management, etc.

The need for clear lines of responsibilities in any organisation cannot be over emphasised. In the case of banks, the Group notes that the responsibilities are well defined for the managerial functionaries. Powers are delegated to the various functionaries of the bank for sanctioning of loans and advances, investments, incurring authorised level of expenditure, etc. The managerial functionaries are also made accountable and their performance is monitored vis-à-vis the performance targets agreed to by the Board, judicious exercise of discretionary powers, etc.

The Group recommends that every director should be given a brief on the functioning of the bank, before his appointment/induction, covering the following:

1. Delegation of various authorities by the Board
2. Strategic Plan of the bank
3. Organisational Structure
4. Financial and other controls and systems
5. Economic features of the market and competitive environment, and
6. Meeting with key management team after briefing

6.3.6 Training of Directors

The Group is of the view that the directors could be made more responsible to their organisations by exposing them to need-based training programmes/seminars/workshops to acquaint them with the emerging developments/challenges facing the banking sector. The directors should be exposed to the latest management techniques, technological developments, innovations in financial markets, risk management and other areas of interest to the organisation to discharge their duties to the best of their abilities. The Group is of the view that such investment would be

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of great value to the financial system. Ideally, in the Group's view, the Reserve Bank of India as the Regulator, could take the initiative in organising such seminars for the directors of banks and financial institutions.

The Group notes that broad guidelines have been issued both by the Government of India and the Reserve Bank in regard to the role expected of their nominees on the Boards of banks. These guidelines emphasise the following points:

1. The director is expected to regularly attend board meetings and take an active part in its deliberations.
2. Members of the Board do not exercise any executive authority individually, but are collectively responsible for the superintendence, direction and management of the bank.
3. While directors can delegate certain powers to any committees, executives or other officers, they cannot absolve themselves of their responsibility of ensuring that the bank operates on sound and prudent lines.
4. They are responsible for safeguarding the interests of the depositors and owners through efficient and well informed administration of the bank.
5. Directors are expected to critically and thoroughly go through the agenda papers well before the Board meeting.
6. They should pay adequate attention to the state of non-performing assets, recovery performance and write—off large debts (say ₹ 1 crore or more).

Based on the meetings attended by them, the nominee directors are required to submit reports to the Government (in the case of its nominees on the Boards of public sector banks) and to Reserve Bank of India (in respect of its nominees on the Boards of all banks).

Presently, there is no mechanism to make the directors on the Boards of banks and financial institutions accountable for the performance of their organisation. The Group is of the view that the lack of clearly documented responsibility and accountability of directors on the Board stems from the manner in which the Board is constituted. In the case of public sector banks, majority of the Board comprises nominees of the Central Government and the individual directors are, therefore, mainly accountable to the political institution of the land. The Group is of the view that while a change in the manner in which the Boards are constituted is essential in order to make the Board and its individual members more accountable, this would necessitate a change in the statutes governing the banking sector. According to the Group, the role of CEOs–their track record, competence and leadership qualities–provides the pivot for good governance practices in a banking company. The process of selection of the CEO, therefore, assumes crucial importance in the endeavour to introduce modern corporate governance standards in banks.

The Group is of the view that it would be desirable to separate the office of Chairman and Managing Director in respect of large sized banks. Keeping in view the balance sheet size, sophistication of business transactions and complexity of the bank, the office of Chairman and Managing Director could be bifurcated into two: The Chairman who is the Chairman of the board and the Managing Director who could function as the Chief Executive responsible for day-to-day management of the bank. The Group is of the view that this functional separation will bring about more focus and vision as also the needed thrust in the functioning of the top management of the bank.

The Group notes that many Expert Committees (including the Committee on Banking Sector Reforms under Chairmanship of Shri M. Narasimhan) had recommended in favour of a reasonably long tenure of services for the whole-time directors. The Group recommends that the whole-time directors should have sufficiently long tenure so as to enable them to leave a mark of their leadership and business acumen on the bank's performance.

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While the responsibilities of nominee directors have been clearly laid down, the responsibilities of the Board of Directors as a whole has not been delineated. Furthermore, there is no practice of advising the directors (other than nominee directors) of banks their responsibilities, role, etc. in the organisation. The Reserve Bank of India had circulated in 1984 among the private sector banks, guidelines on the role and functions of independent/non-executive directors on the Boards of private sector banks. These guidelines were in the nature of operational guidelines bringing home to them the fact that the directors should not interfere in day-to-day affairs of the bank or otherwise intervene in credit/investment/personnel/other operational matters. The guidelines highlight the need for the independent/non-executive directors to take interest in the bank's work concerning their own fields of specialisation/activity and also deliberate on all matters of general policy affecting the bank's functioning. The guidelines exhort that every director should function in a manner most conducive to the interests of the depositors, of the shareholders and of the nation as a whole. The Reserve Bank of India had also circulated in 1992 a list of "do's" and "don'ts" to the private sector banks, with a view to sensitising the directors on their role and responsibilities. A similar list had also been given by the Government to the directors of public sector banks. The Group recommends that these instructions may be reviewed and updated where required, and the roles and responsibilities of independent/non-executive directors be clearly stated.

Keeping in view the recent developments and the changes witnessed in the banks' operations, as also the technical developments, the Group suggests that Reserve Bank may bring out an updated charter indicating clear-cut, specific guidelines on the role expected and the responsibilities of the individual directors. The responsibilities of the directors according to the Group, should illustratively include the following:

1. Deliberating and approving the objectives, business strategies and annual business plans
2. Deliberating and approving the management succession policy of the institution, and assessing senior management's performance on an on-going basis
3. Clearly defining the authorities and responsibilities of both executive directors and relevant senior management
4. Developing and providing a list of checks and balances for use by senior management
5. Formulating policies on vital areas of bank's functioning (viz., loan and recovery policy, investment policy, risk management policy exposure to sensitive sector including capital market, etc.)
6. Guidance on risk management particularly investment assessment, the fixation of risk limits, exposure ceiling both individual and group - borrower ceilings, etc.,
7. Approve the policy on introduction of technology to the bank's various facets of working with a view to provide better service in a most cost-effective manner as measured by targets of productivity and profitability.
8. Maintaining and recording appropriate levels of checks and balances with regard to the influence of the management and/or large shareholder (s)
9. Monitoring on an on-going basis the bank's performance, build up of exposure to various categories of borrowers, industries, sectors, etc against targets of the annual operating plan.
10. Discussing the reports submitted by the Audit Committee, monitoring the follow-up action taken to rectify the deficiencies observed, etc.
11. Ensuring compliance with all legal/regulatory requirements, etc.

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As a step towards effective corporate governance, the Group is of the view that it would be desirable to take an undertaking from every director to the effect that they have gone through the guidelines defining the role and responsibilities of directors, and understood what is expected of them and enter into a covenant to discharge their responsibilities to the best of their abilities, individually and collectively. In this connection the Group would recommend that before appointment of a director, a questionnaire on the lines of the one used by the FSA of UK, modified keeping in view of our requirements could be used as a model Annexure 2 for obtaining relevant information regarding background of the potential appointee.

The Group is of view that in consonance with transparency in regard to responsibility of directors, an appropriate covenant should be obtained from each of the directors, whether they are independent/non-executive directors/nominees of Government/RBI/other institutions having sizable shareholding in banking organisations. The Group accordingly has devised a covenant for adoption by all the banks.

6.3.7 Remuneration to Directors

The Group is of the view that the existing level of remuneration paid (by way of sitting fees etc.) to directors of banks and financial institutions is grossly inadequate, by contemporary standards, to attract qualified professional people to their Boards, and expect them to discharge their duties as per the mutually agreed covenants. A few of the banks/FIs have modified their compensation plans to include a base salary, performance bonus and options to their directors. In order to get quality professional people, the level of remuneration payable to the directors should be commensurate with the time required to be devoted to the bank's work and also to signal the appropriateness of remuneration to the quality of inputs expected from a member. The remuneration of the directors may also include the form of stock option.

6.3.8 Prohibitions Flowing from Section 20 of the BR Act, 1949

The Group is of the view that the statutory prohibition under section 20 of the Banking Regulation Act, 1949 on lending to companies in which a director is interested, severely constricts availability of quality professional directors on to the Boards of banks. The Group notes that internationally, however, banks are permitted to extend credit facilities to companies in which the directors are interested subject to full disclosure and appropriate covenants. The Group is aware that any change in the existing legal framework would require an amendment to the Banking Regulation Act. The Group recommends that we move towards that goal.

6.3.9 Information Flow to/from the Board

The Group notes that the effectiveness of the Board largely depends upon the flow of information to and from the Board. The information furnished to the Board should be wholesome and complete and should be adequate to take meaningful decisions. A distinction needs to be made between statutory items and strategic issues in order to make the material for directors 'manageable'. In this context, the Group reviewed the practices of banks and financial institutions in regard to preparation of the agenda notes, recording of the proceedings of the meeting of the Board, follow up of various action points arising from the decision taken at the meetings, etc. The Group noted that the manner in which the proceedings are recorded and followed up in public sector banks leave much scope for improvement.

An issue that was brought to the notice of the Group was the number of reviews put up to the Board as per the Calendar of Reviews prescribed by the Reserve Bank of India. It was pointed out that the large number of reviews put up to the Board leaves little time to the Board for fruitful discussions on future business strategies and policies. The Group recommends that the Reviews

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dealing with various performance areas could be put to the Supervisory Committee of Board and a summary on each of the reviews could be put up to the Board itself, for scrutiny and further action. The Board's focus should be more on strategy issues, risk profile, internal control systems, overall performance of the bank, etc.

The Group is of the view that procedure followed for recording of the minutes of the Board meetings in banks and financial institutions should be uniform and formalised. The Group would suggest that banks and financial institutions may adopt two methods for recording the proceedings. A summary of key observations made which should be submitted to the next Board meeting and a more detailed recording of the proceedings which will clearly bring out the observations, dissents, etc. made by the individual directors which could be forwarded to them for their confirmation.

The Group is of the view that the draft minutes of the meeting should be forwarded to the directors, preferably via the electronic media, within 48 hours of the meeting and ratification obtained from the directors within a definite time frame. If a director fails to respond within the time specified, it should be taken that he/she has no comments to offer.

In every Board meeting, the Board should review the status of the action taken on the points arising from the earlier meetings and till action is completed to the satisfaction of the Board, any pending item should continue to be put up before the Board.

6.3.10 Company Secretary

The Group noted that the public sector banks do not have a qualified Company Secretary on their rolls. A Company Secretary has important fiduciary and Company Law responsibilities. The Company Secretary is the nodal point for the Board to get feedback on the status of compliance by the organisation in regard to provisions of the Company Law, Listing Agreements, SEBI Regulations, Shareholder grievances, etc.

Did u know? The Public Sector banks historically had no qualified Company Secretary.

In the context of a number of banks in the public sector accessing the capital market, the Group is of the view that there is now a need to have a qualified Company Secretary in order to ensure that the bank is in compliance at all times with the company law related issues as also to be instrumental in redressing grievances of the investors. A qualified Company Secretary, according to the Group, would also fulfil the earlier recommendation in regard to recordings of the proceedings of the meetings of the Board and its Committees. The Group recommends that all banks should consider appointing qualified Company Secretary as the Secretary to the Board and have a Compliance Officer (reporting to the Secretary) for ensuring compliance with various regulatory/accounting requirements. Further, the Institute of Company Secretaries of India may be required to include appropriate inputs in their curriculum in order to accommodate banking provisions, technical teams etc., as part of the professional examination.

6.3.11 Committees of the Board

Supervisory Committee

An issue raised during the deliberations of the Group was whether an additional tier by way of Supervisory Board could be considered for banks, a practice which is followed by banks in Germany. The Supervisory Boards of banks in Germany mainly function as "Executive Committees" of the Board. The public sector banks in India have constituted "Executive

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Committee" or "Management Committee" which meet more frequently than the full Board do. The Group is of the view that instead of creating another tier by way of a Supervisory Board, there could be a Supervisory Committee of the Board in all banks – be they public or private sector, which will work on collective trust concurrently, without diluting the overall responsibility of the Board. The role and responsibilities of the Supervisory Committee of the Board could include monitoring of the exposures (both credit and investment) by the banks, review of the adequacy of the risk management process and upgradation thereof, internal control systems and ensuring compliance with the statutory/regulatory framework.

Audit Committee of the Board

The Group notes that banks have set up–as required in terms of the R.BI guidelines–independent Audit Committees. The Audit Committee comprises a majority of the independent/non-executive directors with the Executive Director of the bank as one of the members. The Group notes that a Chartered Accountant, wherever available on the board, is a member of the Audit Committee.

The international best practice in this regard is to constitute Audit Committees with only independent/non-executive directors. As regards the composition of the Audit Committee, the Basel Committee has suggested that in order to ensure its independence, the Audit Committee of the Board should be constituted with external Board members who have banking or financial expertise, (Enhancing Corporate Governance for Banking Organisations: Basel, September 1999). The Group is of the view that ideally the Audit Committee should be constituted with independent/non-executive directors and the Executive Director should only be a permanent invitee. However, keeping in view the present circumstances, the existing arrangements where the Executive Director is one of the members may continue, and may include the Executive Director and official directors i.e., nominee of Government of India and R.B.I. in respect of public sector banks.

The Group is of view that the Chairman of Audit Committee need not be confined to the Chartered Accountant profession but can be a person with knowledge of 'finance' or 'banking' so as to provide directions and guidance to the Audit Committee, since the Committee not only looks at accounting role but also the overall management audit etc., of the bank.

Nomination Committee

The Group is of the view that it is desirable to have a Nomination Committee for appointing independent/non-executive directors of banks that should scrutinise the nominations received for nomination of independent/non-executive directors with reference to their qualifications, experience and other criteria proposed above. The Group recognises that in the case of public sector banks, the nomination committees may not be of immediate relevance, since the independent/non-executive directors (except shareholder nominees in the case of banks which have issued capital to the public) are appointed by the Central Government. The Group is of the view that in the context of a number of public sector banks issuing capital to the public, a Nomination Committee of the Board may be formed for nomination of directors representing shareholders.

Shareholders' Redressal Committee

Since banks are increasingly accessing capital market, there is a need for an effective machinery for redressal of investor grievances in banks. The Group notes that as of now, the matters relating to investor complaints, etc., are looked after by the line staff. With a view to building up credibility among the investor class, the Group recommends that a Committee of the Board may be set up to look into the grievances of investors and share holders, with the Company Secretary as a nodal point.

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Risk Management Committee

The Group notes that in pursuance of the Guidelines issued by the Reserve Bank of India, every banking organisation is required to set up Risk Management Committees (for management of both credit risk and market risk) with Board level representation to manage effectively the risk profile of the bank. The management of risk particularly arising from over exposure to interconnected entities, came to the fore in the recent past in respect of a few banks. The Group, therefore, recommends that the formation and operationalisation of the Risk Management Committees should be speeded up and their role further strengthened.

Disclosure and Transparency

The Group notes that disclosure requirements for banks have been substantially enhanced in the recent period. Banks are now required to disclose in the 'Notes on Accounts', exposure to sensitive sectors as also exposure to capital market by way of (a) direct investment in shares and debentures, (b) advances against shares and debentures and (c) guarantees issued on behalf of stockbrokers. The Group suggests that it would be desirable if the exposure of a bank to stockbrokers and market makers as a group, as also exposure to other sensitive sectors (viz., real estate), exposure to various sectors, etc. are reported to the Board regularly.

The Group recommends that the following disclosures be made by banks to the board of directors at regular intervals as may be prescribed by the board from time to time:

1. The progress made in putting in place a progressive risk management system—the risk management policy and strategy followed by the bank.
2. Exposure to related entities, viz., details of lending to/investment in subsidiaries, the asset classification of such lendings/investment, etc.
3. Conformity with Corporate Governance standards–structure, various committees, etc.–should be ensured.

Task Find out the corporate governance practices at State Bank of India.

Case Study

Corporate Governance in Islamic Banks

Corporate governance in banking has been analysed almost exclusively in the context of conventional banking markets. For example, there has recently been some discussion of the role 'market discipline' exerted by bank shareholders and depositors in constraining the risk taking behaviour of bank management. At the same time, there is growing interest in, and analysis of, banks as stockholders in companies themselves playing a central role in corporate governance, especially in Germany and other countries with universal banking structures of the traditional type.

By contrast, little is written on governance structures in Islamic banking, despite the rapid growth of Islamic banks since the mid 1970s and their increasing presence on world financial markets. There are now over 180 financial institutions world-wide which adhere to Islamic banking and financing principles. These banks operate in 45 countries encompassing most of the Muslim world, along with Europe, North America and various

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offshore locations. Islamic financing increasingly is a market segment of interest of Western banks, and the latest addition to the list of Islamic banks in October 1996 in the Citi Islamic Investment Bank, Bahrain a wholly owned subsidiary of Citicorp.

Islamic banking represents a radical departure from conventional banking, and from the viewpoint of corporate governance, it embodies a number of interesting features since equity participation, risk and profit-and-loss sharing arrangements from the basis of Islamic financing. Because of the bank on interest (riba), an Islamic bank cannot charge any fixed return in advance, but rather participates in the yield resulting from the use of funds. The depositors also share in the profits according to predetermined ratio, and are rewarded with profit returns for assuming risk. Unlike a conventional bank which is basically a borrower and lender of funds, an Islamic bank is essentially a partner with its depositors, on the one side, and also a partner with entrepreneurs, on the other side, when employing depositors' funds in productive direct investment.

These financial arrangements imply quite different stockholder relationships, and by corollary governance structures, from the conventional model since depositors have a direct financial stake in the bank's investment and equity participations. In addition, the Islamic bank is subject to an additional layer of governance since the suitability of its investment and financing must be in strict conformity with Islamic law and the expectations of the Muslim community. For this purpose, Islamic banks employ an individual sharia Advisor and/or Board.

Question

Find out more about the Islamic banks and their corporate governance structure.

Source: www.al-bab.com

6.4 Summary

- The process of development of codes and guidelines is started with the setting up of different committees on corporate governance.
- These committees gave formulated the codes of best conducts, which covers the different areas such as board structure, remuneration of directors, shareholders' rights etc.
- Since banks are important players in the financial system, special focus on the Corporate Governance in the banking sector becomes critical.
- As per the recommendations made by the Ganguly committee, the banks could be asked to come up with a strategy for implementation of the governance standards recommended. Once the strategy is received from all banks, the progress of implementation could be reviewed after a period of twelve months. Thereafter, the position could be reviewed half-yearly or annually, as deemed appropriate.

6.5 Keywords

Basel II: The second of the Basel Accords, which are recommendations on banking laws and regulations issued by the Basel Committee on Banking Supervision.

Executive director: Working director of a firm who is usually also its full time employee and has a specified decision making role.

Non-bank financial companies: Financial institutions that provide banking services without meeting the legal definition of a bank.

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Non-executive director: Non-working director of a firm who is not an executive director and, therefore, does not participate in the day-to-day management of the firm.

Sarbanes-Oxley Act: Law which establishes a broad array of standards for public companies, their management boards, and accounting firms.

Whistleblowers: A person who tells the public or someone in authority about alleged dishonest or illegal activities occurring in an organisation.

6.6 Self Assessment

Fill in the blanks:

1. The US Sarbanes Oxley Act ('SOX') works on the basis of ..... .
2. The Greenbury Committee were keen to ensure that directors' remuneration was linked to .....
3. …….Committee made important contribution for the functioning of pension funds.
4. ……highlighted the need for having appropriate accountability and checks and balances within each bank.
5. Basel II is also known as……..
6. The Board of Directors has important ……. responsibilities towards the shareholders of the company.
7. Non-executive directors have a……..role to play.
8. Generally, a base salary, performance bonus and …….make up the remuneration of directors on Board.
9. The Ganguly Committee is of the view that the draft minutes of the board meeting should be forwarded to the directors within ……. hours of the meeting.
10. The Ganguly Committee is of the view that it is desirable to have a ……. for appointing independent/non-executive directors of banks.

6.7 Review Questions

1. Give main points of the Greenbury Report and the Hampel Report. Explain their contributions.
2. Briefly explain Higgs Report. Also mention about the Redraft.
3. What were the guidelines laid for the Board of Directors, the Non-executive Directors and the Executive Directors by the Cadbury Committee?
4. Bring out the main points of the Hampel and Turnbull Committee.
5. "In banking, special focus on corporate governance has become critical". Discuss
6. Discuss the distinguishing features of Basel II.
7. Highlight on the recommendations of the Ganguly Committee with regards to the role and responsibilities of the executive and non-executive directors.
8. Analyse the relevance of need based training in enhancing the ability of the board of directors.

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9. Critically evaluate the need for Company secretary in modern public sector enterprises.
10. If you were one of the members of the Ganguly Committee, what recommendation you would have made regarding the remuneration of the directors?

Answers: Self Assessment

1.	comply or be punished	2.	company performance
3.	Hampel	4.	Basel Committee
5.	New Basel Accord	6.	fiduciary
7.	consultative	8.	stock option
9.	48	10.	nomination committee

6.8 Further Readings

Books

A C Fernando, *Corporate Governance: Principles, Policies and Practices*, Pearson

Dr. S Singh, *Corporate Governance: Global Concepts and Practices*, Excel Books

Parthasarthy, *Corporate Governance: Principles, Mechanisms and Practices*, Biztantra

Online links

http://business.gov.in/corporate_governance/cadbury_report.php

www.cg.org.cn/theory/zlyz/greenbury.pdf

www.rbi.org.in/upload/content/images/guidelines.html

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Unit 7: Business Ethics and Corporate Social Responsibility

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Objectives

After studying this unit, you will be able to:

- Identify unethical issues in organisations
- Describe the concept of corporate social responsibility
- Know the CSR of Indian corporations

Introduction

Business is not only an economic function but also a social function. It is the only activity that influences every aspect of the society and nation. Business innovates, develops new products and services to serve humans, produces goods and services for the nation and society, invents new molecules to cure human ailments, provides employment, generates earnings, exports, it pays taxes for the smooth functioning of government, and utilises the resources of society and nation. Corporate social responsibility is about seriously considering the impact of the company's decisions and actions upon the environment and the society. The dependence of any business on its social and ecological environment is so comprehensive that the very existence, survival and growth of any enterprise depend upon its acceptance by the society and the environment. If any business outlives its utility to the society and the environment, it has no place and reason to exist.

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7.1 Business Ethics and Corporate Governance

Ethics is concerned with the discipline of the right and wrong conduct of individuals. More especially, in modern times, problems in business are more often concerned with terms such as 'fair price', 'right product' and proper quality. Ethical issues in business often arise leading to dilemmas, paradoxes and baffling situations. It is, therefore, necessary to understand the ethical principles that pervade human behaviour. It is pertinent to study the role of ethics in corporate organizations.

Did u know? The origin of the word 'ethics' can be traced to the Greek word '*ethikos*' which refers to human character and conduct. According to Webster's collegiate thesaurus, the word 'ethics' can be defined as:

1. The code of conduct governing an individual or a group.
2. The discipline dealing with good and bad and with moral duty and obligation.
3. The complex of ideals, beliefs or standards that characterizes a group, community or people.
4. A group of moral principles or set of values.

Ethics and morality are terms that are used more or less interchangeably. However, there is some difference between the two terms. Ethics are concerned with actions that are proper or improper, conduct that is right or wrong, decisions that are fair or unfair. Morality varies from individual to individual because the values and cultural traits of individuals may differ. Further, what is moral according to one person may be immoral according to another. Moral standards, therefore, cannot be considered as ethical standards in certain contexts. Generally, what is moral or immoral depends more on religious tenets of various groups of persons in the world. However, ethical standards may be common to all major religions.

Ethical issues that arise in management are concerned with issues such as right and wrong behaviour towards other people, proper and improper actions and fair and unfair decisions. Ethical and other moral standards are based on consistent beliefs and codes of human conduct. Further, these issues extend far beyond the commonly discussed problems of bribery, collusion, forgery, impersonation, thefts and reaching into many areas such as marketing policies, capital investments, corporate mergers and acquisitions.

Business ethics and corporate governance are two significant factors that impact a company and how it operates. Business ethics represent the values, principles or characteristics a company follows when conducting business in the economy. Corporate governance is the internal framework a company designs and implements to govern and protect those invested into the company. The relationship between business ethics and corporate governance comes from an organization's owner or executive managers, who create the governance and decide which ethical principles employees will follow.

Various groups are involved in business – managers at different levels and having various functions, workers of different skills and backgrounds, suppliers of different materials, distributors of different products, creditors of different types, stockholders of different holdings and citizens of different communities, states and countries – and a benefit for one may be denial of an obligation to another group. Ethical problems bring about conflicts between an organization's economic performance as measured by revenues, costs and profit and its social performance stated in terms of obligations to persons both within and outside the organization. These obligations comprise: protection to loyal employees, maintaining competitive and healthy markets and producing useful and safe products and services.

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Honesty and goodness are dominant principles in ethics and in morality as well in all major religions. If a society has to function within the framework of laws, social order and freedom, then ethics and democracy become meaningful. Crime, hypocrisy, dishonesty and destructive anti-social behaviour are all unethical tendencies that every person of good conduct and moral behaviour would detest. Religion in the wider context does not merely restrict itself to prayer and piety. On the other hand, it implies good ethical human behaviour that is governed by ethical principles that enhance life in the individual, society and business. A good society alone can encourage people to love their neighbours and make their living decent and profitable in a world of competition and strife. An ethical businessman has to provide goods of quality and proper services with all humility to the community. Ethics has to underline principles such as: (a) Not to harm others. (b) To benefit others.

7.1.1 Ethical Principles in Business

Ethical principles can be classified into two categories: teleological and deontological. The teleological theories determine the ethics of an act by looking at the consequences of the decision (the end), while deontological theories determine the ethics of an act by looking to the process of the decision (the means).

1. ***Teleological (Utilitarianism) Ethical System:*** The teleological morality of a decision is determined by measuring the probable outcome. The theory most representative of this approach is utilitarianism, which seeks the greatest 'good' (or utility) of the greatest number. The most basic form of utilitarian analysis is cost-benefit analysis, where one tallies the costs and benefits of a given decision and follows the decision that provides for the greatest overall gain. Utilitarianism holds that actions are right in proportion as they tend to promote happiness, wrong as they tend to produce the reverse of happiness.

2. ***Deontological Ethical System:*** A deontological system is based on rules or principles that govern decisions. In this system, ethics are measured by the rightness of an act and depend little on the results of the act. According to this, a moral person is one of goodwill, and that person makes ethical decisions based on what is right, regardless of the consequences of his decision. Thus, the student who refuses to cheat during examinations is morally worthy if his or her decision springs from but sense of duty. But it is morally unworthy if the decision is merely one born of self-interest, such as fear of being caught.

3. ***Hybrid Theory:*** Robert Nozick holds that justice and fairness, right and wrong are measured not by equality of results for all, but from ensuring equal opportunity for all to engage in informed choices about their own welfare.

   Enlightened ethical egoism holds that it is important to the individual that the world is a 'good' world; therefore the individual may have a self- interest in curbing pollution or participating in community projects, even though she or he may not individually and personally benefit from the decision.

4. ***Distributive Justice and Social Contract:*** Prof. Rawls of Harvard University propounded this theory. According to it, that when people get together, they form societies and engender cooperation, but when they come together conflict also arises because people do not receive a just distribution of the benefits yielded through their activities. Rawls believe that the base of all distribution systems should be just and the primacy of justice in the basic structure of our system of society necessitates greater equality.

5. ***Individual Freedom:*** According to this theory, all individuals must be allowed to make informed choices by society. Such choices must be within the law and the same freedom enjoyed by one individual in the society must be extended to all within the society. Informed choices means everybody shares the information, and is allowed to make his or her own choice, but without transgressing the law of the state.

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7.1.2 Unethical Issues

All people belong to various organisations. We are frequently facing some ethical dilemmas regarding the right and wrong when values are in conflict. All the organisations expect loyalty from the employees. Modern society has become a cynical society with the 'distrust' and 'mistrust' of scientists, business leaders and managers. Unethical practices are increasing in organisations.

Managers care about ethics because they are interested in preventing unethical behaviour. Many workers resort to unethical behaviour during the highly competitive economic times. Employees believe that they can help a business company by fudging sales figures, abusing competitors and shortchanging customers. Modern managers have to work even harder to communicate the expected ethical conduct to their employees.

Employees are more interested in working for those companies which are ethical and serving for a noble purpose. Many employees are not interested in working for a company with a history of environmental problems, insider trading and law breaking practices. Ethical corporate behaviour is important because the employees translate the ethics of the company into action.

People want to be proud of where they work. According to a study made by Cullen and Victor, workers are more committed to organisations that have a benevolent ethical climate. The organisational commitment is lower in "self-interest oriented" 'egoistic' organisations. Another study suggests that managers who found their senior management to be credible, honest and competent, report positive attachments to their organisations.

Common Ethical Problems faced by the Managers

Many ethical dilemmas can be predicted in modern times. At the same time, mishandling of ethical dilemma can create more problems for the management.

Human Resource Issues

According to Barbara Toffler, 66 percent of ethical issues involves human resources. (Toffler, 1986, Tough Choices: Managers Talk Ethics, New York; John Wiley & sons)

A common problem faced in knowledge industry is to retain the qualified and experienced staff. The most effective way is to create a conducive working environment. Mutual respect and appreciation are necessary for increased production. Equity, reciprocity and impartiality are the cornerstones for the development of human resources.

Conflicts of Interest

Personal and professional conflicts can also take place in any organization. A supplier promises to secure admission for the daughter of a manager in a prestigious school in a city. The supplier does not want any favour for this. What is your stand in this case?

There are many other issues like use of company's resources, sharing information with competitors and getting gifts and compliments from suppliers.

Task

You must have heard about the unethical practices at Satyam Computers that came into limelight a few years ago. Find out the details about the case and how is it related to corporate governance.

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Case Study

Enron Scandal: Does End Justify the Means?

Enron was a Houston-based energy company founded by a brilliant entrepreneur, Kenneth Lay. The company was created in 1985 by a merger of two American gas pipeline companies. In a period of 16 years the company was transformed from a relatively small concern, involved in gas pipelines, and oil and gas exploration, to the world's largest energy trading company (The Economist, 28th November, 2002). Deregulation of the energy market in the USA allowed utilities to choose their energy supplier. The 1980s saw deregulation of the market for natural gas in the USA, and deregulation of the wholesale electricity market followed in 1992 (The Economist, 26th February, 1998). Deregulation had a far-reaching impact, allowing energy providers to compete on price in order to attract supply contracts. One of the effects of deregulation was to create a market in energy trading, similar to a futures and options trading floor, where deals were struck between suppliers and clients on a continual basis.

Enron's success was phenomenal. By 1998 Enron had eight divisions including Enron Energy Services (EES) and Enron Capital and Trade (ECT). In 1994 ECT sold $10 million of electricity. By 1997 the company was selling $4 billion, which constituted almost a fifth of the North American wholesale market. Yet it only produced a small proportion of this itself. In 1998 Enron held $23 billion in assets (see The Economist, 26th February, 1998 for these and other figures). In January 1998, Enron sold a 7% share of EES to two pension funds for $130 million. From 1990 Enron's total return to shareholder ran far in advance of the index. In July 1998 Enron announced a $2.3 billion takeover of Wessex Water in the UK. Indeed, Rebecca Mark, then in charge of Enron's new water business, commented that they intended to be one of the two or three dominant players in the business (The Economist, 30th July, 1998). In 1999 Enron's sales reached $40.1 billion. By 2000 the company's revenues reached over $100 billion (The Economist, 8th February, 2001). Enron became famous for its dexterity in handling risk management derivatives, as well as for its abilities in the area of commodity trading derivatives. Indeed, the company was proud of having 'invented' weather derivatives in 1997 (The Economist, 15th June, 2000). Another area where Enron was praised for its innovation and success was in Internet-based business. At the end of 1999, Enron launched its Internet-based trading platform, Enron Online. The venture was massively successful with 5,000 trades taking place online every day valuing about $3 billion (The Economist, 28th June, 2001). However, the chief executive of Enron, Jeffrey Skilling, dismissed this success by saying that the Internet business was just a better form of telephone, which was the way the company did business successfully before.

Towards the end of its life, Enron had transformed itself from an energy company to a predominantly financial and energy trading company, trading financial derivatives as well as energy contracts and effectively running a gas pipeline on the side (The Economist, 29th November, 2001). Success was so great at Enron that the words over the door as visitors entered the Houston headquarters were changed in 2001 from:

'The world's leading Energy Company' to 'The world's leading company'.

Perhaps a quote from Dante would have been better; 'Lasciate ogni sparanza voi ch'entrate' (this sort of self-confidence and pride is a clear example of counting chickens before they are hatched).

The translation of this is 'Abandon all hope ye who enter here!' It is the last sentence of the inscription over the entrance to Hell in the Divina Commedia, 'Inferno' canto 3, 1.

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Early Worries

An article in The Economist (26th February, 1998) raised queries as to the permanency of Enron's success. Causes for concern were, first, the different speeds of deregulation in different states in America and, therefore, the ability to achieve free competition in all of the states relatively quickly. Second, there were growing concerns that Enron may not have been well equipped to deal with the smaller customers it was taking on. Another main concern, expressed in many newspapers and professional literature, was that the company's management team was arrogant, overambitious and even sycophantic. Some even suggested that Kenneth Lay was like a cult leader with staff and employees fawning over his every word and following him slavishly (The Economist, 1st June, 2000). This is not a healthy way to do business and indicates an ethical and moral problem at the head of the company. Such cases of unethical behaviour are associated with bad corporate governance and should be taken as warning signs. A prophetic, ironic and almost visionary comment begs quotation:

"*Arrogance. . . is Enron's great failing. . . And how does Mr. Lay respond to this charge? Mr. Lay speaks glowingly of the heyday of Drexel and of its star trader Michael Milken, whom he counts as a friend: they were accused of arrogance. . . but they were just being 'very innovative and very aggressive'. The comparison is not especially well chosen, for it is worth recalling what then happened: Mr. Milken ended up in jail for pushing the law too far, and the arrogant Drexel collapsed in a heap of bad debts and ignominy. For all its arrogance, Enron is hardly likely to share that fate: but hubris can lead to nemesis, even so.*"

This quotation proved to be a poignant forecast of later events at Enron, as well as prophetic in terms of the reasons for the company's downfall.

Signs of Distress

In 1997 Enron wrote off $537 million, mainly in order to settle a contract dispute over North Sea Gas. The company also became notorious for relying too heavily on non-recurring items, such as asset sales, to reach its target of 15% annual growth in earnings. The company purchased Portland General Electric, a utility company in Oregon that held access to the California market. By buying into the Californian retail electricity market when the State deregulated electricity, the company seemed o be expanding too far. Furthermore, they had little success in penetrating the market and were only able to attract about 30,000 new customers in the whole State. This was not enough to merit their massive advertising campaign (The Economist, 23th April, 1998). It seems that Enron's success in controlling the energy market came more from its dexterity in energy derivatives trading than its abilities in the core business. The company seems to have overstretched itself as a trader in commodities. In 2001, Dynegy, a competitor in the energy industry, was committed to a merger with Enron but backed out when Enron's accounting problems began to emerge. Indeed, not everyone was seduced by Enron's success. One investment firm, Reed Wasden, had been skeptical of Enron for a number of years. They pointed out that the company's trading margins had collapsed from 5.3 per cent in 1998 to under 1.7 per cent in 2001 (The Economist, 6th December, 2001).

The fall. . . and fall. . . of Enron

In August 2001, the chief executive, Jeffrey Skilling, left the company following concerns about the company's management and about his outburst of 'asshole' at an analyst who dared ask him a tricky question (The Economist, 6th December, 2001). By late autumn it became clear that Enron was suffering serious financial problems with discussion over a takeover or bankruptcy (The Economist, 1st November, 2001). Towards the end of October

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2001, Moody's credit rating agency cut Enron's rating to barely above that of junk bonds. In November 2001, Standard & Poor's downgraded Enron's debt to junk bond status. Unfortunately, Enron's debt contracts included clauses stipulating that the company would have to make additional payments to debtholders if the company was downgraded (The Economist, 6th December, 2001). On one day alone, 30th October, 2001, Enron's shares fell by 19 per cent (The Economist, 1st November, 2001).

Enron's brilliance in derivatives trading fuelled its demise, as the company lost $1.2 billion in capital from a failed hedging deal with a private equity fund. The company had to sell 55 million shares. A severe lack of transparency in Enron's balance sheet meant that no one was aware of this and other off-balance-sheet liabilities until it was too late. Despite such serious problems, even as late as November 2001, there was a general perception that the company was too big to fail and would weather the storm (The Economist, 1st November, 2001). However, by the middle of November 2001 it was clear that the company was doomed. More than 20 class action lawsuits had already been filed. The main accusations covered fraud and material misstatement in the companies' financial reports. Kenneth Lay himself commented that the company had been over geared, with extensive use of debt capital on the balance sheet (The Economist, 15th November, 2001). Furthermore, the company was accused of insider trading. Indeed, Enron top executives sold over $1 billion of Enron shares to other investors. Even though Enron's annual reports indicated financial prosperity, it was clear that Enron's management knew a lot more than they were letting on, making hay while the sun shone. This is a clear illustration of information asymmetry and agency problems, with insider investors profiting from better information than outsiders.

On 2nd December, 2001, the great Enron filed for Chapter 11 bankruptcy. Kenneth Lay resigned in January 2002. In August 2002, Michael Kopper, an assistant to the former finance director of Enron, pleaded guilty to charges of wire fraud and money laundering. On 2nd October, 2002, Andrew Fastow, former finance director of Enron, was charged with: money laundering; securities, wire and mail fraud; and conspiracy to inflate Enron's profits and enrich himself at the company's expense (The Economist, 3rd October, 2002).

Creative Accounting at Enron and its Impact on the Accounting Profession

Transparency is an essential ingredient for a sound system of corporate governance. USA has been dubbed the strongest capital market in the world, with the highest standards of integrity and ethicality. What went wrong? Both the audit function and the accounting function in Enron were fraudulent and opaque. However, Enron's collapse has had repercussions on the whole of the accounting and auditing profession, not just in the USA but worldwide. Enron's accounting was anything but transparent. Confidence in the company collapsed in 2001, when it became clear that their accounts were not only unreliable but fraudulent. Arthur Andersen, one of the Big Five, has now disappeared, partly as a result of his involvement in Enron's fraudulent accounting and auditing. However, Enron was not Andersen's first major problem. They had already paid out millions of dollars in settlements following inaccurate and weak auditing on a number of companies including Sunbeam, Waste Management and Discovery Zone (The Economist, 15th November, 2001). In 2000, Andersen collected $25 million for auditing Enron's books in addition to $27 million for consulting services. This seems excessive and demonstrates a notorious problem of conflicts of interest between the auditing and consultancy arms of accounting firms.

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Examples of Enron's devious accounting abound. The company recorded profits, for example, from a joint venture with Blockbuster Video that never materialized (The Economist, 7th February, 2002). In 2002, Enron restated its accounts, a bad sign in itself and a process that reduced reported profits by $600 million (The Economist, 6th December, 2001). Indeed, the process resulted in a cumulative profit reduction of $591 million and a rise in debt of $628 million for the financial statements from 1997 to 2000. This triggered an investigation by the Securities & Exchange Commission (SEC) into the auditing work of Andersen, Enron's auditors. The difference between the profit figures was mainly attributable to the earlier omission of three off-balance sheet entities. Such profit inflation allowed the company to increase its earnings per share figure (EPS). EPS is simply the total earnings figure divided by the number of shares. The company's exaggerated focus on its EPS was certainly a factor in its eventual decline, as Enron stated in its 2000 annual report that this main aim was to focus on EPS. This is a common strategy and one which can lead to manipulation of accounting numbers in attempts to inflate the EPS figure (The Economist, 6th December, 2001). The pressure on companies in the USA and elsewhere to increase their EPS year on year has been blamed for corporate short-termism. It also provides directors with an irresistible temptation to cheat the figures! Not only did the company clearly manipulate the accounting numbers to inflate the earnings figure, but it was found to have removed substantial amounts of debt from its accounts by setting up a number of off-balance sheet entities. Such special purpose entities are non-consolidated, off-balance-sheet vehicles that have some legitimate uses, such as the financing of a research and development partnership with another company. However, they can also be used to hide a company's liabilities from the balance sheet, in order to make the financial statements look much better than they really are (The Economist, 2nd May, 2002). This was certainly the case for Enron. It meant that significant liabilities did not have to be disclosed on Enron's financial statements, as they were almost attributable to another legal entity. To anyone, this is an obvious example of fraudulent, premeditated and unethical management. Furthermore, about 28 per cent of Enron's EPS was shown to have come from gains on sales of securitized assets to third parties connected to Enron (The Economist, 6th December, 2001).

All this begs the question, 'why did Enron's auditor allow this type of activity?' They had to have been aware of it. Perhaps Andersen considered the transactions were relatively too small to be considered material. However, this is becoming less of a reasonable excuse (The Economist, 6th December, 2001). In December 2001 the chief executive of Andersen, Joseph Berardino, stated that the firm had made an error of judgment over one of the off-balance-sheet entities created by Enron (The Economist, 20th December, 2001). One 'special purpose' vehicle in particular, called Chewco, again created by Enron to offload liabilities for off-balance-sheet financing purposes, was cited as being a chief culprit, as it did not provide Andersen with adequate information. Clearly, had Andersen had this additional information, they would have forced Enron to consolidate Chewco into their accounts. However, such ignorance on the part of Andersen may not be adequate support for its lack of action. According to Enron, Andersen had been carrying out a detailed audit of the main structured finance vehicles, which made the auditing firm guilty of acting too slowly and inadequately (The Economist, 20th December, 2001).

In January 2002, Andersen fired the partner in charge of Enron's audit, David Duncan, as he was found to have ordered the disposal of documents even after the SEC had subpoenaed the firm as part of its investigation into Enron. However, David Duncan clarified that he was not working in isolation, but was in constant contact with Andersen's headquarters. Furthermore, Enron itself ordered the shredding of vast quantities of documentation concerning the company's financial liabilities. The firm was criminally indicted by the

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Department of Justice for shredding documents relating to Enron. In March 2002, Andersen pleaded not guilty in a federal court to charges of obstruction of justice by document shredding (The Economist, 21st May, 2002). Documents pertaining to Enron were not only shredded in Houston but also in London! Berardino resigned as chief executive of Andersen in March 2002. On 15th June, 2002, Andersen was convicted of obstruction of justice. It is difficult for some to see how a company (as opposed to a person) can be found guilty of a crime, but certainly in the USA there is a perception that companies may be associated with unethical behaviour, in the same way as individuals (see The Economist, 13th June, 2002, for a discussion of this issue). Such an approach makes corporate social responsibility a moral, human obligation, as companies are considered to be equivalent to people in a moral sense. The fall of Enron was the biggest corporate collapse ever, and the downfall of Andersen the most significant death of an accounting firm ever.

Conflicts of interest are a frequent problem in the audit profession. Independent appointment of the company's auditors by the company's shareholders is frequently replaced by subjective appointment by company bosses, where the auditor is all too often beholden to the company's senior management. Further, there are conflicts of interest arising from interwoven functions of audit and consultancy. Special, cozy relationships are built over time between companies and their auditors, which can again compromise independent judgment and cloud the auditing function. Such conflicts of interest impinge on the corporate governance function. Improvements in the audit function are clearly emphasized by the Enron case (The Economist, 7th February, 2002). Creating a division between the auditing and consultancy arms of auditing firms may help. Indeed, a complete ban on auditing firms offering both services to the same client may be implemented. KPMG and Ernst & Young, PricewaterhouseCoopers and Deloitte Touche Tohmatsu have all decided to separate their auditing and consulting arms (The Economist, 7th February, 2002). Another solution may be to instigate the rotation of auditors so that special relationships between auditors and their companies may not be allowed to develop. Until now audit companies have been essentially self-regulated. They have used a process of peer review to check their procedures. The oversight bodies have been weak and lacking in regulative clout (The Economist, 7th February, 2002). The Sarbanes-Oxley Act of July 2002 has taken a hard line on the regulation of auditing. The new Act restricts the consulting work that accounting firms are allowed to carry out for their audit clients.

The Financial Accounting Standards Board (FASB) in the USA has been forced to reconsider its position on off-balance-sheet financing, a subject that has troubled them for years. Especially, the FASB is reviewing its rules on how to account for special purpose entities (financing vehicles), such as those created and used by Enron. Attempts to address such issues in the past have been halted by aggressive lobbying (The Economist, 7th February, 2002). Not surprisingly, one important lobbyist was Richard Causey, Enron's former chief accountant (The Economist, 2nd May, 2002). The FASB rule in place at the time of Enron's fall was that a company could keep a special purpose vehicle off its balance sheet, as long as an independent third party owned a controlling equity interest equivalent to at least 3 per cent of the fair value of its assets. The FASB has, post-Enron, considered raising that number to 10 per cent (The Economist, 2nd May, 2002). The Enron saga has added fuel to the process of inter national harmonization of accounting standards. The International Accounting Standards Board (IASB) is in the process of developing internationally acceptable standards for accounting worldwide. The strong card that the USA has traditionally played, in setting the agenda for international accounting, has been severely weakened by the shockwaves from Enron. Under international accounting standards, the removal of material liabilities from Enron's balance sheet via its special purpose entities

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would not have been allowed, as the rules are harsher. The rules-based approach to accounting traditionally applied by the USA has also come under fire, as it provides companies with an incentive to comply with the letter but avoid the spirit of the rules. A more principles-based approach, such as that adopted in the UK, would probably encourage companies to comply more in substance than in form.

Further, there are two accounting standards in the UK that protect investors from the type of creative accounting practised by Enron. First, there is the fifth accounting standard 'Reporting the Substance of Transactions'. This ensures that quasi subsidiaries, such as Enron's special purpose entities, are presented in the group's accounts so that the commercial effects of controlling operations, not owned by the company in a technical sense, are clarified. Second, there is the twelfth accounting standard, which deals with contingent liabilities. Companies in the UK have to disclose a description and a quantification of the effect of each and every contingent liability (see Ryland, 2002). Having suffered severely from Polly Peck and Coloroll, the UK has ensured that these potential black holes in accounting are dealt with. Surely this is encouraging for UK investors, as these two standards make a UK Enron less likely.

The Sarbanes-Oxley Act, brought in quickly in July 2002, also attempted to address accounting fraud through regulation. Chief executives and chief financial officers now have to 'swear' that to the best of their knowledge their latest annual reports and quarterly reports neither contain untrue statements, nor omit any material fact (The Economist, 15th August, 2002). Such new legislation should encourage directors to act ethically and monitor their own financial accounting practices more carefully. They are now personally liable for cases of fraudulent, creative accounting. But is regulation really the answer? Is it not more worrying for shareholders to feel that the directors of companies they 'own' are not so trustworthy that they have to be tied down in this way, not having the integrity to regulate themselves?

The Aftermath

There are distinct similarities between the downfall of Enron and the collapse of Long Term Capital Management, an infamous hedge fund in the USA run by Nobel Prize-winning financial economists. Both companies demonstrated financial wizardry, trading immense quantities of derivative contracts and becoming excessively confident, indeed arrogant, about their abilities to beat the market. Indeed, although Enron had substantial abilities in the hedging field, these can collapse-and did-when the market started to fall. The general decline in stock markets around the world in 2001 had a negative influence on Enron's hedging success. The collapse of Enron also bore similarities to those of Maxwell and Polly Peck in the UK, as these companies also revealed significant audit failures. The personal suffering caused by Enron's collapse has been extensive. When Enron filed for bankruptcy many employees lost their savings as well as their jobs (The Economist, 28th November, 2002). The pensions of Enron's employees were invested in Enron shares, so massive loss in future income for such pensioners is another important consideration. This emphasizes the social implications of corporate collapse and weak corporate governance.

One of the main effects of Enron's collapse has been on the general confidence of the government, corporate and professional bodies, and investors in companies' activities and management integrity. The effects of Enron have been so far-reaching that the term 'Enronmania' has been coined to refer to the reaction among company bosses and investors to fear (indeed terror) that companies with characteristics similar to Enron may share its fate (Ryland, 2002). Indeed, the whole case raises the question, 'how could such a huge and

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successful company have avoided scrutiny for so long and managed to fool investors and creditors?' For the Federal Reserve, the concern was 'how could a company with such huge debts avoid regulatory checks and balances?' The immediate remedy for this situation was the Sarbanes-Oxley Act, which was produced and signed by the President in July 2002. However, an ongoing cause for concern is the choice between a regulated or a more voluntary corporate governance environment. As some countries, such as the USA, adopt a regulated approach to corporate governance reform and react in a regulative manner to corporate governance problems, other countries, such as the UK, consider that a more principles-driven and voluntary approach is more appropriate. The Higgs Report (2003) reviewed corporate governance in the UK and made proposals for improvements in boardroom practice, but avoided any attempt to introduce regulation. This is typical of the UK's more voluntary approach to corporate governance reform and is the UK's response to Enron, inter alia (The Economist, 31st October, 2002).

A Reflection on the Corporate Governance

Severe corporate governance problems emerge from the Enron wreckage. Unfettered power in the hand of the chief executive is an obvious problem and one that characterized Enron's management. Separation of the chairman and chief executive role is not common in the USA: This is a technique that is so successful in the UK as a means of improving the effectiveness of a company's board of directors that its application in the USA would benefit American companies and particularly American shareholders! The Higgs Report (2003) has further strengthened the relevance of this initiative to corporate governance in the UK. The function of the non-executive directors in Enron was weak as they did not detect fraudulent accounting activities through their internal audit function. Indeed, the internal audit committee failed completely in policing their auditors. Serious conflicts of interest have arisen involving members of Enron's internal audit committee. For example, Wendy Gramm was the chairman of Enron's audit committee and her husband, Phil Gramm, a senator, received substantial political donations from Enron. Also, Lord Wakeham was on the audit committee at the same time as having a consulting contract with Enron (The Economist, 7th February, 2002). These examples show that people in responsible positions, who should have detected unethical activities, were themselves not independent.

There were numerous illustrations of unethical activity within the Enron Organization that continued to come to light long after its downfall. For example, in May 2002 it became clear from documents released by the Federal Energy Regulatory Commission that Enron's energy traders developed and used strategies, or tricks, to manipulate the markets in which California bought electric. One trick, the 'Death Star', involved arranging power sales to flow in opposite directions, so that Enron could collect fees for transporting electricity when it had not done so! (The Economist, 9th May, 2002).

Overall, corporate governance in Enron was weak in almost all respects. The board of directors was composed of a number of people who have been shown to be of poor moral character and willing to conduct fraudulent activity. This was the genuine root of the company's corporate governance failure. If the leadership is rotten how can the rest of the company succeed in the long-run? Also, the non-executive directors were compromised by conflicts of interest. The internal audit committee did not perform its functions of internal control and of checking the external auditing function. Furthermore, the company's accounting and financial reporting function failed miserably. Both the financial director and the chief executive were prepared to produce fraudulent accounts for the company. The corporate crimes perpetrated by members of the Enron hierarchy are unnerving. How could the company survive so long with such unethical activities being carried out at

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the highest level? Why did no one notice? Where they did notice problems, why did they not report the company? How could the company's auditors allow such a travesty of justice? The questions raised by the Enron saga are far more numerous than the solutions offered.

There has been a proliferation of books on the downfall of Enron, seeking to explain why events transpired as they did. As we have seen, the USA and the UK reacted strongly to Enron's collapse and corporate governance has been hurled to centre stage, as a result of the terrible weaknesses at the heart of Enron's corporate governance system. The long-term effects of Enron will hopefully be a cleaner and more ethical corporate environment across the globe. Continuous updating of corporate governance codes of practice and systematic review of corporate governance checks and balances are necessary to avoid other Enrons in the future. As in the famous (or infamous) UK novel, The Clockwork Orange (by Anthony Burgess), systems of controlling juvenile delinquents only worked superficially, as they forced a change in behaviour but did not alter the individuals' character and attitudes. The chief miscreant in the novel still wanted to behave amorally, but could not due to the treatment he had received. In a similar way, preventing unethical behaviour within companies through cold, legalistic and mechanistic means cannot alter a person's general approach. In our own research into the attitudes of institutional investors towards corporate governance issues, we found that generally fund managers and directors considered unethical behaviour could not be controlled easily. For example, one corporate governance representative in a large investment institution in the City of London commented that:

"*. . . if people want to be fraudulent there is nothing in the current system to stop them and if they are clever and fraudulent then they will get away with it for even longer and probably get rich on it. Clearly, corporate, governance checks and balances can only serve to detect, not cure, unethical practices.*"

Question

1. Discuss the factors that led to the downfall of Enron?
2. Could the debacle be avoided? If yes, how?

Case Study

Business Ethics – Individual's or Organization's

Dis-connect between an employee and the ground realities widen as she moves up the ladder. Today, businesses are very target driven. At each level, targets are set and are interlinked. The performance of one's superior is determined by one's own performance and this process goes on till the very top echelons. Till such time one meets or surpasses the targets no questions are asked on the way of achieving those and disconnect mentioned earlier plays a huge role. It is only when the shortfall occurs, explanations are demanded and then also words like ethics are given a short shrift. In nutshell, only the end and not the means is what matters. In such an environment, where targets are means to not only success but more importantly survival, ethics boil down to a personal call. These calls have to be taken everyday by millions of people in real time with targets and survival at top of the mind.

The line between right and wrong gets blurred. Can one put a number on the price, less than which a gift is considered a culture token and above which it is considered a bribe?

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Doubt whether any corporate dossier conceptualized at the very top on ethics can address this issue on the ground.

Approaches to Corporate Governance

Over the years, two very distinct approaches to corporate governance have emerged. One is the mix of organization-control perspective and stakeholder-control perspective and other is based on capital market control.

The former approach sacrifices short-term focus at the altar of long-term sustainability. It is based on 1 person 1 vote dictum. The agreed upon goal for the management is to achieve stability and perpetuity of business. Board has representation of employees and society. Major chunk of equity comes from financial and non financial companies, which are ready to wait for longer periods for their investments to fructify. Firms are not too keen on going public thereby not lending themselves to the whims and fancies of markets. Employee welfare, obligation to local community, size and market share make up the essence of this approach. Myopic Market model by Marris is the fundamental pillar of this approach. According to this model, heeding the markets too much has a detrimental effect on the organization.

Excesses in this approach are created by managerial capitalism as executives are given a free hand in managing the show. At times, a host of objectives other than wealth creation are followed.

As the firm expands, it requires additional capital. If this capital is not forthcoming from stable sources like banks then the company has no other choice but to go public. This gives rise to capital market-control system. It is based on 1 share 1 vote dictum. The more the equity held by an investor, the more the firm is at her mercy. Investors are interested in the ends- dividends and capital gains. Hence, companies have to jostle for the mind space of these players. This brings in the short-termism of this approach. This perspective is based on Principal Agent model. Line is crossed in this approach when investor capitalism sets in. All other obligations of the firm are relegated to keeping the share price up and there is intense pressure on executives to perform consistently in the short-run leading at times to violation of norms.

Both the approaches are similar to the extent that they both give minority shareholders a short shrift. They have been taken for granted and most of their rights have remained on paper.

Lost Ground

Recently the stakeholder inclusive approach has lost considerable ground to shareholder savvy approach. The reason is capital becoming mobile. The global investors like private equity funds and pension funds are deluged with choices. But they lack one crucial element which the local investors have which is the closeness to the business which in turn lends stability to the equity provided. This means the firms have to attract these global investors by way of the globally acceptable parameters, toplines and bottomlines or their manifestation- the share price.

Catching up in the offing

What goes round comes back. Human capital is already the most valuable resource of organizations especially the ones operating in the technology sectors. With the focus shifting from attracting capital to retaining talent, the stakeholder inclusive approach with a sharp focus on employees might make up the ground lost in the last two decades or so to the capital-market control approach.

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India Inc.'s Governance Evolution

Corporate entities in India stand out in terms of complexities in the ownership structure. The direct ownership of promoters is quite substantial and if that is not enough, the promoters indirectly have tremendous equity in and control of the firm through the rogue holding companies. It was believed that with the capital market reforms initiated in 1991, the dominance of promoters in the firms will pare. But unfortunately the last decade of the 20th century was marred by scams. The corporate entities went in for private placements making use of the relaxed regulations. These developments made the public spooky. In the last few years SEBI has put its foot down to crack down on the perpetrators and raised the disclosure standards leading to a renewed interest in the markets. The corporates are going global, a sign of their enhanced credibility.

Giants like TCS and Infosys have set global benchmarks in reporting standards and have implemented CSR in the fabric of their organizations.

With capital markets becoming dominant as the time passes and as organizations increasingly care to heed the market and keep the investors happy, it is safe to assume that the Indian corporate entities are veering away from organization-control to market-control approach toward corporate governance.

Right Directors mean Right Business

Board of directors is the highest internal governance mechanism in the organization. The board is the interface between external environment and management. The composition of the board reflects this. It has to straddle between providing necessary freedom to the management for wealth creation and protecting the interests of those who help create and of those who share this wealth. Just like an organization has a culture, it is critical for the board given the role it plays to have its own way of getting a handle on issues. No regulation can substitute for this. The non-executive members should meet separately to thrash out issues among themselves to promote 'constructive dissatisfaction'. As far as the skills of the board members are concerned, they do not need to have finance or risk expertise to play an effective governance role. The task for the board is rather to understand and approve both the risk appetite of the company at any particular stage in its evolution and the processes for monitoring risk.

If the management proposes changing these radically-for example, by switching the portfolio of assets from low to high risk, or by engaging in off-balance-sheet financial transactions that inherently alter the volatility of the business and its exposure to uncertainties-the board should be quite willing to exercise a veto. Also, the management should be sensitive to the tricky context the board operates in and must grasp that directors' independence can be compromised by 'soft conflicts' such as significant charitable contributions to a favorite institution or the employment of board members' children.

Enron Coterie Debacle - The Positive Fallout

There is a silver lining even in the darkest cloud that burst over the corporate world post-millennium. In the run up to the uncovering of some of the biggest frauds almost all in America, ironically a country which has always consecrated regulations, the markets were increasingly being viewed as infallible. Whatever information emanated from the organizations to the markets was taken as the last word. There was a reason behind this. The rules were set by the market and organizations were just playing by them leading to smugness all around. The disasters were eye openers for the gullible investors. Markets were vulnerable after all. Stricter rules followed. The corporate boards world over became

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more agile. The managements retreated. To a certain extent a long-term inclusive focus was restored in the firms having benign effects for every stakeholder.

The Undesirable Side Effect

Innovation is the mantra for success. But for corporates it has become a survival factor. The frauds have happened at the worst time. The organizations need to be more creative. Risk appetite should be high to capture the unexplored high potential markets. This calls for ingenuity on the executives' part. But the atmosphere has become very restrictive. Regulations like SOX go overboard.

Boards would much rather have a conservative rather than an adventurous management. This does not bode well for the society as a whole as cagey entrepreneurs will not be able to fulfill their outstanding objective-wealth creation.

Business Initiatives with Social Spin-offs and not Vice-versa

Prima facie, ITC's e-choupal venture seems an effort in the direction of social responsibility. But intrinsically the effort makes eminent economic sense.

It is not a subsidy but an effort which is mutually beneficial. Corporate social responsibility enthusiasts might label such efforts as social initiatives. But the bottom-line is that such efforts generate returns, which guarantees shareholder support. Till such time the business gains precede societal benefits and the society appreciates this reality, the long-run sustenance of these initiatives is guaranteed. Responsible corporates and not corporate social responsibility is the order of the day.

Crucial Culture

Culture is the way people behave when they are not being watched. It is very organization specific and very unlike regulation which is procrustean. The magnitude of damage that can be caused by an individual to the stakeholders of the firm increases as he/she moves up the corporate ladder. The power to influence attitudes also increases on the way up. Hence self evidently the top brass of the firm has a big hand in shaping the culture of the firm. If the honcho crosses the line, it sends out an implicit signal to the people lower down to knowingly or unknowingly to act in a similar manner as the stakes are not that high as they are for the men at the top. The trickling down of an open culture might take time but one can be rest assured that the only way in which it is going to impact the firm is positively. But where organizations go wrong is where they expect the same things from culture as the regulators do from regulation. It is never going to be a one size fits all story. This is where the earlier talked about concept of ethics being very individual specific and not organization one comes into picture. Do not impose culture. Let people understand and appreciate it and find their own way of incorporating it into their work life.

The Information Imperative

A fair judgment is based on fair information. Often, the best appraisal is done by those who are at a certain distance from the subject matter and at the same time affected by it. Organizations err when they try to preemptively guess others' reactions. This leads to distortion of information. Doing business is the primary task of business; it is not in the best position to evaluate it from different angles. Hence, organizations should pass on information about its policies, practices and risk appetite. Let the other stakeholders primarily the markets assign an appropriate risk premium and cost of capital. Part of this information dissemination has been achieved by regulation manifested in balance sheet et al. The other part has become more crucial as the businesses have grown complex and

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can only be achieved with the will of the management and the board. A culture of transparency goes a long way in achieving the latter. Of course transparency has its limits.

But voluntary initiatives like Triple Bottom Line reporting which not only cover the financial but also the social and environmental impacts of the company signal a start. All kinds of companies from the ones with most to hide like chemical to the fairly innocuous ones with the least to hide have adopted this practice. Why? It does make social and environmental sense, but more importantly, thanks to competition in and integration of the world economy, it makes eminent business sense.

Question

Is there any connect between business culture and corporate governance?

Source: www.ezinearticles.com

7.2 Corporate Social Responsibility

Milton Friedman claims that the ethical mandate of business is to increase the shareholders' profit. It is a general belief that business is accountable to its shareholders because it is running on their resources. But this is a misconception. If business is accountable to shareholders because it uses their resources, then a business should primarily be responsible to society because in real terms, it uses society's resources. The money that business borrows from banks is that of the society. Business directly or indirectly uses natural resources of the nation which belong to the society. Business uses human resources of society, and above all, exists because of society. It is the society that gives business an opportunity to earn. So business is primarily accountable to society.

The socio-economic obligation of business refers to its responsibility in preventing to prevent economic consequences of business from adversely affecting public welfare. Social-human obligation denotes to the obligation of business to nurture and develop its human resources so that employees get every opportunity to grow, develop and advance through life and their careers and to promote human values within the organization.

Keth Devis has defined social responsibility in the following words: "Social responsibility refers to the businessman's decision and actions taken for reasons at least partially beyond the firm's direct economic or technical interest."

Business should play a dominant, dignified and ethical role in discharging its responsibility towards the people and the nation by practicing values of self respect and humanity with a non-corrupt approach and morally high conduct and character.

7.2.1 Justification

The major arguments that justify the need for the social responsibility of business are as follows:

1. ***Public Expenditure:*** There is a deep conviction within sections of the public that business has a clear obligation towards the greater good of the society.
2. ***Long Run Viability:*** If a business fails to meet this need, other groups will assume the responsibility and the power that goes with it.
3. ***Public Image:*** Socially responsible behaviour creates a positive public image for business. Tata and Birla enjoy a very good image among people because of their social welfare programmes.

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4. ***Better Environment:*** Businesses can create a better environment, which will be more conducive to future business success.
5. ***Avoidance of government regulation:*** If business is perceived as meeting its social obligations, costly and restrictive government regulations can be avoided.
6. ***Balance of Responsibility and Power:*** Since a business already has a great deal of social power, its social responsibility should be of equal importance.
7. ***Let Business Try:*** Since other social institutions have failed to resolve many social problems, it's time to give business a try.
8. ***Business has the resources:*** Business has a reservoir of capital and expertise that has great potential for public service.
9. ***Problems can become profit:*** If the innovative skills of businesses can be applied to social problems, some efforts might lead to profits in the traditional business sense.
10. ***Prevention is better than cure:*** If there are any further delays in resolving social problems they are only going to become worse.
11. ***Shareholder Interest:*** Businesses will prosper from an improved social environment.

7.2.2 Scope

Corporate Social Responsibility is one such niche area of Corporate Behaviour and Governance that needs to get aggressively addressed and implemented tactfully in the organisations. At the same time CSR is one such effective tool that synergises the efforts of Corporate and the social sector agencies towards sustainable growth and development of societal objectives at large.

The following forces ensure that businesses recognise and honour its new social responsibilities:

1. The pressure of organized labour.
2. Growing public awareness about quality of life and the need to remove all types of pollution.
3. Public opinion stressing on business morality and integrity to be observed by all organizations in any field of human endeavour.
4. The threat of nationalisation or of severe regulations in business, to prevent public exploitation and evils of monopoly.
5. The development of consumerism in many countries, insisting on consumer protection in the market place.
6. The managerial revolution enabling managers to act as trustees and to adopt an objective attitude in the distribution of surplus among all the interested parties.

There are four important groups that influence and are influenced by business. Business is expected to accept its responsibilities towards these groups:

1. The owner of the business, i.e., shareholders
2. The employees
3. The customers
4. The society at large

The interests of this diverse group are not identical; rather, they are often conflicting. Each group wants a lions' share of the pie. Customers crave for value – added but economical products,

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employees demand better remuneration and working conditions, society expects philanthropy and healthy environment and owners demand for higher and higher ROI. The Management has to bring about an effective synthesis and secure good relations among these four diverse interests.

Responsibilities towards Shareholders

People invest in money to make money. Milton Friedman claims that the ethical mandate of business is to increase shareholders' profit. The primary responsibility of business is to increase shareholders' wealth, to give good returns on investment, to give dividends at the proper time, to protect the interests of even small shareholders, to listen to and respect shareholders, to regularly invite shareholders to participate in decision-making.

So the basic responsibility of a business towards shareholders is to create wealth for them. Economic Value Added analysis is an effective tool to measure the increment in shareholder wealth. Economic values added are increments in the shareholder's wealth beyond its expected return.

Responsibility towards Employees

The Success of an organization is dependent on its employees. Gone are the days when employees were the most neglected resource of the organization. Today, HRM is the Critical Success Factor for the success of all industries, be it Old Economy industries like steel, cement or FMCG or New Economy ones like BPOs and software services. Organizations have many responsibilities, towards their employees:

1. Fair treatment
2. No discrimination on the basis of sex, caste or creed
3. Fair wages
4. Fair appraisal system
5. Healthy and safe working environment
6. Establishment of fair work standards and norms
7. The provision of labour welfare facilities
8. Fair opportunity for accomplishment and promotion
9. Proper recognition, appreciation and encouragement of special skills and capabilities of the workers
10. Installation of an efficient grievances handling system
11. An opportunity for participating in managerial decisions to the extent desirable
12. Proper training and development programmes so that workers can develop themselves according to a changing environment
13. Family Welfare.

Responsibility towards Consumer

1. Providing products of proven quality
2. Regular R&D to augment the product and to innovate

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3. To ensure that product reaches the customer and to check any sort of black marketing or profiteering by middlemen and anti social elements
4. To supply goods at reasonable prices
5. To provide required after-sale services, and to ensure that spare parts should be available in the market
6. To fulfil its commitments impartially and courteously, in accordance with sound and straightforward business principles
7. To provide sufficient information about the product, including its adverse effects, risks and the care to be taken while using the product
8. To ensure that the product supplied does not have any adverse effect on the customer
9. To hear and redress the genuine grievances of customers
10. To avoid any type of cartel formation that a attempts to reap monopoly profits

Responsibility towards Community

1. To prevent environmental pollution and to prevent ecological imbalance
2. Improve the efficiency of business operations
3. Contributing to research and development
4. Development of backward areas
5. Promotion of small scale industry
6. Development of region in which they are operating.

   This includes working on development of schools, social awareness programmes, adult education, health, medical facilities, helping NGOs and the government for social causes such as the Pulse Polio Mission, etc.
7. Taking steps to conserve scarce resources and developing alternatives, wherever possible.

Major Social Responsibilities of Business

1. ***Optimum Utilisation of Scarce National Resources:*** All corporations must use resources judiciously and not waste, misutilise, damage or cause to deteriorate the resources at its disposal. It is essential in an energy/power scarce country like India. Not only this, business should develop alternative sources of energy and power. For instance, ITC uses wind power for some of its projects, while Mahindra and Mahindra spends on research an alternatives fuels.

Example: Reliance is a classical example of efficient utilisation of resources as it uses by-products and waste of one project in another. Its petrochemical plants and refineries are so integrated that they use each other's products.

2. ***Responsibility Not to Make Losses:*** A loss-making unit is a burden on society. It should not only conserve resources of the society but perform its duty towards the customer by providing better products, towards the shareholder by creating wealth, towards the society by utilising its resources well, and towards its employees by not meeting better HR standards.

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Most PSUs that make losses but are kept alive in the name of socialism and employment, are basically a burden on society. Their losses are met by taxing the society. One can say that society pays higher taxes to subsidise the inefficiencies of PSUs. The question arises, why should they?

3. ***Improved Quality of Life:*** An organization should help improve the society's standard of living, which is based on financial power and material growth.

4. ***Responsibility of Employment and Income:*** Every business should make provisions for the payment of fair wages, satisfactory working conditions, steady employment and job security, prospects for promotion, growth and development of workers, and also take adequate measures for employee welfare.

5. ***Offering Quality Products at Fair Prices:*** Business is all about creating customers, and the customer can only be created when customers are satisfied. Customers can be satisfied when they are provided with value – added products at fair prices, after sales services, timely information, and when the product reaches the right customer, etc.

6. ***Environmental Protection:*** Industrialisation is doing much irreparable harm to the environment. It is therefore an obligation on them to not only morally, but also legally undo the damage by taking serious and responsible steps to protect the environment and to keep it healthy condition.

They should adopt modern technology to ensure that their operations do not harm the environment. Businesses should also take actions to educate their employees and people about the environment in general.

Did u know? Krep is regarded as the founding father of the idea of social audit. He wrote a monograph on the measurement of social performance, in which he summarized his findings in 72 industries, covering a 20-year period.

7. ***Fair Trade Practices:*** Fair trade practices of business include:

   (a) Avoidance of formation of cartels or following monopolistic practices.

   (b) By creating shortages for the purpose of black marketing and speculation.

   (c) By exaggerating and making false statements regarding claims.

   (d) Not buying political favours to sway decisions it its favour.

   (e) Following healthy competition with competitors by not indulging in industrial espionage or other unethical means.

   (f) Not deliberately making the organization sick to avoid obligations or to escape from responsibilities.

   (g) Not to involve in insider trading or to take undue advantage of inside information.

   (h) Not bribing public servants and corrupting the democratic structure of the country.

   (i) Paying taxes, duties and other dues honestly and on time.

   (j) To provide required information to shareholders and all other stakeholders.

   (k) Making timely payment of borrowings and interest.

   (l) While dealing with suppliers, instead of using their bargaining power, corporations should invest in good relations with them. This will help suppliers maintain quality

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and develop new products for the organization. This may appear to be costly initially but it ultimately pays. The Japanese usually believe in establishing a good rapport with their suppliers.

(m) Not adopting a communication strategy that is not compliant with social norms.

(n) Business should abide by the laws of the land.

8. ***Local Development:*** Businesses use resources of the society are therefore responsible for the development of their surrounding areas. A business can perform various functions to develop its local area. In fact, if every business house takes responsibility of some villages, miracles can happen in India.

Example: Business houses like Tata Chemicals, ITC and HLL are doing so. Cooperatives like IFFCO are also following this concept. These business houses adopt some village and construct roads, spread literacy, ensure health programmes, promote family planning and other social reform programmes, help farmers in agriculture and marketing of their products, and promote the handicraft and cottage industry of the villages. HLL is giving employment and empowerment to the women of villages through its operation Shakti and ITC is revolutionising the village distribution system through its e-choupal system.

7.2.3 CSR and Indian Corporations

India is a fast growing economy and is booming with national and multinational firms. At the same time, the Indian land also faces social challenges like poverty, population growth, corruption, illiteracy just to name a few. Therefore it is all the more imperative for the Indian companies to be sensitised to CSR in the right perspective in order to facilitate and create an enabling environment for equitable partnership between the civil society and business.

Indian companies are now expected to discharge their stakeholder responsibilities and societal obligations, along with their shareholder-wealth maximisation goal. Nearly all leading corporates in India are involved in corporate social responsibility (CSR) programmes in areas like education, health, livelihood creation, skill development, and empowerment of weaker sections of the society.

Example: Notable efforts have come from the Tata Group, Infosys, Bharti Enterprises, ITC Welcome group, Indian Oil Corporation among others.

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CSR Initiatives by Indian Companies

1. ***Aircel:*** Mobilises public opinion in partnership with WWF India for the 'Save Our Tigers Initiative'
2. ***Coca-Cola India:*** Partners with government agencies and NGOs to combat water scarcity and depleting groundwater levels
3. ***Dabur India:*** Its initiative, SUNDESH, in UP and Uttrakhand aims for the overall socio-economic development of the poor
4. ***Maruti Suzuki India:*** Runs employee volunteering programme, 'e-Parivartan', with NGO Literacy India, for teaching underprivileged people

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5. ***Nasscom Foundation:*** Promotes development through use of information and communication technology, provides tech donations to NGOs

Source: http://money.outlookindia.com/article.aspx?264708

Although corporate India is involved in CSR activities, the central government is working on a framework for quantifying the CSR initiatives of companies to promote them further. According to Minister for Corporate Affairs, one of the ways to attract companies towards CSR work is to develop a system of CSR credits, similar to the system of carbon credits which are given to companies for green initiatives. Moreover, in 2009, the government made it mandatory for all public sector oil companies to spend 2 per cent of their net profits on corporate social responsibility. However, for private sector it is still voluntary, but government is making effort to make it mandatory for all companies to invest 2% of their net profits on CSR.

Besides the private sector, the government is also ensuring that the public sector companies participate actively in CSR initiatives. The Department of Public Enterprises (DPE) has prepared guidelines for central public sector enterprises to take up important corporate social responsibility projects to be funded by 2-5 per cent of the company's net profits.

Indian Corporations have joined hands to adjust all its activities falling under CSR. For this, it has set up a global platform to showcase all the work done by Indian firms.

Example: Confederation of Indian Industry (CII) and the TVS Group collaborated to form the CII-TVS Centre of Excellence for Responsive Corporate Citizenship in 2007. It provides consultancy services and technical assistance on social development and CSR.

Task Prepare a report on the steps taken by Tata for the well being of the society.

Caselet

Reliance – CSR Initiatives in Education

The Dhirubhai Ambani Foundation every year recognises meritorious students at district level through rewards and scholarship schemes through "Dhirubhai Ambani SSC - Merit Reward Scheme" and Dhirubhai Ambani Undergraduate Scholarship Scheme"

The 'Dhirubhai Ambani SSC Merit Reward Scheme' for class X and 'Dhirubhai Ambani Undergraduate Scholarship Scheme' for class XII, were instituted in 1996 for the first three meritorious students from each of the district of Maharashtra, Gujarat and later in Goa. The schemes were extended in 1998 to the first meritorious student amongst the Physically Challenged category.

The Foundation has reached out to a total number of 4763 meritorious students, including 472 Physically Challenged, from 64 districts of the states of Maharashtra, Gujarat, Goa and the Union Territory of Daman, Diu, Dadra Nagar Haveli in the last 10 years.

During 2005 the SSC Merit Rewards were received by 264 meritorious students while 307 received the Scholarships. They represent each of the 64 districts of the state of Maharashtra, Gujarat, Goa and the Union Territory of Daman, Diu, Dadra Nagar Haveli

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and include 71 Physically Challenged and the first ten in the merit order list of CBSE for each of the state and three from Goa.

The SSC Merit Reward consists of ₹ 3,000/- in cash, a good quality bicycle which reflects the desire of the Patron Trustee to motivate meritorious students from Rural India. The Physically Challenged meritorious student is rewarded with ₹ 6,000/-. The Undergraduate Scholarship for Meritorious HSC students, payable each year till graduation ranges between ₹ 9,500/- and ₹ 31,500/- p.a. depending up on the stream chosen by the Scholar. A certificate of Merit from the trustees is given ceremoniously to each of the meritorious student.

These schemes have been well appreciated by the students and parents as they are purely merit based; encourage education of a girl child and offer equal opportunity to Physically Challenged Meritorious students.

'Reliance Kargil Scholarship Scheme'

The Scheme to support educational needs of the children of defence personnel who sacrificed their lives or were disabled during Kargil war, instituted with the generous contribution from Reliance employees. During the year 87 children received financial support for their education from standard IV to XII under the scheme.

"Dhirubhai Ambani Scholars Scheme" for Meritorious Children of Reliance Shareholders.

The Scheme was announced in 2003 as a one time measure to commemorate the silver jubilee of the company's listing on the Bombay Stock Exchange. In the first year 900 meritorious children of the shareholders received the Scholarships. These Scholars are eligible to get the scholarships annually till they complete their undergraduate studies, provided they secure minimum of 60 per cent marks in each of their annual University Examination. A total of 772 scholars, having secured the stipulated marks/ grade at the first year university examination continued to receive the Scholarship for the second year for their education leading to Degree / Diploma course. Of these 540 scholars who are pursuing degree courses in Engineering, Medicine and allied subjects while the rest 232 have chosen courses in commerce, arts and law faculties.

Source: www.karmayog.org

7.3 Summary

- Ethical problems bring about conflicts between an organisation's economic performance and its social performance.
- Ethical principles can be classified into two categories: teleological and deontological. The teleological theories determine the ethics of an act by looking at the consequences of the decision (the end), while deontological theories determine the ethics of an act by looking to the process of the decision (the means).
- Business is not merely an economic but also a social function. It is the only activity, that influences every aspect of the society and nation.
- There are four important groups that influence and are influenced by business, which in turn supposed to accept its responsibilities towards them:
    - The owner of the business, i.e. shareholders
    - The employees

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- The customer
- The society at large

- Major social responsibilities of business the use the resources in a judicious manner, to shun waste, misuse, damage or resources at its disposal. A business should offer quality products at fair prices to society and should follow fair trade practices of business.
- Most big Indian corporations are engaged in some CSR activities. As is the case in many countries, the private sector is generally more active in this area than the governmental/ public sector.

7.4 Keywords

Business Ethics: It refers to the measurement of the business behaviour on standards of right and wrong.

Corporate Social Responsibility: A company's sense of responsibility towards the community and environment (both ecological and social) in which it operates.

Deontological Ethical System: In this system, ethics are measured by the rightness of an act and depend little on the results of the act.

Utilitarianism Ethical System: Here, morality of a decision is determined by measuring the probable outcome.

7.5 Self Assessment

Fill in the blanks:

1. The word ethics has originated from the word .....
2. The basic responsibility of a business towards shareholders is to ..... for them.
3. Ethical principle can be classified as .....
4. ..... and ..... are dominant principles in ethics.
5. Four important group that influence business are shareholders, employees, customers and ……
6. Employees should get ……. wages.
7. The interest of all the stakeholders in business is often .....
8. It is a responsibility of the firm towards its …….. to avoid any type of cartel formation that a attempts to reap monopoly profits.
9. E-choupal is an initiative by ……
10. Government is thinking of making it mandatory for the companies to spend ……% of their net profits on CSR.

7.6 Review Questions

1. "Expenditure on social responsibility is actually an investment." Comment.
2. The interest of the shareholders, customers, employees and society are not identical, rather they are conflicting. Elaborate.

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3. What are business ethics? How important are they in business?
4. Discuss the ethical principles in business.
5. Why there is a growing emphasis on social responsibility now-a-days?
6. Do you think that businesses today follow fair trade practices? Give reasons.
7. Pick any one national and one multinational company and discuss their social responsibility strategies.
8. Do you think Indian companies are on a right track as far as CSR is concerned? Justify your answer
9. Indian government is making effort to make it mandatory for all companies to invest 2% of their net profits on CSR. Is it a right strategy? How will or should the India Inc. react?
10. "CSR is a vehicle on which the companies can race past the profit highway towards growth". Comment

Answers: Self Assessment

1.	*Ethikos*	2.	create wealth
3.	teleological and deontological	4.	Honesty, goodness
5.	society	6.	fair
7.	conflicting	8.	customer
9.	ITC	10.	2

7.7 Further Readings

Books

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Unit 8: Environmental Concerns and Corporations

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Objectives

After studying this unit, you will be able to:

- Identify the environmental concerns
- State what can businesses do to protect environment
- Discuss Indian environment policy
- Explain the concept of environmental audit

Introduction

The economic activities of corporate entities in different countries are causing concerns for planners, managers and environmentally conscious people. The corporations continue to be the biggest consumers of environmental resources and hence they should shoulder greater responsibilities towards the environmental management. There is a pressing need to ensure that environmental concerns are woven into corporate actions and the best corporate governance practices. It is now being realised by the economists, environmentalists, business managers and accountants that (i) if the benefits from rising incomes are offset by the costs imposed on health and quality of life by pollution, this cannot be called development and that (ii) environmental damage can undermine future productivity.

8.1 Environmental Concerns

Industrialisation has created material prosperity but has also caused serious environmental problems to the present and future generations. There are two sources of environmental threats namely, pollution and resource depletion. Pollution refers to the undesirable contamination of environment by the production and use of goods like automobiles. Resource depletion refers to the consumption of scarce resources.

8.1.1 Air Pollution

Air pollution has started from the times of Industrial Revolution. But the costs of air pollution increased in an exponential manner as heavy industrialisation has taken place. In modern times, air pollution affects agriculture, brings hazards to life, increases medical costs and lessens the enjoyment of life.

Greenhouse gasses like carbon dioxide and nitrous oxide absorb and hold heat from the sun, preventing it from escaping back into space. Carbon dioxide is increasing at the rate of 2 percent annually. This leads to global warming, affecting the different parts of the world.

8.1.2 Ozone Depletion

Ozone is a layer in the lower stratosphere preventing all life on earth from harmful ultraviolet radiation. But this ozone layer is destroyed by chlorofluorocarbons (CFCs) gases. These gases have been used in refrigerators, air conditioners, industrial solvents and industrial foam blowers. Several studies reveal that ozone depletion would affect agricultural growth and cause skin cancer.

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8.1.3 Water Pollution

Though water pollution is an age-old problem, it has taken new dimensions. In modern days, water pollution consists of not only organic wastes but also dissolved salts, metals and radio active materials.

Did u know? Nearly 50 percent of surface water is polluted. Water drainage from coal mining operations contains sulphuric acid. In this process, there is a depletion of oxygen in water. The oxygen-depleted water is not able to support fish life and other organisms.

Various inorganic pollutants pose serious health hazards for drinking and cooking water. Mercury finds its way into fresh water supplies and can cause brain damage, paralysis and death. The mining companies are notorious for causing several severe hazards. Oil spills are also a form of water pollution. Oil spills result from offshore drilling. The contamination produced by oil spills leads to threats to sea life, plants and aquatic birds.

The underground water supplies have also become more and more polluted. The underground water contamination is linked to cancer, liver and kidney diseases and damage to the central nervous system.

8.1.4 Land Pollution

Toxic substances are those that can increase mortality rates or incapacitating illness. There are nearly 10,000 different chemical compounds used in India whereas in the U.S, it is nearly 60,000. Many chemicals cause chronic diseases in the long-run.

Example: Benzene is a common industrial toxic chemical used in plastics, dyes, detergents and gasoline. This chemical is a cause of anemia, bone marrow damage and leukemia.

Moreover, the quantity of solid wastages is increasing every year. The amount of garbage is increasing each year but the facilities to handle the wastage have been decreasing.

The depletion of minerals is also a serious threat to the economy. There is a decline in the availability of copper and by 2070, the copper ores will be exhausted.

8.2 Environmental Ethics

Environmental ethics is concerned with the issue of responsible personal conduct with respect to natural landscapes, resources, species and non-human organisations.

8.2.1 Ideas of Environmental or Ecological Ethics

1. The environment has to be protected not only for the sake of human beings but also for other living beings on this planet.
2. The richness and diversity of life contribute value to human beings.
3. The human beings have no right to reduce the richness and diversity except to satisfy their vital needs.
4. The human interference in environment is excessive and the situation is worsening every year.

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5. The quality of life has to be given more importance than the standard of living.
6. Without a sound environmental policy, no progress can be meaningful and relevant.

8.2.2 Holistic Environmental Ethics

1. All parts of natural systems are inter-related, inter-connected and inter-dependent.
2. Human kingdom should support the other natural systems.
3. Nature should not be challenged.
4. Land is a complex biological system.

Did u know? The world population will reach 7 billion by 2010 and will become 10 billion by 2030. The limit for the world population is 15 billion, which can be reached by the end of this century. What will be the future?

At the global level, there is a decrease of 20 percent of forests and 60 percent of water. Global imbalances are taking place in production, distribution and consumption. The ecological inequalities are also increasing.

8.2.3 Ethical Guidelines for Sustainable Development

What is required is sustainable development. Sustainable development seeks to meet the needs and aspirations of the present without compromising the needs of future generations. Sustainable development can be achieved only if the environment is conserved and improved. The natural assets should be well-maintained. Sustainable development is a complex concept involving ecological, economic and ethical aspects.

The ethical guidelines for sustainable development are:

1. The harvest rates not to exceed the reproduction rates.
2. The wastages have to be recycled.
3. The environmental governance should be a commitment to all organisations.
4. Too much of consumerism has to be controlled by persuasion and ethical education.
5. Efforts should be made to promote bio-diversity.
6. There should be the promotion of non-consumption values such as aesthetic, cultural, tourist and future.
7. Sustainable development is our duty to future generations.

8.2.4 Environmental Governance

Environmental governance is an ethical effort supported by the administration and co-operation of people.

It consists of the following measures:

1. Monitoring pollution and over use.
2. Development and maintenance of green areas.
3. Promotion and encouragement of non-conventional sources of energy.

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4. Encouragement of public transport.
5. Environmental regulations of towns and cities.
6. Reduction of inequalities at regional level.
7. Control of too much of consumption by education.
8. Promotion of bio-diversity.

8.2.5 Role of NGOs

NGOs can promote environmental ethics through the following methods:

1. Conducting environmental surveys
2. Assessment of environmental impact
3. Promotion and maintenance of parks
4. Exploring sources of finance for environmental protection
5. Providing local solutions to local problems
6. Encouragement of ecological tourism
7. Prevention of environmental exploitation.

NGOs can help to bridge the gap between science, policy-making and people.

Every person has the right to a healthy environment. Preservation of nature is one of the best values of long-term importance. Those projects that are bound to harm the environment should not be started.

Every form of life is unique and has intrinsic value. Economic ecological balance is the need of our times. There is a need for long-term planning. Nature should be preserved and protected. Bio-terrorism is a silent form of terrorism.

Poor countries cannot afford the Western luxury of environmental protection as it does not hold well. EPI (Environmental Performance Index) is becoming as important as GNP.

Task Ranga and company is a chemical company located on the banks of river Cauvery. The chemical effluents are indirectly passed into the river. A group of people interested in environmental issues wrote an appeal and met the general manager of the company. This group persuaded the management to find out ways of saving the river, which also serves the people for their drinking water. The management said that this company was employing more than one thousand people and it would find out alternative ways of diverting the chemical effluents. For a long period, no action had been taken by the company. Suggest a suitable solution for this problem.

8.3 What can Businesses do?

Environmental Management is not only an issue of legislative/regulatory controls but it also relates strongly to sound business practice. According to a recent survey published in UK, 67% of the 1000 companies stated that they attach more importance to environment today than a year ago. Their reasons for doing this, ranges from public image to financial gains accrued from such actions as cutting down the cost of raw material wastes.

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The industry and financial sector even in India which tended to ignore environmental issues is now becoming aware not only of environmental risks but also its ability to affect investment decisions. In addition, an important motivation for environmental concern is their public image.

So far as the link between environment and business is concerned, the issue is whether it is possible to make profit in business and at the same time keep the environment free from degradation. Till recently, it was believed that what helped business did not help the environment? And business is for profit. But the scene is changing fast and in fact it has changed for many companies.

Though there may be a view that the business is there for profit but at the same time there are many business corporations that are committed not to do harm to environment. Either public pressure or legislation or out of self benevolence, companies have imposed social and environmental obligations. Realisation is increasingly coming to large corporations that business should contribute to the good of the society. When we say that business should contribute to the good of the society, it implies that business has an obligation both for stakeholders and environment. It is also increasingly realised that both business and environment can coexist and ultimately business can generate wealth in a manner that can lead to sustainability in development. In other words improving environment and resource conservation can bring in more profits to the company.

Some business/industrial houses are already implementing 'responsible care' and programmes of assessment of compliances and audits. A positive contribution of business and industry to sustainable development according to Agenda 21, "can be achieved by "using economic instruments in which the prices reflect environmental costs of their production, recycling and disposal. The improvement of production system through technologies and processes that use less resources and produce less waste is an important pathway towards sustainability in business and industry; therefore two programmes have been proposed in this regard": These are (i) Cleaner Production; (ii) Promotion of Responsible Entrepreneurship.

8.3.1 Cleaner Production

The concept of cleaner production is to include optimal environmental care at every stage of the product. The recommendations of Earth Summit were that:

1. Governments, business and industry including Multinational Companies (MNCs) should strengthen partnership in regard to above proposal.
2. Government should adopt mix of economic instruments and other measures like law, standards and audit in consultation with business and industry including MNCs for promoting cleaner production with special consideration for small and medium sized industries.
3. Governments, business and industry should work towards developing system for internalisation of environmental costs into accounting and pricing. This has been dealt with in details in the earlier part of this chapter as also the efforts of Government of India in this direction.
4. Business and industry including MNCs should be encouraged to report annually on their environmental records indicating use of natural resources and energy used.
5. Governments should promote technology know-how and transfer among the enterprises.
6. Industry should integrate cleaner production policies in its operations, also taking into account its implications on suppliers and consumers.

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7. Industries should make efforts in impressing awareness, knowledge and skills of workers for sustainable development operations.
8. Various organisations, International and National should strengthen database on cleaner production and should forge networking.

8.3.2 Promotion of Responsible Entrepreneurship

Entrepreneurship is one of the most important driving forces for innovations towards responding to challenges in regard to marketing, manufacturing and operations. Small and medium sized entrepreneurs play an important role in social and economic development of the country especially for rural development and improving livelihood for women in developing countries. Responsible entrepreneurship can play a major role in this direction. It is proposed that responsible entrepreneurship should encourage:

1. Concept of stewardship in the management and utilisation of natural resources by entrepreneur.
2. Increasing the number of entrepreneurs engaged in enterprises that encourage sustainable development policies.

In order to achieve the above following steps are required to be taken:

1. Governments should encourage the establishment of sustainably managed enterprises. It would mean mix of economic incentives, streamlining of regulatory and administrative procedures in dealing with applications for approval.
2. Governments should encourage in collaboration with private sector, establishment of Venture Capital Fund for sustainable development projects.
3. Business and Industry including MNC's should encourage establishing world-wide corporate policies on sustainable development and arrange for environmentally sound technologies to be available to affiliates owned mostly by their parent companies in developing countries without extra external charges and encourage these affiliates to tailor procedures keeping in view the local ecological situations.
4. Large business and industry including MNCs should establish partnership with small and medium sized enterprises to facilitate exchange of experience in managerial skills, market development and technology transfer wherever appropriate.
5. Business and Industry should establish National Councils for sustainable development and help entrepreneurship in formal and informal sectors.
6. Business and industry should increase efforts in Research and Development of environmentally sound technologies in collaboration with academia, scientists and engineers.
7. Business and industry should ensure responsible and ethical management of products and services from the point of view of environmental aspects. Various codes, regulations, charters, conventions and other initiatives should be integrated in planning and decision-making.

8.3.3 Is it possible?

Is it possible to implement various suggestions outlined above? In many businesses, today there exists stiff competition and declining margins with the result that company's capacity to respond to environmental challenges would increase the expenditure. The question is whether

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companies can afford the environmental costs. At macro level or national level it may be possible to implement recommendations in regard to business moving towards environmentally sustainable practices and acquiring a competitive advantage through strict environmental policies.

Example: Is it possible at the level of individual corporation to become competitive while maintaining environmentally sound practices? The U.S. giant company, Texaco has been investing huge money for environmental compliances and reduction in emissions and the total investment exceeds its assets base. Will it not affect the shareholders value? The cost of adopting environmentally sound practices would continue to increase in view of new regulations required to be met by the industry being mandated every now and then. And there seems to be no end to such regulations in near future. Even without new regulations, the present ones are always under revision for stricter standards. All this means more costs for the company. It seems therefore, that costs for environmentally sound practices may be prohibitive for the companies but this doesn't mean that the managers should not care for environmental issues and return to old ways, meeting at the most legal requirements to escape penalties. There is certainly a trade off between environment and economic concerns and it is advisable that the managers who have a difficult task should concentrate on this aspect. It is probable that solutions which would lead to long term resource conservation and eco-friendly practices will be ones that are equitable to both the environment and business. Therefore managers should look for a situation in which business become profitable, protecting shareholders interest and value and at the same time maintaining high environmental standard. The trade off is such in which environmental benefit is weighed against the value destruction of company. Focus on value should enable the managers to make choices in respect of environmental issues. A choice can be strategic when a manager finds that impact of environmental issues on value is high. The manager may choose to and make heavy environmental investments to come to front line by becoming leaders in a particular business. Instead of only following legal or mandatory requirements, he moves towards innovations, even shows a zeal and missionary approach towards environmental issues. Or he may choose to stay behind and just remain concerned about compliance of legal requirements.

8.4 Environmentally Sound Business Embraces all Disciplines

In 'Earth in the Balance', Al Gore writes that we can produce for the world market place the new products and technologies that foster economic progress without environmental destruction. Also, Michael Porter from Harvard Business School argues that economic progress and environmental protection is not a conflicting proposition. According to these views, the successful managers redesign the product, and adopt newer technologies that are now available; they can achieve goal of less resources depletion and less waste production. It is an eco-friendly business. It means that managers understand the impact of business on ecosystem and sustainability. This requires a new kind of thinking and strategies in respect of environment business relationship. A change is needed at all levels starting from organisational structure, finance, manufacturing, marketing, operations, accounting and other related disciplines.

Example: Consider the case of organisational structure. An organisation's structure is based on its culture. We cannot expect to change organisation structure and its culture unless we understand the processes that gave rise to it. In other words, it is important to know the practices that gave rise to unsustainable nature of business. When we understand these, it becomes easy to chalk out strategies to change the culture for attaining environmentally sustainable business objectives.

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8.4.1 Manufacturing

So far as manufacturing is concerned, the traditional method is that raw material is procured to transform it into a product and in the process some waste is produced which is disposed. But for making the manufacturing process eco-friendly, new concepts of 'Industrial Ecology' as discussed earlier have to be adopted where consumption of raw material is optimised and waste is minimised and the waste of one process serves the raw material for the other.

Example: We can learn much for manufacturing process from what happens, in nature – the case of tropical rain forests. The tropical rain forest is a self sustaining system. No one adds fertiliser to the soil of these forests. There is no human input in so far, as the growth of these forests is concerned. The bacteria, algae, leaves and fruits of the trees of these forests decompose and provide nutrients for maintaining the flora and fauna of the forest through a mechanism of recycling – waste of one is the source of nutrient for others.

In actual practice the nations, especially the developed ones need to change the habits and mindset in so for manufacturing and consumption are concerned. Of course, it is not possible to attain an ideal situation as it obtains in tropical rain forest but it is possible to minimise the use of non renewable resources and attain a situation of minimum waste production by way of recycling.

There is one more aspect in so far as eco-friendly manufacturing is concerned. This refers to technology used in manufacturing. All environmental problems cannot be solved by technological interventions. Technology, no doubt, can make a difference by reducing the rate of consumption of resources but there is no technology that can lower the sea level once it has risen or there is no technology to manufacture ozone in the stratosphere.

Another point is that in a decentralised economy, the manufacturer has no responsibility for the operation or final disposal of the product, the latter may lead to environmental damage. The manufacturing system should be such where manufacturer has the opportunity and incentive for recovery, reuse and recycling of durables.

8.4.2 Marketing

The strategy has to change in respect of marketing if a business is to meet the challenges of environmental issues. In fact, changing marketing strategy may give an advantage to the business as it does in manufacturing. Some of the companies have already, adopted so called 'Green Marketing'.

Example: Samsung Refrigerator being sold in India has a prominent label, "CFC free". Many other products have come to market that claim to be using recycled products. Many fuel efficient cars and appliances have been claimed. The consumers are increasingly becoming aware about these and should prefer to buy eco-friendly products. The consumers express their concern about environment through market behavior. Therefore, the business has to keep this in mind when it devises its promotional campaign. The companies have to make truthful environmental claims while marketing their products.

Notes

Case Study

State Bank of India become Signatory to the Carbon Disclosure Project

The country's biggest lender, State Bank of India, has become a signatory investor to the Carbon Disclosure Project (CDP), a collaboration of over 550 institutional investors with assets under management of US $ 71 trillion.

State Bank has been undertaking several environmentally and socially sustainable initiatives through its 14000 plus branches spread across the length and breadth of the country and was one of the few banks in the country to have enunciated a 'Green Banking Policy', as early as in 2007. "Bank was the first in the entire Banking, Insurance and Financial Services sector to have conceptualised and owned wind farms for generation of green power to part substitute consumption of thermal power by its offices in India and we have already launched a project to measure and manage organisation level foot print to achieve carbon neutrality" said Shri O.P.Bhatt, Chairman, State Bank of India. "Partnering with CDP has only reiterated the Bank's resolve and commitment towards sustainable development" he said.

"We are delighted to welcome the financial powerhouse, State Bank of India, as a signatory. As much of the world's economic recovery will now come from rapid growth in emerging economies like India, it was crucial for us to have a strong partner like the SBI to promote the truly global fight for sustainable development," said Paul Simpson, CEO of CDP.

"We are pleased that State Bank of India has become a signatory, as this conveys a strong message to the Indian finance sector and the strategic role it can play in promoting a sustainable future" said Ravi Singh, Secretary General and CEO of WWF-India.

Being a major bank in the country, SBI stands to become a great catalyst in encouraging the adoption of sustainable strategies by both - businesses and the financial sector. We congratulate SBI on becoming a signatory to CDP; this is a very important milestone for the initiative in India" said Seema Arora, Principal Counsellor & Head of CII-ITC Centre of Excellence for Sustainable Development.

Each year, on behalf of signatory investors, the CDP collects climate change and carbon emissions data from over 5,000 large companies globally, which include the top 200 companies in India listed on the National Stock Exchange. Over 550 institutional investors - ranging from pension funds like TIAA-CREF and insurance companies like Allianz and Swiss Re through blue chip banks and asset managers such as Black Rock, HSBC, Goldman Sachs and Morgan Stanley - are signatories to the CDP.

In India, investors such as HDFC Bank Ltd., IDBI, IDFC, Reliance Capital, Tata Capital, IndusInd Bank and Yes Bank have also become signatories. CDP sends an annual letter and questionnaire on behalf of these financial institutions to the top 200 Indian companies by market capitalisation. In 2010, 51 Indian companies responded to the questionnaire. In the disclosure, Indian companies reported on their carbon emissions data, reduction targets, associated risks and opportunities and increasing board level managerial resources in spearheading the execution of climate change strategies within their organisations.

Compared to the 62% in 2009, 85% of the companies disclosed their GHG emissions in 2010. Although in total only 10 companies disclosed monetary savings as a result of their

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actions, the reported amount stands at a staggering ₹ 393.3 crores (~US$ 85 million), with emissions reductions of 6.2 million metric tonnes of CO2e per year.

About Investor CDP

In 2010, over 2,000 global companies reported on their climate strategies, GHG emissions and energy use, including 82% of the top 500 companies in the FTSE Global Equity Series Index. On February 1, 2011 the Investor CDP information request will be sent out to more than 5,000 companies in over 30 major economies in both developed and emerging markets.

A recent study revealed that the world's top 3,000 companies, by market capitalisation, were responsible for environmental damages worth US $2.15 trillion, in 2008, covering water and air pollution, greenhouse gas emissions, general waste and depleted resources. These external costs caused by companies can reduce returns to investors: "For a diversified investor, environmental costs are unavoidable as they come back into the portfolio as insurance premiums, taxes, inflated input prices and the physical cost associated with disasters. These costs could also reduce future cash flows and dividends. Ultimately, externalities caused by companies could significantly affect the value of capital markets, or their potential for growth, and with that, the value of diversified portfolios," according to a report of the UNEP's Financial Initiative.

CDP provides investors, insurance companies and banks with a lens through which to evaluate these externalities and how they will impact their specific portfolio.

State Bank of India

As a responsible Corporate Citizen, the Bank has always been in the forefront and has been undertaking various initiatives through its Community Services Banking towards welfare of the society as a whole. Be it tree plantation or adoption of a girl child, engaging with various NGOs to facilitate education or providing medical & other services to the underprivileged, or helping in any other social cause, the Bank through its vast network of about 14000 plus branches has been participating wholeheartedly in supporting these causes.

The issues of Global Warming and Climate Change have also not escaped the attention of the Bank. It was as early as in 2007 when a formal Green Banking Policy was laid down by the Bank. And since then the Bank has been endeavouring for reduction of its carbon footprint by urging its vast network of branches and other establishments to adopt several measures to this end, including energy efficient lighting systems, installation of energy savers, water harvesting and efficient water and waste management systems, gradual migration to paperless banking, plantation of fruit bearing trees, etc. Moreover with a view to sensitising all its staff members, the Bank has also introduced awareness modules in all its training programmes run in the various learning facilities all over the country.

The foray into Green power is also one such initiative that the Bank has taken towards achieving carbon neutrality over a period of time. As a move towards that end, it was decided to install windmills for generation of green power for Bank's captive use with a view to substitute polluting thermal power. In the process, SBI has emerged as the first Bank in India to install Wind Mills for captive use, which will go a long way in reducing its carbon footprint and projecting itself as a role model for others to emulate.

In the second phase, discussions have been initiated with various State Electricity Regulatory Authorities to obtain clearance on issues relating to multi point wheeling facility to HT as well as LT connections. In this context, discussions with the Gujarat Energy Development

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Authority to permit LT wheeling to enable the Bank to install additional 20 MW capacity windmills in the State are at an advanced stage.

Besides the above, the Bank has also undertaken a pilot study in respect of LEWWAC (Land, Energy, Water, Waste, Air & Carbon) management to establish carbon emission baselines, developing benchmarks and working on economically feasible ecological solutions for implementation, with the help of external consultants. Based on the finding emerged out of the pilot study, Bank has decided to implement some measures suggested in the pilot project report in order to test their usefulness so that such measures can be rolled out across all its establishments in order to achieve internationally acceptable standards. Accordingly, adopting 'Green Building' standards in all the future constructions of the Bank and initiating every possible measure that will help protecting the environment will be the endeavour of the Bank with the aim of setting an example of Corporate Social Responsibility & reducing Bank's direct as well as indirect carbon foot prints.

Besides internal greening of the Bank, as a part of the Green Banking Policy, the Bank also encourages its clients to adopt greening policies by switching over to efficient manufacturing technologies, and implementing energy efficient systems etc by offering to lend at concessional rate of interest. Clean Development Mechanism projects are offered a loan product – Carbon Credit Plus – that provides for financing of the resultant CER receivables.

Question

How is India and SBI going to benefit from CDP?

Source: www.wwfindia.org

8.5 Indian Environmental Policy

Besides being historically and culturally respectful to environment, India did recognise and visualise the significance of environmental protection and resource conservation before the first International meet on Environment. The Stockholm Conference on Human Environment was convened by UN in 1972 whereas India's Fourth Plan (1969-74) document clearly lays down the following:

"Planning for harmonious development recognises the unity of nature and man. Such planning is possible only on the basis of a comprehensive appraisal of environmental issues. There are instances in which timely, specialised advice on environmental aspects could have helped in project-design and in averting subsequent adverse effect on the environment leading to loss of invested resources. It is necessary, therefore, to introduce the environmental aspect into our planning and development".

Within five years of the Stockholm Conference, India amended its Constitution (The 42nd Constitutional amendment 1976) to include "Environment Protection" as a constitutional obligation. Article 48A lays down:

"The State shall endeavour to protect and improve the environment and to safeguard the forest and wildlife of the country".

Article 51A relates to fundamental duty. This article runs:

"It shall be the duty of every citizen of India to protect and improve the natural environment including forests, lakes, rivers and wildlife and to have compassion for living creatures."

Notes

Soon after the Stockholm conference, India set up a National Committee on Environment Planning and Coordination (NCEPC). This committee was concerned with issues relating to appraisal of development projects, human settlements planning, survey of eco-systems, like wetland, and spread of environment education.

8.5.1 Tiwari Committee on Environment

In 1980, Government of India appointed Tiwari Committee, to make recommendation on environmental issues. The committee recommended the following:

1. Comprehensive reviews and reformation of some Central and State Acts (such as the Insecticides Act, 1968; the Water (Prevention and Control of Pollution) Act, 1974; and the India Forest Act, (1927)
2. New legislation for areas of action not covered by the present laws (such as those concerning toxic substances).
3. The introduction of "Environment Protection" in the Concurrent List of the Seventh Schedule.

The Committee *inter-alia* recommended for the establishment of a separate Department of Environment. Accepting the recommendations, Department of Environment was set up on November 1, 1980 by the Government, assigning it the following functions:

1. To act as nodal agency for environmental protection and eco-development in the country.
2. To carry out environmental appraisal of development projects through other ministries/ agencies as well as directly.
3. To have administrative responsibility for:
   (a) Pollution monitoring and regulation.
   (b) Conservation of critical eco-systems designated as Biosphere Reserves.
   (c) Conservation of marine eco-system

8.5.2 National Committee on Environment Planning

The NCEPC was replaced by a National Committee on Environment Planning, with the following functions:

1. Preparation of an annual "State of Environment Report" for the country.
2. Establishing an Environmental Information and Communication System to propagate environmental awareness through the mass media.
3. To sponsor environmental research.
4. Arranging public-hearings or conferences on issues of environmental concerns.

The word "Environment" is used in its widest sense. It means all the external environmental conditions and factors affecting human, animal and plants. (External factors include climate, water, noise, temperature, soil, etc.) And the State is empowered to take effective steps to improve environmental factors.

Notes

8.5.3 Environment Protection Enactments

At the Stockholm Conference, the then Prime Minister, Mrs. Indira Gandhi said:

"…… extreme forms in which questions of population or environmental pollution are posed, obscure the total view of political, economic and social situations……

It is sad that in country after country, progress should become synonymous with an assault on nature…… Among the rest of mankind, we in India – Inspite of Ashoka – have been guilty of wanton disregard for the courses of our sustenance".

India also embarked on several legislative measures for the protection of environment and for maintaining ecological balance. These were: The Water (Prevention and Control of Pollution) Act, 1974, Forest (Conservation) Act, 1980, Air (Prevention and Control of Pollution) Act, 1981. These enactments were amended from time to time to make them more effective.

Another significant step was setting up of independent Ministry of Environment and Forest at the Central Government level in 1985.

Environment Protection Act 1986

Till 1980's, emphasis seems to have been chiefly to prevent and control pollution. In 1986 the Government of India passed a comprehensive Environment Protection, Act, (1986) as an aftermath of Bhopal tragedy of 1984 to cover many aspects other than prevention and control of pollution given below.

The Environment Protection Act (1986) was passed for the protection of environment, regulation of discharge of pollutants, handling of hazardous substances, speedy response in the event of accidents threatening environment and deterrent punishment to those who endanger human environment, safety and health.

It has been claimed that:

(a) This Act is not only for protection of environment but it is also more effective and bold measure to tackle the problem of pollution as compared to all the previous laws in this regard. Under this Act, the Central Government has been empowered to take all appropriate measures to establish an effective machinery to achieve the objectives of Act.

(b) The Act enables the Central Government to "take all such measures as it deems necessary or expedient for the purpose of protecting and improving the quality of the environment and preventing, controlling and abetting environmental pollution. The Central Government is also empowered to constitute an authority for exercising the power vested in it and to frame rules for that purpose.

(c) The Act has adopted a new position with regard to the question of *locus-standi* so that now even a citizen has the right to approach a Court, provided he has given notice of not less than 60 days of the alleged environmental offence and his intention to make a complaint to the Central Government or the competent authority.

(d) The Act strengthens the penal provisions. The maximum penalties for contravention of the Act has been increased to imprisonment upto five years or fine upto one lakh rupees or both. If, the failure or contravention continues beyond a period of one year after the date of conviction, the offender shall be punishable with imprisonment for a term which may extend to seven years.

(e) The Government has been given the powers to collect samples of air, water, soil or other substances as evidence at the offences under the Act.

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(f) The Act applies to the pollution generated by the Government agencies as well and where an offence under this Act has been committed by any department of Government, the Head of the Department shall be deemed to be guilty of the offence and liable for action under the Act unless he proves that the offence was committed without his knowledge to the commission of such offence.

(g) A special procedure can be prescribed for handling hazardous substances and no person can handle such substances except in accordance with procedure.

(h) The Central Government has been vested with powers of entering and inspecting any place through any person or agency authorised by it.

(i) The Act also authorises the Central Government to issue direction for the closure, prohibition or regulation of any industry, operation or process. It also authorises the Central government to stop or regulate the supply of electricity or water or any other service directly without obtaining a Court order.

Some people are critical of the Act as they feel that:

"The present Act was enacted to bridge the gaps in the existing legislation on this subject, since the existing laws generally focus on specific types of pollution or on specific categories of hazardous substances. Yet some major areas of environmental hazards are not covered. There are uncovered gaps in areas of major environmental hazards. There are inadequate linkages in handling matters of industrial and environmental safety. Control mechanisms to guard against build up of hazardous substances, especially new chemicals, in the environment, are weak. Because of a multiplicity of regulatory agencies, there is a need for an authority which can assume the lead role for studying, planning and implementing long-term requirements of environmental safety and to give direction to, and co-ordinate, a system of speedy and adequate response to emergency situation threatening the environment."

If the authority contemplated by the Central Government continues to be the existing Pollution Control Boards then it is feared that the entire exercise may not yield results. This is so because the Pollution Control Boards (CPCB) till now seems to have adopted a soft line vis-à-vis the industry and prefer to be persuasive rather than punitive.

It may be pointed out that of late various agencies including CPCBs have become more stringent and have recommended strong actions against those who violate the act.

8.5.4 The Seventh and the Eighth Plan

The seventh Plan lays down well defined strategy for environment protection. This strategy is the result of realisation that environment and natural resources, represent the most fundamental building blocks for national development and social well-being. The strategies that are laid down in the Seventh Plan, to achieve substantial development in harmony with environment are:

1. The nation's planning for economic growth and social well-being in each sector must always take note of the need to protect environmental resources, and wherever possible, must work to secure improvement in environment quality.

2. The primary responsibility for environmental protection must rest with each sectoral authority (Ministry, Department, Development Agency, Corporate Body, Municipal Council, Village Panchayat, etc.) which would have to take account of environmental concerns in policies, plans, programmes, projects and legislation that come under their purview.

Notes

3. Environmental management must be integral to all development activities. It should form an important element in the criteria for setting development targets and assessing plan performance in all sectors.
4. The Department of Environment at the centre, and its counterparts at the state level would essentially serve as catalysts to promote environmentally sound national development through provision of management information, technical expertise, monitoring, research and administrative support, and wherever possible limited financial assistance.
5. The prime responsibility with regard to the environment would rest with the various implementing authorities for development programmes and with the community. For this, environmental education and awareness building is crucial.
6. Environmental planning, protection and improvement require a coordinated, highly decentralised approach involving the cooperation and active participation of every segment of the society.

The Seventh Five Year Plan's main components in regard to environment protection are:

1. Pollution monitoring and control.
2. Environmental impact assessment.
3. Resource conservation.
4. Eco-development.
5. Environmental research promotion.
6. Environmental education, training and awareness.
7. Environmental information.
8. Co-ordination and liaison with State Government/Union Territories.
9. Environmental policy and law.
10. International co-operation.
11. Strengthening of the organisation structure.

Eighth Plan

Eighth Year Plan further strengthened the Environmental policies. In the Eighth Plan allocation of funds for the protection of environment were increased and a state-wise allocation was formulated.

The Government of India set up a cell to ensure effective implementation of anti-pollution measures and measures for the protection of environment. India embarked in a big way in the direction of protection of environment in launching new programmes. Noteworthy are the project for cleaning rivers, of which biggest project relate to cleaning of Ganga and Yamuna. India has also embarked on the project of afforestation. India became signatory to Earth Summit 1992.

Task

Find out about the major initiatives taken by the Government of India to address the environmental issues in India. (List the initiatives taken between 2007 and 2010)

Notes

8.6 Environmental Audit

Environmental Audit is an assessment of the extent to which an organization is observing practices that seek to minimize harm to the environment. As defined by US Environmental Protection Agency (USEPA), it is a systematic, documented, periodic and objective review by a regulated entity of facility operations and practices related to meeting environmental requirements.

8.6.1 Objectives of Environmental Audit

Audit objectives typically entail:

1. Verification of legislative and regulatory compliance
2. Assessment of internal policy and procedural conformance
3. Establishment of current practice status
4. Identification of improvement opportunities

8.6.2 Areas of Environmental Audit

Areas of audit normally encompass:

1. Material management, savings and alternatives
2. Energy management and savings
3. Water management and economy of use
4. Waste generation, management and disposal
5. Noise reduction, evaluation and control (internal and external)
6. Air emissions and indoor air quality
7. Environmental emergency prevention and preparedness
8. Transportation and travelling practices
9. Staff awareness, participation and training in environmental issues
10. Environmental information publicity
11. Public enquiry and complaints response
12. Environmental management system set up, suitability and performance

8.6.3 Practice and Procedures

The environmental audit involves the collection, collation, analysis, interpretation, and presentation of information which is used to:

1. Assess performance against a set of requirements or targets, related to specific issues;
2. Evaluate compliance with environmental legislation and corporate policies; and
3. Measure performance against the requirements of an environmental management system standard.

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The systematic, periodic, documented and objective aspects of environmental auditing are fundamental to effectiveness. It is fast developing as an important and powerful tool in the corporate environmental assessment and management toolkit. The requirement periodically to repeat audits ensures that there is an ongoing commitment and a systematic process to improve environmental performance. The scope of repeat audits can also broaden to become more comprehensive as experience and expertise are accrued or as new issues or legislation emerge.

Sometimes the terms assessment, appraisal, monitoring or review have been used interchangeably with audit. Audit implies detailed statistical verification with a periodic cycle between audits. An assessment or review is usually a one-off event which is carried out in less detail and with less direct checking of data.

Environmental Reviews provide a baseline overview of current environmental effects or impacts, relevant environmental legislation and a statement of existing environmental performance. The Reviews provide a basis for establishing a management action plan. They can become part of an environmental management system to help implement the plan. When they are undertaken as the first of a series of periodic environmental audits they have been referred to as a 'Baseline Environmental Audit'.

Environmental audits should be appropriate to the particular circumstances. As environmental auditing draws upon various methodologies, each organisation will define its own system depending upon its size, its activities and its corporate culture. The scope and style of audits vary, but common stages and activities include:

Pre-audit Stage

1. Full management commitment;
2. Setting overall goals, objectives, scope and priorities;
3. Selecting a team to ensure objectivity and professional competence;

Audit Stage

1. On-site audit, well defined and systematic using protocols or checklists;
2. Review of documents and records;
3. Review of policies;
4. Interviews; and
5. Site inspection.

Post-audit Stage

1. Evaluation of findings;
2. Reporting with recommendations;
3. Preparation of an action plan; and
4. Follow-up.

The company must alert its staff when an audit will occur. Prior notification can streamline the audit procedure. Staff can make allowances for the time during which they may be communicating with auditors rather than working. Having the department staff available can help auditors with any clarification they may need during the procedure. Remind staff that the purpose of an environmental audit is to assess the strength of an Environmental Management System, and that it is not an employee review.

Notes

Caselet

Supreme Court on case of Vehicular Emission

A very significant judgement was delivered by the Supreme Court of India on April 24, 1999. The court ordered a ban on registration of private, non commercial vehicles without Euro-II emission norms in the National Capital region (NCR) from April 1, 2000 to check vehicular pollution. The three judge bench headed by the Honourable Chief Justice, A.S. Anand, however, permitted the registration of only 1500 diesel and petrol vehicles a month from June 1, 1999 till March 31, 2000 if these conformed to Euro-I emission norms. As reported in Times of India of April 30, 1999, this judgement would force the auto industry in India to adopt Euro-II norms in the next eleven months as against 2005 as notified earlier by the Central Government. The counsel for Mercedes and Toyota claimed in the court that their cars conform to Euro-II emission norms while TELCO said that its new car, Indica would be able to meet these standards by the end of year. The judgement says that 1500 vehicles (250 diesel + 1250 petrol driven) which shall conform to Euro-I standard may be registered till June 1, 1999 on first come first serve basis. After 2000 no vehicle will be registered unless it conforms to Euro-II norms. The counsel for Maruti Udyog Ltd. (MUL) which produces 80% of vehicles pleaded that the orders of the court should only be passed after hearing views of MUL. The court permitted that Union government may seek modifications or variation of April 29, 1999 order on the basis of data which would be filed on an affidavit of a responsible officer.

8.7 Summary

- There are two sources of environmental threats—pollution and resource depletion. There are many forms of pollution like air pollution, water pollution and land pollution.
- Holistic environmental ethics has to be practiced. Ethical guidelines are necessary for sustainable development. Environmental governance is an ethical effort supported by the administration and the cooperation of people. NGOs can also promote environmental ethics.
- Business must make ethics as an integral part of their corporate goal, taking care that their practices, processes, and products conserve energy and resources and have a minimum impact on ecosystems. Industries that are based on natural resources, like minerals, timber, fiber, and foodstuffs, etc. have a special responsibility for:
  - adopting practices that have built-in environmental consideration.
  - introducing processes that minimise the use of natural resources and energy, reduce waste, and prevent pollution;
  - making products that are "environment-friendly", with minimum impact on people and ecosystem.
- Within five years of the Stockholm Conference, India amended its Constitution (The 42nd Constitutional amendment 1976) to include "Environment Protection" as a constitutional obligation.

Notes

8.8 Keywords

Acid Rain: Rain containing acids that form in the atmosphere when industrial gas emissions (especially sulfur dioxide and nitrogen oxides) combine with water.

Environmental ethics: It is concerned with the issue of responsible personal conduct with respect to natural landscapes, resources, species and non-human organisations.

Ozone: It is a layer in the lower stratosphere preventing all life on earth from harmful ultraviolet radiation.

Pollution: It refers to the undesirable contamination of environment by the production and use of goods like automobiles.

Resource depletion: It refers to the consumption of scarce resources.

8.9 Self Assessment

Fill in the blanks:

1. The two main sources of environmental threats are ……and …….
2. Ozone layer is destroyed by ……..gases.
3. Oil spills result from …….
4. ……. seeks to meet the needs and aspirations of the present without compromising the needs of future generations.
5. The book 'Earth in the Balance' is written by…….
6. To make manufacturing more environment friendly, industries are adopting a new concept called……
7. India set up the National Committee on Environment Planning and Coordination (NCEPC) after the……Conference.
8. ……Committee recommended for the establishment of a separate Department of Environment.
9. ……Act was passed in 1986 for the protection of environment.
10. Under the …….plan, a cell to ensure effective implementation of anti-pollution measures and measures for the protection of environment was set up.

8.10 Review Questions

1. Evaluate the effect of pollution on environment.
2. If you were the manager of a garments manufacturing firm, what initiatives would you take to protect the environment?
3. Describe 'ecological ethics' in your own words.
4. Critically analyse the relevance of sustainable development.
5. NGOs can help to bridge the gap between science, policy-making and people. Discuss
6. With growing realisation of environment protection, many industries now follow an eco-friendly manufacturing and operating process. Are you satisfied with the efforts made by them so far? Give your viewpoint.

Notes

7. Can companies afford the environmental costs? Justify your answer.
8. What do you understand by 'green marketing'? Give a few examples to make it clearer.
9. Discuss the suggestions made by the Tiwari Committee on environment.
10. Assess the contribution of 7th and 8th plans towards the cause of environment protection.

Answers: Self Assessment

1.	pollution, resource depletion	2.	CFC
3.	offshore drilling	4.	Sustainable development
5.	Al Gore	6.	industrial ecology
7.	Stockholm	8.	Tiwari
9.	Environment Protection	10.	8th

8.11 Further Readings

Books

A C Fernando, *Corporate Governance: Principles, Polices and Practices*, Pearson

Bajaj and Agarwal, *Business Ethics*, Biztantra

N K Uberoi, *Environment Management*-2nd Edition, Excel Books

Online links

http://gadfly.igc.org/e-ethics/Intro-ee.htm

http://indiabudget.nic.in/es98-99/environ.htm

http://moef.nic.in/index.php

http://www.buzzle.com/articles/what-is-environmental-ethics.html

Unit 9: Media and Corporate Governance

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Objectives

After studying this unit, you will be able to:

- Know about the media sector
- Discuss media as a means to communicate with the stakeholders
- Identify the ethical issues in advertising

Introduction

For many public relations practitioners much of their time is taken up with media relations. Media is a powerful tool to persuade; the media can be used to inform relevant sections of the public. With the use of trade and specialist publications as well as the new broadcast media, the public can be targeted narrowly and effectively. The media can be used to encourage two-way communication.

Moreover, editorial coverage carries an implicit endorsement of information and is consequently held to be more believable than advertising, which is paid for and expected to be biased. By using the media effectively, the public relations practitioners enhance the reputation of their clients and employers.

The always increasing role of electronic media has created a special importance for media relations. In fact, the news media have become dependent on PR for news and PR has become dependent upon the news media for publicity. Media relations includes ongoing activities to ensure the organisation has a strong public image.

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Media relations activities include helping the public to understand the organisation and its products. Similar to effective advertising and promotions, effective public relations often depends on designing and implementing a well-designed public relations plan.

The plan often includes description of what you want to convey to whom, how you plan to convey it, who is responsible for various activities and by when, and how much money is budgeted to fund these activities. Similar to advertising and promotions, a media plan and calendar can be very useful, which specifies what media methods that are used and when.

9.1 The Media Sector

The media sector can be defined as comprising the creation, modification, transfer and distribution of media content for the purpose of mass consumption, where:

1. ***Media content*** comprises art, reports of facts, and expressions of ideas or opinions in a form that allows these to be consumed independently (in time or in place) from their creation.
2. ***Mass consumption*** requires that the creation, modification, transfer or distribution is undertaken without knowledge of the specific identity of the people to whom the content is to be made available.

The meaning of each of these definitions is best understood by identifying what they exclude.

Caution The media sector involves separation between creation and consumption.

Theatrical or musical performances, or political speeches, are not media content by themselves: there is no de-coupling of creation and consumption. The performance is necessarily "consumed" as it is being created. In contrast to such performances, the media sector involves a process through which, first, the fruits of human creativity are converted to media content and, second, this media content is distributed to, and consumed by, an audience unconnected to its original creation. The essence of the media sector is the separation between creation and distribution, reflecting the use of the term "medium" to describe a means of communication.

Thus, a broadcast (whether live or not) or a recording of the performance or speech, which can be consumed independently of the speech or performance itself, would be media content. The speech script or musical score used by the performer is potentially media content, as it is capable of mass consumption; but its creation or distribution only forms part of the media sector where this is undertaken for the purpose of mass consumption. Speech writing exclusively for the speaker's use, with no prospect of any other distribution, is not a media activity.

9.1.1 The Media Sector concerns Mass Consumption

The requirement that media be for mass consumption excludes various social and commercial exchanges where, to the extent that content is created, the audience, reader or recipient is a specific individual or a "closed group". The supply of voice telephony services allows the transmission of audio content from one person to another, but falls outside the media sector due to the private nature of the communication. Similarly, in consultancy industries, where firms take on commissions to provide bespoke advice to clients, the consumer of any content created (such as written reports) is a specific party; these services therefore lie outside the media sector (but this does not preclude consultancy firms supplying media content as part of their business, e.g. marketing publications).

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For the purpose of defining the media sector, mass consumption is not simply a matter of numbers. The actual audience or readership for some media content might be very small, whilst forms of private communication might involve a large number of people (e.g. an e-mail to a very large group of recipients) yet fall outside the media sector.

The supply of media content may be restricted and controlled in various ways, but this remains within the media sector so long as the restriction is not based on the specific identity of the people (or parties) to whom the content is to be made available. For instance, access to media content may be restricted through pricing arrangements, by geographic location, or because specific equipment is needed to consume the content.

9.1.2 The Media Sector should be Distinguished from its Distribution Channels

Historically, the main industries within the media sector have been television and radio broadcasting, the film and recorded music industries, and the printed press (e.g. newspaper and book publishing). Connected to these areas is the advertising industry, which cuts across all media channels. More recently, the Internet has provided a further channel through which a range of media content — from text to graphical and audiovisual content — can be distributed.

The trend of convergence highlights the need to recognise the distinction between the media sector and the distribution channels associated with it.

In parts of the media sector, the traditional distribution channels have involved the transfer of content to a physical copy (e.g. through the printing of a newspaper or the copying of a VHS video cassette) followed by a logistical process.

Example: Delivery of newspapers to households, supply through high street retail.

In other parts of the sector, content has been distributed through network infrastructure that was essentially devoted to that purpose, such as terrestrial transmission networks for television and radio broadcasting.

With convergence, and more specifically digitalisation, the same (digital) content is often distributed to consumers through a variety of distribution channels. These distribution channels are not used exclusively by the media sector.

Example: A movie might be transmitted through a digital cable network, or downloaded from the Internet; these same networks are also used to provide services outside the media sector, such as voice telephony services.

As a general rule, therefore, it is misleading to try to conceive of the media sector simply in terms of the distribution channels it is associated with. Indeed, it may be more illuminating to think of the media sector as encompassing broad groups of supply chains that map the original creation (or sourcing) of content to its final (mass) consumption, involving various distribution networks and logistical arrangements.

9.1.3 Media Credibility

The concept of media credibility is related to the more general concept of trust. Journalists distinguish between hard news and soft news. Soft news generally deals with the less serious news, the news about personalities or celebrities, human interest, or gossip. Hard news generally concerns the more serious news, news with such salient foci as those of high rank in government or other institutional hierarchies, news of events which impact on large numbers of people or news which possesses national or international significance for the past or future.

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Given the amply documented dominance of TV as the most popular source of news, the question obviously arises whether popularity is synonymous with credibility. If it is, then it might be expected that TV news sources are seen by the public as more credible than other news sources, e. g., newspapers, magazines, radio. But news sources transmit information and, it might be expected, the kind of information they transmit, and the expertise with which they do it, should have some influence on a source's perceived credibility. One is more likely, for example, to turn to the business newspaper, Business Standard, to get accurate information about business than, say, to the Times of India. One is more likely to turn to the BBC World to get information about international business conglomerates than one is to turn to the Zee News for such information. One is more likely to turn to television channels such as Zoom or MTV to get news about stars and their private doings than turn to CNBC.

The Indian Press and the journalists are losing their credibility very fast. The journalists like politicians and bureaucrats have become a privileged class. This is a new phenomenon and poses the greatest danger to the freedom of the press. If a question is asked today whether the journalists have maintained their integrity and honesty of purpose, the answer sadly would be no.

Businessmen openly talk of how journalists can be bought. Certain pressmen in the capital are known to be lobbyists for industrial houses. Some are even rumoured to be on their payrolls.

The Press has rightly come under fire for its own failings, with editors becoming increasingly partisan and taking sides, or switching stance with an ease that would do credit to the "Aya Rams and Gaya Rams" of politics.

But nowadays media has become a powerful tool for both the businesses and public to raise their voices. With the emergence of social media and blogs, people have got a medium to channelise their thoughts and ideas. People have complete trust on this medium and this medium doesn't disappoint them.

Task

List the various forms of media and name a few leading names in that type. (For example-Print-Times of India etc.)

9.2 Media as a means to Communicate with the Stakeholders

Every organisation needs to communicate with their stakeholders and media serves as a perfect medium to communicate with the internal (in some cases) and external (majorly) stakeholders. Communication effort, mode and frequency depend on the cost and the level of influence of the stakeholder. Some will require simple and infrequent updates, others will require regular, detailed and frequent communications.

Information will need to be tailored to effectively communicate with, and sufficiently inform, different stakeholder groups. Communications tools and channels can include:

1. ***Formal Meetings*** – With powerful stakeholders
2. ***Informal Meetings*** – With interested people
3. ***Mailing list*** – To disseminate information to people on project progress
4. ***Newsletters*** – Either through the mailing list, email or printed – more information
5. ***Information displays*** – Visual representation of project progress in public venues
6. ***Web site*** – Regular updates of project information for 'self service'

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7. ***Individual briefings*** – For those with more interest who are prepared to attend
8. ***Tours and Demonstrations*** – For interested external people and organisations
9. ***Public forums*** – More appropriate where there are community stakeholders
10. ***Media releases*** – Report on achievement of significant project milestones
11. ***Advertisements and Postings*** – Newspapers, magazines, notice boards
12. ***Liaison Committee*** – Representatives of larger groups. Distribute minutes.

Caselet

Has the Indian Media Lost it?

The pity of the Indian media is that it is surviving on myths and superstition. Where has all the factual news gone? Astrology, superstition, snakes, sai baba, daily soaps reviews, fashion week etc. are the only sources to retain themselves in the media world. Prime time news is all about superstition news story with some catchy headlines and this is the best time for advertisements. Showing myths and superstition at prime time at repetitive session is irrational.

Media should encourage art, science and literature but it is focusing on astrology, rebirths, religious myths, beliefs and aliens. Now days almost every news channel telecast astrological programmes where an astrologer or some baba is sitting and predicting about deaths, marriages and relationships. The funny part is that sometimes statements made by each astrologer are contradictory which confuses the audience. Superstition and myths are also encouraged as recently in one of the news channel there was programme based on a tantrik who claimed that he can kill a person within three minutes. It was telecast but the action failed and to escape from humiliation the tantrik said that it can only be performed at night.

In the place of live telecast like this it should telecast scientific development taking place and how technology is helping us in day to day life. This kind of telecast will assist in human resource development.

As a developing nation India is lacking behind in many aspects like technology, research development, and social and economic development and human resource development. India should observe that how yellow race people contributed in their country's development and now nobody comments on them in terms of technology, racism and culture.

Japan is more technologically advance than western countries. It is predicted that China will be the next super power after U.S.A. and it is all because of their hard work. There is great need of intelligent journalists who can help in removing social evils like caste system, communalism, poverty, superstition etc. It should not devote maximum time on discussing cricket and cricketers rather it should be utilise on development of rational thinking of the masses. The main focus of media should be on development and upliftment of the society. India can become developed country with the contribution of media so it badly needs responsible writers, journalists and artists.

Source: www.merinews.com

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9.3 Ethics in Advertising

Advertising is one of the most visible activities of business and it does not operate in a vacuum. By informing, persuading and reminding consumers to use their products or services, companies risk public criticism and attack if their advertising is offensive to the audience or if the advertised products or services do not perform as promised. The opinion of people about advertising is divided, some praise advertising while others criticise its role not only in selling the products but also the influence it exerts on the economy and society.

Many laws and regulations are put into force that determines what is permissible in advertising, however, not every issue is controlled by rules. Marketers are often faced with decisions regarding appropriateness of their actions which are based on ethical consideration rather than what is within the law or industry guidelines. There is considerable overlap between what many consider to be ethical issues in advertising and the issues of manipulation, taste and the effects of advertising on values and lifestyles. Certain actions may be within the law but still unethical.

Example: Cigarette smoking has been shown to be associated with high levels of lung cancer and other respiratory tract diseases and many people would consider cigarette advertising as unethical.

Advertising is a highly visible business activity and any lapse in ethical standards can often be risky for the company. Consumer protection groups question the sponsorship or support of sports events by companies selling alcoholic beverages or tobacco products.

Example: Advertisers, such as Calvin Klein, and L'Oreal etc., have been criticised for using overt sex appeals showing women as sex object in their ads. A few years ago, Calvin Klein was even boycotted for featuring objectionable snapshots of teenagers in states of undress.

Sex appeals and/or nudity used simply to gain consumers' attention and not even appropriate to the product or service being advertised are in poor taste. Even when such appeal is used in case of related products, such as condoms, people may be offended by it. Many people consider nudity or suggestive sex in advertising as objectionable. With the increasing levels of clutter in advertising environment, advertisers will probably continue using appeals that attract the attention of consumers, but offend many people.

The primary criticism of advertising is that it is misleading and deceives consumers. This is an extremely difficult issue. There are people who are inclined to believe everything they see or hear. Deception can also occur as a result of how consumers perceive the ad and its impact on their opinions and beliefs. Puffery is advertising that praises the product or service to be sold with subjective opinions, exaggerations, or superlatives without stating any facts and for this advertisers have a right. This further complicates the issue of deception. What really bothers critics is the extent to which advertisers are knowingly and deliberately misleading or untruthful. Sometimes advertisers have knowingly made false or misleading claims, supplied defective pieces to winners of contests or sweepstakes. Cases like this usually involve smaller companies, who definitely succeed in damaging any reputation they have, besides the possibility of prosecution by government agencies. Most advertisers who spend huge sums of money on advertising do not design their message to deceive or mislead consumers.

In India, there is an Advertising Standards Council of India (ASCI) to enforce the ethical code. The council is a non-profit organisation set up by founder members and has developed a regulating code. It proposes to adjudicate on whether an advertisement is offensive. The Council's decisions are binding on its members and in case of any disputes, it proposes to deal with the government.

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The Code of Advertising Standards Council of India is similar to Advertising Standards Authority (ASA) Code of U K and seeks to achieve the acceptance of fair advertising practices in the best interests of the consumer. It does not have any enforcement powers but acts as a moral pressure group and gives the consumer a chance to register her/his complaint, if the ad is considered misleading by the consumer.

In case of a complaint from a consumer, a 14-member sub-committee consisting of people from various walks of life such as medicine, media, law etc., hears the complaint. In the light of the Code, the Council asks the agency or the advertiser to comment and submit the substantiation. If the complaint is upheld by ASCI, it asks the advertiser to withdraw the concerned advertisement. This procedure is completed in two months. ASCI Guidelines are as follows:

1. To ensure the truthfulness and honesty of representations and claims made by the advertisements and to safeguard against misleading advertising.
2. To ensure that advertisements are not offensive to generally accepted standards of public decency.
3. To safeguard against indiscriminate use of advertising for promotion of products which are regarded as hazardous to society or to individuals to a degree or of a type that is unacceptable to society, at large.
4. To ensure that advertisements observe fairness in competition

Code for Commercial Advertising on Doordarshan suggests 33 'Do's and Don'ts' for advertisers and was presented to the Parliament in 1987. It incorporates the Indecent Representation of Women Act and the Consumer Act, which were passed by the Parliament in 1986.

Ethics in Sponsorship

Sponsorship is the financial or non financial support of an activity, used primarily to reach the given business goals. According to IEG's Complete Guide to Sponsorship,

"Sponsorship should not be confused with advertising. Advertising is considered a quantitative medium, whereas sponsorship is considered a qualitative medium. It promotes a company in association with the sponsee."

Now-a-days a large number of events or activities use sponsorship support to offer more exciting programs and to help distribute rising costs. Sponsorship allows to reach specifically targeted niche markets without any waste. In addition, it is a powerful complement to other marketing programs, besides having a great influence on consumers. Sponsorship offers the possibility of achieving several goals at once. According to Schmader and Jackson in their book, Special Events: Inside and Out, a company can benefit from sponsorship in many ways, such as: enhancing image/shaping consumer attitudes, creating positive publicity/heightening visibility, derive sales etc.

Sponsorship activities have become a mainstream component of the marketing mix. As such, there are attempts to make these activities more effective by leveraging them using advertising, sales promotions, or in an increasing number of cases, through cause related marketing.

9.3.1 Advertising Standards

Advertising Standards Council of India (ASCI) works to maintain the ethical code and sets the standards for advertising in India. The council is a non-profit organisation set up by 43 founder members and has developed a regulating code. It proposes to adjudicate on whether an advertisement is offensive. The Council's decisions are binding on its members, and in case of

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any disputes it proposes to deal with the government. The Code of Advertising Practice of ASCI is similar to the Advertising Standards Authority (ASA) Code of U. K, and seeks to achieve the acceptance of fair advertising practices in the best interests of the consumer. It does not have any enforcement powers but acts as a moral pressure group and gives consumer a chance to register her/his complaint, if the consumer considers the ad misleading.

In case of a complaint from a consumer, a 14-member sub-committee (Consumer Complaint Council) consisting of people from various walks of life, such as medicine, media, law etc., hears the complaint. Eight of these members must be from professions and activities not related to advertising. The Council meets twice a month and a minimum of 5 members have to be present for any decision to be taken. In the light of the Code, the Council asks the agency or the advertiser to comment and submit the substantiation. If the complaint is upheld by ASCI, it asks the advertiser to withdraw the concerned advertisement. This procedure is completed in two months. ASCI guidelines are as follows:

1. To ensure the truthfulness and honesty of representations and claims made by the advertisements and to safeguard against misleading advertising.
2. To ensure that advertisements are not offensive to generally accepted standards of public decency.
3. To safeguard against indiscriminate use of advertising for promotion of products, which are regarded as hazardous to society or to individuals to a degree or of a type, which is unacceptable to society at large.
4. To ensure that advertisements observe fairness in competition so that both the consumers' need to be informed about choices in the market place and the cannons of generally accepted competitive behaviour in business, are served.

Advertising Principles of American Advertising Federation

1. ***Truth:*** Advertising shall reveal the truth, and shall reveal significant facts, the omission of which would mislead public.
2. ***Substantiation:*** Advertising claims shall be substantiated by evidence in possession of the advertiser and the advertising agency prior to making such claims.
3. ***Comparisons:*** Advertising shall refrain from making false, misleading, or unsubstantiated statements or claims about a competitor or his products or service.
4. ***Bait advertising:*** Advertising shall not offer products or services for sale unless such offer constitutes a bona fide effort to sell the advertised products or services and is not a device to switch consumers to other goods or service, usually higher priced.
5. ***Guarantees and warranties:*** Advertising of guarantees and warranties shall be explicit, with sufficient information to apprise consumers of their principal terms and limitations or, when space or time restrictions preclude such disclosures, the advertisement shall clearly reveal where the full text of the guarantee or warranty can be examined before purchase.
6. ***Price claims:*** Advertising shall avoid price claims that are false or misleading, or savings claims that do not offer provable savings.
7. ***Testimonials:*** Advertising containing testimonials shall be limited to those of competent witnesses who are reflecting a real and honest opinion or experience.
8. ***Taste and decency:*** Advertising shall be free of statements, illustrations, or implications that are offensive to good taste or public decency.

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9.3.2 Adverse Effect of Advertisement

Advertising has its adverse effects of advertising on the direct consumers as well as companies. In order to sell their products in the markets, companies come out with different trends and bombard customers with different images and false claims and people start believing in them blindly. And as days pass, people get addicted due to false claim made by the company and as a result it may lead to social discimination and insecurity especially seen in the younger population. For example, ads of skin whitening creams, deodorants etc. show people being looked down upon on not using their products.

It is generally agreed that advertising exerts a powerful social influence and is criticised for encouraging materialism in society. Advertising is blamed for manipulating consumers to buy things for which they have no real need, depicting stereotypes, and controlling the media.

Materialism is the tendency to accord undue importance to material interests, and this tendency perhaps lessens the importance of freedom, love, and intellectual pursuits of society, which are non-material. People in many countries and cultures believe that materialism tends to be negatively related to happiness and hence is considered undesirable.

Many people wonder whether advertising encourages materialism or it merely reflects values and attitudes that develop as a consequence of more important sociological forces.

Critics of advertising say that it should be used only to provide useful purchase-related information to consumers, such as price, product features, and performance etc. It should not attempt to persuade consumers by playing on their emotions, anxieties, and psychological needs, such as self-esteem, status, and being attractive etc., fostering discontent and exploiting them to purchase products and services they do not need.

Sex appeals and/or nudity used simply to gain consumers' attention and not even appropriate to the product or service being advertised is in poor taste. Even when such appeal is used in case of related products, such as condoms, people may be offended by it. Many people consider nudity or suggestive sex in advertising as objectionable. With the increasing levels of clutter in advertising environment, advertisers will probably continue using appeals that attract the attention of consumers, but offend many people.

The primary criticism of advertising is that it is misleading, and deceives consumers. It is an extremely difficult issue. There are people who are inclined to believe everything they see or hear. Deception can also occur as a result of how consumers perceive the ad and its impact on their opinions and beliefs. Puffery is advertising that praises the product or service to be sold with subjective opinions, exaggerations, or superlatives without stating any facts and for this, advertisers have a right. This further complicates the issue of deception. What really bothers critics is the extent to which advertisers are knowingly and deliberately misleading or untruthful. Sometimes advertisers have knowingly made false or misleading claims, supplied defective pieces to winners of contests or sweepstakes. Cases like this usually involve smaller companies who definitely succeed in damaging any reputation they have, besides the possibility of prosecution by government agencies. Most advertisers who spend huge sums of money on advertising do not design their message to deceive or mislead consumers.

The most fundamental objective of all advertising is to cut through the clutter, capture attention and create an impression that lingers on in the memory of the target audience. While doing so, advertisers create desires, shape attitudes, alter social values and raise many an ethical question. The truth is that advertising is considered successful to the extent that it increases the demand of the advertised product or service. Competition or declining profits can blow the good intentions out of the boardroom. Faced with such circumstances, the perspective shifts from what is best for

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the society in the long run to what is best for the firm in the short-run. Advertisers say, "ethics is fine for the secure, but what is really needed is the greater market share for a slipping company."

Task

Pick some advertisements and list out the ethical issues related to them.

Case Study

Real Juice Company

The company is in the business of producing and marketing fruit juices. Ritu Joshi and Rohit Jain were looking at the ad copy and turning it over and over again in their mind. The copy read, "The best fitness plan for you - real fruit, honest juice and no sugar." This was the main copy line. The more Ritu Joshi repeated this line in her mind the uneasier she became. "Something is wrong in this copy," she said to Rohit Jain, the marketing head. "We cannot say 'best for health' when we know for sure that the juice contains preservatives and food colour."

Rohit Jain said, "I don't see if anything is wrong in this." "With food colour and preservatives added we couldn't say it is best. This is what is wrong," replied Ritu.

Rohit said, "But this is hyperbole and permitted by law. There is nothing wrong in saying this. Haven't you noticed almost all detergent brands say 'for best wash', or 'whitest wash'? This is simply a way of putting your claim of brand's superiority."

"We are not talking about detergents, washes and fabrics. It is a health and fitness fruit juice. We could say something like 'a great way to plan your fitness programme' or something like that. We are saying real fruit, honest juice, and no sugar' … not a word about food colour and preservatives'. Any consumer can contest our claim."

Rohit Jain thought for a moment then said, "Let us get the legal opinion from our lawyer, Amit Soni, to be on the safe ground."

Amit listened to what Ritu had to say then said, "Companies use advertising to provide information to consumers and offer alternatives in a competitive market situation. Advertising is false when it says A = B and that isn't true. But if the ad is misleading, it falls under the category of unfair trade practice." Loudly reading the ad copy, Amit said, " Hyperbole such as best, newest, most effective way, are permissible and consumers are unlikely to take such claims with any seriousness. When a brand says its air-conditioner is best or most efficient, consumers know that this is just a manner of speech and do not truly believe and put their money on such claims. In case a company tries to accord credibility to its claims, it goes beyond mere hyperbole. For instance, when the toothpaste says I am the best because I score 96% whereas others score 80%, then it is a claim that goes beyond hyperbole. The marketer is then trying to give it a scientific basis on a particular attribute. This enters the realm of false advertising and is misrepresentation under MRTP Act."

"Yes, Real Juice may pass the legal test fine, but ethically it won't be correct," said Ritu Joshi. "Please understand. Here you are not making a claim," said Amit Soni.

"You think so? Then look at this," said Ritu Joshi, showing another campaign ad for Real Juice that showed a fitness instructor of some repute, holding a Real Juice orange can and his words were, 'I trust Real Juice for my fitness and good health…' "Now isn't that a solid claim on behalf of Real Juice," asked Ritu.

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" It depends on whether the endorser is an expert," said Amit Soni. "If he were a doctor, a nutritionist, or a dietician then those words could connote a claim made by an expert and could be contested. For instance, if a doctor says that Real Juice is best for health then the question arises if the doctor has really conducted a test? Has he conducted the test in an independent manner? Did he conduct the test to deliver a certain result? Did somebody finance the test? That would amount to an unfair trade practice. If a complaint is lodged by a consumer that the ad is misleading, the MRTP Commission could grant an injunction that the ad be withdrawn."

Rohit Jain was thinking loudly about another campaign praising canned drinks, claiming that drinks in bottles faced a higher risk of contamination. The campaign was part of Real Juice's fitness and health positioning. Now he wondered if the manufacturers of bottled drinks could contest that claim.

Amit Soni said, "Comparative advertising is healthy but the advertiser must be clear about the claims to be made. In this case, you are saying that Real Juice is good because it comes in cans and bottled drinks are not as good. This is a direct attack on bottled drinks. Advertisers do not disclose all the parameters they have considered in their conclusion of 'best'. They may select some major ones or may choose to highlight the trivial ones and ignore the major ones. These things happen every day and are not strictly provided under the law. There must be prima facie evidence of damage or misrepresentation to establish a case of unfair trade practice."

"So, we are legally safe," said Rohit Jain. "We will reword this campaign, but our other campaigns have passed the muster."

Ritu Joshi felt differently. She said, "Legally we may be safe, but we have to also take an ethical view." The Real Juice commercial showed an ailing old man. The wife proceeds to extract juice from some oranges, but the daughter-in-law sweeps everything aside and pours out Real Juice from a can.

Ritu Joshi said, "You know, this ad says to me 'Real Juice is convenient, Real juice is as good as fresh oranges, Real juice is good for the ailing.' That misleads."

"Don't be absurd," said Rohit Jain, "The proposition here is convenience."

"I am not being absurd," said Ritu Joshi, "We must not forget that our primary platform is health and fitness. This convenience angle is also creating an impression of 'also good for health'. I believe that as responsible advertisers, we have to be more concerned about the ethical aspects than merely the legal angle. This is where we come to the line between what is legal and what is ethical. We may be legally right but our act could be unethical if the words or pictures in the ad could lead the consumer to believe something that is not true. The aura of the fitness instructor used as the endorser creates an impression that the information is coming to consumers from an environment where there are people whose opinion consumers view as being correct. Otherwise why use the instructor as the endorser."

Questions

1. Analyse the issues in the case.
2. What are your views about the ethical dilemma?
3. Why should advertisers bother about ethics if the ads measure up to legal parameters?

Source: SHH Kazmi and Satish K Batra, *Advertising and Sales Promotion*, 3rd Edition, Excel Books.

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Caselet

Amul Macho – "Crafted for Controversies"

As soon as it was released, the Amul Macho TVC - 'Crafted for Fantasies' - went in for a reality check. The commercial, created by the Pushpinder Singh-owned Saints & Warriors, first hit television screens in the first week of April 2007, and raised quite a few eyebrows then. So much so that the Advertising Standards Council of India (ASCI) received a complaint that termed the ad as 'indecent' and 'obscene'.

As per the complaints the ad violated Chapter 2 of the ASCI code. To cite the code, it is important to "ensure that advertisements are not offensive to generally accepted standards of public decency. Advertisements should contain nothing indecent, vulgar or repulsive which is likely, in the light of generally prevailing standards of decency and propriety, to cause grave or widespread offence".

For the record, Saints & Warriors won the Amul Macho account about five months ago this TVC was aired, armed with ideas to make the communication for the brand clutter-breaking. The ad in question has a newlywed woman entering a 'dhobi ghat' (a place where clothes are washed, generally near the banks of a water body), as other women eye her curiously. Regardless of their stares, the woman opens up her bundle of clothes and pulls out the first garment - Amul Macho underwear belonging to her husband. She then starts brushing it, and through her expressions, it is clear that she fancies that the man is still wearing it. The women surrounding her are also taken in by her fantasy, so much so that when she raises a bat-like object (used to thrash the dirt out of clothes), the women actually wince at the thought of the 'man' being thrashed like that. The ad ends with the young woman stretching the underwear in her hands, while the super and voiceover conclude, 'Amul Macho. Crafted for Fantasies'.

Pushpinder Singh, founder, Saints & Warriors, explained that "The temptation to be mediocre and obvious is always there in underwear advertising. It's very easy to show skimpily clad women or have shots of men wearing innerwear. But we chose to be clutter breaking." What Saints & Warriors attempted to do, he said, is to make the underwear a surrogate for male sexuality. "I think the ad is naughty, not vulgar," he clarifies, "but people are free to believe what they think." Furthermore, he said that, in general, people find underwear ads offensive, so perhaps this case is no different.

As per a poll conducted by CNBC-TV18, 49 per cent of those who participated felt that the ad was enjoyable and not obscene, while the rest felt it was vulgar. But Singh, or Pushpi as he is referred to, was nonchalant. "Around 5,000 people took part in that poll, so 49 per cent - virtually an equal amount of people - is a large segment for us, who understood and appreciated the thought behind the ad," he said.

Commenting on the whole issue, Sandeep Sakseria, director, Amul Innerwear, added that the commercial has already won a bronze at the recently concluded Calcutta Ad Club awards. "If the eminent jury finds the ad worthy of an award, I'm sure the ad isn't offensive in any way," Sakseria said. On the question of the ad being derogatory to women, Sakseria candidly said: "If men can fantasise about women, why can't women do the same?" Furthermore, he claimed that sales grew by 35 per cent since the release of the commercial.

Innerwear advertising is always challenging to the marketer. You have to find the differentiator and also convey that to the customer. The market is full of unorganised and unbranded cheap products. Only a section of the market is brand loyal. While VIP, Jockey

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etc are taking up the premium segment, the brands like Amul, Lux, Rupa etc are trying their luck at the mass market. Hence Amul was forced to take the clutter breaking approach to build the brand.

Source: www.afaqs.com/www.marketingpracticeblogspot.com

9.4 Summary

- Media sector can be defined as comprising the creation, modification, transfer and distribution of media content for the purpose of mass consumption.
- Communication effort, mode and frequency depends on the cost and the level of influence of the stakeholder.
- Advertising is one of the most visible activity of business, its not only selling the products but also the influence it exerts on the economy and society.
- Sponsorship is the financial or non-financial support of an activity, used primarily to reach the given business goals.

9.5 Keywords

Advertisement: It is non-personal presentation and promotion of ideas, goods and services by an identified sponsor.

Liaison Committee: Committee designed to make a link between two groups or committees.

Media: Communication channels through which news, entertainment, education, data, or promotional messages are disseminated.

Newsletters: A printed report giving news or information of interest to a special group.

Sponsorship: Sponsorship is the financial or non-financial support of an activity, used primarily to reach the given business goals.

9.6 Self Assessment

Fill in the blanks:

1. Media can be used to promote……communication.
2. Media ……includes art, reports of facts, and expressions of ideas.
3. Businesses arrange for ……meetings with people who may not be direct stakeholders but still interested in the business.
4. Companies distribute their……to disseminate more information to the interested parties.
5. Advertising is a…….form of non-personal presentation of a company's products.
6. The body governing the ethical conduct in ads in India is……
7. One of the major ethical issue in advertising is the use of……
8. ……..is a qualitative medium of product, brand or company promotion.
9. The essence of the media sector is the separation between creation and ……
10. In……., there is no difference between creation and consumption.

Notes

9.7 Review Questions

1. Critically analyse the role of media in modern corporate world.
2. Do you think media can encourage two-way communication? Justify your answer
3. "In media, there is a de-coupling of creation and consumption." Substantiate
4. Bring out the role of digitalisation in increasing the relevance of media.
5. Analyse the role of communication with stakeholders. What tools can be used to communicate?
6. Discuss any one incident where media played a vital role in bridging the gap between the corporate world and their stakeholders.
7. Take the example of 'Fair and Lovely' advertisements and discuss the underlying ethical issues.
8. What are the ethical issues involved with advertising?
9. What is ASCI? What are its main functions?
10. "Sponsorship allows to reach specifically targeted niche segment." Comment.

Answers: Self Assessment

1.	two-way	2.	content
3.	informal	4.	newsletter
5.	paid	6.	ASCI
7.	deception	8.	Sponsorship
9.	distribution/consumption	10.	theatre

9.8 Further Readings

Books

Bajaj and Agarwal, *Business Ethics*, Biztantra

S H H Kazmi, *Marketing Management*, Excel Books, New Delhi.

Vivek Mittal, *Business Environment*, Excel Books, New Delhi

Online links

http://advertising.about.com/od/ethics Ethics_in_Advertising_and_Public_Relations.htm

http://ezinearticles.com/?Ethics-in-Advertising&id=1134642

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Unit 10: Monopoly, Competition and Corporate Governance

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Objectives

After studying this unit, you will be able to:

- Describe the concept and logic of competition
- Discuss India's competition policy
- Explain MRTP Act and Competition Act, 2002
- Identify role of public policies in business

Introduction

An important hallmark of the process of economic reforms initiated in the country in 1991 is that it has made the economy more competitive as compared to the pre-reform period. Though the degree of competitiveness in the business environment in India is much less as compared to a number of industrial market economies in Europe and North America and a number of emergent market economies in east-Asia and elsewhere, there have been clear signs of movement towards market system and competition in recent years. The movement towards greater competition in various sectors of the economy including manufacturing, infrastructure and services has taken place through deregulation, privatisation and globalisation. The present stance of various macroeconomic policies has been in the direction of marketisation of the economy, encouragement to private enterprise and opening up of the economy to foreign competition through international trade and investment. In the process, the structure of government controls has been diminishing and private capital is being increasingly substituted for public capital in various sectors of the economy.

10.1 The Concept and Logic of Competition

There is enormous literature on the rationale and benefits of market competition or competitive markets. Standard managerial economics tells us 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. An economy is in competitive equilibrium when the forces of demand and supply are exactly balanced, leading to the determination of equilibrium price. In a particular product segment, marginal cost and marginal value or 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 off in that particular situation.

As a reference point, standard managerial economics visualises a situation called perfect competition which, in practice, is difficult to realise but describes an ideal market form characterised by the following features:

1. A large number of buyers and sellers (or producers) so that no individual buyer or seller can affect the market price or working of the market by varying individual demand and supply.
2. All the firms in a particular industry produce homogenous products, the homogeneity being in respect of technical characteristics of the product, services associated with the sale or delivery of the product to the consumer.
3. A uniform price rules throughout the market and is determined by industry demand and supply. This price is given for an individual firm, which merely has the status of a price taker and can sell any amount at the prevailing price.

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4. There are no barriers to entry or exit from the industry and any firm can move in or out, depending upon its business prospects.
5. All the firms pursue the goal of profit maximisation.
6. There is no government intervention, regulation or control by way of tariffs, subsidies, rationing etc.
7. Perfectly competitive conditions exist in the markets for factors of production as well.
8. All buyers and sellers have complete knowledge of market conditions and flow of information (relating to present as well as future) is free and costless.

In real life, however, competition has a different connotation as the markets are imperfect and take such forms as monopoly, monopolistic competition and oligopoly. The firms compete on the basis of price, product quality, after-sale services, product delivery, product information and positioning, advertising and associated services. Competition is characterised by inter-firm rivalry, competitive strategies and the degree of competition is closely related to number of firms in the market and the distribution of market share between them. Government interventions and controls, barriers to entry and exit, legislative control, immobility of the factors of production, dominance of public sector firms and obstructions in the free flow of market knowledge or information tend to reduce the degree of competition and increase market imperfection.

The extent of market imperfection can be gauged in terms of the divergence between the actual price and the competitive price in a particular product market. There is, however, an important exception. Sometimes, a monopolist, through a practice known as limit pricing, sets such a low price for its products so as to prevents the entry of new firms in the market. Potential firms find it commercially unviable to operate at the prevailing price of the monopolist. Similarly, existing firms, through price leadership, can reduce competition or tact collusion through such forms as trade associations, cartels, market sharing or strategic alliances.

Sometimes competition creates a paradoxical situation in which competition is self-killing. It happens when the firms with widely divergent competitive strengths compete with one another forcing the marginal firms to go out of business. The end result could be monopoly or oligopoly. This situation may also result through corporate takeovers, mergers, or amalgamations between rival firms.

10.2 Monopoly and other Types of Competition

Before describing monopoly, let's see what the other types of competition are:

Perfect Competition

Perfect competition is said to exist where there is a large number of producers (firms) producing a same kind of product. (Already discussed above)

Imperfect Competition

Imperfect competition is an important market category where individual firms exercise control over the price to a smaller or larger degree depending upon the degree of imperfection present in a case. The existence of imperfect competition can be caused either by the fewness of the firms or by product differentiation. Therefore, imperfect competition has several subcategories.

The first important subcategory of imperfect competition is ***monopolistic competition***.

In monopolistic competition a large number of firms produce somewhat different products which are close substitutes of each other.

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The second subcategory is ***oligopoly without product differentiation*** which is also known as pure oligopoly. Under it there is competition among the few firms producing homogeneous or identical products. The fewness of the firms ensures that each of them will have some control over the price of the product.

The third subcategory is called ***differentiated oligopoly***. It is characterised by competition among the few firms producing differentiated products which are close substitutes of each other. Firms would have control over the price of their individual products.

Monopoly

Monopoly means the existence of a single producer or seller which is producing or selling a product which has no close substitutes. As such it is an extreme form of imperfect competition. Since a monopoly firm wields sole control over the supply of the product which can have only remote substitutes, the expansion and contraction in its output will affect the price of the product.

Case Study

Medical Monopoly

Non-physician providers of medical care are in high demand in the United States. But licensure laws and federal regulations limit their scope of practice and restrict access to their services. The result has almost unavoidably been less choice and higher prices for consumers.

Safety and consumer protection issues are often said to be the reasons for restricting non-physician services. But the restrictions appear not to be based on experimental findings. Studies have repeatedly shown that qualified non-physician providers – such as midwives, nurses, and chiropractors – can perform many health and medical services traditionally performed by physicians – with comparable health outcomes, lower costs, and high patient satisfaction.

Licensure laws appear to be designed to limit the supply of health care providers and restrict competition to physicians from non-physician practitioners. The primary result is an increase in physician fees and income that drives up health care costs.

At a time government is trying to cut health spending and improve access to health care, it is important to examine critically the extent to which government policies are responsible for rising health costs and the unavailability of health services. Eliminating the roadblocks to competition among health care providers could improve access to health services, lower health costs, and reduce government spending.

Question

Analyse the possible factors that have lead to this kind of situation.

Source: www.cato.org/pub_display.php?pub_id=1105

10.3 Regulation of Competition

Market competition, particularly between firms of highly unequal, competitive strength, can be self-destructive. In unregulated markets, there can be widespread negative spillover effects called 'competitive externalities'. 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.

Notes

Some Negative Spillover Effects of Competition

One type of negative spillover effect takes place when a particular technology or standard developed by a company gets an edge over competitors and becomes widely prevalent. Microsoft's Windows operating system has now become universal for personal computers. It can be used to lock out competition in related markets. Microsoft has already faced an allegation that it was tweaking its operating system to perform optimally by using its own Internet browser software and rejected those developed by rival companies. There is similarly a possibility that a camera manufacturer designs the product in such a way that film cartridge of a particular size would fit and an electric company may decide to make power point which would fit only a particular plug manufactured by the same company. Such anticompetitive behaviour needs to be regulated.

The regulation and protection of competition usually requires a competition (or antimonopoly) policy backed by an appropriate legislation. There are three basic areas of competition policy:

1. Control of dominant firms by regulation.
2. Control of mergers to prevent the possibility of monopolies
3. Control of anti-competitive acts like full line forcing and predatory pricing

Did u know? 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-competitive practices. In the USA, 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.

10.4 India's Present Competition Policy

India's present competition policy is contained in the latest Competition Act 2002. The basic objectives of the Act are:

1. to prevent practices having adverse effect on competition;
2. to promote and sustain competition in markets;
3. to protect the interests of consumers; and
4. to ensure freedom of trade carried on by other participants in one market.

The Act covers the whole of India except the state of Jammu and Kashmir and replaces the earlier MRTP Act. The Act prohibits anti-competitive agreements or arrangements. It further prohibits the abuse of dominant position of a firm which enables it to operate independently of competitive forces prevailing in the relevant market or affects its competitors, consumers or the relevant market in its favour. The Act seeks to regulate takeovers, mergers and amalgamations between firms which have the effect of reducing competition.

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Competition Commission of India (CCI) is established under the Act which he entrusted with the task of eliminating practices having adverse impact on competition, protecting the interests of consumers and ensuring freedom of trade carried on by other participant. Under the Act, while determining the adverse effect or competition, the following six factors or criteria are taken into account:

1. Creation of barriers to new entrants is the market;
2. Driving existing competitors out of the market;
3. Foreclosure of competition by hindering entry into the market;
4. Accrual of benefits to consumers;
5. Improvement in production or distribution of goods and services; and
6. Promotion of technical, scientific or economic development by means of production or distribution of goods and services.

The commission further has the responsibility of providing advice to the government on matters relating to competition policy. It is obliged to take suitable measures for the promotion of competition advocacy, creating awareness and imparting training or competition issues.

Task

Make a survey of the wholesale or retail trade in selected products in your region and collect atleast two cases of Tie-in Sales and Collective Price Fixation.

Discuss these cases in the class and suggest ways to control such practices.

10.5 Monopolistic and Restrictive Trade Practice (MRTP) Act

The Directive Principles of our constitution suggest that ownership and control of material resources should be widely distributed and there should be no concentration of wealth and means of production. With this in mind, the Monopolistic and Restrictive Trade Practice Act, 1969, was enacted so as to:

1. ensure that the operation of the economic system does not result in concentration of economic power to the common man's detriment,
2. provide the control of monopolies,
3. prohibit monopolistic and restrictive trade practices.

The Act was amended in 1974,1980,1984,1988 and in 1991. The Act placed many restrictions on companies having assets of more than ₹ 100 crores in respect of new projects, expansion, diversification, mergers, and even in the appointment of directors.

10.5.1 Scope of MRTP

Before the 1991 amendment, the MRTP law sought to control the concentration of economic power by requiring undertakings that had assets over ₹ 100 crores and/or were 'dominant undertakings' to register themselves with the Monopolies and Restrictive Trade Practices Commission. If such an undertaking wishes to expand and enter a new line of production or to participate in mergers, amalgamations and takeovers, it to seek permission from the government.

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MRTP controls the following aspects of economic activity:

1. Restrictive Trade Practices
2. Unfair Trade Practices
3. Monopolistic Trade Practices
4. Concentration of Economic Power.

Notes

Pre-entry Condition after 1991 Amendment

Pre-entry restriction on MRTP companies hindered the rapid growth of industry and in turn of the economy. For rapid industrialisation, the Act was amended in September 1991 and all entry restrictions on MRTP companies i.e. companies having group assets of over ₹ 100 crores were removed. Now, the MRTP Act concentrates only on controlling and regulating the monopolistic, restrictive and unfair trade practices and concentration of economic power to a limited extent.

10.5.2 Restrictive Trade Practice (RTP)

A Restrictive Trade Practice is one which has, or may have, the effect of preventing, distorting or restricting competition in any manner and in particular:

1. which tends to or obstructs flow of capital or resources for production,
2. which tends to impose unjustified costs or restrictions on consumers, relating to goods and services by manipulation of prices, or by conditions of delivery or to affect supplies in market.

The deemed RTPs are as follows:

1. ***Restrictions on Buying/Selling:*** This means restricting person or persons to whom goods may be sold or from whom to be bought. Such as Trade Associations that asks their members not to deal in goods of a particular manufacturer.

Example: Manufacturers restricting its distributor to appoint a sub-distributor or dealer without prior permission. A manufacturer restricting its dealers/distributors to supply goods to particular institutions or consumers. Distributors selling goods to third party without prior permission of the manufacturer, etc.

2. ***Tie in Sales or Full Line Forcing:*** This means requiring a person to purchase something else compulsorily, along with goods he wants to purchase.

Example: Such as forcing dealers to purchase orange drinks with cola drinks, or forcing purchase of gas stoves with gas connections, requiring dealers to maintain a minimum level of stock of the full range of products of the manufacturer, schools making it mandatory to buy uniforms and books only from their own shop, etc.

3. ***Exclusive Dealing Agreement:*** It is about forcing not to deal with goods other than those of the seller. For instance dealers not to deal with similar type of products of the competitor, or buyers force manufacturers not to manufacture identical goods for any other buyer without consent of the particular buyer, producers enter into a long term contract with an artist prohibiting him from giving performances anywhere else, agreements wherein a

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distributor will purchase goods only from the manufacturer or from some other as may be nominated by him.

4. ***Collective Price Fixation and Tendering:*** This is a collective agreement to purchase or sell or to tender only at agreed prices or terms. This is called 'cartel'. It is also called the Knock Out Agreement.

Example: When tyre or cement manufacturers, or some trade associations increase prices or restrict supply uniformly and simultaneously, by mutual agreement.

5. ***Restriction by Association:*** This is when associations don't allow non-members to carry the goods, thereby hampering free flow of goods, resulting in imposing unjustified costs on the customer.

6. ***Discriminatory Dealing:*** Giving concessions or benefits on the basis of turnover or giving huge discount to large buyers will be considered as RTP, if such discounts are injurious to competition. However, discounts are very common in business and many discounts are not considered as discriminatory as cash discount on prompt payment, discount to different classes of customers as government and private customer, incentive to increase sales, newspapers charging different rates for different pages of newspaper, etc.

7. ***Resale Price Maintenance:*** This means not allowing resale below certain price or not to sell above a particular price.

   If maximum price is indicated, the dealer should be free to charge below the indicated price.

8. ***Restriction on Output or Supply:*** This means an agreement to limit, withhold or restrict the output or supply or any goods or allocate any market or areas for disposal of goods.

9. ***Restriction on Manufacturing Process:*** This means an agreement not to use a particular method, machinery or process in the manufacture of goods.

10. ***Price Control Arrangement:*** This means an agreement to sell goods with a view to eliminate competition or any competitor.

11. ***Restriction on Buying:*** To restrict the class or number of wholesalers, producers or suppliers for whom goods may be bought is an restrictive trade practices.

12. ***Collective Bidding:*** This means an agreement among the contenders for bid to be offered at auction or not to be bid at auction.

13. ***Agreement Declared by government to be restrictive:*** The government has powers to declare any agreement as restrictive on the recommendation of the Commission.

Besides all these, many others are treated as RTP.

Example: Such as Dumping of goods, deficiency in insurance services, insisting on collection of gas cylinders from shop, accepting deposits for supply without any possibility of supply, not providing a house as promised, failure to refund deposits, wide variations in prices in different regions, etc., are treated as restrictive trade practices.

Notes

Investigation into RTP

The MRTP commission will enquire into any RTP. If it finds that the trade practice is prejudicial to public, the Commission may give the following directions:

1. the practice shall be discontinued or shall not be repeated
2. agreement relating to RTP shall be modified as may be specified by MRTP Commission.

10.5.3 Monopolistic Trade Practices (MTP)

A Monopolistic Trade Practice is one that has or is likely to have any of following effects:

1. Limiting or controlling production, supply or distribution of goods or services and thereby maintaining price of goods or charge or service at an unreasonable price.
2. Unreasonably preventing or lessening competition.
3. Limiting technical development or capital investment or allowing quality of goods or services to deteriorate.
4. Unreasonably increasing prices of goods or services.
5. Unreasonably increasing the cost of production or charges for any services.
6. Unreasonably raising the profits on production, supply or distribution of goods or services.
7. Adopting unfair or deceptive methods to reduce or prevent competition in goods or services.

If the MRTP Commission reports that the trade practice is against public interest, the government can order the following:

1. Regulating production, supply, storage or control of goods or services and fixing terms of sale, sales price and supply.
2. Prohibiting the undertaking from resorting to such trade practice, that reduces competition.
3. Fixing quality standards for goods.
4. Declaring some type of agreements as unlawful.
5. Asking any party to cancel the whole or part of any agreement.
6. Regulate profits that may be derived from production, storage, supply, distribution or control or goods or provision or services.
7. Regulate quality of goods or services.

Initiation of Inquiry by the Commission

The Commission can enquire into any restrictive, unfair or monopolistic trade practice (a) upon receiving a complaint from any consumer or a consumers' association, (b) on reference made by Central or state government, (c) on an application made by DGIR, (d) on its own.

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10.5.4 Governing Body

MRTP Commission

The Central government provides its powers under Section 5 of the MRTP Act. As per the MRTP Act Commission, it is to consist of a chairman and not less than two and not more than eight other members. The chairman should be a person who has been or is qualified to be a judge of the High Court or the Supreme Court.

One time tenure of the office of a member is fixed for 5 years subject to renewal. However, no member can hold office for more than 10 years or beyond reaching age of 65 years (section 6).

Director General

The Central government has also appointed a Director General of Investigation and Registration. The main function of the Director General is to make preliminary investigation before an inquiry by the MRTP Commission and to maintain a register of agreements required to be registered under the Act.

Powers of the Commission

The MRTP commission has the following powers:

1. Power of a civil court under the Code of Civil Procedures, 1908, with respect to:
   (a) Summoning and enforcing the attendance of any witness and examining him on oath.
   (b) Discovery and production of any document or other material object producible as evidence.
   (c) Reception of evidence on affidavits.
   (d) Requisition of any public record from any court or office.
   (e) Issuing of any commission for examination of witness and
   (f) Appearance of parties and consequences of non-appearance.
2. Proceedings before the Commission are deemed as judicial proceedings within the meaning of Sections 193 and 228 of IPC.
3. To require any person to produce before it and to examine and keep any books, accounts or other documents relating to the trade practice in its custody.
4. To require any person to furnish such information with respect to the trade practice as may be required, or such other information as may be in his possession in relation to the trade carried on by any other person.
5. To authorize any of its officers to enter and search any undertaking, or seize any books or papers relating to an undertaking in relation to which the inquiry is being made, if the commission suspects that such books or papers are being or may be destroyed, mutilated, altered, falsified or secreted.
6. The Commission has the power to order compensation and damage, if a person is found (after enquiry), to be indulging in unfair, monopolistic or restrictive trade practice. An application can be made to the Commission for awarding compensation for loss or damage suffered due to such trade practice.

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Restriction on the Powers of Commission

The Commission cannot restrict any right attached to a patent. It cannot order in respect of conditions attached by a patent holder to his licensee in India. Firms engaged in production, supply, distribution or control of goods for export exclusively cannot be restrained by the Commission. Trade unions and government undertakings engaged in defense production do not come under the purview of the MRTP Act. Judgments of High court are binding the MRTP Commission. It has no power to impose penalties though it can only issue 'cease and desist' order and can order compensation.

The MRTP Act was implemented in keeping with India's adopted political ideology of socialism. Its basic objective was to restrict the concentration of economic power by restricting and controlling the big companies, but in reality it only restricted and controlled the growth of Indian economy. If we examine developments the development up to 1990 we will find that much of the big business was in the hands of few business houses of India as they alone could manage to garner license for manufacturing.

Caution Restrictions on expansion resulted in a low level of production that resulted in high production cost and short supply, both of which are detrimental to the consumer.

As a result, India, which was an economic power in Asia at the time of its independence, soon fell way behind much smaller economies, like Japan and South Korea, which overtook us to emerge as economic giant.

In view of this, the thrust of the 1991 liberalisation removed those sections of the MRTP Act that required large undertakings to seek permission from the government before initiating any activity. The current version of the MRTP Act merely allows for the possibility of the government dividing undertaking or serving interconnections if it feels that such an action is in the 'public interest'. The role of the MRTP Commission remains confined to providing a suitable report – if asked to provide one. The government introduced a Competition Bill which is more suitable in a changed scenario.

Caselet

Maharashtra Government Mulls Amendment of MRTP Act

The Maharashtra government is looking at proposing a floor space index (FSI) of 2 in the Mumbai suburbs after making amendments to the Maharashtra Regional Town Planning (MRTP) Act.

"The Act needs an amendment and then we will be going for an FSI of 2 in the Mumbai suburbs," Maharashtra minister of state for housing Sachin Ahir said on the sidelines of the CII national conclave on real estate. FSI is the ratio of the total floor area of buildings on a certain location to the size of the land of that location. Thus, an FSI of 2 would indicate that the total floor area of a building is two times the gross area of the plot on which it is constructed. Early this month, the Bombay High Court dismissed the Maharashtra government's decision to increase the FSI in Mumbai suburbs from to 1.33 from 1.

The court held that the government's notification of April 2008, finalised in October 2008, was "manifestly arbitrary" as section 22 of MRTP Act, 1966, "does not expressly confer any

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power on the state government whether regulatory or compensatory" to grant such FSI. "It is not open for the state government or the planning authority to contend that under the guise of giving grant of additional FSI of 0.33, they are entitled to charge a fee for the purpose of providing amenities," Justices FI Rebello and AA Sayed stated. "I totally agree that Mumbai needs higher FSI if it has to compete with the global markets. Mumbai needs to grow vertically, as horizontal growth is limited. We need more skyscrapers and hence more FSI," Jones Lang LaSalle Meghraj chairman & country head Anuj Puri said.

Source: www.financialexpress.com

10.6 Competition Act, 2002

In the present phase of economic reforms based on the three pillars of liberalisation, privatisation and globalisation, the Act, as seen in its original spirit, appeared redundant. A number of its provisions in the present-day context lost relevance and required to be substituted with new provisions in tune with the contemporary trends in business environment. The Act did not address a number of present-day issues like the abuse of intellectual property rights. In many respects its provisions were draconian and the implementation and control structure was heavily bureaucratic in nature. The Act was often cited as one of the main hindrances to foreign direct investment in the country.

Caution The MRTP Act has been replaced by the Competition Act 2002 on the recommendations of the SVS Raghvan Committee. As already pointed out, all the cases pertaining to RTPs and MTPs under the MRTP Act have been transferred to the competition commission of India established under the new Act and will be decided according to the provisions of the repealed MRTP Act.

10.6.1 Coverage and Applicability

The Act like the earlier MRTP Act applies to the whole of India except the state of Jammu and Kashmir. The Act however empowers it to exempt any class of enterprises from the Act in interest of public or national security. It can also exempt any practice or agreement arising out of and is accordance with any obligation assumed by the country under any treaty, agreement or convention with other countries. Under the Act, no civil court has jurisdiction to entertain any suit or preceding which the competition commission established under the Act is empowered by the Act to determine. However, the provisions of the Act are in addition to and not in derogation of, the provisions of the any other law in force.

10.6.2 Prohibition of Anti-competitive Agreements

The Act prohibits persons and enterprises from entering into any agreement which has adverse impact on competition in any area of production, supply, distribution, storage, acquisition or control of goods or provision of services in the country, the Act prohibits the following agreements as these have anti-competitive effects:

1. Decisions taken by an association of persons or enterprises which:
    a) Directly or indirectly determine purchase or sale price;
    b) Limits or controls production, supply, markets; technical development, investment or provision of services

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c) Shares the market or source of production or provision of services by way of allocation of geographical area of market;

d) Results in bid rigging or collusive rigging.

2. Tie-in arrangements
3. Exclusive supply arrangements
4. Refusal to deal
5. Resale price maintenance.

As can be easily seen, most of these provisions were contained in the MRTP Act also.

10.6.3 Prohibition of Abuse of Dominant Position

An enterprise under the Act is considered to abuse its dominant position in the market if it:

1. imposes unfair or discriminatory condition or price purchase or sale of goods or service;
2. restricts production of goods or services or market in respect of these;
3. restricts technical or scientific development to the detriment of the consumer interests;
4. indulges in practices which deny market access to others
5. uses its dominant position in one relevant market to enter into or protect other relevant market.

The Act provides that no enterprise shall abuse its dominant position.

10.6.4 Regulation of Combinations

Under the Act, combinations have been defined is terms of assets and turnover limits of enterprises after acquisition, merger or amalgamation. The act prohibits persons or enterprises person entering inter a combination which is expected to have adverse effect or competition within the relevant market in India. In that case, the combination shall be void. Since provision however does not apply to share subscription or financing facility or any acquisition by a public financial institutions, foreign institutional investor, bank or Venture capital fund, pursuant to any covenant of a loan agreement or investment agreement.

10.6.5 Establishment of the Competition Commission

The Act provides for the establishment of Competition Commission of India Consisting of a Chairman and 2-10 members to be appointed by the central government, and having a term of five years. There is also the provision for the appointment of a Director-General to assist the Commission. The basic duties of the Commission as provided in the Act are:

1. to eliminate practices having adverse impact on competition;
2. to promote and sustain competition;
3. to protect the interest of consumers; and
4. to ensure freedom of trade carried out by other participants in markets I India.

Notes

The Commission can enquire into any violation of the provisions of the Act. In order to determine whether an agreement has an appreciable adverse impact on competition, it may apply any one or more of the following competition criteria:

1. Creation barriers to new entrants in the market;
2. Foreclosure of competition by hindering entry; into the market;
3. Accrual of benefits to consumers;
4. Improvement in production or distribution of goods or services; and
5. Promotion of technical, scientific and economic development by means of production or distribution of goods or services.

10.6.6 Criteria of Dominant Position

The Act provides for the following major criteria by which the competition commission of India may determine whether an enterprise commands a dominant position in the market.

1. Market size, resources and economic power of the enterprise;
2. Size and importance of the competitors;
3. Vertical integration of the enterprise;
4. Monopoly position acquired through a statute and dependence of consumers on the enterprise;
5. Barriers to entry in the field of operation of the enterprise;
6. Countervailing buying power;
7. Structure and size of the market in which the enterprise operates;
8. Relative advantage gained by way of contribution of the enterprise to economic development; and
9. Social obligation and costs.

If an agreement of an enterprise in a dominant position is found to be in contravention to the Act, the commission can order the enterprise to discontinue and not to re-enter such agreement or discontinue such abuse of dominant position.

10.6.7 Investigation of Combinations

The Act empowers the Competition Commission to conduct enquiry into any merger or amalgamation of enterprises if such business combinations are expected to have adverse impact on the existing state of competition. In order to determine whether a business combination has or expected to have adverse impact on competition, any of the following criteria may be applied:

1. The extent of barriers in the market;
2. Actual and potential level of competition from imports;
3. Level of combination in the market;
4. Monopoly power of the combination that might result;
5. Extent of effective competition likely to sustain in the market;
6. Extent of vertical integration in the market;

7. Benefits of combination in relation to the loss of competition; and

8. Impact on innovations.

The Act lays down detailed procedure for investigation. If a combination is likely to have significantly adverse impact on competition, the commission may even pass orders that the combination shall not be given effect.

No civil court has the jurisdiction to entertain any suit or proceeding in respect of any matters which the commission is empowered by the Act.

10.7 Role of Public Policies

Public policy is an attempt by the government to address a public issue. The government, whether it is city, state, or federal, develops public policy in terms of laws, regulations, decisions, and actions. There are three parts to public policy-making: problems, players, and the policy.

The problem is the issue that needs to be addressed. The player is the individual or group that is influential in forming a plan to address the problem in question. Policy is the finalized course of action decided upon by the government. In most cases, policies are widely open to interpretation by non-governmental players, including those in the private sector. Public policy is also made by leaders of religious and cultural institutions.

The government affects business transactions and activities of an economy through a system of controls and regulations. Fiscal and monetary policies constitute 'indirect' or 'general' controls; they affect the overall aggregate demand of the economy. In contrast, there may be 'direct' or 'physical' controls; they affect particular choices of consumers and producers. Such controls are in the form of licensing, price controls, rationing, quality control, monopoly control, regulation of restrictive trade practices, export incentives, import duties, import-export and exchange regulations, quotas, authorisation and agreements, anti-hoarding and anti-smuggling schemes, etc. It is this complex and varied set of direct controls, which is often, referred to the term Physical Policies. Unlike fiscal and monetary policies, which affect the entire economy, physical policies tend to affect the strategic point of the economy; they are specially oriented and discriminatory in nature. They are designed and executed to overcome specific shortages and surpluses in the economy. Thus, the basic purpose of physical policies is to ensure proper allocation of scarce resources like food, raw materials, consumer goods, capital equipment, basic facilities, foreign exchange, etc.

The need and mode of physical policies are so varied that it is difficult to attempt any generalisation on them. Particularly in a mixed economy where controls and regulations form an essential ingredient of functioning of the economic system, it is important to discuss some, if not all, of them separately.

10.7.1 Control over Consumption and Distribution

Consumption can be controlled and regulated in two ways: (a) by regulating the production of consumer goods directly through a control over allocation of raw materials and labour and output quotas; and (b) by controlling the physical demand for goods through price controls and rationing.

Price controls are less drastic and more comprehensive than rationing and therefore, more useful as methods of distributing the means of production and the supplies of available goods equitably. Of course, a system of price controls and rationing must go together.

Notes

Normally from the standpoint of distributive justice, the prices of essential goods are fixed at a low level. At the level of such controlled prices, there always exists excess demand and therefore, unless there is rationing, price controls may lead to queues, profiteering, black marketing, hoarding, adulteration and short weighing of goods and many other anti-social and unethical practices. Thus, unless there is an efficient network of public distribution, the purpose of price control may get defeated. This implies the significant role of fair price shops, superbazars, consumer cooperatives, state emporia, civil supplies department, etc.

Price controls may be administered for not only goods in the commodity market, but also services in the factor market. Profit or dividends control, interest control, rent control and wage controls are all examples of factor price controls. Commodity prices and factor prices are interrelated; cost-push inflation (or a wage price spiral) is a glaring example. As such, commodity price controls must be combined with factor price controls. When maximum (ceiling) prices are fixed for essential commodities, floor prices may be fixed for factors like labours in a modern welfare state; minimum wage legislations are enacted to prevent monopolistic and monopsonistic exploitation of labour.

Price controls fall into two categories: statutory and informal. Statutory price controls exist in respect of commodities and/or factors whose prices are fixed by some sort of a judicial body and whose enforcement is imposed by a statute or a legislation enacted by the government. Informal price controls, on the other hand, are not executed through any statute and to that extent they do not involve any penalty clause, such controls are based an informal understanding between government and business. In actual practice when the government lays down an elaborate set of approval clauses and procedures, the business sector may experience the informal measures as formal controls.

Price controls may operate at different levels in different degrees. Sometimes controls may be imposed statutorily on retention or ex-factory prices of products. At the same time consumer prices may be uniformly regulated through an arrangement of freight equalisation or zonal freight costing. Sometimes the government introduces a system of dual prices for producer goods (like steel) as well as consumer goods (like wheat). Similarly, the government may enforce different levels and grades of wages for different categories of labour. In short, there seems to be infinite variations in the form of controls, each more complex and sophisticated than the other, requiring at every step an elaborate and efficient administrative structure to implement them.

10.7.2 Control over Investment and Production

From the standpoint of allocation and utilisation of scarce resources such controls are very essential. The usual methods of control in this context are fixation of quotas, issue of licences, authorisation on the basis of priorities and capacity utilisation, categorisation of industrial activity, strict demarcation of the area of different sectors like public, private, joint, cooperative and small scale, guidelines for foreign investment, etc. Such controls are usually imposed through industrial policy statements, capital goods clearance, industrial development and regulation enactments, control of capital issues, etc. It is very difficult to ensure either equal distribution of wealth and income or balanced regional development strategy or both without such controls over investment and production activity. Particularly in an inflation prone underdeveloped economy, the production of essential mass consumption items, basic raw materials and capital goods must be controlled in this manner so that shortages and bottlenecks may be taken care of. However, if such controls cannot be administered promptly and efficiently, then they may cause inordinate delays and inexplicable decisions and consequently the production target may suffer considerably and thereby the very purpose of production/investment controls may be totally defeated. In fact, production, distribution and consumption should be controlled simultaneously. Controls over investment must be combined with price controls and regulation of monopolies and restrictive trade practices.

Notes

10.7.3 Foreign Trade Controls

The difference between domestic consumption and domestic production is bridged by foreign trade. Foreign trade controls may be of two types: Import controls and Exports controls.

Import controls are imposed in view of import requirements of the economy. Such controls mostly take the form of prohibition of import of certain non-essential items and liberalisation of import of certain essential raw materials and goods. Normally, import controls are executed through a system of quotas and licences. General import controls are based on criteria such as country of origin, degree of essentiality, quotas and monetary ceilings for individual imports, special commitments or obligations and international allocations.

Export controls depend upon internal supply position, domestic consumption requirements, international market conditions, etc. The principal objectives of such controls are (a) earning foreign exchange, (b) conserving stocks of raw materials and final products for internal consumption, (c) enforcing standards of quality and grading, (d) fulfilling export commitment in accordance with trade agreements. For purposes of export control, there are various measures like export incentive schemes, export duties, etc. Reduction, rationalisation or abolition of export duties is made in view of internal and international market conditions.

Foreign trade controls have their limitations. Import quotas and import licensing widen the scope for delay, corruption and arbitrary decisions. Export controls may encourage such a flow of foreign exchange that their availability and utilisation may pose a problem.

Exchange control attempts to influence the balance of payments directly. Mostly underdeveloped countries suffer from balance of payments difficulties because of sluggish exports and heavy import requirements. Exchange controls are designed to attain the objectives of export promotion coupled with import restriction. The authorities intend to control the earning, spending and saving of foreign exchange resources. In its most comprehensive form, exchange control requires exporters to deposit all their foreign exchange with the exchange control authorities in exchange for domestic currency. Sometimes, foreign exchange may be fully convertible. Importers and others may be given foreign exchange only if they satisfy certain required conditions. Restrictions may be placed on foreign travel and education. Exchange controls are designed to promote optimum utilisation of foreign exchange. Controls aim at rationing of a scarce currency and liberalisation of a currency which is plenty; and in this way, exchange control may discriminate against imports from certain countries. Another form of exchange control is the system of multiple exchange rates; normal exchange rate may be used for essential imports and penalty exchange rate for non-essential imports.

There is a great danger in exchange control. If exchange controls are very strict and prolonged, then they lead to black marketing in foreign exchange, gold smuggling, etc. In many countries6, one of the factors behind persisting parallel economy is the illegal transactions in foreign exchange. The countries, which suffer from 'international demonstration effect' and the people therein, who have a craze for 'foreign goods' often help the black market price of foreign exchange to exceed the legal price. It becomes a difficult task for the exchange authority to control this price differential and its associated features like smuggling.

Task

Government of India puts restrictions on imports of certain commodities. Name a few such commodities and prepare a report on the effect of such restrictions on business.

Notes

10.8 Current Trends in Global Corporate Governance

The current trends and likely developments for the future in the field of corporate governance are:

Corporate governance driven by technology: The Internet has freed corporate governance from the corporeal. The computer-tech revolution in instant communications has dramatically affected investor relations, largely with the Securities and Exchange Commission's blessing. At the same time, state regulators are permitting corporation/investor interaction, including the annual shareholder meetings, to proceed electronically. The confluence and extension of these trends is that virtually all corporate communications to, from, and between investors will transpire in virtual space, using fully electronic notices, consents, proxies, document deliveries, and reporting, plus webcast conferences and meetings. Quorums, not now counted electronically, surely will become so. Electronic communication between shareholders will facilitate the monitoring roles of institutional investors.

More inputs by the investors: The increased activism of institutional investors in the name of managerial accountability portends the creation of new structures and even an accountability industry. As technology promotes transparency, monitoring of management can become systematized. Professional monitors may intermediate between shareholders and companies, for example, to nominate slates of directors and disseminate governance information and analysis. Investors who wish to concentrate on economic concerns can still receive timely notice of governance issues that detract from performance.

Globalisation of companies: The globalization of business and finance, accelerated by the advent of the Euro, will foster mergers and consolidations, may create a global currency, and might mark the dissolution of national boundaries for corporate organisations. The long-debated European company charter may prove merely a way-station for an even more globally standardized form. At the same time, standards of corporate governance, now largely a function of national structures and customs, are already beginning to cross national borders. European investor groups now study the methods used by US institutional shareholder activists; thus, the communications revolution will extend to cross-border corporate monitoring and governance standards. Companies in developing countries may be able to harness cross-border communications and technology to compete more equally with enterprises in developed countries.

Making up new rules: along with globalisation, promoters have sparked a renewed interest in private solutions to governance issues, exemplified by the emergence of the limited partnership and the limited liability company. These business forms glorify-in ways upheld by the courts-the contractual resolution of fiduciary issues and the fine-tuning of management liabilities. In a curious reversal, the trend toward privately ordered arrangements may clash with and eventually trump the elaborate corporate monitoring and governance mechanisms that institutional investors so far have favored. Investors may eventually decide that they prefer economic performance to supervisory franchise. Contractually delimited management rights may then replace legislated and court-ordered duties, in exchange for more precisely defined economic performance guarantees by management.

10.9 Summary

- The firms compete on the basis of price, product quality, after-sale services, product delivery, product information and positioning, advertising and associated services.
- Competition is characterised by inter-firm rivalry, competitive strategies and the degree of competition is closely related to number of firms in the market and the distribution of market share between them.

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- Before the 1991 amendment, the MRTP law sought to control the concentration of economic power by requiring undertakings that had assets over ₹ 100 crores and/or were 'dominant undertakings' to register themselves with the Monopolies and Restrictive Trade Practices Commission.
- The Commission can enquire into any restrictive, unfair or monopolistic trade practice (a) upon receiving a complaint from any consumer or a consumers' association, (b) on reference made by Central or state government, (c) on an application made by DGIR, (d) on its own.
- The MRTP Act was implemented in keeping with India's adopted political ideology of socialism. Its basic objective was to restrict the concentration of economic power by restricting and controlling the big companies, but in reality it only restricted and controlled the growth of Indian economy.
- The MRTP Act has been replaced by the competition Act 2002 on the recommendations of the SVS Raghvan Committee.
- The government affects business transactions and activities of an economy through a system of controls and regulations. Fiscal and monetary policies constitute 'indirect' or 'general' controls; they affect the overall aggregate demand of the economy. In contrast, there may be 'direct' or 'physical' controls; they affect particular choices of consumers and producers.

10.10 Keywords

Externalities: Activities and conditions whose benefits and costs are not reflected in the market price of goods and services.

Monopoly: The existence of a single producer or seller which is producing or selling a product which has no close substitutes.

Perfect competition: It is said to exist where there is a large number of producers (firms) producing a same kind of product.

Price control: Restriction on maximum prices that is established and maintained by the government.

Public policy: It is an attempt by the government to address a public issue

Restrictive Trade Practice: One which has, or may have, the effect of preventing, distorting or restricting competition in any manner

10.11 Self Assessment

Fill in the blanks:

1. The extent of market imperfection can be gauged in terms of the discrepancy between the actual price and the ……price.
2. A market where a large number of firms produce somewhat different products is called……
3. ……is an extreme form of imperfect competition.
4. In perfect competition, firms sell……products.

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5. …….. is entrusted with the task of eliminating practices having adverse impact on competition.
6. ……Act was created to protect interests of the common man.
7. ……..is an agreement among the contenders for bid to be offered at auction or not to be bid at auction.
8. The main function of the …… is to make preliminary investigation before an inquiry by the MRTP Commission.
9. …… Act provides that no enterprise shall abuse its dominant position.
10. ……..price controls exist in respect of commodities and/or factors whose prices are fixed by some sort of a judicial body.
11. Two types of foreign trade controls are……..control and……..control.
12. Exchange control attempts to influence the ……. Directly.

10.12 Review Questions

1. Discuss how liberalization, privatisation and globalisation have contributed to the growth of competitive environment in India since 1991. What has been the effect on increased competition on growth?
2. According to you, what are the tests of a good competition policy? Assess India's competition policy as reflected in the competition act on the basis of such tests.
3. What would have happened if there was no MRTP Act? Would it affect you as a consumer?
4. Analyse the governing procedure and rules for MRTP Act.
5. "The MRTP Act was implemented in keeping with India's adopted political ideology of socialism." Discuss the validity of the statement.
6. Do you think that the new Competition Act 2002 will remove the limitations of the MRTP Act? Is the new Act old wine in new bottle?
7. "MRTP Act was often cited as one of the main hindrances to foreign direct investment in the country." Comment
8. Analyse the role of government and public policies in business.
9. Critically analyse the rationale behind price controls. Are they really effective?
10. There is a great danger in exchange control. What is the danger? Can it be averted?

Answers: Self Assessment

1.	competitive	2.	monopolistic competition
3.	Monopoly	4.	homogeneous
5.	Competition Commission of India	6.	MRTP
7.	Collective bidding	8.	Director General
9.	Competition	10.	Statutory
11.	import, export	12.	balance of payments

10.13 Further Readings

Notes

Books

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Unit 11: The Indian Capital Market Regulator – SEBI

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Objectives

After studying this unit, you will be able to:

- Know about the capital market in India
- State the origin and powers of SEBI
- Discuss guidelines and reforms introduced by SEBI

Introduction

SEBI is the Regulator for the Securities Market in India. The Securities and Exchange Board of India was established on April 12, 1992 in accordance with the provisions of the Securities and Exchange Board of India Act, 1992.

The Preamble of the Securities and Exchange Board of India describes the basic functions of the Securities and Exchange Board of India as

"…..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"

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11.1 The Capital Market in India

The emergence of Capital Market can be traced back to the second half of the eighteenth century when the transactions were limited to loan stock transactions of the East India Company. By 1830, some corporate stocks had emerged due to economic boom and establishment of textile mills. Stock Exchange means anybody of individuals, whether incorporated or not, constituted for the purpose of assisting, regulating or controlling the business of buying, selling or dealing in securities.

Did u know? Bombay Stock Exchange was formalised in 1875 with the establishment of 'Native Share and Share Brokers Association'. The stock exchanges of Kolkata and Chennai were started in 1908 and the Delhi Stock Exchange in 1947. There are 23 stock exchanges in India. Some are public limited companies (15), while others are limited by guarantees (5) or are voluntary non-profit making organisations.

In the period of 1994-1995 the number of stock exchanges has gone up from 7 to 22 (In March 2000, the number of stock exchanges increased to 23 with the formation of Inter Connected Stock Exchanges of India Ltd. {ICSEL}), the number of listed companies from 1125 to 9477, the market value of listed companies from ₹ 971 crore to ₹ 6,39,575 crore.

11.1.1 Management of Stock Exchange

The Stock Exchange is managed by a governing body which consists of a President, a Vice-President, Executive Director, Elected Directors, Public Representatives and Nominees of the Government. The executive functions are discharged by the Executive Director or Secretary.

Regulation of Stock Exchange: The Union Government enacted the Securities Contract (Regulation) Act in 1956 (SCR Act) for the regulation of stock exchanges and contracts in securities traded on the Stock Exchanges. The SCR Act and the Securities Contracts (Regulation) Rules (1957) constitute the legal framework for the regulation of Stock Exchanges and protection of the interest of investors.

The Securities and Exchange Board of India Act, 1992 provides for the establishment of the Securities and Exchange Board of India (SEBI) to protect the interest of securities and to promote the development of and to regulate the securities market.

Definition: Under the SCR Act, an Exchange is defined as body of individuals, whether incorporated or not, constituted for the purpose of assisting, regulating or controlling the business of buying, selling or dealing in securities. The SCR says that a Stock Exchange must be recognised by Government.

According to this Act, securities includes (i) Shares, scrips, stocks, bonds, debentures, or other marketable securities of a like nature in or of any incorporated company or body corporate; (ii) Government securities; such other instruments as may be declared by the central government, and (iii) right or interest in securities.

Stock Exchange is regarded as "an essential concomitant of the capitalistic system of economy". It is indispensable for the proper functioning of corporate enterprise. It brings together large amounts of capital necessary for the economic progress of a country. It is citadel of capital and the pivot of money market.

It provides necessary mobility to capital and directs the flow of capital into profitable and successful enterprise. It is the barometer of general economic progress in a country and exerts a

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powerful and significant influence as a depressant or stimulant of business activity. It may be defined as the place or market where securities of joint stock companies and of Government or semi government bodies are dealt in.

11.1.2 Major Stock Exchanges of India

Bombay Stock Exchange

Bombay Stock Exchange is one of the oldest Stock Exchanges of India and Asia. It is also one of the biggest Stock Exchanges of the world. It is said to be the nerve of Indian economy which tells the health of economy. Bombay Stock Exchange had a turnover of ₹ 6,8,028 crore and a market capitalisation of ₹ 9,12,842 crores in 1999-2000. Its business is no more confined to Mumbai alone; in March 2000 it has 275 cities covered by BOLT network and an increase in the number of Trader Work Station to 3803. Its daily turnover had increased from ₹ 11 crore in 1979-80 to ₹ 4587 crore in 2000-01.

It was established in 1857 and at that time its membership fee was just ₹ 1, it increased to ₹ 5 in 1877, ₹ 1000 in 1896, ₹ 2,500 in 1916, ₹ 6,600 in 1929 , ₹ 62,000 during post World War II period. The membership was later changed into 'Card Value'. It was around ₹ 1 crores towards the end of 1998 that shot up to ₹ 2.80 crore in 2000. The highest price at which membership has been sold was in 1996 when the card was sold for over 4 crore.

BSE introduced Bombay On-Line Trading (BOLT) System on January 19, 1995. It provides a quote-driven automated trading facility with an order book functioning as an auxiliary jobber. The process of transferring the equity scrips listed on the BSI from trading in the ring to the BOLT system was completed on 3 July, 1995. The BSE began Debt trading also on the BOLT system from June 26, 1995 in respect of 60 actively traded debentures.

National Stock Exchange

The NSE was incorporated in November 1992 with an equity capital of ₹ 25 crores. It is sponsored by IDBI and co-sponsored by other term – lending institutions, LIC, GIC, other insurance companies, banks and financial institutions viz., SBI Capital Market Ltd. Infrastructure Leasing and Financial Services Ltd. (ILFS) and Stock Holding Corporations Ltd. (SHCL) and the International Securities Consultancy (ISC) of Hong Kong has helped in setting up of NSE. It has a fully automated, electronic, screen-based trading system as it has overcome geographical barrier. The market capitalisation of NSE was ₹ 10,20,426 crores on 1st March, 2000. The objectives of NSE are:

1. To provide fair, efficient and transparent nationwide trading facility for equities, debt instrument and hybrids.
2. To provide access to investors all over the country through an appropriate communication network.
3. To enable shorter settlement cycles and book entry settlement systems.
4. To bring the Indian stock market in line with international markets.
5. To promote the secondary market in debt instruments such as government and corporate bonds.

NSE has an order driven market and it allows members to trade through their office and through communication network. NSE is the first exchange in India to introduce market system of margin which reduced the risk of default by members.

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Over the Counter Exchange of India (OTCEI)

The OTCEI is primarily meant for small size companies and small investors. This exchange has the advantages of transparency, fast settlements and potential to reach the nooks and corners of the country.

Did u know? OTCEI was modelled on National Association of Securities Dealers Automated Quotation System (NASDAQ) in the USA where all off-exchange trading was referred to as Over the Counter (OTC) Market.

OTCEI is incorporated as a company in 1990 under the Companies Act. It became operational in 1992 and was the first stock exchange in India to introduce screen based automated ring less trading system. It is promoted by UTI, ICICI, IDBI, IFCI, LIC, GIC, SBI Caps, and CANBANK as a company under section 25 of the Companies Act 1956, with headquarters at Mumbai. Its objectives are: (a) to help companies to raise capital from the market at the cheapest costs and on optimal terms; (b) to help investors to access capital market safely and conveniently; (c) to cater to the needs of the companies which cannot be listed on other official exchange; (d) to eliminate the problems of illiquid securities, delayed settlements, and unfair prices faced by the investors.

Notes Apart from above stock exchanges there are other national and regional stock exchanges at following places:

1.	Ahemdabad	2.	Bangalore
3.	Bhubaneshwar	4.	Kolkata
5.	Cochin	6.	Coimbatore
7.	Delhi	8.	Guwahati
9.	Hyderabad	10.	Jaipur
11.	Ludhiana	12.	Madhya Pradesh
13.	Chennai	14.	Magadh
15.	Mangalore	16.	Saurashtra Kutch
17.	Uttar Pradesh	18.	Vadodara
19.	Pune		

Caselet

The Rise and Fall of the Indian Stock Market

With the help of Indian stock market updates, one comes to know the fact that the stock prices of various companies have got down. According to the recent updates, the software companies which had shown great promises of growth are now not doing well. The prices of these software companies have reduced, but people need not worry about this, because the IT specialists say that the situation will improve very soon.

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According to the Indian stock market updates, the real estate sector is also suffering a lot. It is not attracting the buyers and the prices of real estate companies have got down. Those who are into real estate business believe that **the** condition has started improving and in times to come, this sector can register a huge growth. Till then, people need to keep patience. Apart from this, the situation of export is not good these days. Earlier, the export sector was generating lots of foreign money and thereby contributing to the growth of Indian economy. Market researchers believe that export will pick up very soon and once again add to the growth of the country.

The NSE & BSE sensex news further shocks people by giving updates regarding the stock prices of companies working in the financial and insurance sector. These companies are quite down. The obvious reason behind this is that the financial products like mutual funds, equity shares, insurance policies are not attracting the buyers these days. This is why, the market share of these companies has come down. According to the opinions of the financial analysts, the financial sector has still a huge potential and it will stabilise in the near future and the share market of India will boom. So, the investors need not to worry about their money, it will multiply very soon.

Quit shockingly, the prices of certain commodities have reduced. Those who read NSE & BSE sensex news must be knowing the downfall in the prices of gold and silver. Those who have invested in these commodities should have a sigh of relief because the prices of gold and silver are picking up these days. All these improvements in the commodity market will enable the investors to mint huge money.

On January 21, 2008, the BSE sensex saw the highest downfall that caused the loss of 1408 point. After that, it recovered and closed at 17,605.40, but it again tumbled to 16,963.96. So, it can be said that in 2008, the sensex has faced lots of jolts. The simple reason of it was the non-performance of various sectors. According to the Times of India, the highest sensex gain in the history Indian stock was on March 24, 1992, during the hey days of Harshad Mehta.

Though, the Indian stock exchange is facing lots of downfalls these days, the investors need not to worry, as different sectors have started picking up.

Source: EzineArticles.com

11.2 Origin of SEBI

A major development in the Indian Stock market took place in 1988 when Securities and Exchange Board of India (SEBI) was established through an administrative order, on the lines of the Securities and Investment Board of the U.K. But it became really powerful organisation in 1992 when CICA was repealed and the office of Controller of Capital Issues was abolished. The Securities and Exchange Board Act of 1992, provides for the establishment of a Board to protect the interest of investors and to promote the development and regulation of securities market. The Board of SEBI consists of six members comprising the chairman, two members from amongst the officials of the ministries of the central government dealing with finance and law, two members who are professional and have expertise or special knowledge relating to securities market, and one member for the RBI.

SEBI is entrusted with following functions (objectives):

(i) Regulating the business in stock exchange and any other securities market;

(ii) Registering and regulating the working of stock brokers, sub-brokers, share transfer agents, bankers to an issue, merchant bankers, underwriters, portfolio managers, investment

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advisers and such other intermediaries who may be associated with securities market in any manner;

(iii) Registering and regulating the working of collective investment schemes including mutual funds;

(iv) Promoting and regulating self-regulatory organisation;

(v) Prohibiting fraudulent and unfair trade practices relating to securities market;

(vi) Promoting investors' education and training of intermediaries of securities market;

(vii) Prohibiting insider trading in securities;

(viii) Regulating substantial acquisition of shares and take-overs and mergers of companies;

(ix) Calling for information from, undertaking inspection, conducting inquiries and audits of the stock exchange and intermediaries and self-regulatory organisation in the securities market;

(x) Levying fees or other charges for carrying out the above purposes.

SEBI has five operational departments, besides which, it has two more departments – the legal department and the investigation department. More about these departments is as follows:

The Primary Market Policy, Intermediaries, Self-Regulatory Organisations (SROs), and Investor Grievances and Guidance Department: It looks after all policy matters and regulatory issues in respect of primary market, registration, merchant bankers, portfolio management services, investment advisers, debentures trustees, underwriters, SROs and investor grievances, guidance, education and association.

The Issue Management and Intermediaries Department: It is responsible for vetting of all prospectuses and letters of offer for public and right issues, for coordinating with the primary market policy, for registration, regulation and monitoring of issue-related intermediaries.

The Secondary Market Policy, Operation and Exchange Administration, New Investment Products and Insider Trading Department: It is responsible for all policy and regulatory issues of secondary market and new investment products, registration and monitoring of members of stock exchanges, administration of some of the stock exchanges, market surveillance and monitoring of price movements and insider trading, and EDP and SEBIs data base.

The Secondary Market Exchange Administration, Inspection and Non-member Intermediaries Department: It looks after the smaller stock exchanges of Guwahati, Indore, Mangalore, etc. It is also responsible for inspection of all stock exchanges, registration, regulation and monitoring or non-member intermediaries such as sub-brokers.

Institutional Investment, Mergers and Acquisition, Research and Publication, and International Relations and IOSCO Department: It looks after policy, registration and monitoring of Foreign Institutional Investors (FIIs), domestic mutual funds, merger and substantial acquisition of shares, and IOSCO (International Organisation of Securities Commissions) membership, and research, publication and Annual Report of SEBI.

Legal Department: This department looks after all legal matters under the supervision of the General Counsel.

Investigation Department: This department carries out inspection and investigation under the supervision of the Chief of Investigation.

SEBI has its regional offices at Kolkata, Chennai, and Delhi. SEBI has also formed two non-statutory advisory committees, the Primary Market Advisory Committee and Secondary Market

Notes

Advisory Committee with the members from market player, recognised investors associates and other eminent persons. SEBI is also a member of International Organisation of Securities Commissions (IOSCO).

Task Prepare a report on the performance of SEBI since its inception.

11.3 Powers and Scope of SEBI

Functional area of SEBI is very wide, it is the rule maker, custodian, and watch dog of the security market. In brief, it has the power to regulate: (i) depositors and participants, (ii) custodians, (iii) debentures trustees and trust deeds, (iv) FIIs (v) inside traders, (vi) mutual fund, (vii) portfolio manager, (viii) investment advisers, (ix) merchant bankers, (x) registrars to issue and share transfer agents, (xi) stock brokers and sub-brokers, (xii) underwriters, (xiii) venture capital funds, and (xiv) bankers to issue.

The SEBI can issue guidelines in respect of following matters:

1. Information disclosure
2. Operational transparency
3. Investor protection
4. Development of financial institutions
5. Priding of issues
6. Bonus issues
7. Preferential issues
8. Financial instruments
9. Firm allotment and transfer of shares among promoters.

SEBI is empowered to register any agency or intermediary who may be associated with the securities market, except under and in accordance with the conditions of a certificate of registration issued by the SEBI.

Caution After the suspension of CICA (Capital Issues Control Act) 1947, SEBI is now authorised to govern all the matter related to issue of capital. SCRA also authorises the SEBI to conduct inquiries into the working of the stock exchange. They are required to submit their annual reports to the SEBI and require the approval of SEBI for amending their rules and bye-laws; SEBI can direct them to amend their bye-laws and rules including reconstitution of their governing boards/councils; and it is empowered to license security dealers operating outside their jurisdiction.

SEBI has been empowered to demand explanation, to summon the attendance and call for documents from all categories of market intermediaries in order to enable it to investigate irregularities, impose penalties, and initiate prosecution. The SEBI is also empowered to notify its regulations and file complaints in courts without the prior approval of the GOI.

Notes

11.4 Certain Guidelines and Reforms introduced by SEBI

11.4.1 Primary Securities Market

1. The issue of capital no longer requires any consent from any authority for making issue and for pricing it.
2. SEBI raised the standards of disclosure in public issues and enhanced the transparency.
3. The offer document is now made public even at the draft stage.
4. Companies without track record making first issue can price the issue at par only. At the first issue companies are free to price its securities, provided it has shown net profits in the immediately preceding 3 years, subject to its existing disclosure requirements.
5. Companies with 3 years track record or companies without track record, but promoted by companies with five years track record, are free to price the issues. They can list the shares on a stock exchange.
6. Not less than 20% of equity (issued) should be offered to public.
7. For issues above 100 crore, book building requirement has been introduced.
8. The pricing of preferential allotment scheme, a minimum of 50% of the net offer to the public is to be reserved for individual investors applying for securities not exceeding 1000 securities, and the remaining part can be allotted to applications for more than 1000 securities.
9. Draft prospectus will be vetted by the SEBI to ensure adequacy of disclosure.
10. Bankers to an issue and portfolio managers have to be registered with the SEBI.
11. Existing listed companies are allowed to raise fresh capital by freely pricing their further issues. However, price should be determined in consultation with the lead managers to the issues. The high and low prices for the last two years should be indicated in the offer document. The draft proposal will be vetted by SEBI to ensure adequacy of disclosure.

11.4.2 Secondary Market and Various Intermediaries

1. The governing body and various committees of Stock Exchanges (SEs) have been recognised, restructured and broad based.
2. Inspection of all 22 SEs has been carried out to determine, *inter alia*, the extent of compliance with the directives of the SEBI.
3. Corporate membership of SE is now allowed, encouraged, and preferred. The Articles of Association of SEs have been amended so as to increase their membership.
4. All the SEs have been asked to establish either a clearing house or a clearing corporation.
5. The BSE have been asked to reduce trading period or settlement cycle from 14 to 7 days for B groups shares.
6. All the recommendations of the Dave committees for improving the working of the OTCEI have been accepted.
7. In accordance with the recommendations of G.S. Patel Committee, BSE has been allowed to introduce a revised carry forward system (CFS) of trading. Other SEs can introduce forward trading only with the prior permission of the SEBI.

Notes

8. Brokers are required to segregate the client and its own account.
9. The capital adequacy norms is 3% for individual brokers and 6% for corporate brokers introduced.
10. Both the Brokers and the Sub-brokers have been brought within the regulatory fold for the first time now; and the concept of the dual registration of stock brokers with the SEBI and the SEs has been introduced.
11. Panel action can now be taken directly by the SEBI against any member of a stock exchange for violation of any provision of the SEBI Act.
12. It has been mandatory for stock brokers to disclose the transaction price and brokerage separately in the contract notes issued by them to their clients.
13. Compulsory audit of the brokers' books and filling of the audit reports with the SEBI has now been made mandatory.
14. Insider trading has been prohibited and such trading has been made a criminal offence punishable in accordance with the provision of SEBI.

11.4.3 Investment Protection Measures

The SEBI has introduced an automated complaints handling system to deal with investors' complaints. For this SEBI issues fortnightly press releases, disclosing names to the companies against whom maximum number of complaints have been received. A representative of SEBI supervises the allotment of share process. Besides many other measures it also issues advertisements frequently to make investor aware of various issues to the securities market and of their rights and remedies.

Classification of Complaints: The complaints received by the SEBI are categorised in five types:

Type I: Non-receipts of refund orders/allotment letters/stock investment.

Type II: Non-receipt of dividend.

Type III: Non-receipt of share certificates/bonus shares.

Type IV: Non-receipt of debentures certificate/interest on debentures/redemption amount of debentures/interest on delayed payment of interest.

Type V: Non-receipt of annual reports, right issue forms/interest on delayed receipt of refund orders/dividends.

11.4.4 Insider Trading

Insider trading in securities is prohibited by SEBI under Insider Trading Regulations 1992. Insider trading can be defined as the sale or purchase of securities by persons who possess price sensitive information about the company, on account of their fiduciary capacity involving confidence or trust. SEBI Insider Regulations 1992 defines the insider as any person who is or was connected with company and who is reasonably expected to have access by virtue of such connection to unpublished price sensitive information with respect to the securities of the company, or who has received or has had access to such unpublished price sensitive information. Broadly insider can be of two types: (a) Primary Insider e.g. Directors, stock exchanges, merchant bankers, registrars, brokers of the company, top executives, auditors, banks etc. (b) Secondary insider e.g. dealers, agents, other employees, etc. (c) others having access to price sensitive information due to their proximity with the company.

Notes

The SEBI Insider Regulations, 1992 prohibits the insider trading and lays down that no insider should:

(i) either on his own behalf or on behalf of any other person, deal in securities of a company listed on any stock exchange on the basis of any unpublished price sensitive information; or

(ii) communicate any unpublished price sensitive information to any person, with or without his or her request for such information except as required in the ordinary course of business or under any law; or

(iii) counsel or procure any other person to deal in securities of any company on the basis of unpublished price sensitive information.

11.4.5 Underwriting

Underwriter makes a commitment to get the underwritten issue subscribed either by others or by themselves. They agree to take unsubscribe portion of the issue. They render this service for a commission agreed upon between the issuing company and the underwriter subject to the ceiling under the Companies Act.

Underwriter services are available from brokers, investment, companies, commercial banks and term lending institutions. Only such person (an individual, firm or a company) who has obtained certificate of registration from SEBI, can act as underwriter. Merchant bankers and stock brokers already having a valid certificate from SEBI for working as underwriters.

Task

Prepare an assignment on the functions and powers of SEBI in case of any Merger and Acquisition of listed companies.

Case Study

Amendments of Group Headed by Mr. M H Kania: Investor Protection Fund

SEBI has been created inter alia for the purpose of protecting the interests of investors in securities. The investor education is more relevant in the context of complexities involved in various options and instruments of investments available in the securities market. Retail investors are not in a position to identify and /or appreciate the risk factors associated with certain scrips or schemes. With the result they are not able to make informed investment decisions.

Since development of securities market largely depends upon proper education of investors, SEBI is committed to spread awareness amongst them.

The Joint Parliamentary Report (JPC) on securities scam of 2001 had recommended that in order to enable SEBI to undertake investor education and awareness campaign effectively, the investor education and protection fund established under section 205C of the Companies Act and investor education resources of RBI should be shifted to SEBI and a joint campaign for investor education and aware ness under the leadership of SEBI must be undertaken.

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The Group noted that majority of the stakeholders have agreed for the setting up of a separate investor protection fund under the SEBI Act. It is also suggested by the stakeholders that the said fund should be utilised exclusively for the purpose of investor education, conducting awareness programme and for protecting the interest of investors.

The Group also noted that the proposed Investor Protection Fund is for the purpose of achieving the objective of Investor Education and awareness.

In terms of section 55A of the Companies Act, SEBI is required to administer the provisions of sections specified in section 55A in respect of issue of capital, transfer of securities and non-payment of dividend in case of listed companies and the companies which intend to get their securities listed on the stock exchange. Further, SEBI is required to protect the interest of investors and enforce redressal of grievances of investors by listed companies. In the light of the above provisions, the Group also discussed the proposition regarding payment of compensation to investors for the purpose of investor protection. In this regard, the Group also deliberated on the suggestion for setting up of a Fund on the lines of Fair Fund established under the Sarbanes Oxley Act, 2002 of United States which is used for compensating the investors out of the penalties received. Another view was expressed during deliberations that the investors in the equity market invest in risk capital and no assured return or compensation for non fulfillment of every expectation may be provided in the statute. However, compensation in respect of fraud or misrepresentations or misstatements by companies or intermediaries may be considered.

Further the Group noted that the Pension Fund Regulatory and Development Authority, Ordinance, 2004 which mandated the Pension Fund Regulatory and Development Authority (PFRDA) to protect the interest of subscribers to the schemes of pension funds has permitted PFRDA to set up the Subscriber Education and Protection Fund. The said Ordinance also specifies the monies which should be credited to the said Subscriber Education and Protection Fund. The said Ordinance also provides that all sums realised by way of penalties by PFRDA under the Ordinance shall be credited to the Subscriber Education and Protection Fund. The Group felt that to achieve the objective of investor protection by investor education and investor awareness, a separate fund under the SEBI Act on the lines of Subscriber Education and Protection Fund under PFRDA Ordinance 2004 to be administered by SEBI may be set up and administered by SEBI for investor education and awareness. Further, the compensation to small investors in respect of fraud or misrepresentations or misstatements by companies or intermediaries may be considered as a matter of investor protection out of the said Investor Protection Fund. In this regard it is felt desirable that SEBI may specify guidelines and parameters for administration of the Investor Protection Fund the for the purpose of Investor Education and Awareness and payment of compensation to small investors. In this regard, the guidelines issued by SEBI in respect of Investor Protection Fund of stock exchanges may be adopted with necessary changes.

As regards the monies to be credited to the said Investor Protection Fund, the Group took into consideration the representation of the National Stock Exchange that the big stock exchanges are utilising the monies for the purpose suitably. The Group also noted that the monies lying with the IPF of small stock exchanges are not being utilised to the full satisfaction. It is considered that the monies lying unutilised for substantial period in the Investor Protection Fund of the stock exchanges should be transferred to the proposed Investor Protection Fund.

The unclaimed dividend and interest lying with the mutual fund and Collective Investment Schemes or venture capital funds and the unclaimed monies or securities of the clients

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lying with the intermediaries for a period of 7 years should be used in a purposeful manner.

Further, all sums realised by way of penalties imposed by the Adjudicating Officer under Chapter VIA of the SEBI Act, should be credited to the proposed Investor Protection Fund.

Recommendation of the Group

The Group recommends that –

A separate Investor Protection Fund under the SEBI Act, on the lines of Subscriber Education and Protection Fund under PFRDA Ordinance 2004 may be established for the purpose of investor education and awareness and for compensation to the small investors in respect of fraud or misrepresentations or misstatements by companies or intermediaries.

The said fund be administered by SEBI to protect the investors and take measures for investor education and awareness and for compensation to the small investors in accordance with the established guidelines or parameters specified by SEBI on the lines of the guidelines in respect of stock exchanges. There shall be credited to the said fund the following amounts, namely

1. Unclaimed dividend or interest under any mutual fund or Collective Investment Scheme (CIS) or venture -capital fund scheme for more than 7 years;
2. any unclaimed money or securities of a client lying with an intermediary in securities market for more than 7 years;
3. monies lying unutilised in the Investor Protection Funds of the stock exchanges;
4. all sums realised by way of monetary penalty under Chapter VIA of SEBI Act.

Question

Do you agree with the recommendations of the group? Why or why not?

Source: Excerpts from report of expert group headed by Mr. Justice M. H Kania (former Chief Justice of India) for suggesting amendments to Securities and Exchange Board of India Act, 1992

11.5 Summary

- SEBI, established in 1988 and became a fully autonomous body by the year 1992 with defined responsibilities to cover both development & regulation of the market.
- A Board by the name of the Securities and Exchange Board of India (SEBI) was constituted under the SEBI Act to amminister its provisions in 1992 with one chairman and five members.
- SEBI has to be responsive to the needs of three groups, which constitute the market, viz., the issuers of securities, the investors and the market intermediaries.
- SEBI has three functions rolled into one body quasi-legislative, quasi-judicial and quasi-executive.
- It drafts regulations in its legislative capacity, it conducts investigation and enforcement action in its executive function and it passes rulings and orders in its judicial capacity.
- Though this makes it very powerful, there is an appeals process to create accountability.
- There is a Securities Appellate Tribunal which is a three member tribunal.

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- A second appeal lies directly to the Supreme Court.
- SEBI has enjoyed success as a regulator by pushing systemic reforms aggressively and successively.
- SEBI has been active in setting up the regulations as required under law.

11.6 Keywords

Bear: Bear is a seller of securities.

Bull: A bull is a buyer in the stock market.

Insider Trading: Insider trading can be defined as the sale or purchase of securities by persons who possess price sensitive information about the company.

Stock exchange: An exchange on which shares of stock and common stock equivalents are bought and sold.

Underwriter: Underwriter makes a commitment to get the underwritten issue subscribed either by others or by themselves.

Utilitarianism: Ethics concept in which the happiness of the greatest number of people in the society is considered the greatest good.

11.7 Self Assessment

Fill in the blanks:

1. …… is one of the oldest stock exchanges in India and its market indicator is Sensex.
2. The two national level stock exchanges in India are ..... and ..... of India.
3. ..... is mutually-owned by a set of leading financial institutions, banks, insurance companies and other financial intermediaries in India.
4. SEBI is the ..... for the Securities Market in India.
5. …….provides a quote-driven automated trading facility with an order book functioning as an auxiliary jobber.
6. OCTEI was modelled on ……
7. The Board of SEBI consists of……members.
8. Insider trading in securities is prohibited by SEBI under …….
9. …… agree to take unsubscribe portion of the shares issue.
10. In general, the index of the utilitarian principle is ……

11.8 Review Questions

1. Explain the rationale behind establishment of SEBI.
2. Has SEBI succeeded so far in being the regulator of securities market?
3. Evaluate the condition of the capital market in India.

Notes

4. Is it necessary for India to have a separate Securities and Exchange board of India? If yes, then why?
5. Has SEBI got any role to play in corporate governance? If yes, then what?
6. "Stock trading is a boon as well as bane." Discuss.
7. How do you think the scams in Indian Stock market could have been done away with?
8. Assess the role of underwriters.
9. SEBI prohibits insider trading. What is your take on it?
10. How has the trading scenario changed since the establishment of SEBI?

Answers: Self Assessment

1. BSE
2. Bombay Stock Exchange, National Stock Exchange
3. NSE
4. regulator
5. Bombay On Line Trading
6. NASDAQ
7. 6
8. Insider Trading Regulations, 1992
9. Underwriter
10. Per capita income

11.9 Further Readings

Books

Dutt and Sundaram, *Indian Economy*, S.Chand, New Delhi, 2007

Francis Cherunilam, *Business Environment*, Himalaya Publishing House

Mittal Vivek, *Business Environment*, Excel Books, 2007

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Unit 12: Government in Transition Economies (including IRDA, AMFI and Commodity Exchange)

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12.1 Role of Government in Developing and Transition Economies

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12.9 Further Readings

Objectives

After studying this unit, you will be able to:

- Identify the role of government in developing and transition economies
- Know about IRDA, AMFI and commodity exchange

Introduction

While consumers and producers make most decisions that mould the economy, government activities have a powerful effect on transition economies. Perhaps most importantly, the government guides the overall pace of economic activity, attempting to maintain steady growth, high levels of employment, and price stability. By adjusting spending and tax rates (fiscal policy) or managing the money supply and controlling the use of credit (monetary policy), it can slow down or speed up the economy's rate of growth -- in the process, affecting the level of prices and employment.

We are also going to cover in this unit details about institutions like Insurance Regulation and Development Authority (IRDA), Association of Mutual Funds in India (IMFA) and Commodity Exchange.

12.1 Role of Government in Developing and Transition Economies

Notes

You must have seen how the slightest change in government policy can change the whole scenario of business. Governments have a major role to play in the economy. It play the following roles:

1. ***Regulatory Role:*** Governments regulate the business. They not only decide the rules of the game but also look after the implementation of those rules.

   (a) *Reservation:* The govt. limits the spheres of investment by reserving the industry for small scale, public and the co-operative sector. For instance, before liberalisation, petroleum, telecommunication, coal, power, etc., were the monopoly of the public sector. But liberalisation brought new investment opportunities for the private sector. Now only two sectors, i.e., railways and atomic energy are reserved for the public sector.

Example: Many industries are still reserved for the small scale sector. Because of this policy we have seen a boom in many industries over the last fifteen years. As of now, along with telecom services, Reliance has established one of the largest grassroots refineries of the world. Other big telecom players like Bharti Telecom and TATA have also invested heavily in telecommunication.

New power projects have been established by the private sector.

Example: Aviation is no more a government monopoly as dozen of private players as Sahara Airlines, Kingfisher Airlines, SpiceJet, Air Deccan have entered this field. Hosts of new players have entered the finance sector, especially the insurance , with business houses like TATAs, AVBirla, Bajaj, ICICI, etc., making the most of new opportunities.

   (b) *Licensing:* Licensing is an effective tool in the hands of the government to regulate business. Earlier, for almost every new venture a licence was required from the government, which used to keep a tight control on production in the private sector. But now only investment in a few industries requires licences. Though in some cases industry may have to acquire license from other authorities like pollution control, ISI, Ministry of Environment & Forests, Food % Drug Administration, etc.

   (c) *Expansion:* The govt. can both provide business house, the opportunity to expand as well as restrict their expansion activities. Earlier, through the MRTP Act the government restricted the expansion of big houses, besides which various restrictions were imposed on increasing production capacity or launching new variants. Restriction existed even on the advertisement budget of big business houses or on their investments abroad.

Did u know? This is the prime reason that we were still driving the same car in 1980 which we drove in 1950; even as late as 1990, we had just one new option in the form of the Maruti car. But when this restriction was repealed the whole equation of business underwent a change. Ranbaxys, AV Birla, Dr. Reddys Lab, ONGC, L&T are now multinational companies, Asian Paints has operations in 28 nations of the world. Indian companies have achieved amendable economies of scale and consumers have a wider choice available from big product portfolios of companies. But even now the expansion of many companies continues to remain at is on the mercy of the government.

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(d) *Foreign Direct Investment:* It is the government that decides whether MNCs can invest in a country or not. Because of these government policies there are very few MNCs in India. Even companies like IBM and Coca Cola had to leave India in the past because of government policies. Today MNCs are in present in sectors like insurance, petroleum, banks and publication, but are they are still not present in the retail sector as the government doesn't allow foreign participation in the retail sector.

(e) *Import and Export Policy:* With a small declaration the government can open and close various avenues for export and import. As a matter of policy the government can use various tools to impose restrictions on import such as quota, tariffs, cumbersome import process, import licenses, etc. Till 1991 India followed a protectionist policy to keep the industry from imports that were deemed harmful. But now the policy has been amended and imports are easy. Due to this, the Indian toy industry was very badly affected and many had to shut down operations. Thus it is the government which decides what can be imported or exported and what cannot.

(f) *Taxes:* Through taxes to the government regulates industry. The Government usually imposes a high rate of tax on the industry which it doesn't want to encourage.

Example: After independence a very high excise was imposed on products like air conditioners, automobiles, etc., whereas there was virtually no tax on production of products reserved for the small scale industry. Also, to increase the use of certain products, the government provides subsidy on items such as fertilizers, tractors and other farm equipment. The government also tries to influence the location of the industry by permitting tax breaks for establishing industry in a particular region.

(g) *Supply of Money:* Demand depends upon the purchasing power of the consumer which, in turn, depends upon supply of money and the supply of money is decided by the government (RBI). There are many ways through which the government regulates the supply of money. The RBI can increase the supply of money in the market by decreasing the CRR, SLR etc. which reduced the interest rate in the market. In the last 15 years interest rates have fallen drastically, which has lent more purchasing power to the consumer. This has boosted the consumer goods industry and the housing industry as well as. The government can also increase or decrease the supply of money by increasing or decreasing income tax rate and interest rate on savings. So any industry is to an extent dependent on the government for enhancing demand.

(h) *Supply of Foreign Exchange (FOREX):* The government not only regulates import and export through its policy decisions, but also controls it through control of the supply of foreign exchange. Before liberalisation, it was the government which used to decide the exchange rate. To restrict import it restricts the supply of FOREX whereas to boost export and discourage import, it devaluates the currency. Even after liberalisation, when the Rupee was convertible, the RBI controlled supply and exchange rate through open market operations. Besides all these, the government regulates business through administrative and physical controls. So we see that the government regulates almost every aspect of business. It provides the opportunity to invest and simultaneously restricts investment in particular area.

(i) *Incentives:* The government also regulates the industry by providing incentives in the key thrust areas. For instance, it gives tax breaks if an industrial unit is established in a backward area. It also grants subsidies under various schemes to the small scale sector. To support export, it establishes special zones like SEZs, it grants subsidies and tax relaxations on exports, import licenses and less import duty for exporters,

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and easy financing through banks. To support a particular industry in the national interest. It also directs financial institutions to give liberal loans to that sector at easy terms. To provide a boost to the housing industry, the government has given exemption to housing loans from income tax.

2. ***Legal Role:*** The Parliament is the law making authority and it is the council of ministers that presents the proposed law on the table of parliament. It is the government which decides and implements the legal structure of the country. A new law was enacted which stipulated that a Non- Resident Indian could not acquire any stake in an Indian company beyond a certain limit.

   The government has enacted many laws to regulate industry. As in the case of IDRA, the MRTP Act was amended to the Competition Act to ensure fair competition among organisations. The Essential Commodities Act, the Environment Act, the Companies Act, the SEBI Act, the Consumer Protection Act, Labour Laws have been enacted protect human resource from exploitation. While doing business, enterprises have to abide by the law. This not only ensures healthy competition but it also gives companies a level playing field. It is the law which protects the intellectual capital of an organisation. Business flourishes only in states which have is a healthy legal system.

3. ***Infrastructure Development:*** In developing nations the growth of infrastructure is imperative and the government plays a critical role in this. It is said that take care of roads and electricity and development and employment generation will take care of itself. Well-established infrastructure is the basic requirement for the establishment and growth of industry. In a developing nation where infrastructure is in a poor state, the government has to take steps to develop the same, i.e. is construction of roads, development of railways, supply of power, transport, finance sector, training and guidance, research and development, etc.

   Since independence, the state in India has invested heavily on infrastructure. Now under the new regime even the private sector is playing a critical role in developing infrastructure. In the budget of 2005-06, provision of SPV (special purpose vehicle) has been made for the development of infrastructure.

4. ***Human Resource Development:*** Today, it is not the raw material or geographical proximity to the market which decides the location of a unit, but the availability of human resources which now days play a decisive role in settling down on the location of any establishment. Today ,when research, new product development, economies of scale, low production cost are the mantra to success, trained and skilled human resource have become the critical success factors for every industry.

   But in developing nations like India, the state plays a critical role in developing human resources as at the time of independence, the private sector was not in a position to invest in higher and technical education. Unlike developed nations, the masses of India were and still are not in a position to afford higher technical education. This is the reason that the state invested heavily in higher technical education established premier education like IITs, IIMs, IVRIs, AIMS, BHU and other universities.

   Dr. Manmohan Singh, the Prime Minister of India announced an investment of ₹ 100 crore in a university in Bangalore to develop it as research house in science. Not only this, thanks to Nehru India retained English as a medium of instruction in education. Because of these efforts of the State, India is justifiably proud of its human resources. Today many businesses such as BPO, software, electronics, are flourishing in India because of its human resources and India is becoming a manufacturing hub for mobile phones, pharmaceuticals, fundamental research etc. Technical and knowledge Level of HR is also a critical input for the industry and the State plays a vital role in influencing and deciding this.

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5. ***Entrepreneurial Role:*** The State also plays the role of an entrepreneur by investing in business. The govt. of India has been one of the biggest investors in business and industry since Independence. Through its investment, the government considerably influences the business environment. In India after independence the government reserved some industries for only the Public Sector where the private sector cannot invest. But the government has invested in other areas, which were not reserved for the private sector. In a developing nation, investment by the government helps the private sector a lot.

   After independence the Indian Government heavily invested in capital intensive industry where gestation period is high and private entrepreneurs are not interested-such as Steel (SAIL), Aluminum (Indal), Railways, Power (NTPC,), Heavy Machines, Earth Moving Machines, Heavy Electrical Machinery (BHEL), Petroleum, Telecommunication etc. All these investments promoted the private industry by making available raw material and machines.

   Investment by the government also changed the competitive environment as it became a competitor to the private sector in alluring the consumer.

Example: Its investment in the Automobile sector (MUL) changed the whole competitive environment of the automobile industry of India. The government also invested in soft drinks and launched the brand 'Double Seven', in Consumer Electronics (Jolly, Uptron), Two Wheelers (Scooter India), Cosmetic Soaps, Bakery Products, Milk Products, Distribution network, etc. Though the new industry policy is not in favour of any further investment, it follows a policy of disinvestment and privatisation. But in total, in the past fifty years the government has played a critical role in deciding the business environment of the country.

6. ***Planning Role:*** State is an architect of the industrial scenario in a country. It is truer for a country like India where the state also performs the task of a planner. India has followed a policy of five year planning system. It is the planning commission which plans the direction of investment for the following five years. This significantly influences the business environment. The planning commission declares the key areas where the state is going to invest and support in the coming five years. All this even influences the investment decision of the private sector, as they get support from the government when they invest in a priority sector.

So we see that the State/government play a vital role in deciding and influencing business environment and therefore the economy. It in fact makes the rule of the game and also acts as an umpire and referee. Besides all this, the political stability of a country also plays a critical role in generating a conducive environment for business. Today, India is attracting foreign investment only because most of the political parties have a consensus on foreign investment except some issues like foreign investment in retail or more than 50% investment in the print media. Even political parties like CPI/M are trying hard to attract foreign investment in states ruled by them.

Whatever the degree of political differences, chief ministers of practically all states are promoting foreign investments. Recently, Orissa chief Minister Biju Patnaik signed a pact with Korean steel major Pasco according to which Pasco will invest more than ₹ .50,000 crore in a steel plant in Orissa. Recent visits of foreign diplomats to India's IT hub Bangalore shows increasing confidence of foreigners in the Indian political system. Hence, political stability itself is a very positive statement for the industry.

According to utilitarianism, the role of government in developing and transition economies is to maximise utility of the largest number of people. A widely, though not universally accepted, index of the utilitarian principle is per capita income. As a consequence, gross or net national (or domestic) product or income directly or indirectly plays a role as measures of utility. In general, the system of national accounts has especially micro but also macro utilitarian foundations. Stagnant or falling utility due to stagnant or falling per capita income and productivity in

centrally planned as well as underdeveloped countries has nourished freedom- linked versions of utilitarianism. Aggregate and per capita output and income statistics in countries across the globe and over time may satisfy a libertarian, egalitarian or other version of utilitarianism.

Task

Analyse the role of Government of India in the growth story of the Indian economy.

Case Study

Government and Technological Developments in India

The IT infrastructures significance to the country has gained visibility in the recent years due to cyber attacks and rapid growth in identity theft and financial frauds. These events have made it increasingly clear that the security of the IT infrastructure has become a key strategic interest to the Government. Although the industry now making investments in security-related infrastructure, their actions are directed primarily at short-term efforts driven by market demands to address immediate security problems.

The Government has a different but equally important role to play in cyber security assurance in the form of long-term strategies. In this direction, the deliberations of the National Information Board (NIB), National Security Council (NSC) have stressed the importance of a national strategy on cyber security, development of national capabilities for ensuring adequate protection of critical information infrastructures including rapid response and remediation to security incidents, long term investments in infrastructure facilities, capacity building and R&D. Governments responsibilities in long-term investment and fundamental research will enable development of new concepts, technologies, infrastructure prototypes, and trained personnel needed to spur on next-generation security solutions.

Government leadership catalyzes activities of strategic importance to the Nation. In cyber security assurance, such leadership can energize a broad collaboration with private-sector partners and stakeholders to generate fundamental technological advances in the security of the Nations IT infrastructure. First, in support of national and economic security, the Government should identify the most dangerous classes of cyber security assurance threats to the Nation, the most critical IT infrastructure vulnerabilities, and the most difficult cyber security assurance problems. Second, the Government can use these findings to develop and implement a coordinated R&D effort focused on the key research needs that can only be addressed with such leadership. While these needs will evolve over time, this Cyber Security Strategy provides a starting point for such an effort.

Public-private partnership is a key component of Cyber Security Strategy. These partnerships can usefully confront coordination problems. They can significantly enhance information exchange and cooperation. Public-private engagement will take a variety of forms and will address awareness, training, technological improvements, vulnerability remediation, and recovery operations.

Question

Can India develop its technological resources without the government's support?

Source: www.mit.gov.in

Notes

12.2 Insurance Regulatory and Development Authority (IRDA)

IRDA is regulatory and development authority under Government of India in order to protect the interests of the policyholders and to regulate, promote and ensure orderly growth of the insurance industry. It is basically a ten members' team comprising of a Chairman, five full time members and four part-time members, all appointed by Government of India. This organisation was established in 1999 after the bill of IRDA was passed in the Indian parliament.

Powers and Functions of IRDA

1. It issues the applicants in insurance arena, a certificate of registration as well as renewal, modification, withdrawal, suspension or cancellation of such registrations.
2. It protects the interests of the policy holders in any insurance company in the matters related to the assignment of policy, nomination by policy holders, insurable interest, and resolution of insurance claim, submission value of policy and other terms and proposals in the contract.
3. It also specifies obligatory credentials, code of conduct and practical instructions for mediator as well as the insurance company. Apart from this, it also defines the code of conduct for the surveyors and loss assessors involved with the insurance business.
4. One of the major functions of IRDA includes endorsing competence in the insurance business. Apart from this, upholding and regulating professional organizations in insurance and re-insurance business is also a major duty of IRDA.
5. IRDA is also entitled to for asking information, undertaking inspection and investigating the audit of the insurers, mediators, insurance intermediaries and other organizations related to the insurance sector.
6. It is also concerned with the regulation of the rates, profits, provisions and conditions that may be offered by insurers in respect of general insurance business if it is not controlled or regulated by the Tariff Advisory Committee.
7. It is also entitled to supervise the functioning of the Tariff Advisory Committee.
8. IRDA specifies the terms and pattern in which books of accounts are to be maintained and statement of accounts shall be provided by insurers and other insurance mediators.
9. It also regulates investment of funds by insurance companies as well as the maintenance of margin of solvency.
10. It is also empowered to be involved in the arbitration of disagreements between insurers and intermediaries or insurance intermediaries.
11. It is meant to specify the proportion of premium income of the insurer to finance policies.
12. It also specifies the share of life insurance business and general insurance business to be accepted by the insurer in the rural or social sector.

12.3 Association of Mutual Funds in India (AMFI)

With the increase in mutual fund players in India, a need for mutual fund association in India was generated to function as a non-profit organisation. Association of Mutual Funds in India (AMFI) was incorporated on 22nd August, 1995.

Notes

AMFI is an apex body of all Asset Management Companies (AMC) which has been registered with SEBI. Till date all the AMCs are that have launched mutual fund schemes are its members. It functions under the supervision and guidelines of its Board of Directors.

Association of Mutual Funds India has brought down the Indian Mutual Fund Industry to a professional and healthy market with ethical lines enhancing and maintaining standards. It follows the principle of both protecting and promoting the interests of mutual funds as well as their unit holders.

The Objectives of Association of Mutual Funds in India

The Association of Mutual Funds of India works with 30 registered AMCs of the country. It has certain defined objectives which juxtaposes the guidelines of its Board of Directors. The objectives are as follows:

1. This mutual fund association of India maintains high professional and ethical standards in all areas of operation of the industry.
2. It also recommends and promotes the top class business practices and code of conduct which is followed by members and related people engaged in the activities of mutual fund and asset management. The agencies who are by any means connected or involved in the field of capital markets and financial services also involved in this code of conduct of the association.
3. AMFI interacts with SEBI and works according to SEBIs guidelines in the mutual fund industry.
4. Association of Mutual Fund of India does represent the Government of India, the Reserve Bank of India and other related bodies on matters relating to the Mutual Fund Industry.
5. It develops a team of well qualified and trained Agent distributors. It implements a programme of training and certification for all intermediaries and other engaged in the mutual fund industry.
6. AMFI undertakes all India awareness programmes for investors in order to promote proper understanding of the concept and working of mutual funds.
7. AMFI also disseminate information on Mutual Fund Industry and undertakes studies and research either directly or in association with other bodies.

12.4 Commodity Exchange

A commodity exchange is a place where various commodities and derivatives are bought and sold. Commodities exchanges usually trade on commodity futures.

12.4.1 Reasons for Trading in Commodity Exchanges

1. ***Hedging:*** Commodities are subject to constant and extreme price fluctuations. Traders are the worst sufferers of the price risk. Forward contracts have come to their rescue.

   A forward contract requires a buyer and a seller to take and make a delivery of a definite quantity of a particular commodity at a future specified date. Such contracts are traded on an exchange, which provides guarantee for all futures dealings, and parties can "hedge" at suitable levels. Hedging lessens risk since it involves the purchase or sale of a commodity with the intention of counterbalancing the profit or loss of another investment. Therefore, any loss on the previous investment will be hedged, or compensated, by a matching profit from the hedging instrument.

Notes

2. ***Speculating:*** Speculators are people who are prepared to bear risks in anticipation of earning profits. Markets are granted liquidity by speculators and it is hard to conceive of a futures market devoid of speculators.
3. ***Arbitrage:*** Arbitrage involves buying a commodity at a low price and instantly selling it for a higher price in another market. Thus, traders can profit from arbitrage opportunities occurring due to price differences between two exchanges.
4. ***Shifting of Risk:*** The minute a trader finalizes a deal and secures a price, he is no longer concerned by unfavorable price shifts. For example, if a seller trades a specific contract for $ 450 and soon after the price comes down to $440, there has been an unfavourable price shift but the seller has made a profit of $10. At this point, the risk has been transferred to the buyer of the contract. Speculators trade on commodities and derivatives by undertaking risks in order to maximize profits.
5. ***Information:*** Exchanges produce huge volumes of data that are intensely scrutinized and monitored by a wide cross-section of people as the data provides gainful insights about the prevailing economic conditions.

12.4.2 List of Exchanges in India

1. Bhatinda Om & Oil Exchange Ltd., Batinda.
2. The Bombay Commodity Exchange Ltd., Mumbai
3. The Rajkot Seeds Oil & Bullion Merchants' Association Ltd.
4. The Kanpur Commodity Exchange Ltd., Kanpur
5. The Meerut Agro Commodities Exchange Co. Ltd., Meerut
6. The Spices and Oilseeds Exchange Ltd.
7. Ahmedabad Commodity Exchange Ltd.
8. Vijay Beopar Chamber Ltd., Muzaffarnagar
9. India Pepper & Spice Trade Association, Kochi
10. Rajdhani Oils and Oilseeds Exchange Ltd., Delhi
11. National Board of Trade, Indore
12. The Chamber of Commerce, Hapur
13. The East India Cotton Association, Mumbai
14. The Central India Commercial Exchange Ltd., Gwalior
15. The East India Jute & Hessian Exchange Ltd.
16. First Commodity Exchange of India Ltd, Kochi
17. Bikaner Commodity Exchange Ltd., Bikaner
18. The Coffee Futures Exchange India Ltd, Bangalore
19. Esugarindia Limited
20. National Multi Commodity Exchange of India Limited
21. Surendranagar Cotton Oil & Oilseeds Association Ltd.
22. Multi Commodity Exchange of India Ltd.
23. National Commodity & Derivatives Exchange Ltd.

Notes

24. Haryana Commodities Ltd., Hissar

25. e-Commodities Ltd.

Of these 25 commodities exchanges the MCX, NCDEX and NMCEIL are the major Commodity Exchanges.

Multi commodity exchange of India Ltd - MCX is an independent and de-mutualised exchange based in Mumbai. Established on 10th November, 2003, it is the third largest bullion exchange and fourth largest energy exchange in the world. Recognized by the Government of India it deals in numerous commodities and carries out online trading, clearing and settlement processes for commodity future market countrywide.

MCX COMDEX is India's foremost and sole composite commodity futures price index.

National Commodity & Derivatives Exchange of India Ltd (NCDEX) located in Mumbai, is a public limited company incorporated on 23rd April 2003. Promoted by national level establishments it is run by professional management. Regulated by the Forward Market Commission with reference to futures trading in commodities, it trades in various commodities online. The NCDEX is covered by:

1. Companies Act
2. Stamp Act
3. Contracts Act
4. Forward Commission (Regulation) Act.

National Multi-commodity Exchange of India Limited (NMCEIL) is considered the first de-mutualised, online exchange dealing in numerous commodities. Incorporated on 20th December 2001, it is promoted and run by:

1. Central Warehousing Corporation
2. National Agricultural Cooperative Marketing Federation of India Limited
3. Gujarat Agro Industries Corporation Limited
4. National Institute of Agricultural Marketing
5. Gujarat State Agricultural Marketing Board
6. Neptune Overseas Limited.

The Commodity Exchanges with their extensive reach embrace new participants, resulting in a powerful price discovery process.

Caselet

How Kulkarni designed the first Ethiopia Commodity Exchange in Africa?

It all started in 2007, when as an employee of Multi Commodity Exchange in Mumbai, Kulkarni was a part of the team that advised the Ethiopian government on the commodities exchange. After a couple of visits to the Ethiopian capital Addis Ababa, when he was involved in training and consultancy for the exchange, Kulkarni landed with a job offer that was too good to refuse. "The challenge in setting up the exchange was just

Contd...

Notes

a job offer that was too good to refuse. "The challenge in setting up the exchange was just what I needed. The terms of employment too were very attractive because I was to be an employee of a United Nations body," he recalls.

Besides his role in running operations, Kulkarni has also advised the ECX management on different issues ranging from trading, risk management, clearing and settlement to acquiring electronic trading technology under World Bank procurement. And as head of trading operations, he designed the world's first exchange-based trading platform for speciality coffee, of which Ethiopia is among the world's largest producers, an achievement that he's very proud of.

"ECX is the first of its kind in Africa, it is a marketplace which serves the various stakeholders, including farmers, traders, processors, exporters and consumers. It was set up by the government to serve coffee growers since the country is among the largest producers of coffee. The other commodities traded on the exchange are sesame seeds and pea-beans. Only physical spot trades are carried out on the exchange on a daily basis," says Kulkarni, who is very proud of the fact that after the exchange was set up, 78% of the total value of sesame exports now go into the pockets of the farmers.

He adds that the exchange flawlessly handles an average trade of over $7 mn a day. Kulkarni, who started his career as a commodities trader in India, moved to Ethiopia in 2008 and is now very comfortable about living and working in Africa.

Source: www.articles.economictimes.indiatimes.com

12.5 Summary

- Governments have a major role to play in the economy. It plays the regulatory role, legal role, entrepreneurial role and planning role. Besides these, it also plays a major role in infrastructure and human resource development.
- The Insurance Regulatory and Development Authority (IRDA) - External website that opens in a new window) was established by an Act of Parliament known as the IRDA Act, 1999. The mission of the IRDA is to protect the interests of the policyholders, to regulate, promote and ensure systematic growth of the insurance industry and other connected matters.
- Mutual Fund Association in India was established seeing the increase in mutual fund players in India. A need for was generated for it to function as a non-profit organisation.
- A commodities exchange is an exchange where various commodities and derivatives products are traded.

12.6 Keywords

Commodity exchange: an exchange for buying and selling commodities for future delivery.

Foreign Direct Investment: investment by a company in a country other than that in which the company is based.

FOREX: An over-the-counter market where buyers and sellers conduct foreign exchange transactions.

Licensing: grant a permit to allow the use of something or to allow a business activity to take place.

Notes

12.7 Self Assessment

Fill in the blanks:

1. ……policy brought new investment opportunities for the private sector in India.
2. Government of India restricted the expansion of big business houses through the…….Act.
3. Government often uses quotas to restrict…….....
4. Demand depends upon the purchasing power of the consumer which, in turn, depends upon ……
5. In transition economies, investments made by the government helps the private sector. This comes under……..role of the government.
6. The …….. declares the key areas where the state is going to invest and support in the coming five years.
7. IRDA was established in the year……
8. ……. is an apex body of all Asset Management Companies which has been registered with SEBI.
9. …… are the worst sufferers of the price risk.
10. ……..is considered the first de-mutualised, online exchange dealing in numerous commodities.

12.8 Review Questions

1. How has licensing and reservation policies of the government helped the Indian economy? Give examples to make your points clear.
2. Analyse the role of government in expansion of Indian MNCs like Reliance, Aditya Birla Group and Tata Group.
3. "Government plays a major role in increasing the purchasing power of the people". Discuss
4. Government has enacted many laws to regulate the industry. Discuss any one such law.
5. "In developing economies, the state plays a critical role in developing human resources". Substantiate
6. Analsye the entrepreneurial role played by the Manmohan Singh's government.
7. "State is an architect of the industrial scenario in a country". Discuss
8. Discuss the role of IRDA. How does it help the common man?
9. Why do people trade in commodity exchanges?
10. Discuss the role of government in transition economies.

Answers: Self Assessment

1. Liberalization
2. MRTP
3. Imports
4. Supply of money

Notes

5. Entrepreneurial
6. Planning Commission
7. 1999
8. AMFI
9. Traders
10. National Multi-commodity Exchange of India Limited

12.9 Further Readings

Books

Dutt and Sundaram, *Indian Economy*, S.Chand, New Delhi, 2007

Francis Cherunilam, *Business Environment*, Himalaya Publishing House

Mittal Vivek, *Business Environment*, Excel Books, 2007

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Online links

http://finance.indiamart.com/markets/commodity/commodity_exchanges.html

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http://siadipp.nic.in/publicat/nip0791.htm

www.amfiindia.com

Unit 13: Corporate Governance in Indian Scenario

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Objectives

After studying this unit, you will be able to:

- Discuss the Company Law and Indian Companies Act
- State the National Code on Corporate Governance
- Explain Clause 49

Introduction

India is now implementing important corporate governance reforms that position the country's corporate governance framework as above average compared to other emerging market economies. However, as is the case with many other countries weaknesses remain in enforcement of rules and regulations.

The IIF is the global association of financial institutions comprising more than 340 member institutions headquartered in over 60 countries operating across the world. In preparing the report the Task Force held meetings in Mumbai and New Delhi with senior officials from the government, the Reserve Bank of India, the Securities and Exchange Board of India (SEBI), the Bombay Stock Exchange (BSE), the National Stock Exchange of India (NSE), private companies, rating agencies, law firms and consultancies involved in corporate governance.

India has 22 stock exchanges and approximately 6,000 publicly listed companies with a total market capitalization of India's stock markets of around US$ 546bn, as of December 30, 2005. Over 40 million people invest in shares and mutual funds in the country. The ten largest companies account for more than one-third of total market capitalization Indian companies have been increasingly attracting foreign capital either through listing on international stock exchanges or through private equity placements and foreign institutional investments. Companies that wish to access markets for capital or that wish to become leading global suppliers to corporations in developed markets are becoming increasingly transparent and are more willing to adopt higher corporate governance standards.

Notes

The EAG India Task Force found that in such key areas as minority shareholder protection and accounting/auditing, India's corporate governance framework is consistent with most of the IIF's guidelines. In October 2004, SEBI revised existing corporate governance requirements to incorporate selected features of the Sarbanes-Oxley Act. Indian companies are required to be in compliance with these new provisions, introduced in Clause 49 of SEBI's listing agreement, by December 31, 2005. Clause 49 requires companies to file a quarterly compliance report with the stock exchange.

The stock exchange in turn is required to file an annual compliance report with SEBI for each listed company. Quarterly reports due on March 31, 2006 will begin carrying compliance information with the new governance listing requirements. A report pointed out that neither the stock exchanges nor SEBI have increased staff as needed to effectively scrutinize compliance with Clause 49 and other rules and regulations. The EAG Task Force said, SEBI personnel need adequate training to develop skills required to build strong cases against errant companies. Moreover, the report stated that the cost of non-compliance to companies in the form of fines, legal action and delisting is low and has proved to be an ineffective mechanism to deal with errant companies.

The report noted that an overhaul of the Indian Companies Act of 1956 (amended in 2002) is likely in the near future, which is designed to simplify procedures and introduce a system based on rules to be prescribed by authorities.

13.1 Company Law and Accounting and Indian Companies Act

The principal forms of business organization in India are: Companies-both public and private, Partnerships and Sole proprietorships. Apart from statutory government-owned concerns, the most prevalent form of large business enterprise is a company incorporated with limited liability. Although companies limited by guarantee and unlimited companies are permitted by law, they are relatively uncommon. Companies incorporated in India and branches of foreign corporations are regulated by the Companies Act, 1956 ("The Act"). The Act, which has been enacted to oversee the functioning of companies in India, draws heavily from the United Kingdom's Companies Act.

Indian Companies Act: The Act requires every Indian company to keep books of accounts and statutory registers and other books, which give a true and fair view of the state of the company's affairs. The Board of Directors of every company is required to present the company's financial statements to the shareholders at every Annual General Meeting. Every company has to appoint a recognized auditor to audit its accounts and statutory registers. The concern acts are:

1. Indian Companies Act of 1956
2. Indian Companies Act of 1882
3. Indian Companies Act of 1913
4. Indian Companies Act of 1866
5. The Securities Contracts (Regulation) Act, 1956
6. Reserve Bank of India Act of 1934
7. Banking Regulation Act of 1949
8. Industries (Development & Regulations) Act, 1951, (IDRA)
9. The Monopolies and Restrictive Trade Practices Act, 1969, (MRTP)

Notes

The Act defines a "company" as a company incorporated under the Act. Indian law however, makes a distinction between a Corporate Body and a Company. A "Corporate Body" is defined to include a foreign company, i.e., a company incorporated outside India. The following are the basic kinds of companies, which come under the purview of the Act:

1. Private Companies
2. Public Companies
3. Foreign Companies
4. Holding and Subsidiary Companies (could be a private or a public limited company)

1. ***Private Companies:*** A private company incorporated under the Act has the following characteristics:
   (a) The right to transfer shares is restricted.
   (b) The maximum number of its shareholders is limited to 50 (excluding employees).
   (c) No offer can be made to the public to subscribe to its shares and debentures.
   (d) Private companies are relatively less regulated than public companies. A private company is deemed to be a public company in the following situations:
      (i) When 25 per cent or more of the private company's paid-up capital is held by one or more public company.
      (ii) The private company holds 25 per cent or more of the paid-up share capital of a public company.
      (iii) The private company accepts or renews deposits from the public.
      (iv) The private company's average annual turnover exceeds ₹ 100 million.
2. ***Public Companies:*** The Act defines a "public company" as one, which is not a private company. In other words, a public company is one on which the above restrictions do not apply.
3. ***Foreign Companies:*** Foreign companies are those, which have been incorporated outside India and conduct business in India. These companies are required to comply with certain rules under the Act. As a result, liaison and project offices and branches of foreign companies in India are regulated by the Act. Such companies have to register themselves with the RoC, New Delhi, within 30 days of setting up a place of business in India.
4. ***Holding and Subsidiary Companies:*** Under the Act, a holding company is merely supposed to publish certain information on its subsidiaries, and is not required to prepare group financial statements. However, the concept of a holding and subsidiary company is of importance in certain situations. A private company that is a subsidiary of a public company loses most of its privileges and exemptions. A company is said to be a subsidiary of its holding company if any of the following conditions exist:
   (a) The composition of its Board of Directors is controlled by the holding company.
   (b) More than half of its voting power is controlled by the holding company.
   (c) It is a subsidiary of another subsidiary of the holding company.

Notes

Case Study

Manipulation of Share Prices

Share price rigging is rampant during bull runs. To see how it happens, let's check the modus operandi. The main format, which evolved during Harshad Mehta's time, involves three participants—promoters, operator and a broker syndicate. There are ancillary participants like fake bill-sellers, and also perhaps unscrupulous auditors and officials. The promoter first finds an operator or vice versa. The promoter should be interested in bumping up the share price, the motivation for which could vary from the basic – offloading his stake at a high price to gullible retail investors – to the more advanced – which comprises complex needs like getting better validation for a GDR issue or in an M & A. It works like this: the promoters commit to the operator not to sell the market while the operation is on. He gives about 10% of his stake to the operator of companies affiliated to the brokers' syndicate. The syndicate normally comprises 6-10 brokers, often dispersed in different cities so as not to arouse suspicion of SEBI or the stock exchange. Their role is to do circular trading which works like this: say broker A sells to B at ₹ 4.5; B will sell to C at ₹ 4.65 and so on. The trades are designed to generate the impression of large liquidity.

After taking prices to a certain level, 'news flow' is created. The news is typically about large orders and capacity expansion. These days it is often about an acquisition or restructuring. Also, financial results need to show improvement. This is done by buying revenue. There are agents who sell fake bills at a certain commission, which could be between 0.5% and 10%. ET has learnt this market tends to boom at the same time as share markets. After the price reaches the target, the syndicate exits. The gains are split between the promoter, operator and syndicate members. In this artificially created bull run, there is a new element: people trying to convert black money to white.

Question

Discuss the ethical issues in this case.

Source: A B Rao, *Business Ethics and Professional Values*, First Edition, Excel Books, New Delhi, 2006.

13.2 National Code on Corporate Governance (1999)

In late 1999, a government-appointed committee under the leadership of Shri Kumar Mangalam Birla, Chairman, Aditya Birla Group, released a draft of India's first national code on corporate governance for listed companies. The committee's recommendations, many of which were mandatory, were closely aligned to international best practices on corporate governance and set higher standards than most other parts of the region at that time. The code was approved by the Securities and Exchange Board of India (SEBI) in early 2000 and was implemented in stages over the following two years (applying first to newly listed and large companies). It also led to changes in the stock exchange listing rules.

13.3 Clause 49 (February 2000)

In February 2000, the Securities and Exchange Board of India (SEBI) revised its Listing Agreement to incorporate the recommendations of the country's new code on corporate governance, produced in late 1999 by the Birla Committee. These rules contained in a new section, Clause 49, of the Listing Agreement took effect in phases over 2000-2003.

Notes

Clause 49 (2004) (SEBI): Listed companies in India (with paid-up capital of ₹ 3 crore and more) have to comply with the corporate governance related provisions of Clause 49 of the Listing Agreement of Stock Exchanges. Clause 49 has been prepared by the Securities and Exchange Board of India (SEBI).

Task Force on Corporate Excellence (November 2000): In May 2000, the Department of Company Affairs (DCA) formed a broad-based study group under the chairmanship of Dr. P.L. Sanjeev Reddy, Chairman, DCA. The group was given the ambitious task of examining ways to "operationalise the concept of corporate excellence on a sustained basis", so as to "sharpen India's global competitive edge and to further develop corporate culture in the country". In November 2000, a task force setup by the group produced a report containing a range of recommendations for raising governance standards among all companies in India. It also suggested the setting up of a Centre for Corporate Excellence. A copy of the report is attached.

Amending the Company Law (ongoing): The Department of Company Affairs (DCA) has amended the Companies Act, 1956 several times in recent years to improve corporate governance and modernise India's company law. In 1999, it introduced provisions relating to nomination facilities for shareholders, share buy-backs and the formation of an Investor Education and Protection Fund, among other things. Further amendments in 2000 covered postal ballots, audit committees, director responsibility statements, and an option for the election of a director by small shareholders. Then in April 2002, DCA constituted a committee to take a fresh look at the Companies Bill, 1997 a comprehensive revision of the 1956 Act that had been pending in parliament for several years and suggest further changes. The committee, released its report in September 2002.

Caselet

Chandra Committee on Auditing and Governance (2002)

Following the collapse of Enron in 2001 and the passing of the Sarbanes-Oxley Act in July 2002, the Department of Company Affairs (DCA) formed a high-level committee in August 2002 to undertake a wide-ranging examination of corporate auditing and independent directors. Chaired by Shri Naresh Chandra, a former Cabinet secretary, the committee produced a report in late 2002 that made a series of strong recommendations regarding such things as the grounds for disqualifying auditors from assignments, the type of non-audit services that auditors should be prohibited from performing, the need for compulsory rotation of audit partners (but not firms), a stricter definition of "independent director" and the need for independent directors to make up no less than 50% of boards. While the committee was clearly influenced by Sarbanes-Oxley, it did not follow its dictates slavishly.

Task

Take example of any three Indian Organisation and discuss their corporate practice.

Notes

13.4 Summary

- India is now implementing important corporate governance reforms that position the country's corporate governance framework as above average compared to other emerging market economies.
- The corporate governance framework in India includes Securities and Exchange Board of India, Company Law and Accounting and Indian Company Acts, CII code on corporate governance, National Code on Corporate Governance, and Clause 49.

13.5 Keywords

Board Committees: Board committees are an aid to assist the board and its directors in discharging their duties and responsibilities.

CII: Confederation of Indian Industries

Clause 49: It is under Listing Agreement of Stock Exchanges. Clause 49 has been prepared by the Securities and Exchange Board of India (SEBI).

13.6 Self Assessment

State whether the following statements are true or false:

1. SEBI established in 1988 and became a fully autonomous body by the year 1992.
2. Private companies can enjoy the right to transfer shares.
3. The Department of Company Affairs (DCA) has amended the Companies Act, 1956 several times in recent years to improve corporate governance and modernise India's company law.
4. India has 22 stock exchanges.
5. Companies can be divided into public and private companies only, according to Indian Companies Act.
6. The stock exchange is required to file a compliance report with SEBI for each listed company for each quarter.
7. The Board of Directors of every company is required to present the company's financial statements to the shareholders at every Annual General Meeting.
8. Clause 49 has been prepared by the Reserve Bank of India.
9. Department of Company Affairs suggested the setting up of a Centre for Corporate Excellence.
10. National Code of Corporate Governance led to changes in the stock exchange listing rules.

13.7 Review Questions

1. Discuss India's corporate governance framework.
2. Write a note on SEBI.

Notes

3. What is the basic distinction between a company and a corporate body?
4. What are the various kinds of companies?
5. Write a note on CII Code of Corporate Governance.
6. Discuss Clause 49 in details.
7. Do you think Indian Companies Act is doing enough to guide the firms well? If you think some more provisions can be added, suggest the same.
8. Write short note on the National Code of Corporate Governance.
9. Compare the corporate governance scene in India with any one western country of your choice.
10. Why is Clause 49 relevant for the companies?

Answers: Self Assessment

1.	True	2.	False
3.	True	4.	True
5.	False	6.	False
7.	True	8.	False
9.	True	10.	True

13.8 Further Readings

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Unit 14: Corporation in a Global Society

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Objectives

After studying this unit, you will be able to:

- Discuss the corporate governance scenario in Asia-pacific
- Explain the role of corporate governance in South Africa and Brazil

Introduction

To most international experts on the subject, corporate governance is interplay between companies, shareholders, creditors, capital markets, financial sector institutions and company law. This is the reason why corporate governance are different in different countries. Here, we shall discuss the corporate governance in the scenario of different countries.

14.1 Asia-pacific

Under corporate governance in Asia-Pacific, we shall discuss the scenario in Japan. Japan rebuilt its economy in the years following World War II. It has developed a unique corporate governance structure.

The major characteristic of Japanese model is a high level of stock ownership by affiliated banks and companies. In Japan banking system has a long term and strong bonding with corporations. There is a concept of keiretsu in Japan which means industrial groups which are inter related by trading relationship and crossholdings of debt and shares. A legal, public policy and industrial policy framework is designed to support and promote keiretsu. Boards of directors composed almost entirely of insiders; and in some corporations are outside shareholders in the board but it is very rare. In financing Japanese corporations' give importance to equity. However, as we said in the starting that there is high level of stock ownership by corporations and banks Equity financing is important for Japanese corporations. This is the cause that insiders play a major role in corporations and in the system as a whole. So, the interests of outside shareholders are marginal. The percentage of foreign ownership of Japanese stocks is small, but it may become an important factor in making the model more responsive to outside shareholders.

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The Japanese basic attitude towards business is dominated by its strong social fabric. Though Japan has an important stock market, yet it does, not play much part in the allocation of resources. This is due to the fact that the objectives of Japanese banks are not the maximization of profits but safety and growth. It is done under the direction of the Ministry of International Trade & Industry (MITI), In Japan, it seems to be a general consensus that although 'profit' is important, the long-term preservation and prosperity of the family (companies) are prime objectives and not profit maximization or shareholders immediate gain in terms of dividend.

Did u know? **Amakudari**

It is the common practice of retiring bureaucrats joining in the industry they previously regulated. This is called 'Amakudari' (descent from heaven).

Key Players: The Japanese system of corporate governance has main bank in centre linked with financial/industrial network. The main bank system and the keiretsu are two different, yet overlapping and complementary, elements of the Japanese model. In fact, almost all Japanese corporations have a close relationship with a main bank. The bank provides finance as well as services to its corporate clients. Services include bond issues, equity issues, settlement accounts, and related consulting services. The main bank is generally a major shareholder in the corporation. In the US, due to anti-monopoly legislation it is prohibited for one bank to provide multiple services. Instead, these services are usually handled by different institutions: commercial bank-loans; investment bank-equity issues; specialized consulting firms-proxy voting and other services.

Most of the Japanese corporations also have strong financial relationships with a network of affiliated companies or keiretsu. Government's industrial policy is also an important factor in the model. Japanese government has pursued an active industrial policy designed to assist Japanese corporations. This policy includes official and unofficial representation on corporate boards, at the time of financial distress of a corporation. In this model the following key players are identified:.

1. bank (an important inside shareholder),
2. keiretsu (a major inside shareholder),
3. management
4. the government.

The interaction among these players are mainly for linking relationships. They do not work for balancing power as it does in the Anglo-US model. In the Japanese corporate governance model the outside shareholders or the non-affiliated shareholders have little or no significant say.

Share Ownership Pattern: In Japan, financial institutions and corporations are the two major owners of the shares, they firmly hold ownership of the equity market. Similar to the trend in the UK and US, the shift during the postwar period has been away from individual ownership to institutional and corporate ownership. In 1990, financial institutions, which include insurance companies and banks, held approximately 43 percent of the Japanese equity market, and corporations held 25 percent. Foreign ownership is rather low it was only about three percent. In both the Japanese and the German model, banks are dominant shareholders and develop strong relationships with corporations.

Composition of the Board of Directors: In Japan the board of directors of a corporations is composed entirely of insiders. Usually the heads of main divisions or department of the company, its administrative body and executive managers are the members of the board. The replacement

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of the board happens only when companies profit falls for a given period and it is done by the main bank and the affiliated companies. They appoint their own candidates to the company's board. Another practice prevailing in Japan about the appointment of retiring government bureaucrats to corporate Boards. In other words in Japanese corporate governance model the composition of the board of directors is dependent upon the financial performance of the company. The size of the Japanese board is larger in comparison to other models, containing 50 members on an average.

Regulatory Framework: In Japan, legal framework is very dominating and influential in developing policies. The government ministries also have enormous regulatory control. However, in recent years, several factors have lesson the governmental control and influence in the development and implementation of a comprehensive industrial policy. The Japanese corporations' role is expanding and growing at home and abroad has fragmented the policy formulation, as there is involvement of more ministries. Another factor is the increasing internationalization of Japanese corporations made them less dependent on their domestic market and therefore somewhat less dependent on their own country's industrial policy. The growth of Japanese capital markets led to their partial liberalization and an opening, albeit small, to global standards is just the other factor. Although, the above factors led to the weakening of the Japanese governmental control over the companies, it is still an important constituent in the Japanese model.

The government agencies provide little effective, independent regulation to the Japanese securities industry. The primary regulatory bodies are the Securities Bureau of the Ministry of Finance, and the Securities Exchange Surveillance Committee, established under the auspices of the Securities Bureau in 1992.

Disclosure Requirements: There is a stringent disclosure requirement in Japan. Corporations are required to disclose a wide range of information in the annual report and or agenda for the AGM. These may include:

1. Financial data on the corporation (on a semi-annual basis);
2. Data on the corporation's capital structure;
3. Background information on each nominee to the board of directors;
4. Aggregate data on compensation, of all executive officers and the board of directors;
5. Information on proposed mergers and restructurings;
6. Proposed amendments to the articles of association; and
7. Names of individuals and/or companies proposed as auditors.

Corporate Actions Requiring Shareholder Approval: In Japanese corporate governance model the following are the routine corporate actions requiring shareholder approval are:

1. Payment of dividends and allocation of reserves;
2. Election of directors;
3. Appointment of auditors.
4. Capital authorizations;
5. Amendments to the articles of association and/or charter (e.g. a change in the size and/or composition of the board of directors, or a change in business activities);
6. Payment of retirement bonuses to directors and auditors;
7. Increase of the aggregate compensation ceilings for directors and auditors.

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Non-routine corporate actions which also require shareholder approval include:

1. Mergers,
2. Takeovers
3. Restructurings

Shareholder proposals are new to the Japanese model. Prior to 1981, Japanese law did not permit shareholders to put resolutions on the agenda for the annual meeting. A 198 amendment to the Commercial Code states that a registered shareholder holding minimum of 10 percent of a company's shares may propose an issue to be included on the agenda for the AGM.

Interaction Among Players: The essence of the Japanese model is the interaction among the key players, which generally links and strengthens relationships. It is preferred by the Japanese corporation that a majority of its shareholders should be long-term, preferably affiliated, parties. Outsiders are generally excluded from the process. Annual reports and materials related to the AGM are available to all shareholders. Shareholders may attend the annual general meeting, and vote by proxy or vote by mail. In theory, the system is simple. Shareholder's active participation is restricted by an informal yet important aspect of the Japanese system: the vast majority of Japanese corporations hold their annual meetings on the same day each year, this practice naturally restricts institutional investors to coordinate voting to attend each AGM in person.

Case Study

Asia's Corporate Governance Challenge

Companies in these parts of the world will have to balance tradition with innovation by diversifying their boardrooms to include directors who aren't family members, experts say.

'The reluctance of family-owned firms to open their equity to outside shareholders has to some extent constrained the development of the capital markets in the Middle East,' says Alissa Koldertsova, a policy analyst at the Paris-based Organization for Economic Cooperation and Development (OECD).

Sharmila Gopinath, program and research expert at the Hong Kong-based Asian Corporate Governance Association (ACGA), emphasizes the need for transparency at foreign companies.

'It is important for listed companies to realize that their shareholders are part-owners of the company,' she says. 'Companies owe their shareholders timely information and the right to have their votes counted at meetings - one share, one vote.'

Issues in Asia

Corporate governance is still a fairly new concept in Asia. 'China has been busy these past few years creating and amending securities rules,' Gopinath says, 'but as far as the market and the private sector are concerned, there is definitely scope for improving corporate governance.'

Gome Electrical Appliances, one of the largest privately owned electronics retailers in China, serves as a prime example of a private, family-owned company struggling to survive under weak governance practices. Huang Guangyu, the company's billionaire

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founder and its biggest shareholder, is serving a 14-year sentence in a Chinese prison for illegal business practices. In late September, he tried to increase his family's control over the company from prison by submitting a proposal to have his younger sister and his lawyer installed as directors. The proposal failed.

'The Gome case highlights the classic problem in the governance of family-controlled companies - how to address conflicts between family shareholders and non-family members,' writes Raffi Amit, a management professor in China, in an article entitled 'The fight for Gome: who's the real victor in China's big boardroom battle?'

'Enforcement of minority shareholders rights in family firms is an important issue.'

China is not the only Asian country with these conflicts. In Taiwan, dismal voting requirements and a lack of independent executives have earned the country a weak governance grade, according to a report released by the ACGA in February.

'Taiwan remains a difficult and challenging market for long-term global institutional investors who are seeking to act responsibly, vote their shares and engage with companies,' the report says. 'Governance practices at most listed companies have some way to go to match global standards.'

At Taiwanese companies, institutional investors - the largest and most sophisticated investor class - find it hard to vote in an informed manner at shareholder meetings. The prevalence of family-owned businesses and the mind-numbingly slow legislative process also reduce the opportunity for long-term investors to carry out business in the country, the ACGA report notes. Governance there has been 'inconsistent'.

'What we found in Taiwan is that while regulators have been willing to talk with us and listen to investors' concerns, regulatory reform is slow,' says Gopinath. 'Legislative amendments take quite a long time to go through the parliamentary system.'

Challenges in India

Corporate governance is currently in the spotlight in India, as studies are indicating that there is a need for stronger regulations and stricter enforcement. The challenge in India is similar to that encountered in China: regulations need to discipline companies' dominant shareholders while protecting their minority investors.

'In India, you have one shareholder who can control more than 50 percent of the shares,' Gopinath explains. 'That presents huge issues, as the controlling shareholder can basically get a 'yes' vote for any resolution he or she might put forward at a meeting. As for foreign institutional investors getting their votes counted at a shareholder meeting? Next to impossible.'

Gopinath points out that foreign institutional investors usually try to vote at these meetings by proxy, but 99 percent of the time proxies are not allowed participate in show-of-hands votes, which are the norm in India. The only time a proxy's vote is counted is if there is a vote by poll, 'but here's the catch-22: proxies cannot ask for a vote by poll because they are not allowed to speak at shareholder meetings.'

Governance practices in Asian countries are a global concern given that investors see China and India as emerging markets.

'Asia is a huge continent, and issues vary from country to country,' says Gopinath. 'We are not advocating 'one system fits all'. What we are saying is that there are global best

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practices, and you can learn lessons from every market - how different jurisdictions tackle similar issues.'

Priorities in the Middle East

In Egypt, the most populous country in the Arab world and one to which foreign investors once flocked, there is a high budget deficit and there has been an increase in fiscal spending to aid in rebuilding the economy, which has been shaken as a result of the recent wave of social unrest in that part of the world.

According to Koldertsova, awareness of good corporate governance practices in the region has been developing relatively rapidly. 'Less than a decade ago, the understanding of corporate governance as a concept was nascent in the Middle East and North Africa,' she says.

In her recent paper entitled 'The second corporate governance wave in the Middle East and North Africa', Koldertsova notes that only three of the 17 Middle East and North Africa jurisdictions - Iraq, Kuwait and Libya - do not have any corporate governance code or guidelines.

'An additional complication is that in the region, what constitutes good corporate governance and good corporate social responsibility practices tends to be confounded,' Koldertsova says. 'There is a growing discussion about CSR all over the region, but perhaps not enough recognition that good corporate governance does not necessarily always equate to good CSR.'

As a manager of the Middle East and North Africa corporate governance initiative at the OECD, Koldertsova believes the 'first wave' of corporate governance in the region was to some extent triggered by the need to attract foreign investment, especially for those countries with no petrochemical resources.

On the other hand, the 'second wave' of governance will need to focus on 'implementation of corporate governance frameworks as opposed to awareness-raising,' she says, adding that 'regulators' capacity to transparently monitor and enforce breaches of existing regulations, and to fine-tune them when necessary, will continue to be tested.'

Question

Why do you think that Asian companies face more challenges as far as corporate governance is concerned than European or American companies?

Source: www.businessinsider.com

14.2 South Africa-Brazil

The King Report on Corporate Governance (1994) evoked interest in corporate governance in South Africa. However, corporate governance was already an issue there, before the King report. But it is the report which brought changes in south African business scenario. The first King Committee on Corporate Governance in South Africa was set up in 1992, reporting two years later. The "King Report 1994" advocated governance standards that went beyond legal compliance and recognised a company's duties to all stakeholders. An updated version of the committee's governance guidelines, King 2, was published in 2002.

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The code identifies seven characteristics of good corporate governance:

1. Discipline
2. Transparency
3. Independence
4. Accountability
5. Responsibility
6. Fairness
7. Social responsibility

The King Report on Corporate Governance for South Africa (the "King Report 2002") has been developed as an initiative of the Institute of Directors in Southern Africa. It represents a revision and update of the King Report first published in 1994, in an attempt to keep standards of corporate governance in South Africa in step with those in the rest of the world. All companies listed on the Johannesburg Stock Exchange have to comply with the provisions of the Report.

King committee's report (2002) outlines certain fundamentals relating to corporate governance. In keeping with its report (1994), the Committee has gone beyond financial and regulatory matters to focus on social, ethical and environmental issues in seeking balance between the interests of share owners and other stakeholders. King committee has taken, into its consideration, the seven characteristics of the good corporate governance. These are discipline, transparency, independence, accountability, responsibility, fairness and social responsibility.

As it has been understood now that apart from the value added to a company by good corporate governance, interest in such practices has been fuelled by the international financial crises of the 1990s. In East Asia, in 1997 and 1998, it was come to light that macroeconomic difficulties could be worsened by systemic failure of corporate governance. It may be stemmed from:

1. Weak legal and regulatory systems;
2. Poor banking regulation and practices;
3. Inconsistent accounting and auditing standards;
4. Improperly regulated capital markets;
5. Ineffective oversight by corporate boards, and
6. Little recognition of the rights of minority shareowners.

The report has set certain codes as a set of principles that does not appear to determine the course of conduct of directors on any particular matter. Directors are required to regulating their conduct and operation with a view to applying not only the most applicable requirements but also to seek to adhere to the best available practice that may be relevant to the company in its particular circumstances.

The Code should be seen as a "living document" which may require to be updated from time to time by the King Committee to ensure the relevance of its recommended principles of corporate practices and conduct. A number of task teams was established to undertake a detailed review of specified areas of corporate governance.

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Application of Code: The Code applies to the following business enterprises:

1. All companies with securities listed on the JSE,
2. Banks, financial and insurance entities,
3. Public sector enterprises and agencies that fall under the Public Finance Management Act and the Local Government: Municipal Finance Management Bill (still to be promulgated),
4. All companies, in addition to those falling within the categories listed above, should give due consideration to the application of the Code insofar as the principles are applicable.

While it is acknowledged that certain forms of State enterprises may not lend themselves to some of the principles set out in this Code, it is recommended that the principles should be adapted appropriately by such enterprises. To assist entities falling within this category, National Treasury will be issuing "Good Practice Guides" as official directives in line with the overall framework for financial management for the public sector.

Boards and Directors

The board is the focal point of the corporate governance system. It is ultimately accountable and responsible for the performance and affairs of the company. The board must give strategic direction to the company, appoint the chief executive officer and ensure that succession is planned. The board must retain full and effective control over the company. The board should ensure that the company complies with all relevant laws, regulations and codes of business practice. The board should define levels of materiality, reserving specific power to itself and delegating other matters with the necessary written authority to management. The board should have unrestricted access to all company information, records, documents and property. The board should consider developing a corporate code of conduct that addresses conflicts of interest, particularly relating to directors and management. The board must identify key risk areas and key performance indicators of the business enterprise. The board should identify and monitor the non-financial aspects relevant to the business. The board should ensure that each item of special business included in the notice of the annual general meeting, or any other shareowners' meeting, is accompanied by a full explanation of the effects of any proposed resolutions. The board should encourage shareowners to attend annual general meetings. A brief CV of each director standing for election or re-election at the annual general meeting should accompany the notice contained in the annual report. Every board should have a charter setting out its responsibilities, which should be disclosed in its annual report The board must find the correct balance between conforming with governance constraints and performing in an entrepreneurial way.

Board Composition

An effective board that can both lead and control the company should head companies. The board should comprise a balance of executive and non-executive directors. Procedures for appointments to the board should be formal and transparent, and a matter for the board as a whole, assisted where appropriate by a nomination committee.

Chairperson and Chief Executive Officer

There should be a clearly accepted division of responsibilities at the head of the company, to ensure a balance of power and authority. The chairperson should preferably be an independent non-executive director. Where the roles of the chairperson and chief executive officer are combined, there should be either an independent non-executive director serving as deputy chairperson or a strong independent non-executive director element on the board. The board

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should appraise performance of the chairperson on an annual or such other basis as the board may determine The chairperson, or a sub-committee appointed by the board, should appraise the performance of the chief executive officer. The board should satisfy itself that an appraisal of the chief executive officer is performed at least annually.

Remuneration

Levels of remuneration should be sufficient to attract, retain and motivate executives of the quality required by the board. Companies should appoint a remuneration committee or such other appropriate board committee, consisting entirely or mainly of independent non-executive directors, to make recommendations to the board within agreed terms of reference on the company's framework of executive remuneration and to determine specific remuneration packages for each of the executive directors. Remuneration must be disclosed in the annual report. Companies should provide full disclosure of director remuneration on an individual basis, giving details of earnings, share options, restraint payments and all other benefits. Performance-related elements of remuneration should constitute a substantial portion of the total remuneration package of executives. Share options may be granted to non-executive directors but must be the subject of prior approval of shareowners. The overriding principle of full disclosure by directors, on an individual basis, should apply to all share schemes and any other incentive schemes proposed by management. Companies should establish a formal and transparent procedure for developing a policy on executive and director remuneration.

Board Meetings

The board should meet regularly, and should disclose in the annual report the number of board and committee meetings held in the year and the details of attendance of each director. Efficient and timely methods should be determined for informing and briefing board members prior to meetings; they have been furnished with all the relevant information and facts before making a decision. Non-executive directors should have access to management and may even meet separately with management.

Board Committees

Board committees are an aid to assist the board and its directors in discharging their duties and responsibilities. There should be a formal procedure for certain functions of the board to be delegated, describing the extent of such delegation, to enable the board to properly discharge its duties and responsibilities and to effectively fulfil its decision taking process. Board committees with formally determined terms of reference, life span, role and function constitute an important element of the process should be established with clearly agreed upon reporting procedures and written scope of authority. As a general principle, there should be transparency and full disclosure from the board committee to the board. Non-executive directors must play an important role in board committees. An independent non-executive director should preferably chair all board committees. Board committees should be subject to regular evaluation by the board to ascertain their performance and effectiveness.

Dealings in Securities

Every listed company should have a practice prohibiting dealing in its securities by directors, officers and other selected employees for a designated period preceding the announcement of its financial results or in any other period considered sensitive, and have regard to the listings requirements of the JSE in respect of dealings of directors.

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Company Secretary

The company secretary has a central role to play in the corporate governance of a company. The board should be cognizant of the duties imposed upon the company secretary and should empower the company secretary accordingly to enable him or her to properly fulfil those duties. The company secretary must provide the board as a whole and directors individually with detailed guidance as to how their responsibilities should be properly discharged in the best interests of the company. The company secretary should provide a central source of guidance and advice to the board, and within the company, on matters of ethics and good governance.

Risk Management

Responsibility: The board is responsible for the total process of risk management, as well as for forming its own opinion on the effectiveness of the process. Management is accountable to the board for designing. The board should set the risk strategy policies in liaison with the executive directors and senior management. The board must decide the company's tolerance for risk. The board should make use of generally recognised risk management and internal control models and frameworks in order to maintain a sound system of risk management and internal control to provide reasonable assurance regarding the achievement of organisational objectives. In addition to the company's other compliance and enforcement activities, the board should consider the need for a confidential reporting process ("whistle blowing") covering fraud and other risks.

Application and Reporting: A comprehensive system of control should be established by the board to ensure that risks are mitigated and that the company's objectives are attained. Pertinent information arising from the risk assessment, and relating to control activities should be identified, captured and communicated that enables employees to carry out their responsibilities properly. Companies should develop a system of risk management and internal control that builds more robust business operations. The board must identify key risk areas and key performance indicators of the company, and monitor these factors as part of a regular review of processes and procedures to ensure the effectiveness of its internal systems of control.

Internal Audit

Companies should have an effective internal audit function that has the respect and co-operation of both the board and management. Consistent with the Institute of Internal Auditors' ("IIA") definition of internal auditing in an internal audit charter approved by the board, the purpose, authority and responsibility of the internal audit activity should be formally decided, including the code of ethics and the definition of internal audit, which is fully endorsed by the King Committee.

Integrated Sustainability Reporting

Every company should report at least annually on the nature and extent of its social, transformation, ethical, safety, health and environmental management policies and practices. The board must determine what is relevant for disclosure, having regard to the company's particular circumstances. Disclosure of non-financial information should be governed by the principles of reliability, relevance, clarity, comparability, timeliness and verifiability with reference to the Global Reporting Initiative Sustainability Reporting Guidelines on economic, environmental and social performance.

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Organisational Integrity/Code of Ethics

Every company should engage its stakeholders in determining the company's standards of ethical behaviour. It should demonstrate its commitment to organisational integrity by codifying its standards in a code of ethics. Each company should demonstrate its commitment to its code of ethics. Companies should strongly consider their dealings with individuals or entities not demonstrating its same level of commitment to organisational integrity.

Accounting and Auditing

The auditors should observe the highest level of business and professional ethics and in particular, their independence must not be impaired in any way. Companies should aim for efficient audit processes using external auditors in combination with the internal audit function. Management should encourage consultation between external and internal auditors. The audit committee should set the principles for recommending using the accounting firm of the external auditors for non-audit services.

Reporting of Financial and Non-financial Information

The audit committee should consider whether or not an interim report should be subject to an independent review by the external auditor. In the case of an independent review, the audit committee's report commenting on an interim report and the auditors' review report, should be tabled at the board meeting held to adopt the interim report. Where non-financial aspects of reporting have been subject to external validation, this fact be stated and details provided in the annual report.

Audit Committee

The board should appoint an audit committee that has a majority of independent non-executive directors. The majority of the members of the audit committee should be financially literate. The chairperson should be an independent non-executive director and not the chairperson of the board.

Relations with Shareholders

Companies should be ready where practicable, to enter into dialogue with institutional investors based on constructive engagement and the mutual understanding of objectives. This should take due regard of statutory, regulatory and other directives regulating the dissemination of information by companies and their directors and officers. When evaluating a company's corporate governance arrangements, particularly those relating to board structure and composition, institutional investors should give due weight to all relevant factors drawn to their attention and to any specific arrangements to eliminate unnecessary variations in criteria and measurement of performance.

Communication

It is the board's duty to present a balanced and understandable assessment of the company's position in reporting to stakeholders. The quality of the information must be based on the principles of openness and substance over form. Reporting should address material matters of significant interest and concern to all stakeholders. Reports and communications must be made in the context that society now demands greater transparency and accountability from companies regarding their non-financial matters.

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Compliance with all of these guidelines should improve company performance. They significantly reduce the risk of business failure for reasons other than commercial viability. Increasingly, audit firms will assess the quality of the board, and compliance with good governance generally, as part of their client acceptance and retention processes. Auditors should encourage their clients to comply with the principles set out in the Code. This practice will help them mitigating the impact of unfavourable corporate governance in South Africa.

Corporate Governance in Brazil

In Brazil, like anywhere else in the world, the corporate governance is influenced by internal and external events. These events have an impact on the values, principles and models effectively of corporate governance. Such factors range from the global environment to those related to the national environment and corporate system.

The country's recent history is an important factor in the analysis of the governance practiced by Brazilian companies. The financing sources, the leadership culture and economic context determined the way by which the Brazilian companies are being governed. As a general rule, companies with a strong leadership and financial capacity to overcome adverse economic periods are forming the prevailing system of governance in Brazil.

The charecteristic of brazilian corporate sector is the prevalence of family owned companies, limited capital pulverization and low percentage of shareholders with voting rights. These charecterstics has an adverse impact on governance practices, causing more conflicts between minority and majority shareholders. In response to the increasing demand for better standards on the governance of Brazilian companies, in the year of 2000, in the São Paulo Stock Exchange (BOVESPA), what has been called as the New Market was established, as well as the Levels of Governance Practice were set forth.

According to New market , the rights granted to the shareholders and by the quality of the information disclosed by the companies affect the liquidty and the value of shares. New Market has introduced a drafted governance practices to be adopted by listed companies, its officers and controllers. Adhering to such governance practices will qualify the company as Level 1 or Level 2, depending on the extent of existing commitment. Despite of being alike, the New Market was designed for companies that have decided to go public and the Levels of Governance Practice are intended for listed companies.

Companies qualified as Level 1 are mostly committed with information disclosure improvements and capital pulverization. On the other hand, companies qualified as Level 2 must adopt all practices of Level 1 and, additionally, are subject to a range of other practices, mainly related to minority shareholders rights and protection.

The relation between better practices of governance and higher profits was measured on a recent study conducted in the United States and can be already noticed in Brazil. The conclusions indicate that the companies which adopt strong governance practices have net profit margins higher than the non accepting segment. In another words governance practices have positivelt affected the companies.

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Caselet

South Africa Corporate Governance Continues to Improve

South African corporate governance practices are considered relatively mature compared to emerging market peers, says Fitch Ratings in a report published, but they remain underdeveloped by international market standards.

Fitch believes that further improvements in South African corporate governance are required, especially regarding transparency and disclosure of interim financial reporting, and related-party transactions and internal audit processes.

"South African corporate governance practices have improved in recent years, but significant further improvement is still required to meet the King III corporate governance guidelines published on 1 September 2009. However, this is expected to be a gradual process," says Roelof Steenekamp, Director in Fitch's South African Corporate team.

"Corporates with weaker corporate governance rated by Fitch also tend to have lower ratings. The current financial downturn has highlighted the increased importance of robust management control processes, and the relative difficulty in implementing some corporate governance practices," adds Steenekamp.

Fitch evaluates the relationship between corporate governance and credit quality in the report, with the board of directors considered a key factor in effective corporate governance analysis.

The agency notes that high downside risk to corporate credit quality exists, should governance practices be weak. This is affected by the fact that governance and management controls impact the ongoing viability of a company, which in turn may impact timely payment of contractual obligations and ultimately constrain a company's credit ratings. On the other hand, sound corporate governance practices would usually not in themselves lead to upward rating pressure.

Source: www.sagoodnews.co.za

14.3 Summary

- The major characteristic of Japanese model of corporate governance is a high level of stock ownership by affiliated bank and companies. The Japanese system of corporate governance has main bank in centre linked with financial/industrial network.
- In Japan, legal framework is very dominating and influential in developing policies. The government ministries also have enormous regulatory control.
- The King Report on Corporate Governance (1994) evoked interest in corporate governance in South Africa.
- King committee has taken, into its consideration, the seven characteristics of the good corporate governance. These are discipline, transparency, independence, accountability, responsibility, fairness and social responsibility.

Notes

14.4 Keywords

Foreign Companies: Foreign companies are those, which have been incorporated outside India and conduct business in India.

Keiretsu: It means industrial groups which are inter related by trading relationship and crossholdings of debt and shares in Japan.

14.5 Self Assessment

State whether the following statements are true or false:

1. In South Africa the Code applies only to the companies with securities listed on the JSE.
2. Bank is not considered major key player in Japanese model of corporate governance.
3. King Report first published in 1994.
4. Transparency is one of the seven characteristics identified by the King Report.
5. Application code applies to al companies with securities listed on JSE.
6. Bank and Keiretsu are two main elements of Japanese corporate governance system.
7. Japanese basic attitude towards business is dominated by more by strong professional values than social values.
8. The legal system of Japan plays a very important role in policymaking.
9. According to Japanese law, the shareholders cannot put resolutions on the agenda for the annual meeting.
10. As per the King's Committee report, the board should appoint an audit committee that has a majority of independent executive directors.

14.6 Review Questions

1. "The Japanese system of corporate governance is unique." Substantiate
2. Describe the term 'keiretsu'.
3. Write a short note on the regulatory framework of Japan.
4. As per the King's code, what are the seven characteristics of good corporate governance? Describe each in brief.
5. Discuss the suggestions of the King's Committee on risk management and audit.
6. Discuss the Japanese system of corporate governance.
7. Explain briefly the King Report.
8. Write a note on corporate governance system in Brazil.
9. What is risk management? Explain keeping King Report in mind.
10. What are the various acts governing Indian companies. Explain any two in brief.

Notes

Answers: Self Assessment

1.	False	2.	False	3.	True
4.	True	5.	True	6.	True
7.	False	8.	True	9.	False
10.	False				

14.7 Further Readings

Books

C V Baxi, *Corporate Governance.*

Dewan, S. M(ed), *Corporate Governance in Public Sector Enterprises*, Delhi, Pearson, Education, 2006.

Geeta Rani, R K Mishra, *Corporate Governance: Theory and Practice*, Excel Books.

King Committee Report on Corporate Governance (2002), Institute of Directors in South Africa.

Mallin, Christine A., *Corporate Governance*, Oxford University Press, 2004.

S Singh, *Corporate Governance.*

Online links

http://saiia.org.za/images/upload/Corporate_Gov_3Mayl2005final.pdf

http://unpan1.un.org/intradoc/groups/public/documents/APCITY/UNPAN023826.pdf

http://www.cvm.gov.br/ingl/inter/cosra/corpgov/brazil-e.asp