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Maisammaguda(H), Medchal -Malkajiri District, Secunderabad, Telangana State-500100, [www.mrec.ac.in](http://www.mrec.ac.in)

## Department of Master of Business Administration E-Content File



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Subject

**CORPORATE GOVERNANCE**

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# CORPORATE GOVERNANCE

## OPEN ELECTIVE -II

### MODULE-1

#### Introduction to Corporate Governance

Over the past two decades, the investment world has seen a large numbers of scandals relating to companies which are attributed to failure of governance. This has been caused due to a combination of factors which can be principally classified into three corporate sins.

• The executive directors of the company lost the sense of business ethics and earnings became the only motive. Directors were not prepared to show losses which led to the use of unethical practices like forging books of accounts to show higher earnings.

• Other directors acted as a puppet in the hands of executive directors, approving improper financial statements and condoning unfair practice. Managers awarded themselves huge bonuses and stock options, often at the expense of other shareholders.

• Auditors colluded or failed to stop executive directors from using improper accounting policies. In the process they lost their independence which they surrendered it in return for high audit fees.

The area of corporate governance has acquired heightened attention in the last decade because of various notable scandals and collapses cited from the USA (Enron, World com, Tyco), the UK (the collapse of Maxwell publishing group), Germany (the cases of Holtzman, Berliner Bank, and HIH), Korea (the widespread banking distress in 1997), Australia (Ansett Airlines and One Tel), France (Credit Lyonnais and Vivendi), and Switzerland (Swissair), India (Satyam and Reebok). The world reaction to these corporate wrongs was massive which led to the development of law and codes for better corporate governance. Cadbury Committee report 1992 (UK), Greenbury report 1995 (UK), The Combined code

1998 (UK), Turnbull report 1999 (UK), OCED principles of corporate governance 1999 etc were some of the international initiatives to regulate corporate affairs.

Especially the collapse of Enron in the USA in 2001 increased the importance of corporate governance both in the USA and in other parts of the world.

## **II. Corporate Governance-The concept**

Corporate refers to the most common form of business organisation, one which is chartered by a state and given legal rights as an entity separate from its owners. This form of business is characterised by the limited liability of its owners. The process of becoming a corporation, called incorporation gives the company separate legal standing from its owners and protects those owners from being personally liable in the event that the company is sued.

The concept of corporate governance is gaining momentum because of various factors as well as the dynamic business environment. The principles of good governance are as old as good behaviour, which needs no formal definition. However, in reference to the corporate world, it has been defined by various persons, some of whom is described below just in order to satisfy that the vital details and spirit of the term are not missed out. Sir Adrian Cadbury Committee, which looked into corporate governance issues in U.K., defines Corporate Governance "as the system by which the companies are directed and controlled. The basic objective of corporate governance is to enhance and maximize shareholder value and protect the interest of other stake holders".[1]Further the Kumar Mangalam Birla committee constituted by SEBI has observed that, "Strong corporate governance is indispensable financial reporting structure."[2]According to ICSI, "We may define 'corporate governance as a blend of rules, regulations, laws and voluntary practices that enable companies to attract financial and human capital, perform efficiently and thereby maximise long term value for the shareholders besides respecting the aspirations of multiple stakeholders including that of the society."[3]

Corporate governance is a multidisciplinary field of study it covers a wide range of disciplines "accounting, consulting, economics, ethics, finance, law, and management"[4]. The main function of corporate governance is to make agreements that describe the privileges and tasks of shareholders and the organization. In case of disagreements because of conflict of interest, it is the responsibility of corporate governance to bring everyone together. It also has the function of setting standards against which corporations work can be managed and administered[5]

Good governance is integral to the very existence of a company. It inspires and strengthens investor's confidence by ensuring company's commitment to higher growth and profits. It seeks to achieve following objectives:

- (i) That a properly structured Board capable of taking independent and objective decisions is in place at the helm of affairs;
- (ii) That the Board is balanced as regards the representation of adequate number of non-executive and independent directors who will take care of the interests and well being of all the stakeholders;
- (iii) That the Board adopts transparent procedures and practices and arrives at decisions on the strength of adequate information.
- (iv) That the Board has an effective machinery to sub-serve the concerns of stakeholders;
- (v) That the Board keeps the shareholders informed of relevant developments impacting the company;
- (vi) That the Board effectively and regularly monitors the functioning of the management team; and
- (vii) That the Board remains in effective control of the affairs of the company at all times. The overall endeavour of the Board should be to take the organisation forward, to maximise long-term gains and stakeholders' wealth.[6]

### **III. Need for and Importance of Corporate Governance**

The need for corporate governance has arisen because of the increasing concern about the non-compliance of standards of financial reporting and accountability by boards of directors and management of corporate inflicting heavy losses on investors. Many large corporations are transnational in nature. This means that these corporations have impact on citizens of several countries across the globe. If things go wrong, they will affect many counties, some more severely than others. It is, therefore, also necessary to look at the international scene and examine possible international solutions to corporate governance difficulties. Corporate governance is needed to create a corporate culture of consciousness, transparency and openness. It refers to a combination of laws, rules, regulations, procedures and voluntary practices to enable companies to maximise shareholder's long-term value. It should lead to increasing customer satisfaction, shareholder value and wealth. With increasing government awareness, the focus is shifted from economic to the social sphere and an environment is being created to ensure greater transparency and accountability.

It is integral to the very existence of a company and can be summarised in the following points:

a) Corporate scams: Scandals in the corporate world, whether centred around corruption, bribery, fraud, or greed tend to have a significant impact on the economy as a whole. The need for corporate governance is, then, imperative for reviving investors' confidence in the corporate sector towards the economic development of society.

b) Wide Spread Shareholders: In today's era, a company has a very large number of shareholders spread all over the world. The idea of shareholders' democracy remains confined only to the law and the Articles of Association which requires a practical implementation through a code of conduct of corporate governance.

c) Changing Ownership Structure: The pattern of corporate ownership has changed considerably, in the present-day-times with institutional investors and mutual funds becoming largest shareholders in large corporate private sector. These investors have become the greatest challenge to corporate managements, forcing the latter to abide by some established code of corporate governance to build up its image in society.

d) Globalisation: Desire of more and more companies to get listed on international stock exchanges also focuses on a need for corporate governance. There is no doubt that international capital market recognises only companies well-managed according to standard code of corporate governance.

#### IV. Issues in Corporate Governance

Corporate governance has been defined in different ways by different writers and organisations. Some define it in a narrow perspective to include in it only the shareholders, while others want it to address the concerns of all stakeholders. Some talk about corporate governance being an important instrument for a country to achieve sustainable economic development, while others consider it as a corporate strategy to achieve a long tenure and a healthy imagine. But to all, corporate governance is a means to an end, the end being long term shareholder, and more importantly, stakeholder value. Thus, all authorities on the subject are one in recognising the need for good governance practices to achieve the end for which corporate are formed. Some governance issues are identified as being crucial and critical to achieve these objectives.

These are:

**Â•Distinguishing the roles of board and management:** Constitutions of more and more companies stress and underline that the business is to be managed "by or under the direction of" the board. In such a practice, the responsibility for managing the business is delegated by the board to the CEO, who in turn delegates the responsibility to other senior executives. Thus, the board occupies the key position between the shareholders (owners) and the company's management (day-to-day managers of the company).

**Â•Separation of the roles of the CEO and chairperson:** The composition of the board is a major issue in corporate governance as the board acts as a link between the shareholders and the management and its decisions affect the performance of the company. All committees that studied corporate governance practices all over the world, starting with the Cadbury committee, have suggested various improvements in the composition of boards of companies. It is now increasingly being realised that the practice of combining the role of the chairperson with that of the CEO as is done in countries like the US and India leads to conflicts in decision making and too much concentration of power in one person resulting in unsavoury consequences. Combining the role of both the CEO and chairperson removes an important check on senior management's activities. This is the reason why many authorities on corporate governance recommend strongly that the chairman of the Board should be an independent director in order to "provide the appropriate counterbalance and check to the power of the CEO" (IFSA).[7]

**Â•Directors and executive's remuneration:** This is one of the mixed and vexed issues of corporate governance that came into the limelight during the massive corporate failures in the US between 2000 and 2002. Executive compensation has also in recent times become the most viable and politically sensitive issue relating to corporate governance. According to the Cadbury report: "The over-riding principle in respect of Board remuneration is that shareholders are entitled to full and clear statement of directors present and future benefits, and how they have been determined." Other committees on corporate governance have also laid emphasis on other related issues such as "pay-for performance", heavy severance payments, pension for non- executive directors, appointment of remuneration committee and so on.

**Â•Disclosure and audit:** The OECD lays down a number of provisions for the disclosure and communication of "key facts" about the company to its shareholders. The Cadbury Report termed the annual audit as "one of the

cornerstones of corporate governance". Audit also provides a basis for reassurance for everyone who has a financial stake in the company. There are several issues and questions relating to auditing which have an impact on corporate governance. There are, for instance, questions such as: (i) How to ensure independence of the auditor? (ii) Should individual directors have access to independent resource? Etc.

**Â•Composition of the board and related issues:** A board of directors is a "committee elected by the shareholders of a limited company to be responsible for the policy of the company. Sometimes, full time functional directors are appointed, each being responsible for some particular branch of the firm's work. [8] The composition of board of directors refers to the number of directors of different kinds that participate in the work of the board. Over a period of time there has been a change as to the number and proportion of different types of directors in the board of a limited company. The SEBI appointed **Kumar Mangalam Birla Committee's Report** defined the composition of the Board thus:

"The Board of directors of a company shall have an optimum combination of executive and non- executive directors with not less than 50 percent of the board of directors to be non- executive directors. The number of independent directors would depend upon whether the chairman is executive or non- executive. In case of a non-executive chairman, at least one-third of the board should comprise independent directors and in case of executive chairman, at least half of the board should be independent directors. [9]

## **V. India and corporate governance**

Corporate governance has played a very important role in the present economic condition of India. India successfully started its move towards open and welcoming economy in 1991 by following the LPG policy. From then onwards it has seen an amazing upward trend in the size of its stock market, that is, number of listed firms was increasing proportionately [10] If India wants to attract more countries for foreign direct investments, Indian companies have to be more focused on transparency and 'Shareholders value maximization' [11]

Kumarmangalam Birla Committee described the concept of corporate governance instead of defining or giving a meaning of it. Three key constituents of corporate governance as the shareholders, the Board of Directors and the Management and has attempted to identify in respect of each of these constituents, their roles and responsibilities as also their rights in the context of good governance. Fundamental to this examination and permeating throughout this exercise is the recognition of the three key aspects of corporate governance; namely, accountability,

transparency and equality of treatment for all stakeholders.

The pivotal role in any system of corporate governance is performed by the board of directors. It is accountable to the stakeholders and directs and controls the management. It stewards the company, sets its strategic aim and financial goals and oversees their implementation, puts in place adequate internal controls and periodically reports the activities and progress of the company in the company in a transparent manner to the stakeholders. The shareholders role in corporate governance is to appoint the directors and the auditors and to hold the board accountable for the proper governance of the company by requiring the board to provide them periodically with the requisite information, in a transparent fashion, of the activities and progress of the company. The responsibility of the management is to undertake the management of the company in terms of the direction provided by the board, to put in place adequate control systems and to ensure their operation and to provide information to the board on a timely basis and in a transparent manner to enable the board to monitor the accountability of management to it.[12]

Naresh Chandra Committee 'Report of the Committee on Corporate Audit and Governance' describe: The fundamental theoretical basis of corporate governance is agency costs. Shareholders are the owners of any joint-stock, limited liability Company, and are the principals. By virtue of their ownership, the principals define the objectives of a company. The management, directly or indirectly selected by shareholders to pursue such objectives, are the agents. While the principals might wishfully assume that the agents will invariably do their bidding, it is often not so. In many instances, the objectives of managers are quite different from those of the shareholders. Such misalignment of objectives is called the agency problem and the cost inflicted by such dissonance is the agency cost. The core of corporate governance is designing and putting in place disclosures, monitoring, oversight and corrective systems that can align the objectives of the two sets of players as closely as possible and, hence, minimise agency costs.

**Narayan murthy Committee on 'Report of the SEBI Committee on Corporate Governance' commented on Corporate Governance in the following manner:[13]**

Â·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 globalised 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.

Â·Corporate governance is about ethical conduct in business. Ethics is concerned with the code of values and principles that enables 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 organisation. Ethical leadership is good for business as the organisation is seen to conduct its business in line with the expectations of all stakeholders.

Â·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 mindset and ethical standards of management.

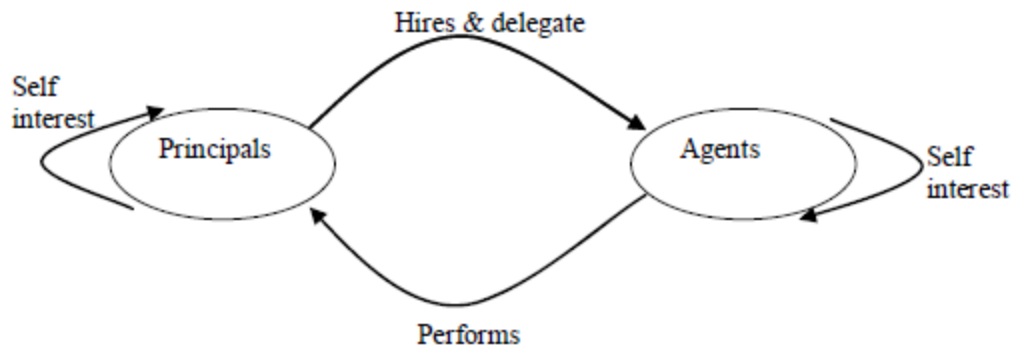
## **VI. Conclusion**

In this paper, we saw how important it is for a company to follow good corporate governance practices. The paper started going deep into the root cause of factors that affect corporate governance such as distinguishing the roles of board and management, composition of the board and related issues, choice of auditors and audit committee, directors and executives' remuneration etc. Then we looked at the brief history of corporate governance in India. India being an emerging economy needs to work more on regulating the corporate governance policies. The future of corporate governance is becoming a little clear now; the investors are promoted to behave more like owners rather than just traders. Independent directors have more defined roles and responsibilities.

## **THEORIES OF CORPORATE GOVERNANCE**

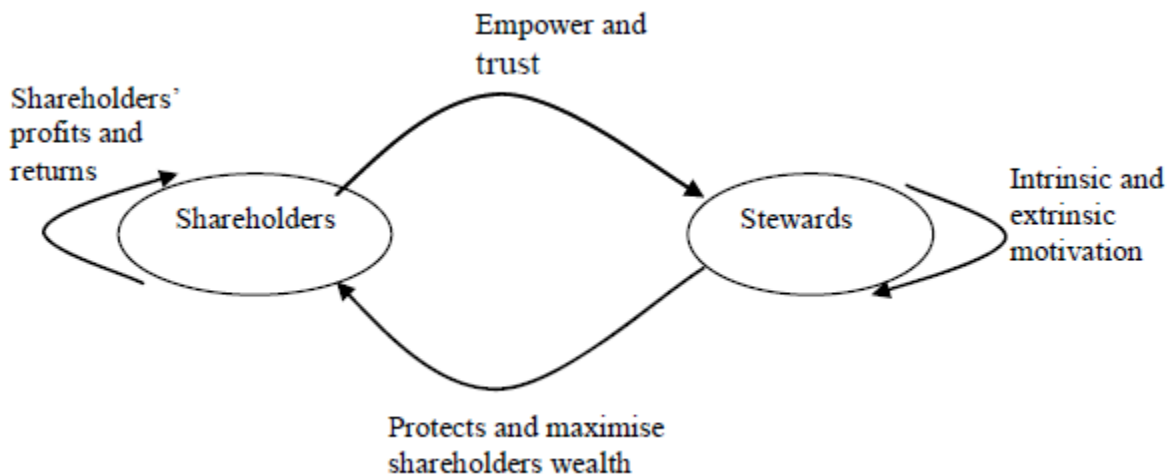
### Agency Theory

Agency theory defines the relationship between the principals (such as shareholders of company) and agents (such as directors of company). According to this theory, the principals of the company hire the agents to perform work. The principals delegate the work of running the business to the directors or managers, who are agents of shareholders. The shareholders expect the agents to act and make decisions in the best interest of principal. On the contrary, it is not necessary that agent make decisions in the best interests of the principals. The agent may be succumbed to self-interest, opportunistic behavior and fall short of expectations of the principal. The key feature of agency theory is separation of ownership and control. The theory prescribes that people or employees are held accountable in their tasks and responsibilities. Rewards and Punishments can be used to correct the priorities of agents.



### Stewardship Theory

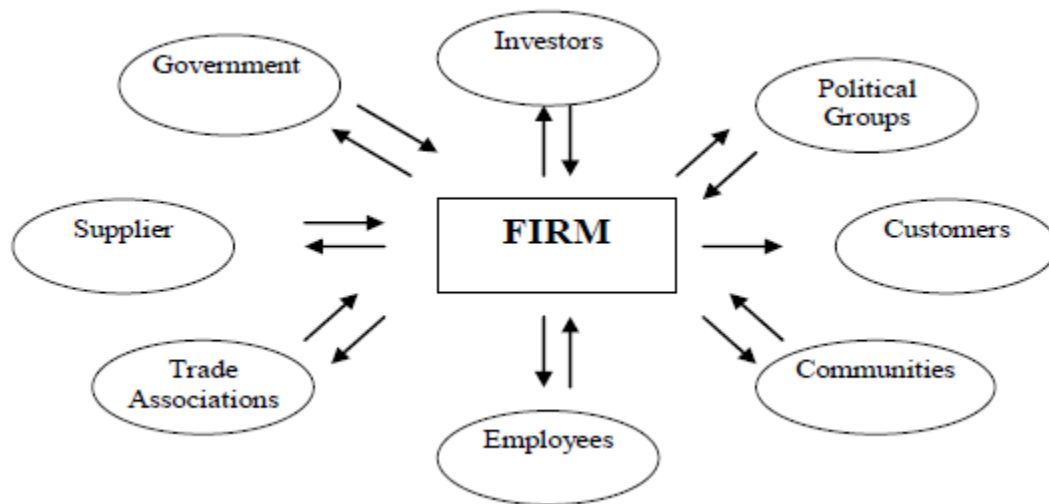
The steward theory states that a steward protects and maximises shareholders wealth through firm Performance. Stewards are company executives and managers working for the shareholders, protects and make profits for the shareholders. The stewards are satisfied and motivated when organizational success is attained. It stresses on the position of employees or executives to act more autonomously so that the shareholders' returns are maximized. The employees take ownership of their jobs and work at them diligently.



### Stakeholder Theory

Stakeholder theory incorporated the accountability of management to a broad range of stakeholders. It states that managers in organizations have a network of relationships to serve – this includes the suppliers, employees and business partners. The theory focuses on managerial decision making and interests of all

stakeholders have intrinsic value, and no sets of interests is assumed to dominate the others



### Resource Dependency Theory

The Resource Dependency Theory focuses on the role of board directors in providing access to resources needed by the firm. It states that directors play an important role in providing or securing essential resources to an organization through their linkages to the external environment. The provision of resources enhances organizational functioning, firm's performance and its survival. The directors bring resources to the firm, such as information, skills, access to key constituents such as suppliers, buyers, public policy makers, social groups as well as legitimacy. Directors can be classified into four categories of insiders, business experts, support specialists and community influentials.

### Transaction Cost Theory

Transaction cost theory states that a company has number of contracts within the company itself or with market through which it creates value for the company. There is cost associated with each contract with external party; such cost is called transaction cost. If transaction cost of using the market is higher, the company would undertake that transaction itself.

### Political Theory

Political theory brings the approach of developing voting support from shareholders, rather by purchasing voting power. It highlights the allocation of corporate power, profits and privileges are determined via the governments' favor

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**MODULE –II,**

**CORPORATE GOVERNANCE CODES AND COMMITTEES**

***Kumar Mangalam Birla Committee (2000):***



Another Committee named as K.M. Birla Committee was set up by SEBI in the year 2000. In fact, this Committee's recommendation culminated in the introduction of Clause 49 of the Listing Agreement to be complied with by all listed companies. Practically most of the recommendations were accepted and included by SEBI in its new Clause 49 of the Listing Agreement in 2000.

**The main recommendations of the Committee are:**

(a) The board of a company should have an optimum combination of executive and nonexecutive directors with not less than 50% of the board comprising the non-executive directors. In case, a company has a non-executive chairman, at least one-

third of board should be comprised of independent directors and in case, a company has an executive chairman, at least half of the board should be independent.

(b) Independent directors are directors who apart from receiving director's remuneration do not have any other material pecuniary relationship or transaction with the company, its promoters, management or subsidiaries, which in the judgement of the board may affect their independence of judgement.

(c) A director should not be a member in more than ten committees or act as chairman of more than five committees across all companies in which he is a director. It should be a mandatory annual requirement for every director to inform the company about the committee positions he occupies in other companies and notify changes as and when they take place.

**(d) The disclosures should be made in the section on corporate governance of the annual report:**

(i) All elements of remuneration package of all the directors, i.e., salary, benefits, bonus, stock options, pension etc.

(ii) Details of fixed component and performance linked incentives along with the performance criteria,

(iii) Service contracts, notice and period, severance fees,

(iv) Stock option details, if any, and whether issued at a discount as well as the period over which accrued and exercisable.

(e) In case of appointment of a new director or re-appointment of a director, the shareholders must be provided with the information:

(i) a brief resume of the director,

(ii) nature of his experience in specific functional areas, and

(iii) names of companies in which the person also holds the directorship and the membership of committees of the board.

(f) Board meetings should be held at least four times in a year, with a maximum times gap of 4 months between any two meetings. The minimum information (specified by the committee) should be available to the board.

(g) A qualified and independent audit committee should be set up by the board of the company in order to enhance the credibility of the financial disclosures of a company and promote transparency. The committee should have minimum three members, all being non-executive directors, with majority being independent, and with at least one director having financial and accounting knowledge. The chairman of the committee should be an independent director and he should be present at AGM to answer shareholder queries.

Finance director and head of internal audit and when required, a representative of the external auditor should be present as invitees for the meetings of the audit committee. The committee should meet at least thrice a year. One meeting should be held before finalization of annual accounts and one necessarily every six months. The quorum of the meeting should be either two members or one-third of the members of the committee, whichever is higher and there should be a minimum of two independent directors.

(h) The board should set up a remuneration committee to determine on their behalf and on behalf of the shareholders with agreed terms of reference, the company's policy on specific remuneration package for executive directors including pension rights and any compensation payment. The committee should comprise of at least three directors, all of who should be non-executive directors, the chairman of the committee being an independent director.

(i) A board committee under the chairmanship of a non-executive director should be formed to specifically look into the redressal of shareholder complaints like transfer of shares, non-receipt of balance sheet, declared dividends etc., The committee should focus the attention of the company on shareholders' grievances and sensitize the management of redressal of their grievances,

(j) The companies should be required to give consolidated accounts in respect of all their subsidiaries in which they hold 51% or more of the share capital,

(k) Disclosures must be made by the management to the board relating to all material, financial and commercial transactions, where they have personal interest that may have a potential conflict with the interest of the company at large. All pecuniary relationships or transactions of the non-executive directors should be disclosed in the annual report.

(l) As part of the Directors' Report or as an additional thereto, a management discussion and analysis report should form part of the annual report to the shareholders,

(m) The half-yearly declaration of financial performance including summary of the significant



events in last six months should be sent to each household of shareholders,

(n) The company should arrange to obtain a certificate from the auditors of a company regarding compliance of mandatory recommendations and annex the certificate with the Directors' Report, which is sent annually to all the shareholders of the company,

(o) There should be a separate section on corporate governance in the annual reports of companies, with a detailed compliance report on corporate governance.

***Committee # 4. Naresh Chandra Committee (2002):***

Consequent to the several corporate debacles in the USA in 2001, followed by the stringent enactments of Sarbanes Oxley Act, Government of India appointed Naresh Chandra Committee in 2002 to examine and recommended drastic amendments to the law pertaining to auditor-client relationships and the role of independent directors.

**The main recommendations of the Committee are given below:**

(a) The minimum board size of all listed companies as well as unlisted public limited companies with paid-up share capital and free reserves of Rs. 100 million and above, or turnover of Rs. 500 million and above, should be seven, of which at least four should be independent directors.

(b) No less than 50% of the board of directors of any listed company as well as unlisted public limited companies with a paid-up share capital and free reserves of Rs. 100 million and above or turnover of Rs. 500 million and above, should consist of independent directors.

**(c) In line with the international best practices, the committee recommended a list of disqualification for audit assignment which included prohibition of:**

(i) Any direct financial interest in the audit client,

(ii) Receiving any loans and/or guarantees,

(iii) Any business relationship,

(iv) Personal relationship by the audit firm, its partners, as well as their direct relatives, prohibition of

(v) Service or cooling off period for a period of at least two years, and

(vi) Undue dependence on an audit client.

ADVERTISEMENTS:

**(d) Certain services should not be provided by an audit firm to any audit client, viz.:**

(i) Accounting and book keeping,

(ii) Internal audit,

(iii) Financial information design,

(iv) Actuarial,

(v) Broker, dealer, investment advisor, investment banking,

(vi) Outsourcing,

(vii) Valuation,

(viii) Staff recruitment for the client etc.

(e) The audit partners and at least 50% of the engagement team responsible for the audit of either a listed company, or companies whose paid-up capital and free reserves exceeds Rs. 100 million or companies whose turnover exceeds Rs. 500 million, should be rotated every 5 years.

(f) Before agreeing to be appointed (Section 224 (i)(b)), the audit firm must submit a certificate of independence to the audit committee or to the board of directors of the client company.

(g) There should be a certification on compliance of various aspects regarding corporate governance by the CEO and CFO of a listed company.

It is interesting to note that majority of the recommendations of this committee are the culmination of the provisions of Sarbanes Oxley Act of the USA.

Committee : 5. N.R. Narayana Murthy Committee (2003):



SEBI constituted this Committee under the chairmanship of N.R. Narayana Murthy, chairman and mentor of Infosys, and mandated the Committee to review the performance of corporate governance in India and make appropriate recommendations. The Committee submitted its report in February 2003.

**The main items of Committee recommendations are as follows:**

(a) Persons should be eligible for the office of non-executive director so long as the term of office did not exceed nine years (in three terms of three years each, running continuously).

(b) The age limit for directors to retire should be decided by companies themselves.

(c) All audit committee members shall be non-executive directors. They should be financially literate and at least one member should have accounting or related financial management expertise.

(d) **Audit committee of listed companies shall review mandatorily the information, viz.:**

(i) Financial statements and draft audit reports,

(ii) Management discussion and analysis of financial condition and operating results,

(iii) Risk management reports,

(iv) Statutory auditors' letter to management regarding internal control weaknesses, and

(v) Related party transactions.

(e) The audit committee of the parent company shall also review the financial statements, in particular, the investments made by the subsidiary company.

(f) A statement of all transactions with related parties including their bases should be placed before the independent audit committee for formal approval/ratification.

Of any transaction is not on an arm's length basis, management should provide an explanation to the audit committee, justifying the same.

(g) Procedures should be in place to inform board members about the risk assessment and minimisation procedures.

(h) Companies raising money through an Initial Public Offering (IPO) shall disclose to the audit committee, the uses/application of funds by major category (capital expenditure, sales and marketing, working capital etc.) on a quarterly basis. On an annual basis, the company shall prepare a statement of funds utilized for purposes other than those stated in the offer document/prospectus. This statement shall be certified by the independent auditors of the company. The audit committee should make appropriate recommendations to the board to take up steps in this matter.

(i) It should be obligatory for the board of a company to lay down the code of conduct for all board members and senior management of a company. They shall affirm compliance with the code on an annual basis. The annual report of the company shall contain a declaration to this effect signed off by the CEO and COO.

(j) A director to become independent shall satisfy the various conditions laid down by the Committee.

(k) Personnel who observe an unethical or improper practice (not necessarily a violation of law) should be able to approach the audit committee without necessarily informing their supervisors. Companies shall take measures to ensure that this right of access is communicated to all employees through means of internal circulars etc. Companies shall annually affirm that they have not denied any personal access to the audit committee of the company (in respect of matters

involving alleged misconduct) and that they have provided protection to whistle blowers from unfair termination and other unfair or prejudicial employment practices. Such affirmation shall form a part of the board report on corporate governance that is required to be prepared and submitted together with the annual report.

(1) For all listed companies there should be a certification by the CEO and CFO confirming, the financial statements as true and fair in compliance with the existing accounting standards, effectiveness of internal control system, disclosure of significant fraud and significant changes in internal control and/or of accounting policies to the auditors and the audit committee. It is worth noting here that majority of the recommendations of this committee have been accepted by SEBI and thereby incorporated in the revised Clause 49 of the Listing Agreement in 2003 and 2004.

**The main features of its recommendations pertaining to corporate governance are as follows:**

(a) The (new) company law should provide for minimum number of directors necessary for various classes of companies. There need not be any limit to the maximum numbers of directors in a company. This should be decided by the companies or by its Articles of Association. Every company should have at least one director resident in India to ensure availability in case of any issue regarding accountability of the board.

(b) Both the managing director as also the whole time directors should not be appointed for more than five years at a time.

(c) No age limit may be prescribed in the law. There should be adequate disclosure of age of the directors in the company's document. In case of a public company, appointment of directors beyond a prescribed age (say) seventy years should be subject to a special resolution passed by the shareholders.

(d) A minimum of one-third of the total strength of the board as independent directors should be adequate, irrespective of whether the chairman is executive or non-executive, independent or not. A director to be independent should satisfy certain conditions laid down by the Committee.

(e) The total number of directorships, any one individual may hold, should be limited to a maximum of fifteen.

(f) Companies should adopt remuneration policies that attract and maintain talented and motivated directors and employees for enhanced performance. However, this should be transparent and based on principles that ensure fairness, reasonableness and accountability. There should be a clear relationship between responsibility and performance vis-a-vis remuneration. The policy underlying directors' remuneration should be articulated, disclosed and understood by investors/stakeholders.

(g) There need not be any limit prescribed to sitting fees payable to non-executive directors including independent directors. The company with the approval of shareholders may decide on remuneration in the form of sitting fees and/or profit related commissions payable to such directors for attending board and committee meetings, and should disclose it in its director's remuneration report forming part of the annual report of the company.

(h) The requirement of the Companies Act, 1956 to hold a board meeting every three months and at least four meetings in a year should continue. The gap between two board meetings should not exceed four months. Meetings at short notices should be held only to transact emergency business. In such meetings, the mandatory presence of at least one independent director should be required in order to ensure that only well considered decisions are taken. If even one independent director is not present in the emergency meeting, then decisions taken in such meeting should be subject to ratification by at least one independent director.

(i) Majority of the directors of the audit committee should be independent directors if the

company is required to appoint independent directors. The chairman of the committee should be independent. At least one member of the audit committee should have knowledge of financial management or audit or accounts. The recommendation of the committee, if overruled by the board should be disclosed in the Directors' Report along with the reasons for overruling.

(j) There should be an obligation on the board of a public listed company to constitute a remuneration committee, comprising non-executive directors including at least one independent director. The chairman of the committee should be an independent director. The committee will determine the company's policy as well as specific remuneration packages for its managing/executive directors/senior management.

(k) The rights of minority shareholders should be protected during general meetings of the company. There should be extensive use of postal ballot including



electronic media to enable shareholders to participate in meetings. Every company should be permitted to transact any item of business through postal ballot, except the items of ordinary business, viz., consideration of annual accounts, reports of directors and auditors, declaration of dividends, appointment of directors, and appointment and fixation of remuneration of the auditors.

(l) All non-audit services may be pre-approved by audit committee. An audit firm should be prohibited from rendering certain non-audit services as specified by the committee,

(m) Public listed companies should be required to have a regime of internal financial controls for their own observance. Internal controls should be certified by the CEO and the CFO of the company and mentioned in the Directors Report.

(n) Detail of transactions of the company with its holding or subsidiary or associate companies in the ordinary course of business and transacted on an arm's length basis should be placed periodically before the board through the audit committee. The transactions not in a normal course of business and/or not on an arm's length justification for the same. A summary of such transaction should form part of the annual report of the company.

(o) Every director should disclose to the company on his directorships and shareholdings in the company and in other companies.

It is important to mention here that despite various recommendations made by the above Committee on corporate governance, the Committee kept silence on two major issues on corporate governance.

## SEBI- CLAUSE 49 GUIDELINES

In corporate hierarchy two types of managements are envisaged:

- i) companies managed by [Board of Directors](#); and
- ii) those by a [Managing Director](#), whole-time director or manager subject to the control and guidance of the Board of Directors i.e., he is liable to the Board of Directors and the function of the corporate.

- As per Clause 49, for a company with an Executive [Chairman](#), at least 50 per cent of the board should comprise independent directors. In the case of a company with a non-executive Chairman, at least one-third of the board should be independent directors.
- It would be necessary for chief executives and chief financial officers to establish and maintain internal controls and implement remediation and risk mitigation towards deficiencies in internal controls, among others.
- Clause VI (ii) of Clause 49 requires all companies to submit a quarterly compliance report to [stock exchange](#) in the prescribed form. The clause also requires that there be a separate section on corporate governance in the annual report with a detailed compliance report.
- A company is also required to obtain a certificate either from auditors or practicing company secretaries regarding compliance of conditions as stipulated, and annex the same to the director's report.
- The clause mandates composition of an [audit](#) committee; one of the directors is required to be "financially literate".
- It is mandatory for all listed companies to comply with the clause by 31 December 2005.

Corporate Governance may be defined as “A set of systems, processes and principles which ensure that a company is governed in the best interest of all

stakeholders.” It ensures Commitment to values and ethical conduct of business; Transparency in business transactions; Statutory and legal compliance; adequate disclosures and Effective decision-making to achieve corporate objectives. In other words, Corporate Governance is about promoting corporate fairness, transparency and accountability. Good Corporate Governance is simply Good Business.

Clause 49 of the [SEBI](#) guidelines on Corporate Governance as amended on 29 October 2004 has made major changes in the definition of independent directors, strengthening the responsibilities of audit committees, improving quality of financial disclosures, including those relating to related party transactions and proceeds from public/ rights/ preferential issues, requiring Boards to adopt formal code of conduct, requiring [CEO/CFO](#) certification of financial statements and for improving disclosures to shareholders. Certain non-mandatory clauses like [whistle blower](#) policy and restriction of the term of independent directors have also been included.<sup>[1]</sup>

term ‘Clause 49’ refers to clause number 49 of the Listing Agreement between a company and the stock exchanges on which it is listed (the Listing Agreement is identical for all Indian stock exchanges, including the [NSE](#) and [BSE](#)). This clause is a recent addition to the Listing Agreement and was inserted as late as 2000 consequent to the recommendations of the Kumarmangalam Birla Committee on Corporate Governance constituted by the Securities Exchange Board of India ([SEBI](#)) in 1999.

Clause 49, when it was first added, was intended to introduce some basic corporate governance practices in Indian companies and brought in a number of key changes in governance and disclosures (many of which we take for granted today). It specified the minimum number of independent directors required on the board of a company. The setting up of an Audit committee, and a Shareholders’ Grievance committee, among others, were made mandatory as were the Management’s Discussion and Analysis (MD&A) section and the Report on Corporate Governance in the Annual Report, and disclosures of fees paid to non-executive directors. A limit was placed on the number of committees that a director could serve on.

In late 2002, [SEBI](#) constituted a Committee to assess the adequacy of current corporate governance practices and to suggest improvements. Based on the recommendations of this committee, SEBI issued a modified Clause 49 on 29 October 2004 (the ‘revised Clause 49’) which came into operation on 1 January 2006.

The revised Clause 49 has suitably pushed forward the original intent of protecting the interests of investors through enhanced governance practices and disclosures. Five broad themes predominate. The independence criteria for directors have been clarified. The roles and responsibilities of the board have been enhanced. The quality and quantity of disclosures have improved. The roles and responsibilities of the audit committee in all matters relating to internal controls and financial reporting have been consolidated, and the accountability of top management—specifically the CEO and CFO—has been enhanced. Within each of these areas, the revised Clause 49 moves further into the realm of global best practices (and sometimes, even beyond).

By Circular dated 8 April 2008, the Securities and Exchange Board of India amended Clause 49 of the Listing Agreement to extent the 50% independent directors rule to all Boards of Directors where the Non-Executive Chairman is a promoter of the Company or related to the promoters of the company.

At the end of the first India Corporate Week in December 2009, the Ministry of Corporate Affairs issued new Corporate Governance Voluntary Guidelines and new Corporate Social Responsibility Voluntary Guidelines.

## ROLE OF GOVERNMENT IN CORPORATE GOVERNANCE

Recent corporate scandals have led to public pressure to reform business practices and increase regulation. The public outcry over the recent scandals has made it clear that the status quo is no longer acceptable: the public is demanding accountability and responsibility in corporate behavior. Already policymakers have adopted numerous reforms. In 2002, Congress speedily passed the Sarbanes-Oxley Act, imposing (among other things) new financial control and reporting requirements on publicly traded companies. The Securities and Exchange Commission (SEC) and the self-regulatory organizations it oversees--both the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD)--have adopted new standards for public companies and securities dealers. These responses make clear that the governance of corporations has become a central item on the public policy agenda. To address this challenge, the Center for Business and Government and its Regulatory Policy Program organized a conference in May 2004 on the role of government in corporate governance. This

report summarizes the findings of this conference and is organized in three parts: (1) government regulation versus self-regulation, (2) the design of regulatory standards, and (3) regulatory enforcement.

### **MODULE-III**

#### **BOARD AND LEADERSHIP:**

The board of directors is those elected people in the organization whose responsibility is to take the strategic decision for running the organization whether it's for the profitable cause or Nonprofit organization. The board of directors is the whole sole responsibility for the management of the enterprises. Board of Directors (BOD) also referred to as Board of the company, Trustee of the company. It can also be said that directors are the real brain of the company.

A person on the board of directors can be a director or the officer in the company.

MBA

## STRUCTURE OF THE BOARD OF DIRECTORS

### Structure of the Board of Director

- **Chairman:** Chairman is the top of all board of director, He can be executive as well as non-executive person. He is responsible for the overall business of the business.
- **Managing Director:** Managing director is appointed by the board of director basically by the executive directors for looking at the performance of the executive directors, Look for the business hygiene and provide insights, guidance to them.
- **Executive Director:** They are the real directors of the company who are managing the different area of the company and take the strategic decision, getting salary drawn from the company
- **Non-Executive Director:** Non-executive directors are basically appointed to have a different view or opinion besides executive directorship.



## ROLES AND RESPONSIBILITY OF BOARD OF DIRECTORS

### *Responsibilities of the Board of Director*

- Set out the rules, Governance, Policies, the strategy of the company
- To make the annual budgets including cash, Sales target, Expense approval for the forthcoming year.
- Responsible for the organization performance
- Responsible for the compensation arrangement of the top officials
- To elect the CEO of the company by casting their votes

### *Roles of Board of director*

- They have to establish the vision of the company.
- Ensure that companies are implementing the strategies as desired by them.
- Doing the SWOT analysis of the organization in a timely manner.
- To check that internal control are effective at the organization level.
- Communicate with the higher management of the companies.
- To maintain official relations with the relevant stakeholders.
- To work with the best interest of the shareholders.

### *TypeS of Directors*

#### **Executive and Non-Executive Directors**

In a literal sense, there is no difference between executive and non-executive directors but difference arises in the way that the executive director has more knowledge of the company while the non-executive director has knowledge of outside companies as well so can make a better decision and provide logical and competitive insights.

## ***#2 – Board Meeting***

Board members are required to arrange a board meeting at the defined intervals. As per the UK companies act, Board of directors need not to hold a specific meeting in a year but should require for the healthy decisions board meeting should be held as per the requirement so it's generally said that least 4 board meeting during the year to discuss the performance, declaration of dividend, adoption of books of accounts, directors performance, appointment of directors, compensation reviews.

## ***Directors Remuneration***

Director's compensation is decided by the board of the company. If the company is listed on the exchange then compensation of the directors will be fixed by the remuneration committee which will follow the transparent and clear rules for deciding the compensation that needs to be paid to the BOD. They will not directly or indirectly involve in this decision making.



In the annual account of the company, it is a compulsory requirement to disclose the amount paid to the directors during the period with a detailed sheet showing individual records.

### ***Maximum & Minimum No of Directors***

A public company needs to have at least 3 directors and if the company is private then they need to have at least 2 directors.

One Director Company: Startup or a one-person company (OPC) is allowed to have only a single director to be appointed and at the same time director can be the shareholder of the same company and also be the whole sole person of the business who is running that business.

A public company can appoint a maximum of fifteen directors but can appoint even more than that bypassing the special shareholder resolution.

### ***Maximum no. of Directorship***

This is about the company can have minimum and maximum no. of director, but a director can be appointed as a director in how many companies at the same time?

A person can be a director not more than 20 companies at the same time. So if the person was a director in more than 20 companies then he has to select those

companies in which he wanted to remain as a director within the prescribed limit and terminate its directorship in other companies and also intimate his choice to all the companies.

## **Disqualification of Directors**

- If a person is of age less than 16 years then he can't apply for the directorship in the company
- The bankrupt person that is not properly discharged also can not apply
- A person who is from the firm of auditor
- Directors should avoid the financial transaction with the company
- Directors should not have taken any loan or ask for a guarantee from the company

## **II. Leveraging Good Governance:**

A good governance framework is a critical success factor for the creation and successful operation of a council company. Focusing on governance reflects good practice and high performing organizations (in the public and private sector) prioritise the continuous improvement of governance as a corporate priority.

Where governance works best is when it is considered, articulated, understood and enacted. There are some great examples of governance systems for council companies, which foster positive relationships, allow risks to be proactively managed, ensure the appropriate level of control and flexibility, and are aligned to council constitutions and company law.

### **Competitive Advantage:**

At its best, having good governance arrangements allows for a competitive advantage which drives the business forward to success.

At its worse, it is opaque, poorly thought through or not enacted. This can lead to confusion, poor risk management, conflicts of interest, deteriorating relationships, under-performance, poor value-for-money, reputational damage and compliance issues.

C. Co believes a robust Governance Framework for Local Authority Trading Companies should:

- Reflect the principles of good governance set out in the CIPFA Delivering **Good Governance in Local Government Framework**.
- Be transparent and understood.
- Specify the distribution of rights and responsibilities between shareholders, the board and managers/employees, commissioners and contract management.
- Balance the need for control and flexibility appropriately at each level.
- Provide the structure by which company objectives are set.
- Ensure company boards can be held to account and that an administration's priorities be fulfilled.
- Enable each company board to have the operational flexibility to be innovative and run the company within the agreed parameters.
- Enable investment conversations to play out.
- Spell out rules and procedures for making decisions.
- Separate the role of contract management, the shareholder, and the board (of Directors).

To achieve these characteristics there will be a number of roles, capabilities and processes in place to ensure good governance is embedded across the system. These would be clearly documented to ensure transparency, common understanding and consistency. There should also a requirement for training and engagement sessions so that the arrangements are clearly understood by members, officers, company directors and company employees.

The organizations we see doing well have ensured that board members are provided with the opportunity for training or mentoring. Investing time and energy in making sure key stakeholders understand their role and have clarity on legal responsibilities (and liabilities) and how to run a dynamic and effective board are vital ingredients to the success of the company.

## **Conflicts of Interest**

Conflicts of interest abound at the board level. They constitute a significant issue in that they affect ethics by distorting decision making and generating consequences that can undermine the credibility of boards, organizations or even entire economic systems.

Many corporations require board members to sign a conflict of interest policy at the time of appointment or to declare any conflicts of interest at the beginning of board meetings. Conflict of interest policies normally specify how directors should avoid conflicts of interest. This narrow focus only scratches the surface, given the scope, responsibilities and dynamics of decision making in the boardroom.

The real danger lies in the extent to which boards and directors are unaware of the many subtle conflicts of interest that they are dealing with. The boardroom is a dynamic place where struggles of ego, power, rules, and authority continuously surface, and it is not always clear, in the turmoil of group dynamics, what constitutes a conflict of interest or the manner in which one should participate in board deliberations. Furthermore, director duties tend to diverge from one company to another and from country to country, which adds even more complexity.

In countries with relatively strong shareholder rights, such as in the US, directors are expected to be accountable to shareholders. However, excessive promotion of the interests of shareholders can lead to conflicts with other stakeholders. Due to different contractual arrangements, the interests of stakeholders are often in conflict. Board members are required to always use ethical and appropriate judgment to make seemingly correct choices when conflicts arise.

In many other countries, directors have a duty to the company, not to shareholders. In Germany, for example, the company is considered distinct from the collective shareholders, which prevents shareholders from claiming that the directors have a duty toward them first and foremost. Shareholders are seen as one kind of stakeholder among a pool of many, and the company does not have a duty to maximize shareholder value. Boards are composed of interested directors, such as representatives of employees, shareholders, and other stakeholders. The loyalties of these stakeholder representatives are often divided, and considering that

multiple-role directors have to rebalance different interests, the potential for conflict becomes clear.

When the interests of a broader group of stakeholders, such as a government or society, are added to the mix, this judgment goes far beyond what might be included in a written conflict of interest policy. In this article we seek to analyze conflicts of interest as a four-tier pyramid by exploring more and more in depth the conflicting situations, right down to the fundamental purpose of business, in view of helping board directors make better decisions by taking an ethical stand in shaping business in society.

### The four tiers of conflicts of interest

A tier-I conflict is an actual or potential conflict between a board member and the company. The concept is straightforward: A director should not take advantage of his or her position. As the key decision makers within the organization, board members should act in the interest of the key stakeholders, whether owners or society at large, and not in their own. Major conflicts of interest could include, but are not restricted to, salaries and perks, misappropriation of company assets, self-dealing, appropriating corporate opportunities, insider trading, and neglecting board work. All board members are expected to act ethically at all times, notify promptly of any material facts or potential conflicts of interest and take appropriate corrective action.

Tier-II conflicts arise when a board member's duty of loyalty to stakeholders or the company is compromised. This would happen when certain board members exercise influence over the others through compensation, favors, a relationship, or psychological manipulation. Even though some directors describe themselves as "independent of management, company, or major shareholders," they may find themselves faced with a conflict of interest if they are forced into agreeing with a dominant board member. Under particular circumstances, some independent directors form a distinct stakeholder group and only demonstrate loyalty to the members of that group. They tend to represent their own interest rather than the interests of the companies.

A tier-III conflict emerges when the interests of stakeholder groups are not appropriately balanced or harmonized. Shareholders appoint board members, usually outstanding individuals, based on their knowledge and skills and their ability to make good decisions. Once a board has been formed, its members have

to face conflicts of interest between stakeholders and the company, between different stakeholder groups, and within the same stakeholder group. When a board's core duty is to care for a particular set of stakeholders, such as shareholders, all rational and high-level decisions are geared to favor that particular group, although the concerns of other stakeholders may still be recognized. Board members have to address any conflicts responsibly and balance the interests of all individuals involved in a contemplative, proactive manner.

Tier-IV conflicts are those between a company and society and arise when a company acts in its own interests at the expense of society. The doctrine of maximizing profitability may be used as justification for deceiving customers, polluting the environment, evading taxes, squeezing suppliers, and treating employees as commodities. Companies that operate in this way are not contributors to society. Instead, they are viewed as value extractors. Conscientious directors are able to distinguish good from bad and are more likely to act as stewards for safeguarding long-term, responsible value creation for the common good of humanity. When a company's purpose is in conflict with the interests of society, board members need to take an ethical stand, exercise care, and make sensible decisions.

Tier-I conflicts: Individual directors vs. company

Directors are supposed to “possess the highest personal and professional ethics, integrity and values, and be committed to representing the long-term interest of the shareowners.” However, in many cases shareholders have sued directors for taking advantage of the company. An actual or potential conflict between a board member and a company is called a tier-I conflict.


A company is normally considered as a separate legal entity that is independent from its directors, executives and shareholders. Powerful directors such as founders or dominant shareholders can be accused of misappropriating company assets if they are found stealing from their own company; directors who trade on the basis of material, non-public information can be sued for insider trading; those caught accepting bribes or working for competing companies may be asked to

resign; directors who sign agreements on behalf of the company that mainly contribute to their own enrichment may be charged with self-dealing. For example, the well-known case of Guth vs. Loft Inc. in 1939 addressed the issues of individuals pursuing business opportunities for self-enrichment.

When board members fail to dedicate the necessary effort, commitment and time to their board work, it can result in a conflict between the board member and the company. Directors often serve on multiple boards in order to benefit from several compensation packages. This can often complicate matters for the respective directors, as they may not be able to allocate sufficient time to governing any one company. According to the Spencer Stuart US Board Index 2014, approximately 25% of S&P 500 boards do not impose a limit on the number of board positions. Crainer and Dearlove described that directors who were unable to devote a sufficient amount of their time to any one board, “stuffed the document in their briefcases, all 200 pages or so, and leafed through them in the taxi to the meeting. They extracted, at random, a paper, formulated a trick question and entered the meeting room ready to fire. After all, board work is a power game.” Lack of effort, focus and dedication are types of conflict of interest that have not yet received the attention they deserve.

It is well understood that tier-I conflicts arise when directors take advantage of their positions. However, when directors lack commitment and dedication to their duties, the conflict of interest is somewhat more subtle and much less obvious. Companies need to issue guidelines regarding directors’ conflicts of interest and ensure that directors follow these rules and act in the interest of the organizations they serve.

Companies can self-assess their exposure to tier-I conflicts by asking the following questions:

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1. Has the company experienced situations in which individual directors have taken advantage of the company through compensation, self-dealing, stealing, insider trading, accepting bribes or appropriating opportunities for personal benefit?
  2. How could negligence of board work or lack of commitment present a conflict of interest?
  3. Would signing a code of conduct at the time of appointment be helpful?

Tier-II conflicts: Directors vs. stakeholders

To whom do board members owe their loyalty? This depends very much on law and tradition and the prevailing legal system, social norms or the company's specific situation. For example, directors might declare that they owe their duty of loyalty to shareholders, the company itself, certain stakeholders or other board members.

The complex institutional loyalty of board directors

In the US, directors often have a duty of loyalty toward the company's shareholders. The idea of maximizing shareholder value came from Milton Friedman, who proposed that executives and directors should focus solely on creating value for shareholders. Others argue that since the directors and executives are paid by the company, they are employees of the company – not of the shareholders – so they should thus focus on the interests of the company rather than on those of the shareholders.

According to Lynn Stout, a distinguished professor of corporate and business law at Cornell Law School, shareholder value maximization is a choice, not a legal requirement. The assumption that shareholders are principals and that directors are their agents is legally incorrect. Corporate law clearly states that shareholders cannot control directors or executives. They have the right to vote on the positions of the directors of the board and recover damage compensation from directors and executives if they are found to have stolen from the company but they have no right to tell executives how to run the company.

Being loyal to shareholders is, in any case, easier said than done. Shareholders come and go and their interest in the company is limited to their shareholding period. Shareholder's interests vary depending on their investment horizon, degree of diversification and investment strategy. Given the many types of shareholders, reaching a consensus for all of them is a daunting task. Ordinary individuals and families who invest for their retirement or to fund future expenses are often represented by institutional investors such as sovereign wealth funds, banks, hedge funds, pension funds, insurance companies and other financial institutions. These powerful representatives interact with board members frequently and exercise most of the pressure, but when they put personal interest before that of the ultimate shareholders, interests could be misaligned. For example, the representatives may be striving for short-term personal gain or compensation while the ultimate investors may want the same as all other stakeholders: the creation and preservation of the corporation's long-term sustainable wealth.



If maximizing shareholder value is a widely accepted norm, then board members would be better positioned if they announced that their loyalty lay with the ultimate shareholders. This would lead them to become stewards of the company and refrain from being distracted by proposals that generate immediate stock returns but endanger the long-term prospects of the company.

A study of directors' duties in all 27 EU member states and Croatia showed that in Europe directors primarily have a duty of loyalty to their company. This principle is universally accepted and undisputed across the 27 EU countries. All board members, including shareholder representatives, are required to balance the interests of all stakeholders with the long-term prospects of the company. To balance the interests, composition and independence of the board of directors are often defined in the corporate governance codes.

For example, according to the Swedish Corporate Governance Code (applicable from November 1, 2015), "boards of Swedish listed companies are composed entirely or predominantly of non-executive directors. The Code also states that a majority of the members of the board should be independent of the company and its management. At least two members must also be independent of the company's major shareholders, which means that it is possible for major shareholders of Swedish companies to appoint a majority of members with whom they have close ties." Even if all directors have a duty of loyalty to their company, most directors serving on the Swedish boards could have close ties with major shareholders, and according to the Code, some directors could have ties with minority shareholders, management, or other stakeholders. The ties with various stakeholder groups potentially create divided loyalties for directors.

The laws of some countries require stakeholder representatives on boards to serve the interests of their respective principals in some situations. For example, banker directors, who are only appointed as board members when a company is in financial distress, must be loyal to their bank, which lent money to the company in question. When the company nears insolvency, the duty to shareholders or to promote the success of the company will be modified by the obligation to act in the interest of the creditors. While it may be perfectly legal for such interested parties to be members of the board, it can help if each stakeholder group puts their ultimate objectives on the table before starting negotiations. This allows minority shareholders and minor stakeholders to have their perspectives heard, which may incite majority shareholders to be more inclined to balance their own interests with those of others.

## Influence of domineering board members on others

Both independent and interested directors can potentially be influenced by powerful CEOs, chairpersons or other directors through compensation, favors, relationships or psychological manipulation. Board members may also forsake their institutional duties out of personal loyalty to the CEO or chairperson. One way directors can determine whether they have been overly influenced is by asking themselves, “Have I been influenced or manipulated in order to agree with others?”

Persuasive influence often comes from people holding the combined role of CEO and chairperson as they can sway other board members’ compensation. Even if a board comprises primarily independent directors, it may not be able to remain truly independent from the management. Paul Hodgson, director at BHJ Partners in Portland, Maine, reportedly said about boards that “Shareholders can sit back and say ‘These directors are being paid so well that I can’t see them ever questioning management on anything, because this is a gig they would hate to lose.’” If most of the board members generate a significant total income from board compensation packages, how independent could they be in reality?

Personal, familial and professional relationships can also potentially affect an independent director’s judgment. The social connections between directors and CEOs or chairpersons cannot always be thoroughly checked. For example, retired CEOs may remain chairpersons on the company’s board, and many of the directors on that board may owe the chairperson their job. Or the CEO may invite close friends to join the board as directors. In both cases, the directors in question may be influenced by a sense of loyalty or duty to the chairperson or CEO, even if the CEO or chairperson is not acting in the best interests of the company or its shareholders or other stakeholders. Independent directors would be reluctant to contradict the views of a CEO or chairperson to whom they felt they owed their loyalty, so rather than do so they may either comply or step down from their role.

Boardrooms are dynamic places where heated discussions occur. Those occupying positions of power, such as the CEO and the chairperson, may manipulate directors into agreeing with their preferred decisions using psychological tactics such as tone of voice and eye contact to dominate the discussion, rebuff criticism, or intimidate others for their personal gain. In some cases, board members may feel as though they are being victimized or manipulated while those dominating the discussion may just think that they are leading a dynamic interaction. Such unbalanced dynamics, including superiority and inferiority complexes, reduce the effectiveness

of board discussions and prevent independent directors from exercising their duty as directors.

Board directors organized as a self-interested stakeholder group

Regulators and researchers have argued that boards should comprise a greater number of independent directors to ensure that business decisions are not disproportionately influenced by powerful stakeholders. The Spencer Stuart Board Index 2014 survey confirmed that S&P 500 boards elected 371 new independent directors in the 2014 proxy year, a 9% increase from 2013. This followed a 16% increase during the 2013 proxy year.

Independent directors can form a distinct stakeholder group. This happens more often when directors are put in a “survival” mode, in case of financial or political crisis, severe shareholders’ conflicts, hostile takeover or growing tension with management. Such coalitions are growing in power and authority as independent board members increasingly remain loyal to each other in the boardroom, subjugating the interests of the organizations they are supposed to represent to their own. In other words, these stakeholder groups have their own motives and interests and the strategic decisions they make benefit themselves rather than the organizations they are paid to serve.

In certain countries, unless specified otherwise, directors decide what their salary, shares and options will be. If no independent body such as a shareholder committee or a regulator oversees the compensation of directors, this can easily lead to a conflict of interest with the company. In the case of *Calma v. Templeton* (April 2015), the Delaware Chancery Court in the United States allowed a claim that challenged the directors' stock compensation from going forward because it was considered “excessive.” The compensation plan limited the number of shares to 1 million per year per participant, which represented a value of US\$55 million at the time of the lawsuit. The court determined that the entire decision process for compensation was unfair because the awards to the outside directors were decided by the recipients themselves.

In a 2013 Harvard Business Review article, “What CEOs really think of their boards,” one CEO was quoted as saying, “They like their board seats – it gives them some prestige. They can be reluctant to consider recapitalization, going private, or merging – ‘Don’t you know, we might lose our board positions!’ I have been shocked by board members saying, ‘that would be an interesting thing to do, but what about us?’” Another CEO was quoted as saying, “In one situation, we had

a merger not go through because of who was going to get what number of board seats... It is still the most astounding conversation of my life.” Rather than steering the company toward long-term value creation, directors who are primarily focused on their own interests tend to lose their objective vision when it comes to making the right decisions for the company. An exceptionally destructive scenario might consist of two stakeholder groups – the executive directors group vs. the independent directors group – leveraging their full control over the board and benefiting one another by building an “I’ll scratch your back if you scratch mine” relationship with both groups continuing to add to their individual compensation at the expense of the company and other stakeholders.

We can see that high compensation does not always have as positive an effect as it was intended to. The more compensation directors receive, the greater their personal desire to be re-elected becomes, so they increasingly focus on remaining on the board, enjoying their status and fame, boosting their compensation further, and obtaining more directorships on other boards.

The structure and level of directors’ compensation varies internationally. According to the German Corporate Governance code, the compensation of supervisory board directors consists of a combination of cash and shares and is linked to individual background and involvement in board and committee functions. At Deutsche Bank, 25% of the directors’ compensation was converted into shares of the company based on the average share price during the last 10 trading days of the year.

In China, not all board members receive compensation from the company they serve. For example, shareholder representatives working full time at the Industrial and Commercial Bank of China (ICBC) receive their compensation from China’s sovereign wealth fund – China Investment Corporation (CIC). This means that state owners oversee the compensation of both executive directors and independent directors, which effectively eliminates the possibility of self-dealing. At ICBC, the modest pay still attracts high-quality independent members to the board, especially those with positive character traits such as conscientiousness, integrity, competence, judgment, focus, and dedication, which cannot be motivated or demotivated solely with money.

1. In your legal system, to whom do board members owe their duty of loyalty?
2. Can you define whether in your specific context loyalty to shareholder or loyalty to company is primary? Are there minority shareholders to be concerned about?

3. If a director claims to owe his or her duty of loyalty to shareholders, would one be able to specify who the shareholders are, i.e. fund managers or activists, large shareholders on the board, minority shareholders not on the board, or the ultimate shareholders?
4. Can a director be fully independent when the CEO or chairperson decides on the compensation and succession of the directors?
5. If a director is independent, could you specify who they are independent from (i.e. management, shareholders, other stakeholders, etc.)?
6. Have you experienced a situation in which domineering directors felt as though they were having a heated discussion while others felt as though they were being suppressed?
7. Are you aware that directors can form coalitions and leverage their full control of the board to benefit one another in an “I’ll scratch your back, you scratch mine” type of relationship?



#### Tier-III conflicts: Stakeholders vs. other stakeholders

Directors on boards have another duty: exercising due diligence when making decisions. In Germany duty of care is a legal obligation. The law states that “executive members have to exercise the care of an ordinary and conscientious business leader.” Directors have a fiduciary responsibility to the company from the moment they are recruited, and they are expected to display a high standard of expertise, care and diligence by gathering as much information as possible and considering all reasonable alternatives in order to make sensible decisions.

The trust placed in directors gives them maximum autonomy in decision making, and decisions are not questioned unless they are deemed irrational. This business judgment rule protects directors from potential liabilities, as their decisions are not tainted by personal interest. Though directors are not allowed to act in their own interests, they can promote the interests of a particular stakeholder group against the company, or the interests of one group of stakeholders against another, or they can favor one subgroup over another within the same stakeholder group. It is up to directors to make wise decisions when stakeholders are in conflict.

If a board is composed of interested directors who remain loyal to their respective stakeholders, then it is necessary for stakeholder representatives to cooperate and find the optimal coalition to address common interests. Directors on boards must keep in mind the interests of weak or distant stakeholders to ensure their interests are not overlooked.

## Conflicts of interest between stakeholders and the company

A company is an aggregation of stakeholders bound together by economic interest. All stakeholders expect to receive a sizable slice of the pie in exchange for their input. Each group of stakeholders has a different contractual arrangement with the company and distinct motives that means they will be more likely to push for decisions that benefit themselves first and foremost. For example, creditors, such as banks, will prefer the company to play it safe in order to maximize the chances that it will pay off its debt, but this low level of risk taking could hurt the company's long-term growth potential. At the other end of the spectrum, shareholders can benefit from the successful outcome of a risky project while their losses are limited to the amount of their investment, so they are more likely to encourage risk taking, even if it means putting the company's survival at risk.

Employees receive cash compensation plus benefits. By negotiating above-average compensation for workers, unions put the profitability of the company at risk. Many companies have gone bankrupt as a result of out-of-control labor costs. In 2008, for instance, workers at GM, Ford and Chrysler were among the most highly paid in the US with over US\$70 an hour in wages and benefits once retirement benefits were included in the calculation. This was considerably higher than the average hourly labor costs of US\$25.36 for all private-sector workers, and the three car manufacturers were paying about US\$30 per hour more than their Asian rivals operating in the US. GM and Chrysler declared bankruptcy whereas Ford Motor Company managed to survive without bailout funds. Eventually, all three recovered by adjusting labor costs to be more or less in line with competitors, which they did by creating private trusts to finance the benefits of future retirees.

As a result of the financial difficulties that many companies encountered during the 1980s and early 1990s, some companies allowed labor unions to designate one or more members of the firm's board of directors. The first major company in the United States to elect a union leader to its board was Chrysler in 1980. Board members representing unions have a delicate balancing act to play and they need to be aware of the potential conflicts of interest inherent in their role. On the one hand, if they push for high wage increases they could lead the company into bankruptcy and negatively affect all stakeholders in the long run. On the other hand, if they agree to substantial wage reductions they could lose the trust of the workers they are supposed to defend and represent.

Weak corporate governance could open the door for management to take excessive risks. When the bonuses and incentives of top management are linked to quarterly

earnings and profits, managers may be more inclined to focus on the short term, which sometimes leads to hazardous environmental and social impacts. BP's decision to save US\$1 million a day by circumventing safety procedures on its Gulf of Mexico rigs is a poignant example of such decisions. The disaster eventually cost the company nearly US\$100 billion.

Consumers and customers depend on companies for the reliable supply of products and services. When a company changes its pricing strategy, depending on the product it can potentially have serious repercussions on consumers. In September 2015, Turing Pharmaceuticals raised the price of Daraprim – a 62-year-old drug for the treatment of a life-threatening parasite infection – from US\$13.50 to US\$750 per tablet. For some patients, treatment became unbearably expensive, and hospitals were forced to use less-effective alternatives to limit costs. Martin Shkreli, the 32-year-old founder, hedge fund manager and chief executive of Turing, said, “This is still one of the smallest pharmaceutical products in the world....It really doesn't make sense to get any criticism for this.” But in December 2015, Martin Shkreli was arrested for “repeatedly losing money for investors and lying to them about it, illegally taking assets from one of his companies to pay off debtors in another.”

It is challenging for directors to decide which stakeholder group to prioritize when it comes to value distribution and how to slice the pie. In conflict situations, customers can hurt companies, and companies can harm the interests of customers. Closely involved stakeholders such as creditors, employees, top management or shareholders all have motives to push for decisions that benefit themselves but that may potentially hurt the interests of the company in the long run.

#### Conflicts of interest between different classes of stakeholders

Conflicts can arise between the different classes of stakeholders, e.g. shareholders vs. creditors. Creditors, such as banks, play an important role in corporate governance systems. In some countries, they not only lend to firms but also hold equity so that they can have board representation. In the US, regulations prevent banks from dealing with debt-equity conflicts through equity ownership. With the Federal Reserve's quantitative-easing program, share buybacks became the preferred way to boost stock prices for the benefit of shareholders. In 2015, S&P 500 index companies returned more money to shareholders through share buyback and dividend payments than they earned. Some of them even borrowed money to pay dividends, which represents a direct transfer of value from creditors to shareholders since a higher level of debt increases the probability of default and

reduces the value of the creditor's stake. An extreme example to illustrate this is that a company can borrow money, then sell all its assets to pay shareholders a liquidating dividend, leaving creditors with a worthless business.

Executives may sometimes take part in controversial activities in the name of shareholders' interests. Lou Gerstner had a record of fixing ailing companies and was credited with rescuing IBM through tough decision making, including massive layoffs. One major change took place in 1999, when IBM overhauled its pension plan under Gerstner to help cut costs, shocking long-term employees. In 2002 Gerstner ended his tenure at IBM with an annual salary of over US\$1.5 million, an annual pension of over US\$1.1 million and over US\$288,000 in deferred compensation in 2001 alone. IBM employees later filed a class-action lawsuit over the pension changes, and in 2004 the company agreed to pay US\$320 million to current and former employees in a settlement. If an executive's compensation is linked to cost savings on the back of employees, the two groups are considered to be in conflict of interest.

Even when executives proclaim that they are dedicated to the interests of shareholders, the fact that they try hard to minimize shareholder involvement in corporate governance shows that there is a conflict of interest between the two groups. As Steve Pearlstein wrote in *The Washington Post* in 2013, "This blatant hypocrisy is most recently revealed in the all-out effort by the business lobby to prevent shareholders from voting on executive pay or having the right to nominate a competing slate of directors." The same year, the Swiss population passed a referendum "against corporate rip-offs," which allowed shareholders to control the salaries of executives. A majority of 67.9% of voters supported the reform, which stipulated that the shareholders of all Swiss public listed companies must elect all the members of a company's remuneration committee, and all directors are subject to annual re-elections.

Supporters spent CHF 200,000 to put forward the initiative, while opponents spent CHF 8 million trying to block it. This Swiss referendum was one of the first social responses to the conflict of interest between executives and shareholders. The initiative was launched by businessman Thomas Minder, whose own story illustrated how entrenched executives could damage all other parties to benefit themselves. Minder's company, Trybol, supplied cosmetics to Swissair. It suffered significant losses when Swissair went bankrupt in 2001 due to a failed expansion strategy. Before the bankruptcy, it was made public that Swissair's top executive was to receive a golden parachute totaling CHF 12.5 million. Minder was so irritated that he started the anti-rip-off initiative.



Could certain stakeholder groups, such as management, creditors, or shareholders benefit specifically from corporate decisions that could potentially hurt the other stakeholders? This is apparent when the value increase for one class of stakeholders is directly linked to the value reduction of another class of stakeholders.

#### Conflicts of interest within a group of stakeholders

In closely held companies, large shareholders can exploit minority shareholders by leveraging their control power. More often, directors are influenced by the controlling shareholder sitting on the board. Their directorship as shareholders, preference for capital structure, dividend policy, and investment strategy, or their position with regard to mergers and acquisitions might be in conflict with other shareholders.

In 2015 Volkswagen AG's supervisory board comprised 20 members, with only one independent director. The founding Piëch and Porsche families co-dominated the board in alliance with unions and the government. Volkswagen chairman Ferdinand Karl Piëch, the grandson of Ferdinand Porsche (Porsche founder), leaked the following comment to the press without the board's knowledge: "I am distancing myself from Winterkorn (Volkswagen CEO)." These six words further inflamed a decades-long battle between the two shareholding families behind Volkswagen and Porsche. Ferdinand Karl Piëch probably instigated this tension with the intention of extending his influence as a controlling shareholder. But during the shareholder showdown, Winterkorn won the support of the Porsche family, the labor leaders and the state of Lower Saxony. After losing the battle, Ferdinand Karl Piëch resigned as chairman of Volkswagen AG. However, before long Martin Winterkorn found himself having to resign amid the VW emissions scandal in September 2015.

The Volkswagen case shows that it is difficult for a board to optimize the interests of shareholders when they have conflicting interests. In practice, when most directors on boards are shareholders or stakeholder representatives, infighting becomes a common issue. Minority shareholders are vulnerable when the controlling owner attempts to squeeze out the other shareholders, for example by buying, selling or leasing assets at non-market prices, as a way to shift corporate resources to the large owner.

Conflicts within one group of stakeholders are not limited to shareholders. Creditors on boards could have an unfair advantage over other creditors in that

they could use insider information to shield themselves from potential trouble and hurt other class of debt holders, especially when the firm is in financial distress.

The following is a checklist of tier-III conflicts of interest:

1. Why is a key stakeholder group pushing for decisions that may benefit themselves but potentially hurt the interests of the company in the long run?
2. How can the pie be divided when there are conflicts of interest between the different classes of stakeholders, such as shareholders vs. creditors, executives vs. employees, or executives vs. shareholders?
3. How can conflicts of interest between subgroups of one particular stakeholder group be dealt with?
4. How can a director make a wise decision when stakeholders have conflicting incentives and goals?



Tier-IV conflicts: Company vs. society

The way a company views its purpose will affect its notion of responsibility, accountability and how it creates value. The ethical behavior of executives has deep roots in Western ethical traditions. Discussions on business ethics have been ongoing since the market economy emerged more than 750 years ago. In general, company and society are not in conflict: Corporations contribute to society by inventing new technologies, fulfilling consumers' demands for goods and services and creating jobs; society creates the conditions that allow companies to harness their potential for the common good of humanity.

In 1981 Business Roundtable, an association of chief executive officers of leading US companies working to promote sound public policy, stated that "Corporations have a responsibility, first of all, to make available to the public quality goods and services at fair prices, thereby earning a profit that attracts investment to continue and enhance the enterprise, provide jobs, and build the economy" and that, "the long-term viability of the corporation depends upon its responsibility to the society of which it is a part. The well-being of society also depends upon profitable and responsible business enterprises." Initially executives accepted this definition of the responsibilities of companies but their stance changed dramatically when in 1997 the Business Roundtable redefined the purpose of a corporation in society as being "to generate economic returns to its owners" and that if "the CEO and the directors are not focused on shareholder value, it may be less likely the corporation

will realize that value.” It became a duty for board members to admit that the sole purpose of corporations was to maximize shareholder value.

If not managed properly, maximizing returns for shareholders – for example by deceiving customers, defaulting on payments to creditors, squeezing suppliers and employees and evading taxes – can strip value generation from other stakeholders. Indirect harmful effects on society include shaping the rules of the game (e.g. lobbying to change a law, tax rules, accounting rules, subsidies, etc.), pollution, market manipulations through collusion, or limiting the opportunities for future generations to improve their lives. Such behavior may well increase payoffs to shareholders in the short term but it can only lead to the eventual demise of the corporation and total destruction of long-term shareholder value. The only class of stakeholders that benefits from this short-term value maximization exercise are chief executives enjoying high compensation, severance packages and golden parachutes. According to Fortune, the average tenure of CEOs in the 500 largest companies in the US is 4.9 years. When a CEO believes they could be dismissed at any time, they may be more inclined to take decisions that maximize their own income in the short term in the name of maximizing shareholder value. If all CEOs behave in this manner and boards of directors allow it, companies will end up doing more harm than good to society.

In a study of stewardship, companies potentially ranking highly in stewardship used a broad vocabulary to describe their relationships with other stakeholders in their 10K reports – words including air, carbon, child, children, climate, collaboration, communities, cooperation, CSR, culture, dialog, dialogue, ecological, economical, environment, families, science, stakeholder, transparency and well-being. This mirrored their long-term approach to building rapport with local communities and the broader society.

By comparison, companies potentially ranking low in terms of stewardship used words like appeal, arbitration, attorney, attorneys, claims, court, criticized, defendant, defendants, delinquencies, delinquency, denied, discharged, enforceability, jurisdiction, lawsuit, lawsuits, legislative, litigation, petition, petitions, plaintiff, punitive, rulings, settlement, settlements, and suit. This indicates that companies rarely benefit from bad actions in the long run, as cost will come back to the company in the form of litigation, sanctions, fines or public humiliation.

The aftermath of the 2008 financial crisis demonstrated that greed does not pay. From 2008 to 2015, 20 of the world’s biggest banks paid more than US\$235 billion

in fines for having manipulated currency and interest rates and deceived customers. For example the Bank of America alone paid approximately US\$80 billion while JP Morgan Chase paid up to US\$20 billion. These fines were expected to deter further wrongdoing and to change corporate culture.

Society and various stakeholders place their trust in board directors to run companies and they hold them accountable for doing so. Directors need to understand that a company cannot prosper if it is in conflict with society, and that since they have the power and authority to recruit, monitor and support management, they are on the front line when it comes to changing the company's culture from having a short-term focus to considering the long term when resolving potential conflicts between the company and society.

Self-assessment questions to ponder with regard to this last dimension include:

1. Why does your company exist?
2. How does it create value?
3. Is your company a contributor or a value-extractor in society?
4. Do you have the courage to take an ethical stand when your company is in conflict with society?

## Conclusions

A company is the nexus that links the interests of each stakeholder group within its ecosystem. The board is the decision-making body and its successes and failures are determined by the ability of its board directors to understand and manage the interests of key stakeholder groups. It is not an easy task to balance the interest of different stakeholders when shareholders are the ones who put money and often more visible and demanding. There is no "one size fits all" solution to corporate governance issues, and there is no straightforward answers to manage all the conflicts of interest given the unpredictable nature of firm and business environment contexts, boardroom dynamics and human behaviors. In principle, decisions at the board level should be ethical and reasonably balanced.

Boards need to have a specific policy in place for dealing with tier-I conflicts of interest between individual directors and the company. This policy needs to specify processes for dealing with major actual and potential conflicts, such as misappropriation of assets; insufficient effort, focus and dedication to board work;

self-dealing and related transactions; insider trading; and taking advantage of corporate opportunities in an open and transparent way. If possible, the policy should be signed by all directors and updated regularly, and conflicts of interest should be declared at each board meeting. The control mechanisms could be institutionalized. ICBC's supervisory board is composed of five to seven stakeholder professionals and some of them are full-time on-site supervisors. By attending board meetings as non-voting delegates, ICBC's board of supervisors is able to monitor the performance of directors and senior management, auditing processes, and overall activities and decisions that affect the company in the short and long term. Monitoring is based on several criteria, such as work attitude, behavior, capacity to fulfill duties, contribution, and so on. In addition, retiring and leaving directors, presidents and other senior management members have to undergo an auditing process by the board of supervisors. This type of institution is rarely seen in Western countries, so a similar and feasible solution is to allow external auditors to play a role here.

To deal with tier-II conflicts, directors need to disclose their relationship with stakeholders. This gives them an opportunity to declare in advance who they represent. Even if the law requires all directors to represent the interests of the company, identifying their connections with specific stakeholder groups improves transparency and avoids the risk of conflicts of interest. It is also crucial to specify who nominates new directors, who decides on directors' compensation, how the pay structure and level are determined, and how pay is linked to performance and function. In performing their duties, all directors need to put aside their ego, follow rules in discussions, respect others, and avoid toxic behavior in the boardroom. Coalitions can be beneficial when they are aimed at acting in the best interest of the company, but they can be harmful when they are formed with the aim of dominating the board or benefitting a particular stakeholder group.

Tier-III conflicts of interest can be minimized when directors and boards "slice the company pie" properly in an effort to support cooperation and avoid inducing sabotage, riots, retaliation, fines, in-fights or legal actions. Wise decision making requires understanding deep-rooted conflicts between stakeholders and the company, between different stakeholder groups, and between subgroups of one stakeholder group. No company can survive without the input of each stakeholder group: responsible shareholders, understanding debt holders, innovative employees, satisfied customers, happy suppliers, great products and services, friendly communities as well as effective and efficient government.

Tier-IV conflicts between the company and society are philosophical. Solving them requires directors to act as moral agents and be able to distinguish “good” from “bad.” Do companies compensate stakeholders because they are useful, because they are protected by law? Or do they do so because stakeholders contributed to the success of the company? Should companies consider the interests of future generations who have not directly contributed to profitability and who are not represented on the board? Should companies make corporate sustainability investments because they are popular, because they portray the company in a favorable way and increase profitability in the long run, or because they are a way to show true gratitude?

Good governance starts with the integrity and ethics of every director on every board. Board directors have a moral obligation not to take advantage of the company, but to be loyal to the company, make wise decisions, neutralize conflicts among stakeholders, and act in a socially responsible way. An ethical board sets the purpose of the company, which in turn influences all dealings with stakeholders. The four-tier pyramid summarizing the different levels of conflict of interest can help board directors anticipate and identify potential conflicts, deal with conflicts and make sensible decisions to chart a course for the future of the company.

## **MODULE-IV**

### **Models of corporate governance:**

#### **Introduction:**

Corporate governance is defined as the management and control system of an organization, in accordance with the principles and best practices in this field. At the entity level, it seeks the way to structure the distribution of power and responsibilities among shareholders, directors and the management. Today, the concept is used to describe the action of governing, the manner of managing, administering, in the states, world organisms, but also businesses. Mainly, it seeks

how the power of various factors of decision and control can be balanced and the tools for both shareholders and other stakeholders in the capital of an entity can be implemented. Corporate governance provides rules and appropriate control mechanisms through which, on the one hand shareholders can supervise the decisions of managers, and on the other hand partners can be monitored and motivated. Such a system, within a modern business environment, should initiate and support research and development activities, contribute to social stability by building human but also cultural capital. It easily detaches the conclusion that modelling corporate governance should be integrated in strategies concerning sustainable development, through continuous involvement in restructuring the main branches of the economy or social sector reform. If in the traditional governance model, the company was run by the owner family, economic, managerial and technological have determined the need of a leadership realized by professional managers. In this way new relationships and economic processes between business owners and executives have occurred.

Their modelling and exercise makes the subject of corporate governance, but its basic objectives have remained unchanged. There are three main models of leadership on which the corporate governance theory is based: the Anglo-Saxon, the Continental and the Japanese model.

### 1. THE ANGLO-SAXON MODEL – BASED ON ENTREPRENEURSHIP AND PRIVATE PROPERTY

Anglo-Saxon model is characterized by the dominance in the company of independent persons and individual shareholders. The manager is responsible to the Board of Directors and shareholders, the latter being especially interested in profitable activities and received dividends. It ensures the mobility of investments and their placement from the inefficient to the developed areas, but it however feels a lack of strategic development. In the U.S., financial markets activities dominate the allocation of ownership and control rights into organizations. Legislation always appeared hostile to concentration, especially in the banking industry, but in the recent years there have been notice new regulations development, more forced by the new economic trends: the increasing influence of boards, investors are increasingly demanding and cautious and managers give more importance to key business issues. Enterprises are required to disclose more information compared to those Japanese or German.

On financial markets (NASDAQ) smaller companies are also present, even if some are still in growth and development. Corporate governance was encouraged by the work of various associations which have introduced a motion to support the shareholders, such as National Association of Investors Corporation (founded in 1951) which advises on investments on the stock exchange and National Council of Individual Investors, which protects interests of the shareholders in front of regulatory authorities.

Mainly are considering the transparency and access to information, strengthening the relationship between regulators and shareholders, and promoting business ethics. The governance model takes place in organizations at three levels:

shareholders-directorsmanagers, since managers authority derives from the administrators. Legislation limits the rights of shareholders to intervene on the current activities of the entity, for example they can only decide the elected members of the Board.

However, they can influence changes in the managers' attitude and manner of leading; they may decide to liquidate holdings or refuse to increase its capital contribution of the entity, thus stopping the funding. Financial support of shareholders is the most important weapon they have in front of managers.

The Securities and Exchange Commission (SEC) has reduced its strict rules on collective activities of shareholders, proposing various regulations to encourage investment relationship that allows managers and owners to discuss possible advantages and disadvantages of business strategy. Institutional investors play an ever important in Anglo-Saxon systems.

They already dominate the UK, holding even two thirds of the equity of companies. So, investment relationship – a feature of UK governance system – is gaining more ground in the United States in relations between company management and institutional investors.

There were critics which have claimed that these phenomena occurred due to repeated failures of internal and external control mechanisms. The Anglo-Saxon countries are characterized by the emergence of



financial markets and strong banking restrictions, especially regarding the holding of shares in companies outside the banking sector.

Great Britain can be perceived as a special presence in Europe, having recognized the importance of the financial market in London, where many national companies are listed. The banking system does not have a central role in governance structures, banks being considered merely “credit providers”.

In the economic entities, capital structure is dispersed and shareholder power is stable compared with that of managers. The Governance model (similar to the American) is dominated by the influence of external capital markets, through merger and acquisitions, but also through the control exercised over securities trading.

Regulatory institutions act to protect investors by implementing specific policies and practices of corporate governance system. Such a system requires an independent Board, responsible for monitoring and control of management, to improve its organizational performance and recovery.

In the UK, but also in other Anglo-Saxon countries, where market economy has significantly developed through sustained economic growth, there is a high degree of dispersion of capital and shareholder structure. Population can directly intervene to the economic development through holding shares, making of its own availabilities investment on capital market.



### THE CONTINENTAL-EUROPEAN MODEL – CHARACTERIZED BY MAJOR SHAREHOLDERS’ INTERESTS

The Continental European model is characterized by a high concentration of capital. Shareholders have common interests with the organization and participate in its management and control.

Managers are responsible to a wider group of stakeholders, besides shareholders, such as unions, business partners, etc. It can be said that in Italy, the idea of corporation dates back to ancient Rome, from time of Emperor Trajan.

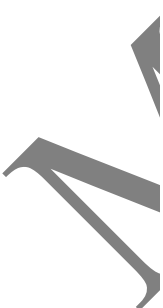
At that time they had institutions „collegia artificum” similar to the contemporary, which were legal entities for various types of trade. The members of „collegia artificum” enjoyed tax benefits and other reliefs.

They were inspired by the example of Greek society and the goal was to assist entrepreneurs. Italian corporatism saw two levels: the Catholic and fascist.

Catholic-inspired corporatism appeared in 1891 and has grown to early-twentieth century. Representative is the name of Giuseppe Toniolo, economist and sociologist, who has always promoted solidarity, rejecting individualism and liberal doctrines. Fascist corporatism developed during the years 1920-1940, and its general principles were set out in the Charter of Labour in 1927 and were institutionalized with the advent of new corporations, bringing together different categories of entrepreneurs and workers.

1939 was the crucial step by establishing Chamber fascista. Its abolition coincided with the removal procedure.

The 1980s brought into attention a new concept, later debated by the Italian literature: neocorporatism.



Currently, market and companies management regulation is prevalent public in a less receptive environment and exposed to adverse conditions. Socio-economic reality generated some different structures of distribution and control management, each specific to the reference market and with special characteristics.

Ownership and control of listed companies are significantly concentrated, shareholders having the opportunity of intervention in the management process. In the German system of governance, the enterprise is seen as the combination of various interest groups aimed to coordinate the national interest objectives. From a historical point of view, German banks have played an important role in corporate decisions.

Only one of four companies in Germany is entitled to public transactions, thus most companies seek financial assistance from banks. A great importance is given to the protection of creditors, even to the point where a bank might dominate a firm. Unlike the U.S., German banks may hold only actions of their own clients. This ensures the depositary voting rights to control the decisions and votes in a company. In Germany, the corporate governance system is a dual one, aiming at the same time a national policy to provide employees access to information and participation in various activities of the enterprise and industrial democracy. Within companies we can find an executive board and a supervisory council. The first effectively manages the company, but under the direction of the second, most decisions are, necessarily, confirmed by it. Such a governance structure is a mechanism for management monitoring and control.

#### THE JAPANESE MODEL – SPECIFIC TO A ORIENTED CONTROL GOVERNANCE SYSTEM

The Japanese model brings, as a new, the holding concept, which designates industrial groups consisting of companies with common interests and similar strategies. The managers' responsibility manifests itself in relations with shareholders and keiretsu (a network of loyal suppliers and customers).

Keiretsu represents a complex pattern of cooperation and also competition relationships, characterized by the adoption of defensive tactics in hostile takeovers, reducing the degree of opportunism of parties involved and keeping long term business relationships.

Most Japanese companies are affiliated with this group of trading partners. The characteristic pattern of governance is dominated by two types of legal relationships: one of co-determination between shareholders and unions, customers, suppliers, creditors, government and another ratio between administrators and those stakeholders,

including managers. The necessity of the model results from the fact that the activity of a company should not be upset by the relations between all these people, relationships that generate risks.

Management decisions pursue improving the income and power of an enterprise, in particular by specific corporate governance practices, although sometimes the shareholders control on the management can be hampered.

Therefore, the Japanese model (similar to the German one) is based on internal control; it does not focus on the influence of strong capital markets, but on the existence of those strategic shareholders such as banks.

As in Germany, major shareholders are actively involved in the management process, to stimulate economic efficiency and to penalize its absence. It also aims to harmonize the interests of social partners and employees of the entity.

The Japanese governance system facilitates the monitoring and flexible financing of enterprises, effective communication between them and the banks, as the main source of financing consists in bank loans. It should be noted that the owners are other companies or even banks, control the management strategies; ownership is always oriented to the control, justifying the limited issue of shares.

Most packages are held by few shareholders who can also be of major creditors, suppliers, customers, in order to maintain long term relationships of trust and not only to obtain gain. In Japan, the corporate policies are influenced by the active intervention of the government, since officials are stakeholders in many companies.

The Central Bank and Ministry of Finance are monitoring the supervision and control within the company, in its relations with its strategic partners.

Government structures have created an informal negotiation system to implement certain policies and corporate strategies (gyosei shido). In the 1980s, the governmental influence manifested itself indirectly through appointments to the board of directors and managers of some functionaries out of system (amakudari).

They were retired at the age of 55 and belonged to various private companies to lead and participate effectively in developing strategies, driven by government policies. Corporate governance oriented to control is easily achieved in Japan due to a concentrated shareholder structures, unlike the United States. Many voices say that Japan has to go the longest road to improve standards of governance, a significant gap being now, as in the past, corporate transparency.

The existing situation is seen as a consequence of the market dominated by companies founded and ran by families. Banks and other institutional investors have usually a minor role in terms of corporate governance discipline. Their main responsibility is to provide debt financing, the existence of equity and bank directors should occupy top management positions. If an entity is profitable, the banks shall be limited to monitor and protect the interests of foreign investors. At present, Japan's system is focused on transactional networks and not enough on individuals. Relations between keiretsu and stable banking system is generally based on strong management and sometimes even isolated. There are two favourable factors: the first refers to passivity of shareholders and second is the predominance of internal directors.

#### CONVERGENCES AND DIVERGENCES OF DIFFERENT SYSTEMS WORLDWIDE USED

Managers in the U.S. and Britain are mainly specialized in finance and marketing, and their mobility is much higher in contrast to France and Japan, where they tend to remain in the company a long time. In the United States most managers are from outside the country compared to France, Italy and Japan, where the situation is completely opposite.

The U.S. have been opened to foreign influences, considering this a way to a successful diversification of business concepts and strategies. A good example is of those companies which are more numerous, led by foreigners. For example, McDonald's led by the Australian Charles Bell and Coca Cola with the Irishman Neville Isdell. In countries like France, Italy, Japan, where companies are characterized by governmental influences or familial control, management teams will be more reserved in the global strategies, most preferring to maintain

local control. The United States enhances the quality of accounting in achieving economic transactions, unlike Japan, where capital providers such as keiretsu and banks have information sources that are not public, the quality of accounting information presented and the relevance for their investment decisions can be questioned. Following the success of the U.S. market, countries like Germany and Japan, with a governance model by characterized intervention, have oriented their system closer to the AngloSaxon one. In contrast, the Japanese model brings more and more in its centre the importance of human capital and focuses on the banking system.

The quality of accounting is important in the United States, both statistically and economically, where a high degree of quality is associated with reduced sensitivity of the cash flow invested a relationship that in Japan does not exist. In the U.S., the institutional investors are not allowed to own more than one company or work with other institutional owners to influence managers. They can resist some kind of pressure, but are aware that those investors cannot be ignored, considering the voting power, but also that on their actions depend the current and future business situation.

Corporate governance addresses the concerns about capital providers: risk assessment associated capital, capital allocation estimate for maximum efficiency, monitoring and managing funds on a continuing basis. The comparisons of systems in the United States, Germany and Japan reveals two different answers to these issues: direct disclosure of management actions and a longterm development of relations between owners and other participants in the entity. While each answer is different and sufficient for the needs of an economy, association could provide specific competitive advantages for the market global company.

A review of the three main models of corporate governance shows that there are at least two dimensions that may provide a basis for comparison between them: the first considers the system (for example, the claims are priority) and the second relates to the evaluation governance effectiveness (how well supported priority requests are). Maximizing the owners' assets is interpreted differently in each system, because they, as well as the holders of claims are different from one country to another.

The American system emphasizes the role of free market, based on it to exercise a control over the companies' owners. Japanese model focuses on business network acting in an interdependent way and on the own interests of all involved parties, especially through mutual control. In the German system, the company is considered an entity that produces richness, so that the market is closely monitoring its economic activity, the yield being the engine of national wealth. Interests of employees and creditors are a control factor and stimulation in obtaining gain.

Each model has emerged from the need to increase economic efficiency, measures in this respect and including measures to streamline the system of governance being significantly different.

In the U.S. corporate success is primarily measured by financial return on invested capital. The Japanese system focuses on capital efficiency and the German one concentrates on human capital performance. The fact that these systems have endured economic and social transformations, demonstrates that despite all the differences and specific weaknesses, each has enough strengths to support the existence and influence a nation's own economy.

The Japanese system is difficult to understand for outsiders. From a historical perspective, it is based on legal recognition at national level, a mixture of public and private property, in which to each citizen is accepted the right to a fair share of all those things strictly necessary for the welfare. Power of property and rights of debts are equally divided between participants only theoretically.

Although corporations in Japan resemble the structure of those of the United States, here the interest of shareholders overrides. Their status is clearly different in the two models, those in Japan who have only one quarter of action simply does not matter, particularly because of a weak capital markets and with no influence.

Models of governance in Germany and Japan are characterized by the strong presence of interested parties (stakeholders), especially banks, which increases the efficiency of corporate governance and provides competitive advantages of the two countries. In opposition, the populist policy of the United States inhibits the influence of such

stakeholders, leading to inefficiency and increased agency costs. German and Japanese systems focus on expanding public-private partnership that leads to possible competitive advantage by reducing costs of risk capital

## CONCLUSIONS

Each model was developed based precisely on cultural, historical and technological features, and they show the way and means in which the models appeared under the influence of national economic and social specific conditions. It turned out that no model of governance is perfect and even better, their existence over time showing that each one is effective in its own way, and corporate governance structure specific to a country is difficult to transfer to another country.

Western societies have promoted corporate governance as a democratic culture, based on dynamism and willingness to impose on the market, which created the conditions of globalization. Essential objectives are to obtain profit, support creativity, research and innovation, solutions to globalization requirements. The new economy and knowledge based society place in the centre of corporate governance that form of capital which has become increasingly important – human capital.



In some European countries (Belgium, Spain, Portugal, Italy etc.), but also at the international organizations level (OECD), the objective of developing mechanisms of governance is improving the information provided on the capital market and improve company performance, competitiveness and/or access to capital. For countries with tradition in the field and liquid capital markets (UK, France, Germany, etc.), the main objective of these mechanisms relates to the Board of Directors' work, meaning improve its quality and the quality of provided information about corporate governance.

Good governance is still difficult to measure, organizations carrying out such assessments need more representative criteria so that entities must notify their management processes in an efficient manner. The implemented model essentially depends on the firm's theory of voluntary or mandatory approach, but also on the boundaries between markets, entrepreneurs and civil society. The literature cannot provide



yet a general method which to base on a comparative study, because the measurement techniques of social responsibility performance are not rigorously founded.

MRECMBA

## **MODULE-V**

### **WHISTLE – BLOWING AND CSR IN CORPORATE GOVERNANCE**

#### **Corporate Governance:**

As per The Institute of Company Secretaries of India (ICSI), Corporate Governance is defined as “The application of best management practices, compliances of law in letter and spirit and adherence to ethical standards for

effective management and distribution of wealth and discharge of social responsibility for sustainable development of all stakeholders.”

The main objective of Corporate Governance policies and practices should be wealth creation, wealth management and wealth sharing. Adherence to laws and regulations, financial goals and communications with stakeholders are major factors that make up the way in which corporations is governed.

Frits Bolkestein, the European Union’s internal market Commissioner highlighted some of the wider impacts of corporate governance in a speech. “Economies only work if companies are run efficiently and transparently. We have seen vividly what happens if they are not- Investment and jobs will be lost and in the worst cases –of which there are too many- Shareholders, employees, creditors and the public are ripped off.”

The financial meltdowns of Enron, Tyco, AIG, WorldCom, and Xerox have increased the concerns about corporate governance, which is system of regulations and policies to hold corporate leaders accountable and protect company stakeholders.

The most important feature of ICSI definition on Corporate Governance as discussed above is that corporate governance practices should be adhered to in letter and spirit. It is high time for companies to embrace the spirit of the corporate governance practices rather than settle for the chore of compliances.

Hence, to create, manage, share the wealth, only an inclusive approach to corporate governance can sustain. For this inclusive approach, the model of corporate governance should be such that it promotes the interest of all the stakeholders, namely the employees, customers, shareholders, investors, creditors, the community at large.

According to me, the top five mechanisms, which are vital for implementing better and effective Corporate Governance in any organisation, are:

1. Independence of Board
2. Role of Auditors (Internal and Statutory) and Audit Committee
3. Whistle Blowing
4. Shareholder Activism
5. Fast Track Redressal Forums and Independent compliant mechanisms.

Any code on corporate governance can only provide the framework or structure to ensure that companies are governed to the best interest of stakeholders at large.

## **What is Whistle Blowing?**

In common Parlance, it is speaking out on Malpractices, Corruption, Misconduct or Mismanagement. Whistle Blowing can be defined in a number of ways. In its simplest form, whistle blowing involves the act of reporting wrongdoing within an organisation to internal and external parties. It is raising a concern about malpractices within an organisation or through an independent structure associated with it.

Mathews (1987:40) defines whistle blowing as the act by an individual who believes that the interest of the public overrides the interest of the organisation he or she serves. The act of whistle blowing can have an extraordinary influence on the organisation, on society and on the whistle blower.

The Association of Certified Fraud Examiner's 2012 "Report to the Nation on occupational Fraud and Abuse" pointed out that more than \$ 3.5 trillion in annual losses is attributed to fraud.

The scenario of whistle blowing is very complicated in India. References of whistle blowing and whistle blowers is made in various committee reports (for eg: in 1998 by CII Code of Corporate Governance, in 1999 by Kumar Mangalam Birla Committee, in 2002 by Naresh Chandra Committee and in 2003 by N.R Narayana Murthy Committee), listing agreement and Voluntary Guidelines of Corporate Governance . There is Whistle blower Protection Laws in US, UK, Norway but in India, awareness is yet to come.

## **Developing an Effective Whistle Blower Policy:**

All business entities often struggle with an appropriate level of segregation of duties making a whistle blower policy a good mitigating tool. The Whistle blower policies effective implementations not only reduce the fraudulent activities but also send a signal to both internal and external agencies that organisations exercises good corporate governance.

The Whistle Blower Policy may be drafted and implemented by management but it should be submitted to Audit Committee and Board of Directors. The foundation of Whistle Blower Policy is a clear and specific definition of Whistle Blowing. The key aspects are:

1. Clear definition of individuals covered by the Policy
2. Non retaliation provisions

3. Confidentiality
4. Process
5. Communication

The Whistle Blower Policy should include the methods to encourage employees, vendors, customers and shareholders to report evidence of fraudulent activities. It should properly address the processes that the employees should follow in filing their claims. Specific Reporting Mechanisms within the process could include telephone, emails, hotlines, websites or suggestion boxes. The first steps of creating an environment where a whistleblower will report problems that exist is the crucial one, to be fully effective whistle blower policy must be consistently implemented, claims investigated and evaluated and proper enforcement taken when necessary. Clause 49 of the Listing Agreement keeps whistle blowing as non-mandatory item but it should be mandatory.

### **Company Secretaries – An Effective Whistle Blowers:**

A very famous quote by Napoleon:

“The World suffers a lot not because of the violence of bad people but because of the silence of good people.”

Economic Volatility, Global Competition, Growth risk appetite demands the governance professionals, the Company Secretaries to prioritise their role as whistle blowers.

Employees are usually the first to witness dangers and wrongdoings on Job. Although most employees remain silent, many chase to speak out and bear witness in corporate crimes that has not been addressed when flagged through normal company channels i.e Corporate Security, Audits, Inspections, Law enforcement combined.

Company Secretaries rank among the most productive, valued and committed members of their organisations. As they are the part of Top management and Board of Directors, they have a strong conscience; they are committed to formal goals of their organisation and have strong sense of professional responsibility.

Company Secretaries is also Corporate Governance Officer (CGO) and required to perform following roles:

1. To ensure the effective running of the activities of the Board and its Committees.
2. To ensure compliances of all listing rules, other Regulatory Codes and Acts.

3. Keep under review all legal and regulatory developments affecting the company operations and make sure that directors and management are properly informed of the same.
4. Manage relations with all stakeholders with regard to Corporate Governance, Corporate Social Responsibility, etc.
5. Work with Board of Directors, Management to ensure that all regulatory reporting is correct and does not lead to errors resulting in offences under Various Acts.
6. Act as the Conscience Keeper of the Company.
7. Act as the Primary point of contact for Board of Directors and source of guidance in order to assist their decision making process.
8. To assess, manage the compliances in the governance domain, governance processes, tracking of outcomes of governance processes and disseminate the information and documents for proper governance.

In ensuring implementation of proper corporate governance practices in the organisation, Company Secretary requires Governance Management and Reporting which includes:-

1. Development of Board framework and to determine the level of Independence
2. Monitoring and reporting on the Independence of Audit Committee
3. Development and Maintenance of a Board Charter to ensure that Board decisions can be measured against it.
4. Acting as Board voice for providing shareholders feedback.
5. Participating in Strategic Planning process, Risk Management process, Internal Control process, MIS, Corporate Communications, Succession Planning, Board performance evaluation process.

In light of above, Company Secretary acts in the capacity that ensures high level corporate administration in accordance with best governance practices which results to well run, governed and sustainable business for the benefit of its stakeholders at large.

Company Secretary can be useful aid to implement whistle blowing as an internal regulator for ensuring good corporate governance in spirits. As he is a part of Board decisions process and recipient of all important information flowing in the organisation, he can easily smell the rat. He can suspect the improper activities/unethical practices adopted by organisations or some of its members.

Some of the instances of unethical practices/improper activities adopted by certain organisations, which is required to be reported or for which whistle should be blown are:

1. Theft
2. Harassment
3. Unethical practices
4. Fraud
5. Dishonesty
6. Discrimination
7. Lack of Independence of Board/Committees
8. Improper Director Remuneration Packages
9. Lack of Independence of Auditors
10. Violation of Regulations and Code of Conduct
11. Insider Trading
12. Corruption
13. Bribery
14. Lack of Work Place Safety Hazards
15. Financial Statement Misrepresentation
16. Lack of Proper Internal Controls.

He can also support the ombudsman function with the Board by establishing a symbiotic relationship between the governance and compliance. According to the Association of Certified Fraud Examiners 2010 Report to the Nations on Occupational Fraud and Abuse, 40 percent of fraud cases studied in public companies were detected by tips- three times as many as by any other method. The presence of hotlines i.e. may be Audit Committee Chairman or Ombudsman greatly facilitated tip reporting.

Company Secretary can adopt internal or external whistle blowing system. He can make his allegations internally to other people or committees i.e. Chairperson of Audit Committee or any hotline developed by company or can make allegations to external agencies like regulators, law enforcement agencies, media, etc.

Before Reporting or Whistle Blowing, Company Secretary should consider following factors:

1. Whether he has enough facts and evidences to support his allegations?
2. Under which situation and circumstances, he should opt for Whistle Blowing?
3. Whether there is any other mechanism or channel other than whistle blowing for reporting and which system should be opted to blow whistle, Internal or External?
4. What Protections the Company or law will provide for whistle blowing and whether there are any chances of success?
5. Whether any actions or investigations will be initiated after whistle blowing i.e. whether management or regulators will positively participate?

### **Practical Challenges for Company Secretary as Whistle Blower**

Company Secretary as key recipient of almost all information can face reprisal, sometimes at the hands of the organisation or group, which he accused, sometimes under law. There is often a fear of losing their relationship at work or outside work. They may get punished, terminated, suspended or at risk of their own well beings. Few instances where whistleblowers have to face harsh consequences to the extent of losing their life:

1. The Satyendra Dubey Fate (2003), 2. Majunath Shanmugham Incident (2005), and 3. Most recent case of sudden demise of colleague CS Shasheendran (2011).

Hence, in order to encourage whistle blowing as an indispensable ingredient for ensuring good corporate governance in spirit, proper law should be enacted in India which should provides rewards and protection to whistle blowers similar to which is prevalent in USA under Dodd –Frank Whistle Blower rules. Organisations should protect, compensate whistle blowers, proper mechanisms should be set up, and identity of whistle blowers should be protected. Whistle blowing should be made mandatory requirement under Listing Agreement and even disclosures on corporate fraud risks should be made mandatory by Directors in Directors Responsibility Statement annually. Under US Corporate Governance law, Sarbanes-Oxley Act, 2002 has made it criminal offence, which is punishable by fine and up to 10 years in prison, for taking any action harmful to a person who provides truthful information about a federal offence to a law enforcement officer. There should be strict rules for hiding identity of Whistle Blowers, Ombudsman should be appointed by the company for dealing with such allegations who will directly report to Shareholders, Contentions of frivolous complaints should be taken care by imposing heavy penalties on malicious complaints.

## **Conclusion**

Today with Scandals like Satyam, Tyco, AIG, Enron, Worldcom, Zerox, need for more ethical governance has arisen. Whistle blowing has already been described as one of the basic tenets of Corporate Governance, but in India, there is no definite Whistle Blower laws. If this tool of Corporate Governance is used in true letter and spirit, it can be saviour for protecting the stakeholders and the larger public interest. It can be success factor for survival of corporates, build their brand image, which will support in raising funds. It can be effective tool in curbing and reporting corporate frauds, which earlier used to go unreported.

As it is always said, norms of Corporate Governance are not merely to be complied with but have to be adopted as day-to-day practice of any organisation. Hence, Corporate Governance is a mixture of meeting both the letter and spirit of law. It is high time India Inc, which is an emerging economic powerhouse, to strive to raise the standards of Corporate Governance Practices to Global Benchmark.

## **Types of whistleblowing**

There are two types of whistleblowing, and these are

### **. Internal whistleblowing**

When an employee from an organization informs about the illegal activities or misconduct or any wrongdoing to his seniors holding the top position in that company, it is known as internal whistleblowing.

### **External whistleblowing**

When an employee informs about the wrongdoing to someone who is not part of his organization, for instance, a statutory body or a lawyer or any other authority figure it is known as external whistleblowing.



## **How companies benefit from whistle blowing**

It is a common myth that if someone from a company has been accused of wrongdoings by a whistleblower, then the organization is also at fault. The various benefits from whistle blowing that happen to an organization are as follows-

- Its exposure to risk is minimized
- The company gains increased confidence from the shareholders when it stands behind the whistleblower
- It boost its CSR or Corporate social responsibility
- The act can protect everyone's interest which is associated with the organization
- Can prevent potential legal action against the company
- Protects the customers as well as the organization by combating misconduct and fraud
- Whistle blowing culture helps a company in preventing unnecessary loss of capital
- It encourages clear communication that results in honest transactions

### **Advantages of whistle blowing**

#### **1. Personal honor**

Some people are driven by honor and they want to do what they feel is right even if they have to face the existing system alone and defy conventions. Individuals who decide to act as a whistleblower are offended by the actions of other people.

They cannot turn and look another way when they come to know about wrongdoings in the workplace that could have an impact on lots of people. The act of whistle blowing is a personal honor for them through which they can fulfill their duty to themselves and their country. Doing the right thing lifts a heavy burden from their chest.

#### **2. Empower other honest people**

The act of whistleblowing demands lots of courage, and it is not an easy feat to stand against the system or figures of authority that have name, fame, and money working for them.

Once the whistleblower wins a case or settles an argument against such influential people, he provides other honest people with the necessary boost to come forward and take such an action against the people they know are wrongdoers. When you start having faith once again in the system, it becomes easy to gather your courage and move forward.

### 3. Exposes malpractice

Whistle blowing plays an essential role in curbing the actual wrongdoings in organizations, government offices, and federal agencies. When someone steps over the legal or ethical line, it is the whistleblower that makes such an act a public knowledge so that the people involved in the misgivings can be held accountable.

People who had earlier got away are now forced to face scrutiny because of resulting investigations, media attention, and lawsuit. This helps in bringing about the necessary reforms so that no such act can retake the place. Companies that are engaged in similar practices will now start thinking about their conduct and the dread might stop them from continuing with such illegal and harmful practices

### 4. Is offered protection

The person who has shown the courage of whistleblowing is appreciated by the common masses and adjudged a hero. He has shown immense courage in bringing out the corrupt practices so that the guilty can be punished.

The whistleblower is offered protection from retaliatory acts like dismissal, demotion, denial of employee benefits and termination of employment that can harm him. The Whistleblower Protection Program offers employees protection who show the courage to report violations of securities law, financial reform, environmental and safety regulations. The companies that are held accountable can face suspension and fines and even civil suits.

### 5. Financial reward

If the evidence from the whistleblowing results in a lawsuit and the government can recover the lost funds, the whistleblower is eligible to receive an award up to 30% of the recovered funds. This is often a considerable amount and can set up that person for life in financial terms

## 6. Your bond with like-minded people will strengthen

Whistleblowing is an act that will have long-lasting effects on a whistleblower. His action will act as a booster to others, and his bond will strengthen with like-minded people who prefer honesty and truth above everything else.

He will gain respect from his spouse, kids, and community members and that will encourage him to move forward without fearing repercussions from the people associated with the fraud.

## 7. The law is in your side

The wheels of justice takes a lot of time to grind but remember it is slow but steady and often is on the side of the whistleblower. Legislators have gone out of their way to provide whistleblowers with a sense of justice to encourage such emotions in others.

The law has been giving a consistent message to the wrongdoers that they will be tried and punished irrespective of their high status and position in society.

## **Disadvantages of whistleblowing**

### 1. Reduced prospects of employment

The most common disadvantage of whistleblowing is that the person who is responsible for this act garners a lot of attention. This makes him infamous and acts as a blot on his credibility. The organization that he works for terminates his employment because for them he is a Judas or a traitor and they will not keep him within the company after this.

Even in the outside world, no one is ready to give employment to such an infamous person as his reputation might rub on that company and make them infamous by association.

### 2. May face retaliation

Taking any action against the whistleblower is illegal, but it does not stop the companies from taking them. Sometimes it is brutal as the termination of employment or can be subtle like a change of job duties, exclusion from group meetings, no interactions with him or reassignment of the job to another branch.

The whistleblower needs to be prepared for all the consequences because he will have no choice but to face them after his act of whistleblowing

### 3. Notoriety

The act of whistleblowing brings notoriety because of the investigations, legal testimonies, and media interviews. In the eyes of a common man, the whistleblower is a hero but for the industry players, he is considered as a disloyal person without any discretion who had exposed his own company to the outside scrutiny.

He is unofficially even blacklisted in his profession because no one is now going to trust him with any company secrets.

### 4. Unnecessary complications

A whistleblower generally assumes that he has taken this step for the greater good, but in fact, it can lead to several challenges. The media starts digging into his personal and professional life and can come out with a secret that he is not comfortable sharing with the world. Any past grievances can come to light that can portray him as a negative character.

### 5. Your finances will suffer

Legal action is expensive, and until the case is resolved, a whistleblower will have to shoulder the financial burden for the situation. He has been fired from his post; it could mean extra expenses for him and can cause severe financial worries.

### 6. They are labeled

After the act of whistleblowing, the whistleblower is labeled for life. Wherever he goes, he is pointed out as the whistleblower. This often hurts the sentiments of the individual who has tried to do the right thing and instead of applause is being labeled as someone who is at fault and should be ashamed of the fact.

#### Outside threat

Whistleblowing is not an easy step as it can give rise to several problems in the life of the whistleblower. He is exposed to risks from all directions as the company

against which he is speaking as well as the people related to the fraud and corruption will try to stop him from giving his testimony.

## 8. Stress

Threats, blackmail and anguish can lead to **stress** and anxiety in the life of a whistleblower after he has decided on whistleblowing. His co-workers might not agree with his actions and the people he thought as friends could leave him alone as no one wants to be associated with an infamous person.

This can be bad for his physical as well as mental health and can cause cracks in both personal and professional relationships.

## 9. The lawsuit will take forever

Whistleblowing complaints take lots of time to resolve as they have to be appropriately conducted through the right **channels**. It might seem that the lawsuit is taking forever and at this point, many people start having doubts.

The trick is not to lose faith because adverse conditions have a way to test your strength.

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## Corporate Social Responsibility in India

India is the first country in the world to make corporate social responsibility (CSR) mandatory, following an amendment to the Companies Act, 2013 in April 2014. Businesses can invest their profits in areas such as education, poverty, gender equality, and hunger as part of any CSR compliance.

### The methodology of CSR

CSR is the procedure for assessing an organization's impact on society and evaluating their responsibilities. It begins with an assessment of the following aspects of each business:

- Customers;
- Suppliers;
- Environment;

- Communities; and,
- Employees.

The most effective CSR plans ensure that while organizations comply with legislation, their investments also respect the growth and development of marginalized communities and the environment. CSR should also be sustainable – involving activities that an organization can uphold without negatively affecting their business goals.

Organizations in India have been quite sensible in taking up CSR initiatives and integrating them into their business processes.

It has become progressively projected in the Indian corporate setting because organizations have recognized that besides growing their businesses, it is also important to shape responsible and supportable relationships with the community at large.

Companies now have specific departments and teams that develop specific policies, strategies, and goals for their CSR programs and set separate budgets to support them.

Most of the time, these programs are based on well-defined social beliefs or are carefully aligned with the companies' business domain.

### CSR trends in India

Since the applicability of mandatory CSR provision in 2014, CSR spending by corporate India has increased significantly. In 2018, companies spent 47 percent higher as compared to the amount in 2014-15, contributing US\$1 billion to CSR initiatives, according to a survey.

Listed companies in India spent INR 100 billion (US\$1.4 billion) in various programs ranging from educational programs, skill development, social welfare, healthcare, and environment conservation, while the prime minister relief fund saw an increase of 139 percent in CSR contribution over last one year.

The education sector received the maximum funding (38 percent of the total) followed by hunger, poverty, and healthcare (25 percent), environmental sustainability (12 percent), rural development (11 percent). Programs such as [technology incubators](#), [sports](#), armed forces, reducing inequalities saw negligible spends.

Taking into account the recent amendments to CSR provisions, industry research estimates CSR compliance to improve and range between 97 to 98 percent by FY 2019-20.

## Examples of CSR in India

### **Tata Group**

The Tata Group conglomerate in India carries out various CSR projects, most of which are community improvement and poverty alleviation programs. Through self-help groups, it has engaged in women empowerment activities, income generation, rural community development, and other social welfare programs. In the field of education, the Tata Group provides scholarships and endowments for numerous institutions.

The group also engages in healthcare projects, such as the facilitation of child education, immunization, and creation of awareness of AIDS. Other areas include economic empowerment through agriculture programs, environment protection, providing sports scholarships, and infrastructure development, such as hospitals, research centers, educational institutions, sports academy, and cultural centers.

### **Ultratech Cement**

Ultratech Cement, India's biggest cement company is involved in social work across 407 villages in the country aiming to create sustainability and self-reliance. Its CSR activities focus on healthcare and family welfare programs, education, infrastructure, environment, social welfare, and sustainable livelihood.

The company has organized medical camps, immunization programs, sanitization programs, school enrollment, plantation drives, water conservation programs, industrial training, and organic farming programs.

## **Mahindra & Mahindra**

Indian automobile manufacturer Mahindra & Mahindra (M&M) established the K. C. Mahindra Education Trust in 1954, followed by Mahindra Foundation in 1969 with the purpose of promoting education. The company primarily focuses on education programs to assist economically and socially disadvantaged communities.

Its CSR programs invest in scholarships and grants, livelihood training, healthcare for remote areas, water conservation, and disaster relief programs. M&M runs programs such as Nanhi Kali focusing on education for girls, Mahindra Pride Schools for industrial training, and Lifeline Express for healthcare services in remote areas.

## **ITC Group**

ITC Group, a conglomerate with business interests across hotels, FMCG, agriculture, IT, and packaging sectors has been focusing on creating sustainable livelihood and environment protection programs. The company has been able to generate sustainable livelihood opportunities for six million people through its CSR activities.

Their e-Choupal program, which aims to connect rural farmers through the internet for procuring agriculture products, covers 40,000 villages and over four million farmers. It's social and farm forestry program assists farmers in converting wasteland to pulpwood plantations. Social empowerment programs through micro-enterprises or loans have created sustainable livelihoods for over 40,000 rural women.

## Corporate philanthropy

Corporate philanthropy involves the act of donating to a charity or a foundation whose mission is to fight a cause and deliver social impact. The donations can consist of monetary help as well as in-kind contribution.

**The term philanthropy comes from ancient Greece and literally means “love for the humankind”. In the past, this practice was narrowed down to moguls’ big donations. Those had the primary goal of showcasing the donor’s good**



heart and sensitiveness. Over time, the concept broadened until including corporate social initiatives, growing from a donation-based notion to a richer and deeper framework.

While philanthropy can employ different techniques, one way most companies donate to charity is through matching gift programs. The latter consists of acknowledging how much the employees are donating. And then matching the amount, doubling or tripling it. Take Apple, for instance. Since Tim Cook became CEO, the Cupertino giant donated more than \$50 million to charities and non-profits.

Collective imagery sees corporate philanthropy as an activity that can have a positive impact on the organization's brand image. Also, it can be a powerful point of differentiation. Nevertheless, it's important to underline that the pure act of donating profit shares is not enough. Big and successful companies need to truly believe in the causes they are supporting. They must show interest and raise their voices. Moreover, stakeholders are interested to see how they can integrate donations and grants with their overall business model.

In summary, philanthropy nowadays is not pure charity anymore. It needs to showcase the company's own identity and mission in order for it to be effective and praised.

### **Why is corporate philanthropy different from CSR**

We often use both concepts in the same way. But there are some differences.

Corporate philanthropy is meant to be driven by a desire to make a social change. The company just makes donations of property or money to have an impact and improve their brand image. But it isn't involved in the corporate main activities.

Corporate social responsibility, on the other hand, is really integrated into the company's activities and identity.

### **Corporate philanthropy examples**

To have a better idea of what corporate philanthropy looks like, corporate giving programs made by other companies are the best starting point.

One of the best is Apple's. The company has given 78 million dollars to charities through matching gifts and volunteer employee programs. Per year, each employee gives 10 thousands of dollars to charities. That's a lot. This is improving efficiently Apple's brand image.

## **RELATION BETWEEN CSR AND CORPORATE GOVERNANCE**

### **Introduction:**

**Corporate Governance and Corporate Social Responsibility (CSR) are conceptualised** by the Western countries, where their practices have developed tremendously in the last decade. During these periods the idea has been exported to other parts of the globe largely through the activities of multinational National companies. It may be noted that the Corporate Governance and CSR are two related and interwoven business concepts that are deeply embedded in business practices. In this context, an attempt is made to discuss the concept of CSR and Corporate Governance, and their interrelationship, within legal and regulatory framework in India.

### **Definition:**

The idea of CSR largely started as a philanthropic gesture by a few wealthy businessmen. However, during the last decade the CSR is becoming buzz word in the corporate sector. The changing context within which companies operate, shaped by environmental and globalization forces, affects the way that the role of business is perceived. Now days, a growing number of companies worldwide have acknowledged the importance of CSR in doing business. There is no universally accepted definition of the word "CSR", the meaning and definition of CSR depends upon on mainly two factors; Firstly, context in which it is used and secondly, stakeholder. The difficulties in defining precisely CSR are in part reflective of the way in which this topic has developed and the context of its use. For some, it has grown out of corporate philanthropy with a clear emphasis on social improvements or strategic investment keeping in view long term goals. For others, CSR has a much broader definition and is closely related to the sustainable

development and environment issues. CSR has been defined in many different ways. For the purpose of this paper, we will use three key definitions of the World Business Council for Sustainable Development, The European Union and the World Bank which covers all the elements of CSR.

#### World Business Council For Sustainable Development (1999)

CSR is the ethical behaviour of a company towards society; management acting responsibly in its relationship with other stakeholders who have a legitimate interest in the business, and it is the 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 the local community and society at large.

#### The European Union (2004)

CSR is a concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis. In simple words, CSR may be defined as obligations and accountability of a company towards all of its stakeholders in its all operations.

#### **World Bank**

According to the World Bank, “Corporate social responsibility is the commitment of business to contribute to sustainable economic development by working with employees, their families, the local community and society at large to improve their lives in ways that are good for business and for development”

#### **Corporate Governance**

The concept of corporate governance was almost non-existent in India. In late 90's the concept of corporate governance was introduced in India by the Securities and Exchange Board of India (SEBI) through Listing Agreement, which is applicable to the listing companies only. According to OECD 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 spells out the rules and procedures for making decisions on corporate affairs.

According to Sir Adrian Cadbury, “Corporate Governance is the system by which companies are directed and controlled.....” Corporate governance may be defined as the broad range of policies and ethical practices which are adopted by an organisation in its dealing with the stakeholders.

### **Relationship Between Corporate Governance And CSR**

The conceptualization of CSR was, initially, purely in terms of philanthropy or charity. However, the post-liberalization phase has seen a fundamental shift from this philanthropy-based model of CSR to a stakeholder- participation based model. Furthermore, CSR is gradually getting fused into companies’ Corporate Governance practices. Both Corporate Governance and CSR focus on the ethical practices in the business and the responsiveness of an organisation to its stakeholders and the environment in which it operates. Corporate Governance and CSR results into better image of an organisation and directly affects the performance of an organisation.

The OECD principles on Corporate Governance, UN Global Compact Participation throw light on CSR scheme but in India CSR, by virtue of clause 49 of the listing agreement, have been made totally optional.

It is pertinent to mention here that transparency, disclosure, sustainability and ethical behaviour is central theme in both CSR and Corporate Governance.

Further, it is worthwhile to mention that CSR is based on the concept of self governance which is related to external legal and regulatory mechanism, whereas Corporate Governance is a widest control mechanism within which a company takes its management decisions.

Furthermore, the objectives and benefits of CSR and Corporate Governance are similar in nature, some of them are stated herein below: Rebuilding of public trust and confidence by increased transparency in its financial as well as non-financial

- reporting and thereby increasing the shareholder value. Establishing strong brand reputation of the company.
  - Making substantial improvement in its relationship with various stakeholders
  - Contributing to the development of the region and the society around its area of operation
  - Addressing the concerns of its various stakeholders in a balanced way so as to maintaining a strong market position.
- Furthermore, it may be worthwhile to note that in case of unlisted companies there is not robust system of corporate governance, although there are

some provisions in the Companies Act, 1956, in this context the relationship between Corporate Governance and CSR is very important and significant. In order to appraise present position of CSR and Corporate Governance, it would be worthwhile to examine the legal and regulatory framework dealing with CSR and Corporate Governance.

### **Legal Landscape Of Corporate Governance And CSR In India**

As corporate governance becomes increasingly driven by ethical norms and the need for accountability, and CSR adapts to prevailing business practices and legal framework, a potential convergence between them surfaces. In India, the provisions relating to Corporate Governance and CSR are covered under following heads:

The Companies Act, 1956 (applicable to both listed and unlisted companies)•  
Securities and Exchange Board of India and regulations (applicable to listed companies)•

It may be noted that for the unlisted companies the norms are made comparatively easier and are prescribed in the Companies Act, 1956.

Whereas in case of listed companies, all the Companies Act, 1956 provisions are applicable and also the SEBI regulations, including the provisions of listing agreement with Stock Exchange, for transparency, disclosure and corporate governance are applicable.

#### **. The Companies Act, 1956**

The Companies Act, 1956 is applicable to all type of companies, both listed and unlisted companies. The Act contains elaborate provisions about the functioning of companies and appointment, role, position, responsibilities and liabilities of board of directors as well as protection of interest of investors in cases of oppression and mismanagement. One of the important provisions is contained in section 252 of the Act, which provides for appointment of small shareholders' director by a company. At the same time, Section 292 of the Companies Act, 1956 restricts powers of the Directors on various matters. Also, Section 372 A restricts powers of companies to give loan, guarantee etc with obtaining prior approval of shareholders.

#### **Clause 49 of the Listing Agreement SEBI'**

Kumar Mangalam Birla Committee on Corporate Governance brought in substantial change in Corporate Governance norms through change in the listing agreements of Stock Exchanges, more particularly Clause 49 in the Listing Agreement.

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. Clause 49 of the Listing Agreement with Stock Exchange, which is applicable to all listed companies, contains elaborate provisions to improve the quality of corporate governance ensuring transparency, disclosure, appointment of independent directors, remuneration committee and audit committee.

. The Companies Bill, 2011 As per the latest draft of the Companies Bill, 2011 as finalised by the Ministry of Corporate Affairs, it has been decided to take a middle-path in enforcing CSR by giving companies the choice to either spend two percent of their net profits on philanthropic activities, or mandatorily explain why they could not do so. In the earlier draft there was mandatory obligation on the companies to spend two percent of their profits on CSR activities, This has diluted the proposed mandatory CSR spending provision due of the corporate sector's serious objections to it.

Further, the Companies Bill 2011 has taken significant step by incorporating, under Clause 216, provisions relating to Class Action or Derivative Action. Class Action and Derivative Action are exceptions to the rule of Foss v.

Harbottle which talks about majority rule. Corporate democracy is on the notion of participative management and shareholders take decisions by resolutions and decisions of the majority will prevail. In the case majority commits fraud and misfeasance thereby corporate right of minority is infringed then they can file a suit in the name of company under Class and Derivative Action In India till now in a very limited way Class and Derivative action in Corporate Governance was allowed under Section 397 and 398 of Companies Act, 1956 in case of oppression and mismanagement. Whereas, under Clause 216 of the Companies Bill provides for Class Action and Derivative Action in order to protect interests of minority shareholders, this will further strengthen the mechanism of Corporate Governance.

## **Conclusion**

For many years, the approach of companies on the role of business in society could be summarized with the following words of Milton Friedman: “there is one and only one social responsibility of business to increase its profits” and “Business of business is business”. However, it may be worthwhile to mention that the world

has moved far ahead from the aforesaid words of Milton Friedman, now a day's Corporate Governance and CSR are integral part of any company.

It may be noted that, at present, the provisions of Corporate Governance are mandatory and recommendatory under various provisions discussed hereinabove. However, there is no concrete system for CSR, it is purely optional. Furthermore, since Corporate Governance and CSR is interrelated and complementary to each other, by incorporating CSR provisions within Corporate Governance framework would be beneficial for India.

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MPRECA MBBA