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Central Vigilance Commission

Satarkta Bhawan, Block-A,
GPO Complex, INA,
New Delhi-110023
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Subject:- Corporate Governance and Ethics - Challenges and Imperatives, a note by Smt. Ranjana Kumar, Vigilance Commissioner.

Smt. Ranjana Kumar, Vigilance Commissioner, has prepared a note on "Corporate Governance and Ethics - Challenges and Imperatives" which deals with various issues relating to principles of Corporate Governance.

2. The note is available on the Commission's website i.e. <http://www.cvc.nic.in> in downloadable form. The CVOs may kindly incorporate the note/contents of the note in their organizations' vigilance journal/newsletter to be published, released on the occasion of the Vigilance Awareness Week to be observed from 12/11/2007 to 16/11/2007 for information of all employees in their organizations.



(Rajiv Verma)
Under Secretary

Encl:- Note of Smt. Ranjana Kumar, Vigilance Commissioner

All Chief Vigilance Officers

Corporate Governance & Ethics – Challenges & Imperatives

1. A corporation is a congregation of various stakeholders, namely, customers, employees, investors, vendor partners, government and society. A corporation should be fair and transparent to its stakeholders in all its transactions. This has become imperative in today's globalized business world where corporations need to access global pools of capital, need to attract and retain the best human capital from various parts of the world, need to partner with vendors on mega collaborations and need to live in harmony with the community. Unless a corporation embraces and demonstrates ethical conduct, it will not be able to succeed.

2. What is "Corporate Governance"

It is known fact that vital needs of success of any organization lingers on its ability to mobilize and utilize all kinds of resources to meet the objectives clearly set as part of the planning process. Managing well depends on internal and external factors, the latter include availability, cost effectiveness; technological advancement. Increasingly, revelations of deterioration in quality and transparency, have called for adoption of internationally accepted 'Best Practices'. The acceptance of the concept gave rise of 'Corporate Governance'. 'Corporate Governance' encompasses commitment to values and to ethical business conduct to maximize shareholder values on a sustainable basis, while ensuring fairness to all stakeholders including customers, employees, and investors, vendors, Government and society at large. Corporate Governance is the system by which companies are directed and managed. It influences how the objectives of the company are set and achieved, how risk is monitored and assessed and how performance is optimized. Sound Corporate Governance is therefore critical to enhance and retain investors' trust.

3. 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 organization. Ethical leadership is good for business as the organization is seen to conduct its business in line with the expectations of all stakeholders. What constitutes good Corporate Governance will evolve with the changing circumstances of a company and must be tailored to meet these circumstances. There is therefore no one single model of Corporate Governance.

4. I do feel it is necessary to trace the evolution of the concept for better comprehension. Economic and Commercial activities the world over grew manifold after the Bretton Woods and formation of World Bank and the International Monetary Fund. Cross border trades and exchange rate mechanisms resulted in specialization within financial market. Several players in the field, International commerce and settlements grew manifold giving rise to standards and benchmarks. ISO 9000 and International best accounting practices are the culmination of the experience of the stakeholders in different fields of economics and commerce, the policymakers included.

5. As I see it, Corporate Governance is nothing but the moral or ethical or value framework under which corporate decisions are taken. It is quite possible that in the effort at arriving the best possible financial results or business results there could be attempts at doing things which are verging on the illegal or even illegal. There is also the possibility of grey areas where an act is not illegal but considered unethical. These raise moral issues.

6. In fact, the very definition of corporate governance stems from its organic link with the entire gamut of activities having a direct or indirect influence on the financial health of corporate entities. The Cadbury Report (1992) simply describes Corporate Governance as 'the system by which companies are directed and controlled'. So far as corporate governance is concerned, it is financial integrity that assumes tremendous importance. This would mean that the directors and all concerned should be open and straight/forthright about issues where there is conflict of interest involved in financial decision making. When it comes to even the purchase/procurement procedures, there is need for greater transparency.

7. The Corporate system and diverse ownership did contribute in a substantial measure to prosperity, employment potential and living standards of the subjects across the globe. Notwithstanding the contributions, the failures too caused concerns among the regulators. Existing laws, rules and controls did not adequately address the issues related to the failures caused by deficient or intentional fraudulent managements. In USA, the Sarbanes-Oxley Act 2002 was passed to address the issues associated with corporate failures, achieve quality governance and restoring 'investor' confidence.

8. The Securities and Exchange Commission of USA initiated action against multinational accounting firms for failure to detect blatant violation of accounting standards, and penalties running to several million dollars were recovered, from certain multinational consultancy firms.

9. Why Corporate Governance?

- a) The liberalization and de-regulation world over gave greater freedom in management. This would imply greater responsibilities.
- b) The players in the field are many. Competition brings in its wake weakness in standards of reporting and accountability.
- c) Market conditions are increasingly becoming complex in the light of global developments like WTO, removal of barriers/reduction in duties.
- d) The failure of corporates due to lack of transparency and disclosures and instances of falsification of accounts/embezzlement and the effect of such undesirable practices in other companies.

10. It is the increasing role of foreign institutional investors in emerging economies that has made the concept of corporate governance a relevant issue today. In fact, the expression was hardly in the public domain. In the increasingly close interaction of the economies of different countries lies the process of globalisation. This involves the rapid migration of four elements across national borders. These are (i) Physical capital in terms of plant and machinery; (ii) Financial capital; (iii) Technology; and (iv) Labour.

11. The increasing concern of the foreign investors is that the enterprise in which they invest should not only be effectively managed but should also observe the principles of corporate governance. In other words, the enterprises will not do anything illegal or unethical. This need for re-assurance is felt by the FIIs due to the fact that there have been cases of dramatic collapse of enterprises which were apparently doing well but which were not observing the principles of corporate governance.

12. In India corruption is an all embracing phenomenon. In this, if the respective players in the field were to adopt healthy principles of good corporate governance and avoid corruption in their transactions, India could really take a step forward to becoming a less corrupt country and improving its rank in the Corruption Perception Index listed by the Transparency International.

13. Studies in India and abroad show that markets and investors take notice of well managed companies, respond positively to them and reward such companies with higher valuations. A common feature is that they have systems in place, which allow sufficient freedom to Board and Management to take decisions towards progress and to innovate, while remaining within the framework of effective accountability. In other words they have a good system of corporate governance. Strong corporate governance is indispensable to resilient and vibrant capital markets and is an important instrument of investor protection.

14. Securities and Exchange Board of India constituted a Committee on Corporate Governance under the Chairmanship of Mr. Kumar Mangalam Birla. The committee observed that there are companies, which have set high standards of governance while there are many more whose practices are matters of concern. There is increasing concern about standards of financial reporting and accountability especially after losses are suffered by investors and leaders in the recent past, which could have been avoided with better and more transparent reporting practices. Companies raise capital from market and investors suffered due to unscrupulous managements that performed much worse than past reported figures. Bad governance was also exemplified by allotment of promoters' share at preferential prices disproportionate to market value, affecting minority holders' interests. Many corporates did not pay heed to investors' grievances. While there were enough rules and regulations to take care of grievances, yet the inadequate implementation and the absence of severe penalty, left much to be desired.

15. The Kumar Mangalam Committee made mandatory and non-mandatory recommendations. Based on the recommendations of this Committee, a new clause 49 was incorporated in the Stock Exchange Listing Agreements ("Listing Agreements"). The important aspects, in brief, are:

- (i) Board of Directors are accountable to shareholders.
- (ii) Board controls are laid down code of conduct and accountable to shareholders for creating, protecting and enhancing wealth and resources

- of the Company reporting promptly in transparent manner while not involving in day to day management.
- (iii) Classification of non-executive directors into those who are independent and those who are not.
 - (iv) Independent directors not to have material or pecuniary relations with the Company/subsidiaries and if had, to disclose in Annual Report.
 - (v) Laying emphasis on calibre of non-executive directors especially independent directors.
 - (vi) Sufficient compensation package to attract talented non-executive directors.
 - (vii) Optimum combination of not less than 50% of non-executive directors and of which companies with non-executive Chairman to have atleast one third of independent directors and under executive Chairman atleast one half of independent directors.
 - (viii) Nominee directors to be treated on par with any other director,
 - (ix) Qualified independent Audit committee to be setup with minimum of three all being non-executive directors with one having financial and accounting knowledge.
 - (x) Corporate governance report to be part of Annual Report and disclosure on directors' remuneration etc., to be included.

16. Naresh Chandra Committee recommendations relate to the Auditor-Company relationship and the role of Auditors. Report of the SEBI Committee on Corporate Governance recommended that the mandatory recommendations on matters of disclosure of contingent liabilities, CEO/CFO Certification, definition of Independent Director, independence of Audit Committee and independent director exemptions in the report of the Naresh Chandra Committee, relating to corporate governance, be implemented by SEBI.

17. Narayana Murthy Committee recommendations include role of Audit Committee, Related party transactions, Risk management, compensation to Non-Executive Directors, Whistle Blower Policy, Affairs of Subsidiary Companies, Analyst Reports and other non-mandatory recommendations.

18. When it comes to corporate governance, I think we will have to look at the hardware as well as the software aspect. So far as the software aspect is concerned, I would suggest, it depends on the values cherished and practiced by the members of the Board of Directors as well as the management of an organisation. It is always possible to mouth very high principles but act in a very lowly manner. If there is going to be divergence between practice and precept, then we are not going to achieve good corporate governance. This is the first point to be realised.

19. The most important aspect for observing corporate governance is the top management, particularly the board of directors and the senior level management of an enterprise - walking their talk. It is by walking their talk that the top management can earn credibility. This also has a direct bearing on the morale of an organisation.

20. When it comes to the hardware aspect of corporate governance, we go into the issue of a code, which becomes a reference point for behaviour. But the sad fact

in our country is that even though there is a lot of talk about corporate governance, when it comes to reality, nothing much happens.

21. With the SEBI trying to bring some discipline in the stock market especially in terms of greater transparency and disclosure norms, corporate governance in the Indian context at least seems to focus primarily and rightly on the issue of transparency. It is lack of transparency that leads to corrupt or illegal behaviour. If corporate governance is concerned with better ethics and principles, it is only natural that the focus should be on transparency. But how is this transparency to be achieved? One method of course is the code. Another would be the regulatory authorities like SEBI, RBI etc. laying down guidelines so that a certain degree of transparency is automatically ensured. Another legal approach to achieve better corporate governance may be to look at the whole issue of bringing the corporate sector under the discipline of debt and equity. Perhaps amendment of the Companies Act and bringing in this discipline will also help in automatically ensuring better ethics and corporate governance.

22. Perhaps the most important challenge we face towards better corporate governance is the mindset of the people and the organisational culture. This change will have to come from within. The government or the regulatory agencies at best can provide certain environment, which will be conducive for such a mindset taking place, but the primary responsibility, is of the people especially the members of the board of directors and the top management.

23. Another important aspect is to realise that ultimately the spirit of corporate governance is more important than the form. Substance is more important than style. Values are the essence of corporate governance and these will have to be clearly articulated and systems and procedures devised, so that these values are practiced.

24. We then come to a common moral problem in running enterprises. One can have practices which are legal but which are unethical. In fact, many a time, tax planning exercises may border on the fine razor's edge between the strictly legal and the patently unethical. A clear understanding of the fundamental values which govern corporate governance and their explicit articulation in a proper code backed by well established structures and traditions like the ethics committee and audit committee may be the best insurance for good corporate governance under the circumstances.

25. Corporate governance and ethical behaviour have a number of advantages. Firstly, they help to build good brand image for the company. Once there is a brand image, there is greater loyalty, once there is greater loyalty, there is greater commitment to the employees, and when there is a commitment to employees, the employees will become more creative. In the current competitive environment, creativity is vital to get a competitive edge.

26. 10 Essential Governance Principles

A company should:

* **1. Lay solid foundations for management and oversight**

- Recognise and publish the respective roles and responsibilities of board and management.
- * **2. Structure the board to add value**
 - Have a board of an effective composition, size and commitment to adequately discharge its responsibilities and duties.
- * **3. Promote ethical and responsible decision-making**
 - Actively promote ethical and responsible decision-making.
- * **4. Safeguard integrity in financial reporting**
 - Have a structure to independently verify and safeguard the integrity of the company's financial reporting.
- * **5. Make timely and balanced disclosure**
 - Promote timely and balanced disclosure of all material matters concerning the company.
- * **6. Respect the rights of shareholders**
 - Respect the rights of shareholders and facilitate the effective exercise of those rights.
- * **7. Recognise and manage risk**
 - Establish a sound system of risk oversight and management and internal control.
- * **8. Encourage enhanced performance**
 - Fairly review and actively encourage enhanced board and management effectiveness.
- * **9. Remunerate fairly and responsibly**
 - Ensure that the level and composition of remuneration is sufficient and reasonable and that its relationship to corporate and individual performance is defined.
- * **10. Recognise the legitimate interests of stakeholders**
 - Recognise legal and other obligations to all legitimate stakeholders.
- * **11. Corporate Governance Rating be made mandatory for listed companies.**

27. Openness, integrity and accountability are the key elements of Corporate Governance for any corporate entity. These factors assume greater importance in case of Public Sector Banks. It is, therefore, necessary that the Board of Directors, external auditors and supervisors of bank strive to achieve greater degree of openness, transparency, integrity and accountability in the working of the institution.

28. Banks deal in trust. If trust is in suspicion, damaged or lost, the resulting financial loss cannot measure the true risk. Trust being the foundation of banking, the discussion over applicability of good governance has really been a non-issue. Good governance and practices are synonymous to banking, banks and bankers. The essence of Corporate Governance is a framework of effective accountability to all stakeholders. Corporate Governance is an instrument for benefiting all stakeholders of a corporate entity. In its widest sense, Corporate Governance is almost akin to a trusteeship. It is about creating an outperforming organisation, which leads to increasing customer satisfaction and shareholder value.

29. A code for corporate governance for public sector banks in India could be in the form of a set of prescriptions and proscriptions for the key decision makers of a bank- its Chairman, Executive and non-Executive Directors, institutional investors and external auditors. Such a code, it is believed, would enable the Boards of the banks to resolve conflict of interests between shareholders, customers, employees and other stakeholders. An informed debate on the issue of contemporary banking in the board rooms would help develop the vision to imagine crises and the will to act pre-emptively.

30. In a deregulated milieu, the Public Sector Banks are bound to demand, and rightly so, greater functional autonomy for flexibility in decision making. Such autonomy, however, needs to be accompanied by greater accountability on the part of their Boards to the stakeholders. A Code of Corporate Governance could be an effective instrument for achieving this goal.

31. The Reserve Bank of India has set up various working groups to evaluate its existing corporate governance norms for banks. The Khan Working Group Report, though it did not deal with corporate governance *per se*, recommended full operational autonomy and flexibility to the management and boards of banks. The Narasimham Committee I recommended a gradual progress towards BIS norms and suggested the ending of the dual control over the sector by the RBI and the Ministry of Finance. The Narasimham Committee II (1998) recommended reducing government control and strengthening of internal controls. Additionally, Dr. Patil Advisory Group and Varma Group have made recommendations on international best practices of Corporate Governance for banking companies.

32. The report of the Consultative Group of Directors of Banks/Financial Institutions – chaired by A.S. Ganguly – has tackled the issues of ethics, transparency and corporate governance. It has focussed on more fundamental issues like the supervisory role of boards of banks and financial institutions and functioning of the boards vis-à-vis compliance, transparency, disclosures, audit committees etc. A governance framework must include effective systems of Control

and Accountability, and above all responsible attitudes on the part of those handling public money. It is important that the drive to provide improved services at reduced costs should be maintained and that this drive should not be stifled. At such time it is even more essential to maintain honesty in the spending of public money and to ensure that the traditional public sector values are not neglected in the effort to maximise economy and efficiency.

33. Ethics in managing an organisation are vital for long term survival. It is defined as disciplined dealing with what is good and what is bad and what are moral duties and obligations. As far as business ethics are concerned, a minimum code of ethics has to be practiced in competition, public relations and social responsibilities. Corporate Governance encourages ethical standards and sound business practices.

34. Corporate governance extends beyond corporate law. Its objective is not mere fulfilment of legal requirements but ensuring commitment on managing transparently for maximising shareholder values. As competition increases, technology pronounces the deal of distance and speeds up communication, environment also changes. In this dynamic environment the systems of Corporate Governance also need to evolve, upgrade in time with the rapidly changing economic and industrial climate of the country.

35. Finally the key lesson for us to learn are that Regulations and Policies are only one part of improving governance. Existence of a comprehensive system alone cannot guarantee ethical pursuit of shareholder's interest by Directors, officers and employees. Quality of governance depends upon competence and integrity of Directors, who have to diligently oversee the management while adhering to unpeachable ethical standards. Strengthened systems and enhanced transparency can only further the ability. Transparency about a company's governance process is critical. Implementing Corporate Governance structures are Important but instilling the right culture – work culture is Most Essential.

36. Corporate Governance in the Public Sector cannot be avoided and for this reason it must be embraced. But Corporate Governance should be embraced because it has much to offer to the Public Sector. Good Corporate Governance, Good Government and Good Business go hand in hand.

Sd/-
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