Corporate Governance and Business Ethics: Challenges for Corporate Sectors

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Good corporate governance practices are a *sine qua non* for sustainable business that aims at generating long term value to all its shareholders and other stakeholders. It is essential for the integrity of corporations, financial institutions and markets. It ensures the health of our economies and their stability.

Introduction

Two decades ago the term corporate governance had not been coined. The matters involved were of concern only as an esoteric branch of commercial law. Today, the subject is a central, political and economical issue in many countries including Britain, the U.S.A. and even in India. Corporate Governance is a relationship among stakeholders that is used to determine and control the strategic direction and performance of organisations. There is, however, no such standard definition of corporate governance. But it can broadly be understood to refer to the system by which companies are directed and controlled, including the roles of the board of directors, management, shareholders, and other stakeholders. Corporate governance provides the structure through which the objectives of the company are set and the means of attaining those objectives and monitoring performance are determined. The classic definition was provided by Sir Adrian Cadbury in 1992 is ‘Corporate governance is the system by which companies are directed and controlled.’ Although this definition focuses usefully on the board of directors, it is a somewhat narrow and mechanistic view of governance. Ira Millstein, the US lawyer whose views on corporate governance command international respect, defined corporate governance in 2003 as:

“that blend of law, regulation and ... voluntary private sector practices which enables the corporation to attract financial and human capital, perform efficiently ... generating long-term economic value for its shareholders while respecting the interests of stakeholders and society as a whole.”

Millstein recognises that good governance requires both regulation and voluntary measures, and he draws attention to the benefits for companies of good governance practices. The Organisation of Economic Co-operation and Development (OECD) is a unique forum where the governments of 30 democracies work together to address the economic, social and environmental challenges of globalization, in close co-operation with many other economies. One of these challenges is corporate governance; a topic on which the OECD has developed internationally agreed Principles of Corporate Governance, which have served as a basis for regional policy dialogue programmes throughout the world. Since 1999, the OECD’s *Principles of Corporate Governance* has become an international benchmark for policy makers, investors, corporations, and other stakeholders worldwide. OECD revised the Principles of Corporate Governance in 2004, which stated as follows:

“Corporate governance involves a set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set and the means of attaining those objectives and monitoring performance are determined.”

The OECD has developed the following six principles of corporate governance:

Principle I : Ensuring the Basis for an Effective Corporate Governance Framework;
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Principle II: The Right of Shareholders and Key Ownership Function;
Principle III: The Equitable Treatment of Shareholders;
Principle IV: The Role of Stakeholders in Corporate Governance;
Principle V: Disclosure and Transparency;
Principle VI: The Responsibility of the Board;

When the OECD Principles referred to corporate governance involving a set of relationships between management, the directors, shareholders and other stakeholders, they articulated four basic principles to govern those relationships:

- Accountability – to shareholders
- Responsibility – to stakeholders
- Transparency – in all actions
- Fairness – in treatment of shareholders.

The objectives of this article are as follows:

1. To visualize the concept of business ethics and corporate governance as a necessity.
2. To show the Indian approach towards the corporate governance principle.
3. To highlight, with the help of few case studies, how good corporate governance can be profitable in the world market today.

The Ethical Viewpoint

Corporate ethics play an important role in ensuring good corporate governance and better corporate management. Corporate ethics and corporate governance support corporate management. Ethical lapses and dilemmas are one of the root causes of many problems that corporate management is facing today. Ethics can be defined broadly as the study of what is right or good for human beings. It attempts to determine what people ought to do and what goals they should pursue. Business ethics, as a branch of applied ethics, is the study and determination of what is right and good in business settings. Unlike legal analyses, analyses of ethics have no central authority, such as courts or legislatures, upon which to rely; nor do they follow clear-cut, universal standards. Despite these limitations it is still expected to make ethical judgements for better corporate management. However, the question is how to ensure that the ethical or legal principles of the organisation have been provided with care. The quest may lead us to get a hint about the ethical principles that are mentioned below:

Due Process

Due process means following rules and principles so that an individual is treated fairly and uniformly at all times. It also means fair and equitable treatment to all concerned parties. Two types of due process exist: procedural due process and substantive due process. Procedural due process ensures that a formal proceeding is carried out regularly and in accordance with the established rules and principles. Substantive due process deals with a judicial requirement that enacted laws may not contain provisions that result in the unfair, arbitrary, or unreasonable treatment of an individual. Due process requires due care and due diligence.

Due Care & Due Diligence

Due care means reasonable care which promotes the common good. It maintains minimal and customary practices. Due diligence requires organizations to develop and implement an effective system of controls, policies, and procedures to prevent and detect violation of policies and laws. Due diligence is another way of saying due care.

Due Professional Care

As the name implies, due professional care applies to professionals such as business managers and executives, accountants, auditors, engineers, lawyers, doctors, and others. Individuals should apply the care and skill expected of a reasonable prudent and competent professional during their work.

Codes of Conduct

Today professionals want to practice their expertise, not necessarily to become managers and deal with human challenges. They have different goals and motives.” The expert knowledge in different fields will make the professionals to tackle new challenges in their day to day’s working field. Such areas of knowledge include knowledge about the legal framework, knowledge about human resource management, knowledge about strategic management, knowledge about costing & accounts etc. The acquisition of such knowledge makes a professional to be more efficient in finding out a prompt action while facing with a challenge. However, apart from acquiring the knowledge there are some ethical issue or code conduct which a professional must adhere to. The code of ethics is the principle guidelines for the professionals beyond which they are not expected to go. For example, The Institute of Company Secretaries of India identifies that “the Code is designed to assist in defining appropriate personal and professional conduct, to provide guidance in the identification and resolution of ethical issues, and to help the members of the Council and the members of
the Senior Management of the Institute to maintain the culture of honesty, integrity, transparency and accountability. The Code of Conduct shall be in addition to and not in derogation of the Code of Conduct to members of the Institute as regards the Council Members and the Code of Conduct laid down in the ICSI Service Rules as regards the members of the Senior Management. Every Council Member and Member of the Senior Management must comply with the letter and spirit of this Code.” Section 22 of the Chartered Accountants Act defines and describes what constitutes ‘professional misconduct’. Under Section 22 of the Act, the expression ‘professional misconduct’ shall be deemed to include any act or omission specified in any of the schedules. Corporate governance objectives are also formulated in voluntary codes and standards (i.e., codes of conduct) that do not have the status of law or regulation.

Indian Approach to Corporate Governance

Some aspects of corporate governance have been enshrined in the law that is administered by the Ministry of Corporate Affairs (GoI), SEBI and other sectoral regulators. The Ministry of Corporate Affairs has been working towards strengthening of the corporate governance framework through a two pronged strategy. The Task Force of CII on corporate governance headed by Shri Naresh Chandra and the recommendations of the Institute of Company Secretaries of India were also helpful for strengthening corporate governance framework. The Ministry of Corporate Affairs has examined committee reports as well as suggestions received from various stakeholders on issues related to corporate governance and “Corporate Governance -Voluntary Guidelines 2009” are prepared and disseminated for consideration and adoption by corporate sectors. These guidelines provide for a set of good practices which may be voluntarily adopted by the Public companies. Private companies, particularly the bigger ones, may also like to adopt these guidelines. A brief outlook of the guidelines is highlighted as follows:

A. Board of Directors

Companies should issue formal letters of appointment to Non-Executive Directors (NEDs) and Independent Directors - as is done by them while appointing employees and Executive Directors. The letter should specify the term of the appointment, fiduciary duties, list of actions that a director should not do, the remuneration, including sitting fees and stock options etc, if any. Such formal letter should form a part of the disclosure to shareholders at the time of the ratification of his/her appointment or re-appointment to the Board.

To prevent unfettered decision making power with a single individual, there should be a clear demarcation of the roles and responsibilities of the Chairman of the Board and that of the Managing Director/Chief Executive Officer (CEO). The roles and offices of Chairman and CEO should be separated, as far as possible, to promote balance of power.

B. Nomination Committee

The companies may have a Nomination Committee comprising of majority of Independent Directors, including its Chairman which should consider the proposals for searching, evaluating, and recommending appropriate Independent Directors and Non-Executive Directors [NEDs], The Nomination Committee should also evaluate and recommend the appointment of Executive Directors.

Maximum Limit of Directorship

In case an individual is a Managing Director or Whole-time Director in a public company the maximum number of companies (public limited companies or private companies that are either holding or subsidiary companies of public companies) in which such an individual can serve as a Non-Executive Director or Independent Director should be restricted to seven.

C. Independent Directors

The Board should put in place a policy for specifying positive attributes of Independent Directors such as integrity, experience and expertise, foresight, managerial qualities and ability to read and understand financial statements. All Independent Directors should provide a detailed Certificate of Independence at the time of their appointment, and thereafter annually. In order to enable Independent Directors to perform their functions effectively, they should have the option and freedom to interact with the company management periodically.

Tenure for Independent Director

I. An Individual may not remain as an Independent Director in a company for more than six years.

II. A period of three years should elapse before such an individual is inducted in the same company in any capacity.

III. No individual may be allowed to have more than three tenures as Independent Director in the manner suggested in ‘I’ and ‘II’ above.
D. Remuneration Committee

Companies should have Remuneration Committee of the Board. This Committee should comprise of at least three members, majority of whom should be non executive directors with at least one being an Independent Director. This Committee should have responsibility for determining the remuneration for all executive directors and the executive chairman, including any compensation payments, such as retirement benefits or stock options. This Committee should also determine principles, criteria and the basis of remuneration policy of the company which should be disclosed to shareholders and their comments, if any, considered suitably. This Committee should also recommend and monitor the level and structure of pay for senior management, i.e. one level below the Board. This Committee should make available its terms of reference, its role, the authority delegated to it by the Board, and what it has done for the year under review to the shareholders in the Annual Report.

E. Audit Committee

Companies should have at least a three-member Audit Committee, with Independent Directors constituting the majority. The Chairman of such Committee should be an Independent Director. All the members of audit committee should have knowledge of financial management, audit or accounts.

The Audit Committee should have the responsibility to –

- monitor the integrity of the financial statements of the company;
- review the company’s internal financial controls, internal audit function and Risk Management Systems;
- make recommendations in relation to the appointment, reappointment and removal of the external auditor and to approve the remuneration and terms of engagement of the External Auditor;
- review and monitor the external auditor’s independence and objectivity and the effectiveness of the audit process.

The Audit Committee should also monitor and approve all Related Party Transactions including any modification/amendment in any such transaction. A statement in a prescribed/structured format giving details about all related party transactions taken place in a particular year should be included in the Board’s report for that year for disclosure to various stakeholders.

F. Secretarial Audit

In order to ensure the transparent, ethical and responsible governance, the companies may get the Secretarial Audit conducted by a competent professional. The Board should give its comments on the Secretarial Audit in its report to the shareholders.

G. Mechanism for Whistleblowing

The companies should ensure the institution of a mechanism for employees to report concerns about unethical behaviour, actual or suspected fraud, or violation of the company’s code of conduct or ethics policy. The companies should also provide for adequate safeguards against victimization of employees who avail of the mechanism, and also allow direct access to the Chairperson of the Audit Committee in exceptional cases.

Is Corporate Governance Operating?

These facts make it difficult to argue that law enforcement lacked an arsenal of statutes and regulations with which to charge companies and individuals for corporate misconduct. Enron and WorldCom to name only the most widely known involved issues of finance and accounting, which are largely rule-based disciplines. This misconduct did not occur in a corporate “Wild West” where lawlessness required that one make it up as one went along. But ethics can be reasonably seen as an intangible, yet powerful, catalyst and supporter of compliance. Put another way, it is not possible to legislate for ethical behavior. Ensuring sound ethical practice requires participation and even leadership from all ranks within a company. It is accurate to say that global shifts in standards are facilitating and adding pressure to the adoption of ethical practice everywhere. The convergence or harmonization with International Accounting Standards has been a positive step towards uniformity and improved controls in territories such as Hong Kong, Malaysia, and Singapore. 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. That said, a systematic approach to governance and ethics remains very much a work-in-progress for many.
CASE STUDY: IBM SINGAPORE

They may not be quick to admit it, but for companies like IBM, the global computing giant, the demise of former peers in the corporate elite must be chilling. But as a blue-chip American company with revenues of nearly US$100 billion, did IBM learn any lessons from the demise of Enron and WorldCom?

“IBM has always had a focus on conducting business with integrity,” says Ong Wee Gee, CFO of IBM Singapore. “Our good name and reputation for integrity are important competitive advantages, and to maintain these, we depend on each and every employee.” Reputations have played a huge part in IBM’s success, certainly. The trouble is, sometimes people slip. Last year, for instance, IBM was forced to restate its 2004 revenue figure for its Global Services unit by US$260m, after discovering improper sales of third-party hardware at its Japanese unit. In a filing to the US Securities and Exchange Commission (SEC), the company conceded that a review of third-party agreements had found “certain IBM Japan employees acted improperly and inconsistently with IBM’s policies and practices.”

To a company of IBM’s stature such revelations are embarrassing, and can prompt a dip in share price. But they are rarely fatal. But for IBM, like most companies, the particular challenge of recent years has been juggling the expectations of stakeholders while achieving compliance with a raft of new rules and regulations on financial reporting and governance. That fact was reinforced earlier in 2006 when the SEC formalized a probe into IBM’s disclosures of its first-quarter 2005 earnings and expensing of stock compensation. IBM began expensing the value of its stock options in the first quarter of 2005, a year ahead of when it was required to do so, and some analysts had complained that IBM’s guidance about the impact of the move on its quarterly earnings had been confusing.

Despite such setbacks, Ong says IBM hasn’t been spooked by the scandals that have befallen others. He says the company’s audit committee "has always been demanding" and that the company’s relationship with its external auditor continues as before. But with 329,000 employees in 75 countries the need to cultivate a unified set of ethics, supported by standard processes, is more important than ever. To this end IBM has a global set of business conduct guidelines which every employee at IBM is required to read and verify once a year. The same guidelines apply in every country – subsidiaries are not given rein to tailor their approach and are incorporated into employee orientation. Furthermore, ensuring that employees are clear about IBM’s zero-tolerance approach to breeches of its conduct guidelines are a formal part of managers’ annual objectives.

CASE STUDY: NATURA BRAZIL

Natura is the leading company in the Brazilian cosmetics, perfumery and personal hygiene products sector. Committed to the quality of its relationship with stakeholders, Natura established a sustainable development business model, focused on constant innovation and improvement of its products. Since its foundation in 1969, Natura has held a passionate view of its products. Ten years later, the company made the choice to sell its products directly to its customers, a strategy which proved to be one of the main reasons for its continued success. The company grew steadily during the 1980s, and then underwent a broad restructuring process. In the mid-1990s, Natura launched itself abroad, starting up distribution centers in neighboring countries, such as Argentina, Chile and Peru. Natura has a substantive history behind its path towards good governance practices.

Good Corporate Governance Practice

When Natura finally decided to go public, the company had already come a long way in implementing good management practices and had a very well-structured governance platform. Its financial reports were prepared in accordance with US GAAP, its Board of Directors included external directors, the Audit Committee was also chaired by an external director and an investor relations department was in place. When Natura considered on which stock exchange to list its shares, its choice was clear. Natura decided to voluntarily adhere to the listing requirements of the Novo Mercado (New Market), the most demanding special corporate governance segment of BOVESPA (Sao Paulo Stock Exchange). Currently, Natura’s Board of Directors is comprised of 5 directors, 2 of whom are external directors. The positions of the Chairman and CEO are separate. To assist the Board to carry out its functions, four committees have been established: Strategy; Corporate Governance; Audit, Risk and Finance; and Human Resources. The company reports its results on a
quarterly basis and also conducts conference calls regularly with financial market analysts. The financial statements are prepared in accordance with the Brazilian Corporate Law and best practices of information disclosure. The company’s Investor Relations Department has several meetings with analysts and investors each year in order to discuss business results and material developments in the product markets.

Results:
Natura’s commitment to its investors, its reliable corporate governance practices and its deep concern about sustainable development led to extraordinary operational results. Its sales grew 33% in 2004 and 117% over the past three years. Its operations in the rest of Latin America also evolved consistently, growing 52% in 2004 and 107% over the past three years, in dollar terms, from US$ 11.6 million in 2001 to US$ 24.1 million in 2004. Its share in the domestic market went up from 17.1% in 2003 to 19.2% in 2004 and to 21.4% in 2005.

Problems in Good Corporate Governance
Success of corporate governance is based on complete transparency and “arms length” relationship between owners and managers. Historically there have always been reasons excuses and incentives to encourage, “beating the system” and unhealthy corporate practices like tax evasion, as an attempt to create a level playing field in an unfriendly business and regulatory environment. Therefore a transparency and accountability are generally resisted by corporate managers; including family entrepreneurs who are not enlightened enough to the change in their role. We have seen that in India, or for that matter, in any protected environment, market forces alone cannot be depended upon to ensure change in corporate practices. Left to itself, the process of change in corporate governance would be very slow. Hence, the need for a regulatory mechanism which will ensure effective monitoring for good corporate governance is now realized.

Conclusion
In 21st century Indian corporate sector must adopt globalization concept and must have the resources utilized optimally to get a place among the top world market. There is no doubt that as the economy has become more advanced and more complex, the company law regime has also expanded in its scope and breadth so as to keep pace with market reality. Thus law makers of the country were aware that besides company law statutes- like the Companies Act, the Securities Regulation Act, etc. – they should also prescribe certain norms of governance for the management of the corporations. These norms of corporate governance have a statutory backing through its incorporation in various statutes and regulations. For instance, as per the provisions of Section 217 of the Companies Act, 1956 a company is required to give Directors’ Responsibility Statement regarding preparation of annual accounts, applicable accounting standards, etc. Also, clause 49 of the Listing Agreement requires a separate Corporate Governance Report together with Management Discussion & Analyses to be given along with Directors’ Report. The OECD Principles, for instance, call on businesses to recognize and safeguard stakeholders’ rights, including legitimate interests and information needs. These principles require the corporate boards to be truly accountable to shareowners and to take ultimate responsibility for their firm’s adherence to a high standard of corporate behavior and ethics. Effective corporate governance requires due diligence in rallying the support and commitment of the broad network of business stakeholders, including shareowners, employees, customers and communities. If stakeholders are adversely affected by a company’s actions, shareowner value will suffer. Indian professionals are ready to take on any challenges or tasks they are assigned to. The real need is to have technical efficiency in every field of a profession and the globalization has made this as ever-changing characteristic.

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