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# Ethics and Corporate Governance

**LEARNING OBJECTIVES**

After studying this chapter, readers will be able to comprehend the following:

- Concept of corporate governance
- Nature of corporate governance
- Objectives of corporate governance
- Significance of corporate governance
- Limitations of corporate governance
- Committee reports on corporate governance
- Corporate governance practices in India
- Relationship between corporate governance and business ethics

## 19.1 INTRODUCTION

- Over the last couple of decades, there have been multiple consumer movements and soaring levels of awareness among stakeholders across the world. This has forced organizations to realize that their stakeholders have become deeply concerned about unethical business practices such as financial irregularities, tax evasion, supply of poor quality products and services, non-compliance with environmental issues, hazardous working conditions etc.
- Organizations have begun to recognize and appreciate the importance of integrity and transparency in business activities. This, in turn, has led to the adoption, implementation and administration of certain codes for good corporate practices that highlight the manner in which such organizations are directed and controlled, and in the long run, shall translate into economic gains.
- Moreover, contemporary investors seek to invest in businesses that are not only managed properly, but also have proper measures of corporate governance to ensure the optimum use of the human, financial as well as infrastructural resources of a business. Thus, organizations are beginning to integrate the core concepts of ethics into their corporate cultures, while establishing relevant corporate governance mechanisms in the business.

**QUOTES**

*Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The aim is to align as nearly as possible the interests of individuals, corporations and society.*

*—Sir George Adrian Hayhurst Cadbury, Chairman of Cadbury Schweppes PLC*

*Good corporate governance is about 'intellectual honesty' and not just sticking to rules and regulations, capital flowed towards companies that practiced this type of good governance*

*— Mervyn Eldred King, Chairman, King Committee on Corporate Governance*

## 19.2 CONCEPT OF CORPORATE GOVERNANCE

- **Corporate governance** refers to a set of systems and practices to ensure that the business activities of an enterprise are being managed in a manner that ensures accountability, transparency and fairness in all its transactions, and fulfil stakeholder aspirations as well as societal expectations.
- According to the *Kumar Mangalam Birla Committee*, instituted by the Securities and Exchange Board of India (SEBI) in 1999, corporate governance may be defined as the enhancement of long-term shareholder value, while, at the same time, protecting the interests of other stakeholders.
- At its most fundamental level, corporate governance deals with issues that result from the separation of ownership and control.
- In today's transforming business scenario, corporate governance is no longer a management jargon, but a corporate necessity, and the quality of corporate governance is one of the key drivers of value for shareholders.
- Sound governance policies and practices by an organization indicate a degree of control, which is exercised by major representatives of various stakeholder groups for the furtherance of business growth and protection of stakeholders' interests.
- A well-established system of corporate governance includes the efficient use of available resources, value addition and wealth creation within the comprehensive framework of corporate philosophy. It aims to maintain a strong balance between economic and social goals as well as between individual and cooperative goals, and align the interests of individuals, corporations and the society as far as possible.
- There are usually three key participants in corporate governance—the board of directors, management and the stakeholders of the firm. The complex interactions among these three participants can be graphically represented with the aid of the corporate governance triangle (see Fig. 19.1).

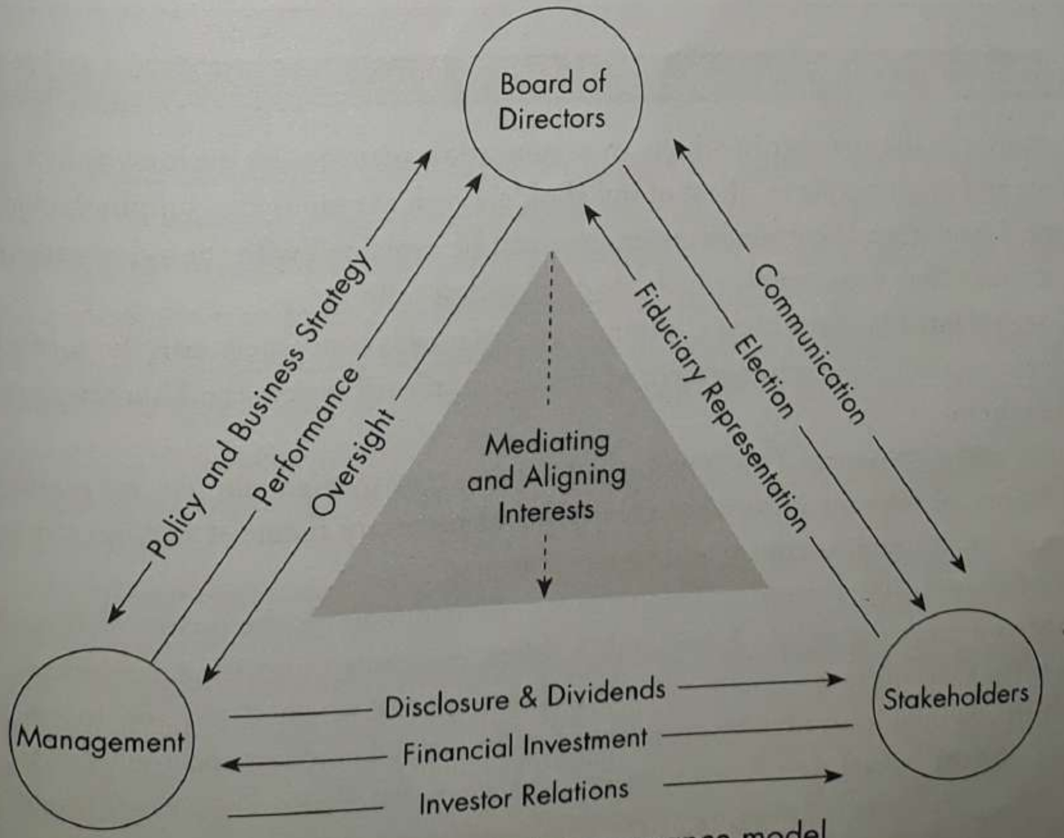


**Fig. 19.1** Corporate governance model

- The structure of the triangle represents the governance model where good corporate governance represents a balance and equilibrium among the three participants.
- The board of directors are responsible for overseeing the performance of their management team, who are gauged through their performance. They also maintain a *fiduciary relationship* (i.e., a relationship based on trust) with their stakeholders. The management policies and structure should be transparent enough to adequately disclose relevant information to their stakeholders and ensure timely payment of dividends, for their investments in the business.
- By establishing the relationship between the parties involved, the model offers optimal conditions for the business to thrive, fulfil its strategic goals, and ensure sustainable long-term performance.

**Concept Note: What is 'Good' Corporate Governance?**

- Corporate governance deals with the principles of rights and equitable treatment of stakeholders while abiding by the principles of integrity and business ethics.
- In fact, bad corporate governance is being recognized by several firms as one of the root causes of corruption in organizations as well as in our society.
- Good corporate governance relates to the adopted systems of disclosure and transparency, which provide regulators, stakeholders and the economy at large, with precise information regarding the financial, operational and other aspects of the organization.
- The bottom line for good corporate governance involves the dual aim of pursuing profits and doing so in a transparent and accountable manner. In this context, the top management, including the Board of Directors, as inspired by stakeholders and societal values, have a critical role to play in implementing and abiding by the code of conduct.

## 19.3 FEATURES OF CORPORATE GOVERNANCE

Corporate governance is the manner in which an organization manages its business activities in a manner that is transparent and accountable to a host of stakeholders such as employees, suppliers, customers and the local community. The nature of corporate governance can be explained with the aid of certain fundamental principles and features that it possesses, which are discussed as follows:

- **Control of organizational activities:** Corporate governance is concerned with the formulation of long-term objectives and the proper management of the organizational systems and human resources necessary to accomplish them.
- **Transparency and disclosure:** This implies that the top management should not maintain any secrecy and must disclose all relevant information (in terms of necessary financial and operational data) to the stakeholders in an accurate, adequate and timely manner.
- **Protection of shareholders' rights:** Corporate governance requires the board of directors and the top management to protect the rights of their stakeholders, especially minority stakeholders.
- **Accountability:** Corporate governance is a top-down approach, where the top management must be accountable for their actions, thereby creating value for the stakeholders and the society.
- **Pillared on ethical principles:** Corporate governance is based on core ethico-moral principles and values. It requires an organization to avoid unfair practices, cheating, exploitation and similar other business malpractices.

- **Universal application:** The fundamentals of corporate governance are legally recognized across several countries and all organizations must abide by its principles voluntarily.
- **Systematic process:** Corporate governance is a systematic process based on laws, procedures, practices and rules, which seek to increase the wealth of the shareholders and to protect the rights of all the stakeholders of the company.
- **Efficient management:** A strong, prudent, autonomous and non-partisan board of directors is required to lead and support a merit-centric managerial structure, in order to support the long-term strategic objectives of the firm.

## 19.4 OBJECTIVES OF CORPORATE GOVERNANCE

The fundamental objective of corporate governance is to boost and maximize shareholder value and protect the interest of other stakeholders by enhancing the corporate performance and accountability. Fundamentally, it aims to develop an environment of trust and confidence amongst those having competing and conflicting interests. It is integral to the very existence of a company and strengthens the confidence of investors by ensuring the commitment of the organization to higher growth and profits. Broadly, it seeks to achieve the following objectives:

- **To facilitate objective decision-making:** A well-defined system of corporate governance ensures that an appropriately structured board of directors, which is capable of taking independent and objective decisions, is placed at the helm of affairs.
- **To align stakeholder and corporate goals:** Corporate governance ensures a high degree of congruence between the steering beliefs of the organization and the beliefs of its stakeholders.
- **To maintain the balance of the board:** Good corporate governance ensures that there is adequate balance in the board, with reference to the representation of adequate number of non-executive and independent directors who would take care of their interests and well-being of all the stakeholders;
- **To adopt transparent business practices:** The top management and the board adopts transparent procedures and practices and arrives at decisions on the strength of suitable information.
- **To promote stakeholder interest:** Good corporate governance ensures that the organization, in terms of the top management, possesses effective machinery to promote the concerns and interests of stakeholders.
- **To provide timely information:** It ensures that the shareholders are up-to-date with reference to relevant developments, which have an impact on the company and its operations.
- **To monitor corporate functioning effectively:** A good system of corporate governance empowers the board to monitor the functioning of the management teams in the company, effectively and regularly, thereby discouraging mismanagement.
- **To maintain adequate control:** The board of directors remain in effective control of the affairs of the company at all times.
- **To develop an efficient organizational culture:** Corporate governance encourages managers to persuade organizational members to change and adopt to a new ethical organizational culture.
- **Achieves corporate goals:** Good corporate governance helps accomplish the corporate goals by investing in profitable ventures and outlets.
- **Creates social responsibility:** A strong corporate governance framework encourages the efficient use of resources, as well as accountability for the stewardship of such resources, thereby creating social responsibility.

- **Improves social cohesion:** Most of the organizational functions such as profit-earning, treatment of shareholders, administration of their boards etc. depend on the quality of corporate governance, which in turn helps build a unified society that works toward the well-being of all its members.

## 19.5 SIGNIFICANCE OF CORPORATE GOVERNANCE

The corporate governance framework shapes corporate efficiency, stability in employment, retirement security, and a deep-rooted responsibility for the society. It is intended to increase the accountability of a company and to avoid massive disasters before they occur. The importance of corporate governance may be discussed as follows:

### 19.5.1 To Companies

- **Improving access to capital:** Corporate governance plays an important role in improving access for emerging market companies to global portfolio equity. Well-governed companies are known to receive higher market valuations.
- **Improving performance.** Improved governance structures and processes help ensure quality decision-making, encourage effective succession planning for senior management and enhance the long-term prosperity of companies.
- **Developing a strong system of internal control:** Adopting good corporate governance practices lead to a strong and efficient system of internal control, thus leading to greater accountability and improved profit margins.
- **Adding value:** In addition to the benefits offered to individual client companies, working to improve corporate governance contributes more broadly to a company's mission to promote sustainable investment.
- **Reducing investment risk:** Improving the corporate governance of investee companies enables the firm to work in higher risk environments. It should also bring an increase in the market valuation of companies and attract more investors.
- **Avoiding reputational risk:** If an organization does not work to improve the corporate governance of stakeholders, then it assumes not only investment risk, but also a reputational risk for involvement with companies with poor governance or, in the worst cases, corporate scandals.
- **Developing capital markets:** Improving corporate governance standards, particularly in the area of transparency and disclosure, contributes to the development of the public and private capital markets.
- **Ensuring survival in competitive markets:** Corporate governance helps businesses survive in an increasingly competitive environment through mergers, acquisitions, partnerships and risk reduction through asset diversification.
- **Provides an exit policy:** It helps in providing an exit policy and ensures smooth inter-generational transfer of wealth and divestment of family assets, as well as reducing the chance for conflicts to arise.
- **Offers future growth prospects:** Robust corporate governance practices can pave the path for possible future growth, diversification or a scale, including the ability to attract equity investors, nationally as well as from overseas, thereby reducing the cost of credit for corporations.

### 19.5.2 To Shareholders

- **Incentivizes the board:** Good corporate governance can provide proper incentives to the board as of directors as well as the top management, to pursue objectives that are in the interest of the company and shareholders, as well as facilitate effective monitoring.

- **Offers investment security:** Better corporate governance can provide shareholders with greater security on their investments, due to the element of trust involved.
- **Ensures transparency:** A strongly developed system of corporate governance ensures that shareholders are sufficiently informed on decisions concerning fundamental issues like amendments of statutes, or articles of incorporation, sale of assets etc.
- **Increases Trust:** When all shareholders are able to rely upon the data provided by companies, the level of trust increases and organizations are able to develop stronger, longstanding relationships with their stakeholders, such as favourable credit terms or repeat business opportunities.

### 19.5.3 To the Economy

- **Premium for integrity and transparency:** When compared to poorly governed firms with a strong financial record, majority of the institutional investors across the worlds prefer to pay a premium for the shares of a well-governed company, characterized by integrity and transparency.
- **Enhances corporate value:** The adoption of corporate governance principles and practices play a key role in increasing the corporate value of employees.
- **Minimizes waste, risks, corruption and mismanagement:** Strong governance practices happen to increase levels of transparency, trust and integrity, all of which create an environment conducive to reducing risks, opportunities for corruption and any source of mismanagement.
- **Promotes sustainability:** A company committed to good governance is more able to quickly identify and resolve any systemic issues in order to safeguard its reputation as well as its future, thereby reducing the likelihood of costly corporate crises and scandals.
- **Better employment generation:** Good corporate governance leads to increased access to external financing by firms, which in turn, may lead to greater investment, higher growth and thus, more employment creation in the economy.

## 19.6 LIMITATIONS OF CORPORATE GOVERNANCE

Corporate governance happens to be one of the most intensely regulated domains under the purview of the legislative framework, especially since corporations are privately owned, but are treated as independent legal entities. This in turn renders their corporate assets vulnerable to a variety of potential abuses. Some of the major limitations of corporate governance have been discussed hereunder:

- **Lack of proper structure:** Corporate governance has no definite structure or design and it is largely considered ambiguous. There is a lack of awareness about its various issues, such as quality and frequency of financial and managerial disclosure, compliance with the codes of best practice, roles and responsibilities of the board, shareholders rights, etc.
- **Inadequate government support:** A multitude of recent corporate scandals have resulted in public pressure to reform business practices, increase regulation, increase accountability, and responsibility in corporate behaviour. Government actions have often proven to be ineffective in terms of weak regulatory systems, poor auditing and law enforcement standards.
- **Increased operational costs:** The abuse of corporate governance has necessitated the enactment of a large body of laws designed to prevent such abuses from recurring. Corporations must comply with these laws by maintaining corporate documentation, including legal compliance, annual registration etc. This may prove to be quite taxing and expensive for corporations.

- **Principal-agent conflicts:** Often, conflicts arise when the shareholders of an organization do not actively participate in the functioning of the business and instead hire professional management, who tend to act in their best interest as employees but not in the best interest of the shareholders.
- **Illegal insider trading:** Illegal insider trading[1] occurs when a shareholder divulges private information to outsiders, which could have a financial impact on the company's short-term or long-term performance. Since access to confidential corporate information can be widely dispersed, laws against insider trading can be difficult to enforce.
- **Misleading financial statements:** There are multiple ways of presenting accurate information on a financial statement in a manner that is misleading to investors. It is also possible to present factually incorrect information that is difficult to detect by creating complex networks of subsidiaries. This in turn, puts a lot of pressure on the framework for corporate governance.
- **Conflict between dominant and minority shareholders:** Indian corporate governance practices have always been known for disciplining dominant shareholders and protecting minority shareholders. Because of this conflict, ownership and management have become widely separated and the owners are unable to exercise effective control over the management or the board.
- **Governance issues in family-owned businesses:** Family control triggers governance problems such as lack of checks and balances over executive decision-making and behaviour, and a lack of transparent reporting to the outside world.
- **Problems of non-compliance:** Failure to comply with disclosure norms and the failure of the auditor's reports to conform to the law attracts nominal fines and minor penalties.
- **Deprivation of minority shareholders:** In certain occasions, non-voting preferential shares are used by promoters to channelize funds and deprive minority shareholders of their dues. They may also be defrauded by the top management during corporate takeovers or mergers.
- **Privacy and data protection issues:** Cybersecurity has turned out to be one of the most important aspects of modern corporate governance, especially since there is limited knowledge of the directors and other corporate leaders about the hazards in this domain.
- **Governance of CSR activities:** Often, companies appear to be reluctant towards making investments towards CSR, and on several occasions, such investments are done merely for the sake of doing it.