Drastic changes needed to implement ethical conduct

By Priti Suri and Ashutosh Chandola, PSA, Legal Counsellors

PSA
Legal Counsellors
E-601 Gauri Sadan, 5 Hailey Road
New Delhi - 110 001, India
Tel: +91 11 4350 0500
Fax: +91 11 4350 0502
Email: p.suri@psalegal.com

The downfall of major banking and insurance corporations, motor vehicles manufacturers and other corporations in the US is a testament to the unprecedented economic crisis. India too, has started to feel the heat of the global meltdown. The recent Satyam scandal has revealed that corporate governance in India is inadequate, compromising the interests of shareholders and other stakeholders i.e. entities directly or indirectly involved with a corporation.

This inadequacy can partly be attributed to an absence of adequate management and risk evaluations and the lack of stringent enforcement against transgression at top management levels. Although the two concepts are old, their implementation requires drastic changes and a complete overhaul.

A well-governed company develops its internal code of conduct in a manner which ensures ethical conduct of business. Shareholders expect companies to conduct business in an ethical manner which involves fairness, transparency, accountability, and responsibility at the board level.

The law prescribes several ethical practices which must be followed by companies as a part of good corporate governance under the Companies Act. Some of these include: (a) disclosure of interest by directors in contracts or arrangements entered into by the company (section 299); and (b) directors' declaration that they have taken proper and sufficient care while preparing the annual accounts under the director's responsibility statement (section 217(2 AA)). Balance sheet disclosures must be perfect in accordance with established, standard accounting practices.

Clause 49 of a listing agreement, the only codified corporate governance provision under the Indian legal system for listed companies, also prescribes certain ethical practices which include: (a) certification of financial statements by the CFO; (b) mandatory induction of independent directors on the board in order to maintain transparency and accountability; (c) disclosure of criteria for making payments to non-executive directors in annual reports; and (d) quarterly disclosures of the application of funds raised through public issues or rights issues according to major categories (capital expenditure, working capital, marketing costs, etc.).

Despite their existence, these provisions are not necessarily implemented by corporate bodies with rigorous fervour. The penalty for non-compliance with the listing agreement, equal to about US$193,000 to US$5 million with up to 10 years imprisonment, has also failed to ensure strict implementation by listed companies. In the case of non-compliance by unlisted companies, the maximum penalty prescribed under the Companies Act is about US$1,000, or imprisonment of up to one year, however this has also proved unsuccessful in dissuading non-compliance.

Therefore, regulators need to strictly implement ethical practices and ethical conduct through the boards of corporations. Enforcement can be ensured by having a prescribed code of conduct which requires the board to remain transparent and accountable to regulators and shareholders for all its actions and decisions. It is neither possible nor practical to involve shareholders in every business decision.

Transparency in all transactions is crucial. Dealings with clients, customers, vendors and other group companies must be fair and open. Boards must be aware of any deviation from the established norms (statutory or internal) and should authorize specifically any such digression.

Risk management, on the other hand, envisages assessing the exposure to risks while simultaneously remaining profitable and competitive. Risk management tends to be ignored where the economic climate is euphoric. Accounting practices prevalent in India work to help ascertain these risks, however, they provide a narrow view by taking cognizance only in terms of avoiding risks, as opposed to anticipating and planning for them and emerging from them successfully.

For effective risk management, legislators must ensure that companies have a vigilant, visionary and qualified, independent chief risk officer (CRO) who will assume responsibility for the identification of risks. The CRO, like the company secretary under the act, should be a mandatory requirement for listed companies or where a certain capital threshold is crossed so that unlisted public companies also benefit.

The CRO should have complete two-tier freedom; firstly, to present his impartial views to the board, and secondly, where the board is unyielding, at the shareholders meeting. This will allow the board to make informed decisions based on the advice of the CRO and will also cause the board to be accountable when it does not adhere to its suggestions to the detriment of the shareholders.

Eventually, any stringent enforcement depends upon a corporation's board. The impact of the actions or omissions of any corporation is far-reaching and not confined to shareholders and employees. Rather, it touches upon the moral fabric of society. Corporations must be conscious of their social responsibility and the impact of their behaviour, and, apply behavioural changes "at home" and "in-house" as a first step.

Priti Suri is the proprietor of PSA and Ashutosh Chandola is an associate at the firm.