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# Ethics in Indian Business- The Qualifying Factor

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# Ethics in Indian Businesses: The Qualifying Factor?

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Ethics in a business is the most significant qualitative factor that retains investors of equity capital over a longer period, sustains a business and creates value for all stakeholders. Companies and their management recognize ethics to be a creator of value and its absence to be a pervasive risk. How to uphold moral value across the breath of a company remains one of their key challenges? Regulators are overseeing companies through moral compasses and consequences of failing are punitive and severe. This creates a need for attention of the top management to deal with matters of ethical dimensions.

Do ethics make good business sense for Indian companies and adherence to ethical practises drive value? Few empirical studies support this case. The Corporate Executive Board (CEB) in 2013 based on their integrity index, point that the companies having highest integrity index score have 16% better returns than companies with the lowest score. Further, companies with a culture of high integrity have 12 % better employee productivity than others.<sup>1</sup> The UK Institute of Business Ethics in their study also find companies which took steps to implement their declared ethical values financially outperformed those that did not go beyond a declaration of commitment to business ethics<sup>2</sup>. TARI's own framework - Wealth from Trust, has empirical evidences that a company gets a premium on valuation over its peers having similar performance parameters in a given industry for qualitative factors.

Lofty targets and stringent deadlines, management's inattentive focus on ethical issues along with a highly vibrant and competitive market are some of key concerns for integrity issues in the Indian businesses. According to Global Fraud Report 2013/14<sup>3</sup>, companies exposed to fraud and unethical practices in India has increased from 67 % to 71 % and average percentage of loss of revenue has increased to 1.4% in current year in comparison to 1.2%. This trend is alarming!

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<sup>1</sup>Leslie Altizer (2013), Culture as Competitive Advantage, Compliance & Ethics Professional, March/ April 2013.

<sup>2</sup> <https://www.icsa.org.uk/assets/files/pdfs/bookshop/Checklist%20of%20the%20week%2003.06.13.pdf>

<sup>3</sup> Global Fraud Report by Kroll, 2013/14

A report by TARI and UN Global Compact (2013) highlights that 43 % of companies ceased to exist, and another 30% of companies continued their business but at a reduced level, which were hit by fraud and illegal activities. In some of the listed companies, market valuations significantly eroded with little or no trading of their stock. Scale of operations and market valuations have been marginally impacted in only 21% of the companies hit by fraud.<sup>4</sup>

Promoters are concerned that unfair or illegal business practices for creating competitive business advantages not only destroy reputation and value in days, but it will also attracts personal civil and criminal liabilities. Today bribery, fraud and corruption is a key Board room risk.

India has been plagued for years as having laws, which have been drafted with best intentions but due to weak regulatory oversight and long judicial process gave little accountability to perpetrators. Companies Act, 2013 and recent changes in securities Laws are watershed changes in Indian business laws that reinforce the importance of business ethics in the organizations at top level and ensure public trust in conduct of business. The bars are set higher for listed companies, who need to adhere to the requirements of revised clause 49 of the listing agreement.

### **Board of Directors as the Conscience Keepers**

The Companies Act of 2013 and securities laws create an enhanced framework for directors to demonstrate their duty of care and loyalty as vanguards of interests of all shareholders and stakeholders. They need to show affirmative and measurable actions in discharge of their duties. The law requires directors (section 166): act in good faith to promote the objects of the company for the benefit of its members as a whole, and in the best interests of the company; and not to involve in a situation in which they may have a direct or indirect interest that conflicts, or possibly may conflict, with the interest of the company.

The spectrum of Indian companies, whether government owned company, multinational or domestic family held, have a dominant shareholder. High ownership concentration in companies results in agency conflict arising between dominant shareholder and minority shareholders.<sup>5</sup>

This creates challenges for independent directors, who are appointed by the principal shareholders to stand up to them and demonstrate their independence where the majority has a conflict with the minority or with the company. However, their actions reflecting their independence is under scrutiny and the consequences of failure to uphold are severe. It is expected that such personal liabilities of independent directors for failure to exercise diligence in their decision making will bring about a change in their functioning and improve their exercise of professional scepticism.

The dominant shareholders at times seek to have personal gains and advantages, at core of which are abusive related party transactions. TARI and UN Global Compact<sup>6</sup> study reports related party

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<sup>4</sup>Thought Arbitrage Research Institute and UN Global Compact (2013), Fraud and Corruption in Private Sector in India.

<sup>5</sup> Kaushik Dutta and Naveen Kumar (2013), Policies and Practices of Ethical Corporate Governance: Need and Relevance. Background Paper for UN Global Compact.

transactions as the second most common fraud technique (23%). The Act needs directors including the independent directors to set up framework for determining arms' length in such transactions and approve each transaction individually. In case they exceed certain threshold, these transactions need to be approved by minority shareholders. This oversight in the medium term would put a focus on related party transactions that are abusive towards the minority and would reduce self dealing by the dominant shareholders.

The other areas that make directors personally liable include their responsibility to maintain internal controls, fair financial statements, dealing with public money raised through an IPO or statements in a prospectus etc. These collectively will result in higher vigil and engagement by the Board and ensure higher ethical compliance.

### **Law as a Deterrent: Framework to Punish Evil**

Stringent laws and certainty of punishment are considered as pre requisite for deterring unethical business practices /fraud and fostering compliance of law in letter and spirit. In India, the chances of conviction for cases of conviction is .006%, which by any definition is extremely low and the expected gains far exceed the probability of any adverse consequences.<sup>7</sup>

Average fine for breaches of corporate laws imposed by the Ministry of Corporate affairs from 2005 to 2011 was below Rs. 3000. For breaches of securities laws from 1998 to 2012, the fine imposed by SEBI for 75% of the cases was way below Rs. 50000.<sup>8</sup> Going by theories of chance it makes breaching laws almost profitable in India! This may change with the current sets of laws.

The company law in India, for the first time defines what is meant by fraud and entails stringent penalties for it (Section 447). Some acts for which a director/officer of the company is liable for punishment of fraud of the Section 447 include: inducing persons to invest money (section 36); conducting business of the company with fraudulent or unlawful intent (section 206(4) and 339(3)); fraud, misfeasance or other misconduct or withholding of information (section 213); making false statement in any of the return, report, certificate, statement or any other document (section 448). These offences fraud are cognizable and person accused under these sections cannot be released on bail or own bond. This section can be invoked for corruption and bribery too.

Now, fraud does not need any wrongful gain or wrongful loss to happen, mere intention to defraud is punishable under this section and any person who is found to be guilty of fraud, can be imprisoned for a term from 6 months to 10 years and additionally can be liable to fine to extent amount involved in the fraud to three times the amount involved in the fraud.

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<sup>6</sup> Thought Arbitrage Research Institute and UN Global Compact (2013), Fraud and Corruption in Private Sector in India.

<sup>7</sup> Corruption in Delivery of Public Services by Bibek Debroy(2013): page 95- Fighting Corruption – Way Forward, Ed Samuel Paul

<sup>8</sup> Thought Arbitrage Research Institute and UN Global Compact (2013), Fraud and Corruption in Private Sector in India.

Responsibility, accountability and liability for company are on its directors and officers including auditors are fixed and definitive. The enormity of punishment may keep unscrupulous members of Indian businesses under the straight and narrow path.

### **Oversight Mechanism: Enhancing the Certainty for Consequences**

One of the stumbling blocks to effective prosecution was multiplicity of regulators and investigative agencies working on a case. Satyam has over 5 government agencies investigating the fraud and it has taken nearly five years for the initial judgment by a court. This is quite long considering the fact that this has been the largest fraud in India has been prosecuted in a special fast track court.

Enforcement agencies under the law are now empowered enough to take any punitive action.<sup>9</sup> The Serious Fraud Investigation Office (SFIO) has been provided statutory backing under new Company Law (Section 211) for the purpose of investigating the affairs/fraud relating to a company. The SFIO is empowered as a sole authority to investigate such cases, papers, documents for such malafide practices that involve fraud. This will not create a multiple investigators and will build the expertise in SFIO required to investigate complex fraud cases and defend the conclusions based on conclusive evidences.

The SEBI, now in its legislative capacity can conduct investigations, substantially pass orders, seek information from any person or entity, and put strict sanctions for breaches of securities laws. SEBI has also been given powers to pass disgorgement orders for an amount equivalent to wrongful gains or to losses averted by contravention of regulations.

Auditors of the company (including, Cost Accountants for Cost Audit and Company Secretary in Practice for Secretarial Audit) are entrusted as gatekeepers to keep oversight on ethical sphere of company. They are now responsible (under Section 143) for reporting any offenses of fraud as covered under the Company law to the Board of directors of company immediately and to the Central Government after stipulated time period during the course of performance of their duties.

Whistle Blowers protection and processes would enhance the vigil mechanism of companies .Proxy advisors also serve as external vigilance for listed companies and keep watch on corporate intentions and counter those, which have the potential to affect the interests of the minority shareholders. Impact of proxy firms with rise in shareholder activism could be significant in the manner of influence on how companies have performed on various parameters of corporate governance.

### **Where the Winds of Change may take us**

The regulatory regime of new company law along with revised Clause 49 of the listing agreement endeavors to induce core values of integrity into the culture of Indian corporations. The company

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<sup>9</sup> Kaushik Dutta and Naveen Srivastava (2014), Corporate Fraud: Risks and Challenges Ahead, Prime Directory.

law framework focuses on the business integrity and its violations through sanctions by enforcing stringent penalties and punishment. However, it is to be understood that they only deter the unethical activities but do not provide incentives to companies to raise their standards of integrity. The capital markets provide the mechanisms for rewarding companies whose high levels of governance and integrity supplement their performance. This premium can be significant and creates a multiplier of wealth for shareholders.

Indian businesses for their desire grow in the global marketplace over the long term needs to be cognisant of the laws of other countries like USA or UK, where unethical practices can create mission critical risks. They have no option but to proactively implement benchmark ethical business practices, which goes beyond the context of law.

Good necessarily does not become very wealthy but being good is an insurance against evil consequences. Indian businesses know the value of that!

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