Chapter 1
The objective of the business is to create wealth for a society, maintain and preserve that wealth efficiently and to share the wealth with the stakeholders, especially with its common shareholders, while satisfying the society's needs for products and services efficiently and at a reasonable cost and price. Public Corporations are the means by which aforesaid objectives are best achieved in modern day context. Based on the above objectives the importance of corporate governance is beyond limit to a society, nation and the world as a whole. The dimensional phenomenon of corporate governance is thus global and that is why it has become an oft repeated word now-a-days. With the globalization the importance of the corporate governance has increased manifold as associated with good corporate governance is the financial inflow from around the globe to a country. Every country is, therefore, applying maximum effort to improve their corporate governance and therefore codes and guidelines on corporate governance are appearing fast often one claiming superiority over the other, in order to attract global investors and also retain domestic investors. In the Indian context, the corporate governance is all the more important because family and their descendants dominate the corporate scene which results in distortion and inequity. The changing profile of the equity from the concentrated to widely dispersed one as a fallout of liberalization, globalization and privatization makes the study on corporate governance in Anglo-Saxon context even more important. As globalization gathers momentum countries world over would be struggling against each other to better their corporate governance practice to improve the confidence level of investors so that both domestic and foreign investors can be attracted to invest capital in their corporations. The importance has been foreseen by few enlightened companies, irrespective of their country of origin or operation, and has single handedly developed their own corporate governance standards to attract and retain investors. The countries where corporate governance systems did not existed has started thinking actively for the same and we observe now several new entrants all over the world. What was once
a matter of least importance and an element for reducing agency cost of a corporation, fifteen years ago, has now become the most talked and discussed issue of attracting capital as much as possible and utilizing them in disciplined, responsible and transparent way in the corporate business. We have to refine and upgrade our corporate governance to the best possible standards to inspire confidence in investors, make up our resource crunch, and boost our economic activities, which in turn will deliver us job, employment, wealth and save us from episode like Satyam. The study is on the presumption that the present corporate governance system and practices in India are operating at sub-optimal levels. There is enough scope to enhance their performance and effectiveness. But it can be possible only if the limitations underlying the various aspects of our CG are studied against the backdrop of benchmarked system of world and the limitations are identified and remedial measures taken at the earliest. The United Kingdom is a pioneer in corporate governance regulation. As is said nothing can be written on corporate governance without referring to Cadbury Committee Report which has started the entire process of corporate governance. Ferran (2001) writes, “The UK has led the way in the development of successful non-statutory voluntary codes and guidance relating to corporate affairs. The takeover code and the various corporate governance codes that were developed by committees in the 1990s (Cadbury, Greenbury, Hampel, Turnbull), much of the substance has now been consolidated into the Combined Code, are much admired internationally.” The current study of corporate governance practices between Indian and United Kingdom is, therefore, of great significance especially for India, as its ownership pattern is gradually shifting to widely dispersed because of market forces and Govt. policy, as many state owned companies are being privatized and existing family-owned companies are becoming highly diversified industrial groups. UK throughout the periods since Cadbury has developed its CG system and practices in such a way that it is now able to tightrope its executives and aligns their interest with that of its widely dispersed shareholders. The UK approach has been adopted as a benchmark by numerous countries. The study is all the more relevant and significant because Anglo-Saxon capital markets today dominates the world and all country desires to access the funds available through London Stock Exchange(LSE) which is not possible till we improve our corporate governance system to a level comparable to that of level of United Kingdom to satisfy UK investors. United
Kingdom will also be benefitted from the study so far as assessing the current status of CG in India as UK companies will also need to expand their operation in emerging and growing markets of India and they will need to have insight of the CG system and practices in India. It is in this context that comparative study on actual practices based on UK companies carries special importance and relevance. The successful companies in the coming years will be those that will embrace the best corporate governance practices in the world in order to maximize shareholder value. Those who will not care will be left behind.

1.1: Rise of Business Corporation

The business has been in existence since civilization because of the human needs for products and services. In the initial phase the business entity that existed were, however, mainly managed by single individual and were termed as proprietary business. As the business units grew larger with the growth of needs, some of these proprietary forms of business changed into partnership form to acquire more capital and to avail expert input of partners in the business. Partnership form had bigger dimensions than a proprietary form. Industrial revolution sparked the process of new inventions of modern machines fuelled the growth of the corporation. To cope up with the increased demands of complex products and services by modern men and women, some of the partnership firms which were capable of further expanding themselves, went for expansion and transformed them as what we call now corporations. In such corporations a larger number of owners were engaged to bring in required capital. To satisfy further the needs of further complex products and services, corporations grew stronger and stronger of the new modern age business forms, that were far bigger in size than the abovementioned proprietorship and partnership forms. Faced with the need for raising further capital to exploit new opportunities in scale and scope, but hindered by the owner’s wealth constraints and risk aversion, these corporations further moved to widely held ownership structures with professional managers. Limited liability and longevity were the unique and most attractive features that led to its phenomenal growth. There is some conflict on the exact dates of enactment of limited liability and the surfacing of corporations as is in existence in its current form. Bansal (1989) throws lights on the origin of these companies in Indian and UK context, “The Joint Stock Company was introduced in India through the Indian
Companies Act, 1850, which was the first piece of company legislation in India and patterned on English Companies Act, 1844, which provided mainly for registration of joint stock companies. Concept of limited liability in India was introduced in 1857. In England, guilds were the earliest form of business associations. Joint Stock Companies came much later. The Company of Staple (chartered in 1391), and Company of Merchant Adventurers (Chartered in 1407) were the earliest joint stock companies to be formed in England. In those days, a company could be formed either by means of incorporation, i.e., under common law, or by the authority of Parliament, or by the Royal Charter, or by prescription. Accordingly companies could be either statutory companies (those formed under an act), or Chartered companies, (those formed under a Royal Charter), or by prescription. Since it was not easy to obtain either the assent of Parliament or a Royal Charter, a large number of companies in UK were formed by means of a deed signed by prospective shareholders. Notwithstanding the difference in the method of formation, the pattern of management of all these companies was similar. The rise of such corporation can be gauged from the fact that in UK there are over 1.8 million active companies and of these 12,400 are public limited companies and some 2,700 are listed on the Alternative Investment Market (AIM) for new companies not on the official list. In comparison there are around 550,000 companies in India of which around 72,000 are publicly limited (as of January 2000). Nearly 80-85% of the Indian companies are small scale; families managed enterprises and are either public limited companies or private limited companies. (Institute of Directors, 2005). As per Lyon & Ivancevich (1976), “In 1811 the State of New York passed laws that limited a person’s responsibility, making sure the person could not lose more than the person had invested.” The New York Laws thus helped make the corporation a popular type of business organization. Corporations’ laws have been in continuous improvement which has resulted in further attractiveness of corporations. The increased demands for more sophisticated products, such as computers, aero planes, cars, air conditioners etc have encouraged the growth of corporations”. The corporation form of business has evolved further and now a day it is the dominant form of business organization. Globalization has fuelled this business form to expand across countries and we see many multinational corporations cutting across the boundaries of nations. Globalization has made corporations much stronger. As Mehra (2005) puts it, “Out of the 100 biggest
economies of the world, 51 are transnational corporations. These corporations have become so powerful that they are circumventing democratically elected governments. Such is the pressure of civil society that more often than not market capitalization is determined not by the profits announced by the company but by the public perceptions of how they discharge their social and environmental obligations. In future sky is the limit for such widely held public listed corporations. In fact these types of corporations can be called one of the wonderful commercial inventions of the modern day.

1.2: Corporations and their characteristics

The corporation, being an artificial person and a creation of law, has legal standing independent of its owners. Colley, et al.(2003) mention, “The corporation form of business was legally made possible by the US Supreme Court under Chief Justice John Marshall in the early nineteenth century. Marshall himself defined a corporation in Dartmouth V. Woodward in the following terms: “A corporation is an artificial being, invisible, intangible and existing only in the contemplation of the law. Being the mere creature of law, it possesses only those qualities which the charter of its creation confers upon it, either expressly or as incidental to its very existence......(the most) important are immortality and, if the expression may be allowed, individuality, properties by which perpetual succession of many persons are considered as the same, and may act as a single individual.” Several features of corporations have made such business units very attractive to investors and other stakeholders alike, the most important of them include:

Limited Liability: Unlike in a partnership, stockholders of a corporation hold no liability for the corporation’s debts and obligations. As a result their “limited” potential losses cannot exceed the amount, which they paid for the stock. Not only does this allow corporations to engage in risky enterprises, but limited liability also forms the basis for trading in corporate stock.

Perpetual Lifetime: The assets and structure of the corporation exist beyond the lifetime of any of its shareholding, officers or directors. This allows for stability of capital, which thus become available for investment in projects of a larger size and over a longer term.
Divisibility of ownership: This permits transfer of ownership interests without disrupting the structure of the organizations.

1.3: Corporation and its importance

Most large businesses today are corporations. It is said that no invention of the industrial age has created as much wealth over the past centuries as has the development of limited liability, publicly traded corporations. These businesses dominate economic life in virtually every country. Mehra (2005) writes, "The corporate form of business has established its importance and dominance in the present day business environment over other form of doing business. The existence of a corporation in the present form reflects the mankind belief in the democratic structure and institutions: One where the capital resources of common many are mobilized and utilized for the purpose of delivering benefits to the millions of owners as well as to the benefits of society. Transparency, accountability, fairness and responsibility on the part of governance of a corporate are the added features that make it a complete economic unit. Segregation of ownership from management has paved the way for professionalization and to expand the activities around the globe. Because of its phenomenal growth the corporate has surpassed the boundary of nations and become global and is fast becoming a uniting factor between nations."

The influence and importance of corporations can be gauged from the fact that out of the largest 100 economic entities in the world 49 are nations and 51 are corporations. (Madhav Mehra, 6th International Conference held in London). In UK almost all companies producing goods of utmost sophistication ranging from super computers, nuclear submarines, mobiles and information technology products, defense equipments, transport airplanes and aircraft engines, sophisticated military warfare equipments for domestic and global consumptions, are produced by these corporate, apart from products and services for domestic consumptions. In fact sky is the limit for a corporate expansion when properly governed and administered. Infosys in our country is an example. Globalization has made few corporations even bigger than the country in which it operates. Dine (2000) writes, "The immense power of corporations is indicated by a comparison between the economic wealth generated by corporations, measured by sales, compared with a country's gross domestic product (GDP). On this basis the combined revenues of just General Motors and Ford...
exceed the combined GDP of all the sub-Saharan Africa and fifty-one of the largest
one hundred economies are corporations. Further, the number of transnational
corporations jumped from 7,000 in 1970 to 40,000 in 1995, and they account for most
of the world’s trade. As per Jensen and Meckling (1998), “publicly held business
corporation is an awesome social invention where millions of individuals voluntarily
entrust billions of dollars, francs, pesos, etc of personal wealth to the care of
managers.”

1.4: Major weakness of a corporation and genesis of corporate governance

A corporation has its inherent weakness that the ownership is different from the
controller of the corporation. Lyon & Ivancevich (1976) elaborates the weakness of a
corporation, “The disadvantages of a corporation vis-à-vis proprietary or partnership
forms are that the proprietor or partners of a business are eager to do their business
because failing means that they will go out of business. The owners of a corporation,
however, usually have little interest in the workings of the business. They are mainly
interested in the dividends they will receive. This lack of interest can cause poor
corporate management.” The numerous owners who contribute to the capital of the
company are the actual owners of the business. They elect a Board of Directors to
monitor the functioning of the company on their behalf. The Board, in turn, appoints a
team of managers with a chief executive officer (CEO) at its head who actually handle
the day-to-day functioning of the company and report periodically to the Board. Thus
managers are the agents of shareholders and function with the objective of
maximizing shareholders’ wealth. The problem lies in the insufficiency of the
directives between the representatives of the shareholders and managers to guide the
latter in minutest details about how, when and what to do with the funds contributed
by the former. It is not possible for the Board to fully instruct the management on
desired course of action under every possible situation. The list of possible situation
and alternatives are infinitely long. Consequently, no codes, directives or written
charters can be wholesome to guide management about the right course of action in
every situation. As a result management cannot be held responsible for any violation
of such directives which either is inadequate or inefficient, in the event it does
something else then desired by the shareholders/Board, under the given
circumstances. Financiers of the company capital i.e., shareholders may take the
liberty to spend the money on behalf of the company but they have least inclination to run the business. Neither have they expertise to do so. So these liberties go to the management. The reality is even more tilted in favor of the management. In real life managers enjoy enormous amount of power in joint-stock companies and the common shareholders have very little say in the matter as to how his or her money is used in the company. In companies with highly dispersed ownership the manager may function with negligible accountability. Most shareholders do not care to attend the General Body Meeting to elect or change the members of the Board of Directors and often grant their “proxies” to the management. Even those who attend the meeting find it difficult to have their say in the selection of directors as only the management proposes a list of directors for voting. In India, where there are no or very few companies having nomination committee, the entire process goes to the entrenched controlling groups or their CEO who most often are selected not by its board of directors. On his part, the CEO frequently packs the board with his friends and allies who rarely differ with him. In India especially often the CEO himself is the chairman of the Board of Director as well. Consequently the supervisory roles of the chairman are severely compromised and the management, who really has the keys to the business, can potentially use the corporate resources to further their own self-interests rather than the interest of the shareholders. The consequences is that managers can engage in all kinds of behavior that are detrimental to the firm: outright theft (for example setting up a company and using transfer pricing to appropriate funds, the kind of which we have observed in the Satyam episode in India), enjoying private benefits of control (perks, pet projects, foreign tours, empire building, favoring friends and families, transferring his favorites to important and pet projects etc, etc); exerting insufficient efforts; taking biased decisions, excessive executive compensation, managerial entrenchment (i.e., managers resisting replacement by a superior management); sub optimal use of free cash flows, and so on. Berle and Means (1932) have elaborated this phenomenon of distance of ownership from control in detail in their book on Modern Corporation “The Modern Corporation and Private Property” published in 1932. The distance of ownership from management, as a result, is fast becoming its curse which is evident from the large numbers of corporate scandals unearthed throughout the globe. Good “corporate governance” arrangement is projected as substitute and solution but the agency problem is here to
stay and corporations will have to find out progressively the most effective solution through improved corporate governance arrangements. With the growth of corporation and shareholding base, which is desirable for a nation, this problem is likely to increase further unless controlled through latest tools and techniques of Corporate Governance.

1.5: Governance versus Management

Governance and Management are two separate concepts which need to be understood in their right perspectives in order to understand corporate governance.

Governance is about the set of mechanism, structure and arrangement, which ensures that decisions about the corporations are made effectively in the interest of owners. Governance mechanism is generally the Board of Directors and its auxiliaries Committees which are selected and formed by shareholders who are the owners. Thus the views of the Board of Directors are supposed to reflect the views of the owners.

Management, is on the other hand, is about the structural arrangement, created by the Board to ensure that whatever decisions have been made under the Governance systems are implemented to the fullest extent. Under this arrangement come the CEO and his management team which helps and supports him in carrying out the decision of the Board.

Since there is a conflict of interest between managers and actual owners because of the inherent agency problem, the governance arrangement ensures that the management does carry out the decisions as per the board directives, and that the wish and expectations of the shareholders are prevailed.

The importance of governance can be gauged from the fact that a governance failure in a companies can lead to almost sure and instantaneous death of a firm as can be observed from failures like Enron which was finished in 23 weeks, Barring in 6 weeks and Satyam Computer Services, in case of India, in just 15 days.
Charkham (2005) writes over the issue of distinguishing Governance and management while differentiating between directors and managers, “The companies Act do not require directors to be managers; they requires directors to see that the business is properly managed, which is quite a different matter. In law there is indeed only one class of director and all are equal--- or at least nearly equal. Any qualifying objective is descriptive but not in law definitional. ... Being a director imposes a quite different set of responsibilities from those which attend any specific executive function, a fact which is not always appreciated by directors who are also executive ‘barons’ with responsibility for sections of an enterprise. A ‘finance director’ or ‘marketing director’ is simply a director who has responsibility for specific executive functions. Strict logic would render the term ‘non-executive directors superfluous.’ Tricker (1998) throws lights on the issue, “The role of management is to run the enterprise and that the board is to see that it is being run well and in the right direction... Typically, management operates as a hierarchy. There is an ordering of responsibility, with authority delegated downwards through the organization and accountability upwards to the ultimate boss, on which desk ‘the buck stops’. By contrast, the board should not operate as a hierarchy. Each member bears the same
legal duties and responsibilities and together the members need to work as equals, reaching agreement by consensus or, if necessary, by voting.”

1.6: Corporate Governance defined

Authors have defined corporate governance in several ways and it is hard to get a single acceptable definition of corporate Governance. Narrow definition takes care of its owners alone which are their equity provider like “corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment”. Broad definition involves the relationship of the corporation to its stakeholders and society and is defined as the combination of laws, regulations, listing rules, and voluntary practices that enable the corporation to attract capital, perform efficiently in achieving the corporate and social objective, and reduce agency cost.

Goplasamy (2006) writes, “Corporate Governance, by the very nature of the concept, cannot be exactly defined.”

Daines et al. (2008) observes, “Shareholders, regulators, hedge fund managers, press commentators, board members and policy makers increasingly stress the importance of good governance, arguing that it improves firm performance, shareholder welfare and the health of the public markets. However, defining good governance and distinguishing good governance from bad governance has proved more elusive, especially given the great variety of corporate governance mechanisms (and combinations) employed by firms.”

One definition may be ‘corporate governance is the set of arrangement and all sorts of actions which converges the interest of all its constituencies: large shareholders, small shareholders, managers and stakeholders, toward achieving the common goal of short term as well as long term profitability of the company and increasing the value of the firm.

“If management is about running businesses, governance is about seeing that it is run properly. All companies need governing as well as managing” (Bob Tricker, 1984)
Shann Turnbull (2000) expresses his views, “There are no agreed definitions or boundaries for defining or investigating corporate governance”.

Defined broadly, the term corporate governance includes all types of firms whether they are formed under civil or common law, owned by the government, institutions or individuals, privately held or publicly traded, profit or not-for-profit firms.

Shleifer & Vishny (1996), in their survey on corporate governance writes at its start, “Corporate Governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment.”

The most simple and concise definition is from Sir Adrian Cadbury (1992), head of the committee on the Financial Aspects of Corporate Governance in the United Kingdom who defined corporate governance as: “Corporate Governance is the system by which companies are directed and controlled”.

Owen et al. (2006) defined corporate governance as, “the set of control mechanisms and institutions which protect the suppliers of capital to a company, particularly suppliers of equity capital, the shareholders, who have only residual protection after all other claimants have been satisfied.”

As per OECD (1999) Code on Corporate Governance, “it is a set of relationship between a company’s management, its board, its shareholders and other stakeholders. Through these relationships it provides a structure for setting the objectives of the company, the means for attaining them and monitoring performance. Good corporate governance should provide incentives to the board and management to pursue objectives which are in the interests of the company and shareholders and it should facilitate effective monitoring, thereby encouraging firms to use resources more efficiently.”

Khan (2005) embraces within the boundary of corporate governance, social responsibilities, business ethics, and defines, “In a nutshell, corporate governance is a set of relationship between company, its Board, its Directors, its management, its shareholders and other stakeholders. Corporate Governance assimilates business ethics and social responsibilities as extension of company as part of the system.
Corporate Governance aims at fixing liability, fixing responsibility and determining accountability of management towards stakeholders in particular and society at large. Joshi (2004) refers the views of World Bank in her book, “The World Bank (1999) states that from a corporate perspective, corporate governance is about maximizing value subject to meeting the company’s financial, legal and contractual obligations”.

In India, the CII (1997) defines, ‘corporate governance deals with laws, procedures, practices and implicit rules that determine a company’s ability to take managerial decisions vis-à-vis its claimants- in particular, its shareholders, creditors, customers, the State and employees.’

The Business Roundtable (2002), an association of chief executive officer in USA writes, “a good corporate governance structure is a working system for principled goal setting, effective decision—making and appropriate monitoring of compliance and performance”.

Goplasamy (2006) defines corporate governance both in narrow sense and the broader sense. “In a narrow sense, corporate governance involves a set of relationship amongst the company’s management, its board of directors, shareholders and other stakeholders. Corporate governance is concerned with aligning the interests of investors and managers and in ensuring that the firms are run for the benefit of all classes of investors. In a broader sense, however, good governance is the extents to which companies are run in an open and honest manner, creates overall confidence, enhance efficiency of international capital allocation, and contribute ultimately to the nations overall wealth and welfare.”

1.7: Evolution of CG in UK

The seed for impending improvement in corporate governance were borne during the period 1980 - 1990 when major scandals broke out in UK one after another which mainly related to creative accounting procedure and financial reporting irregularities. The major scandals surfaced during the period were: Maxwell, Polly Peck International, the Bank of Credit and Commerce International (BCCI), British and Commonwealth, the Mirror Group News International, Barings Bank and Coloroll.
These successive breakouts led to the formation of Cadbury Committee during the month of May, 1991 by the London Stock Exchange, Financial Reporting Council and the Accounting fraternity, with an authority and role to review those aspects of corporate governance especially related to financial reporting and accountability. The formation of Cadbury Committee marked the first ever attempt by any country to conceive these scandals as problems of governance of corporate and the determination to strike at its root by diving deep into the system of corporate governance. There are reference available (Goobey, 2001), however, of attempt to deal with the problems in corporate governance but they were unorganized. Goobey (2001) of Hermes Pensions Management Ltd. addresses in his speech, “The formation of the Cadbury was not the first flowering of concern about corporate governance. As Jonathan Charkham’s work testifies, these were apparent before the Polly Peck affair, or the discovery of Maxwell’s misappropriations. Jonathan Panel Paper was published in March 1989, and, to quote a later work of his, ‘dwelt at length on the reasons why it is essential that any public company board should contain an adequate proportion of independent directors.” Despite the clear and precise mandate to look into the financial aspects, Sir Adrian Cadbury, realized the need of overall improvement of the corporate governance system of UK and investigated beyond the boundary of the mandate given to him to look into details of structural aspects of the corporate governance to separation of roles; the establishment, composition, and operation of key board committees; the importance of, and contribution that can be made by non-executive directors; and the reporting and control mechanisms of a business. The Committee submitted its report on December 1992, within a span of just over eighteen months from the date of its formation, along with a Code of Best Practice and chose to adopt the most novel and flexible design where the company could apply and implement these codes at ease and in case it found difficulty it can avoid the particular provisions but the reasons of its non-furnishing the provisions would have to be furnished to let its ultimate owner, the shareholder, decide the merit of the company reasons or difficulty. With this method of adoption of the code provision, the world came to know of the most successful way of adaption of corporate governance code and practices and many countries even today is preoccupied to adapt the mode and practice on the matter of corporate governance. With the advent of the code, UK regained the lost prestige, and like the previous position held by the country as
exporter of company law, it also became famous for the exporter of corporate governance codes. The Code of Best Practices had 19 recommendations which were incorporated into the London Stock Exchange. The Cadbury Code was widely welcomed with most of the recommendations with the result that there was remarkable improvement in UK corporate Governance within a very short period of its operation starting from the years ending after 30 June 1993. One key recommendation of the Committee however met an opposition which was related to reporting on effectiveness of internal control system. Cadbury Committee Report (1992) had observed, “Since an effective internal control system is a key aspect of the efficient management of a company, we recommend that the directors should make a statement in the report and accounts on the effectiveness of their system of internal control and that the auditors should report thereon.” The recommendation by Cadbury Code for compliance on effectiveness on company internal control system led to the formation of ‘Working Group on Internal control’ led by Paul Rutteman, to find out the form in which the directors to report and the manners of reporting on the effectiveness of the company’s system of internal control. The Rutteman Report (1994) published under the heading ‘Internal control and Financial Reporting’ scaled down the Cadbury proposal on the ground of practicality and recommended for compliance only on the matter of Internal Financial Control instead of entire system of Internal Control. The second major milestone in UK corporate Governance appeared on the scene when with the initiative of Confederation of British Industry (CBI), in January 1995, ‘Greenbury Committee’ was established to report on Directors remuneration and prepare a code of such practice to deal with remuneration issue and accordingly named ‘The study Group on Director’s Remuneration’. The Study Group delivered its report within a span of six months in the month of July 1995 titled, ‘Directors’ Remuneration- Reports of a Study Group chaired by Sir Richard Greenbury”. The approach undertaken by the committee was to recommend package to non-executive directors in such a way so as to align the interest of directors with that of shareholders and link reward to performances. The committee furnished a Code of Best Practice on Director’s remuneration and majority of its recommendations were adopted by the London Stock Exchange (LSE). Earlier guidance on the matter of remuneration from ProNed, the ABI, the NAPF, the Committee on the Financial Aspects of Corporate Governance, the Institute of
Directors and others were replaced by the Greenbury Code. The repercussion of the Greenbury Code was that from the period onward (1995) disclosure on Director’s Remuneration became quite exhaustive in UK company accounts and the remuneration segments in the annual reports. The third major initiatives in corporate governance in UK came in November 1995, when with the initiatives of the Chairman of the Financial Reporting Council (FRC), Sir Sydnet Lipworth, the Committee on corporate governance headed by Sir Ronnie Hampel was established during November 1995. The committee had the sponsorship of the LSE, the CBI, the IOD, the NAPF, the ABI and the Consultative Committee of Accountancy Bodies. The seed of the formation of the committee was in their previous two major reports (Cadbury & Greenbury) on Corporate Governance of UK. Both the committees had recommended that a new committee should be formed after an elapse of time to review the implementation of their findings. Hampel committee devoted two full years to study the CG practices adopted by UK companies vis-à-vis previous codes and the report titled ‘Committee on Corporate Governance- Final Reports was published in January 1998, together with a summary of conclusions and recommendations. The Hampel committee endorsed the recommendations of the Cadbury and Greenbury committees. Along with it the committee also endorsed the original proposal of Cadbury in Internal Control System which had in fact been curtailed and restricted to Internal Financial Control by Rutteman Committee. Having achieved the mandate for soundness of the UK corporate Governance Codes and its provisions, the LSE went ahead to publish the new listing rules which was the amalgamation of the three important committee till date: the Cadbury, the Greenbury and the Hampel and named ‘The Combined Code 1998’; the first ever in its series and the fourth major milestone towards UK corporate Governance Journey (Figure- 1.2).

The Combined Code of 1998, the first ever of its kind in the series, was intended to produce a set of principles and code embracing Cadbury, Greenbury and the Hampel committees works, consolidating at one place and hence the term ‘Combined’. The Combined Code contained both principles and detailed Code provisions. The 1998 Combined Code was in force from 31 December 1998 until reporting years commencing on or after 1 November 2003, when it was superseded by the revised Code in 2003. It was appended to Listing Rule 12.43A requiring companies to provide in their annual reports a narrative statement of how they have applied the
Code principles and state that they have complied with the Code provisions or, if not, why not, and for what period. The Code restored the requirement of Cadbury Code again of the need for companies to have the Boards to maintain a sound system of internal control. With the restoration into The Combined Code 1998 (D.2.1), “The directors should, at least annually, conduct a review of the effectiveness of the group’s system of internal control and should report to shareholders that they have done so. The review should cover all controls, including financial, operational and compliance controls and risk management” the need was felt again for guidance on proper implementation of the same and accordingly the Institute of Chartered Accountants in England & Wales (ICAEW) established Turnbull Committee, chaired by Nigel Turnbull, in the second half of the year 1998. The committee delivered its report, the Turnbull Guidance, “Internal Control: Guidance for Directors on the Combined Code” published in September 1999. In particular, the report provided guidance on principles D.2 of the Code determining the extent of compliance with the Code provisions D.2.1 and D.2.2. KPMG Review (1999), p.9.

The importance of the Turnbull Committee Report has been effectively summed up in The KPMG Review, “Turnbull if embraced in the right spirit and with the right backing, will be a genuinely a good step forward for corporate governance. It’s healthy for business and healthy for those investing in business.” Yet another milestone appeared was achieved when keeping in view the importance of allocation of capital in effective manner and its role in productivity in UK, the Chancellor of the Exchequer commissioned Paul Myners in March 2000 to conduct a review of Institutional Investment in the UK to find out whether there were distortions in Institutional investment decision making. The committee came out on 6 March 2001 with its report, ‘Institutional Investment in the United Kingdom: A Review’ (Myners Review). The main findings were that many pension funds trustees lack the necessary investment expertise to act as strong and discerning customers of the investment consultants and fund managers who sell them services. Myners recommended a set of principles on comply and explain basis which the UK Govt. agreed with the explanation that the same will help pension industry, consumer, corporate and Govt. too. There was also a promise to review after two years the extent to which the principles had been effective in bringing about behavioral change.
Simultaneously the Directors Remuneration Report Regulations 2002 as contained in Schedule 7A to the Companies Act 1985, was introduced w.e.f. 31st December 2002 to enhance transparency in setting director’s pay, improve accountability to shareholders, provide for a more effective performance linkage and to strengthen the powers of shareholders in relation to directors’ pay. The regulation required quoted companies to prepare a director's remuneration report which complied with the Regulations, and to put the Report to a shareholder vote. The regulations increased the amount of information shareholders were given on directors' remuneration, certain disclosures, as well as performance graphs. The Regulation did not apply to Alternative Investment Market companies. Nor did they apply to companies incorporated outside Britain which were listed in London. (Freshfields Bruckhaus Deringer). The Regulation had a very significant impact upon attitude and behavior’s towards and in respect of directors’ remuneration. (Deloitte, 2004). Another milestone of UK corporate Governance was covered when keeping in view the roles and importance of non-executive directors, the UK Govt. decided to assess the various issues relating to quality, independence and effectiveness of non-executive directors. A committee was, therefore, formed under the chairmanship of Sir Derek Higgs to undertake a review to assess: population of non-executive directors in the UK, the mode of appointment, how the pool might be widened, their independence, effectiveness, accountability, remuneration, role of Combined Code, role of boards, Institutional Investors, govt. in strengthening non-executive directors. The Higgs Review developed the UK framework of corporate governance with such recommendations in the area of directors development as requirement of an annual meetings with non-executive directors without management and to report the same in the Annual Reports, training and development of individuals for future director roles, induction programme for new non-executive directors, performance evaluation, expansion on the role of the senior independent director to provide an alternative channel to shareholders and lead evaluations on the chairman’s performance; added emphasis on the process of nominations to the board through a transparent and rigorous process and evaluation of the performance of the board, its committees and individual directors, etc. Further recommendations included stating the number of meetings of the board and its main committees in the annual report, together with the attendance records of individual directors; a chief executive not to become chairman.
of the same company. The report was submitted by the committee on 20 January 2003 and contained a number of proposals to improve corporate governance including recommendations for changes to the Combined Code 1998. The Smith Committee was later formed by Financial Reporting Council, under the chairmanship of Sir Robert Smith, in the month of October 2002, to develop guidance on Audit Committees in the Combined Code 1998. This was on the request of UK Govt. to FRC, in the backdrop of dramatic failures in the United States in early 2002 on account of accounting and auditing failures. The committee submitted its report, 'Audit Committees, Combined Code Guidance, A report and proposed guidance by an FRC-appointed group chaired by Sir Robert Smith' commonly known as 'Smith Report, Guidance on Audit Committees'. The report was submitted in December 2002 and published on January 2003 along with the Higgs Report on the same day. The guidance took effect from 1 July 2003. Tyson committee on the Recruitment and Development of non-executive directors was commissioned by DTI following the publication of Higgs Review of the Role and Effectiveness of Non-Executive Directors in January 2003 on the backdrop of faulty procedures of selection of non-executive directors, where it was observed that the standard practices by which non-executive directors are selected often overlooks talented individuals from a broad variety of backgrounds with the skills and experience required for effective board performance. Tyson Report (2003) made several recommendations about the identification, recruitment, selection and training of non-executive directors. In addition, the Review proposed the creation of a group of business leaders and others to suggest on how companies should bring greater skills and experience and describe the profile of relevant skills and experience from person belonging to non-commercial background. Another major milestone came in terms of revision and extension of The earlier Combined Code 1998 which included recommendations of the Turnbull Report(1999), Smith Report(Jan 2003)& Higgs Report(Jan 2003) and was termed The Combined Code 2003. The Combined Code 2003 was published in the month of July 2003 and superseded the earlier Combined Code issued by the Hampel Committee in 1998. The LSE amended its listing rules to accommodate The Combined Code 2003 and became effective from 1 November 2003. One important difference with that of its previous version is that The Combined Code 2003 did not included material on the disclosure of directors’ remuneration because of the reason that “The Director
Remuneration Report Regulations 2002 were in force and had superseded the earlier Code provisions. The Combined Code provided for a 'formal and rigorous annual evaluation of the board's performance, the committees, and the individual director's performance and at least half the board in larger listed companies to be independent non-executive directors. The Combined Code applied from the reporting years commencing on or after 1 November 2003. ‘Myners principles for institutional investment decision-making: Review of progress’ came into the scene thereafter to honor the govt. commitment of reviewing the extent of earlier Myners principles for better investment decision making in pension funds. The paper surveyed the progress made by the pension scheme and mentioned about the growing acceptance of the Myners principles. OPERATING AND FINANCIAL REVIEW which came into effect on or after April 2005 with the provision for information on the company's current and prospective performance and strategy provided another boost to the CG initiatives. Based on the requirement of clarifications on internal control in the Combined Code 1998, Turnbull Committee had been established in the year 1998 to frame guidance and accordingly the committee had furnished ‘Internal Control: Guidance for Directors on the Combined Code’ in the year 1999. Five years hence, keeping in view the importance of internal control system and risk management, the need was felt to review the impact of the code and to determine further if there was need to update the guidance. Accordingly in 2004, the Financial Reporting Council, the UK corporate governance responsible body, established the Turnbull Review Group. The group revealed that the original Turnbull guidance has considerably improved the internal control and risk management environment in UK thereafter and strongly endorsed retention of the flexible, principles-based approach of the original guidance and recommended only for a small number of change. The “Internal Control: Revised Guidance for Directors on the Combined Code” was published by the Financial Reporting Council in October 2005. The next major initiative came in the form of The Combined Code 2006 which superseded and replaced the earlier Combined Code 2003 and became effective from 1 November 2006. Another dimension in UK corporate governance was added when the Combined Code 2006 was revised and improved to its latest version The Combined Code 2008 which applies to accounting periods beginning on or after 29 June 2008 and is currently in vogue in UK. Thus the UK journey which started from the day of formation of the
Fig. 1.2: Corporate Governance Journey Path (U.K.)
Cadbury Committee has undergone a long path to the current stage of development of The Combined Code 2008. The importance of the Codes and guidelines of UK CG can be estimated from the fact that about 75% of the well known and famous code of best practices on corporate comes from UK. Important Codes worldwide as on date can be listed as: Cadbury Code(1991), Greenbury Report (1992), Kings Committee Report (South Africa)-1994, Vie’not Report (France)(1995), Hampel Committee Report (1995), The Combined Code (1998), OECD Principles, Higgs Report(2003), Smith Report (2003), Tyson Report on recruitment of NED(2003). The long CG journey path of UK detailing committee formation, committee reports on a time scale is attached with the chapter (Figure 1.2) for better visibility.

1.8: Evolution of CG in India

In India the interest in corporate governance was triggered because of the Cadbury Reports (1992) (Som, 2006) and the first initiative came from the Confederation of Indian Industries (CII) in the year 1998 when it came out with a voluntary code for Indian corporate ‘Desirable Corporate Governance: A Code’. With this CII became the first business Association to take the initiative in formulating India’s first endeavor to develop a code for Indian Corporate. The Code was developed under the Chairmanship of noted industrialists and past president of CII, Sri Rahul Bajaj. The code focused on listed companies (Sobham & Werner, 2003) which adopted its recommendations quickly, and 30 large listed companies, accounting for over 25 per cent of India’s market capitalization, voluntarily adopted it. The Code contained recommendations on the structure and composition of the board and disclosure. The Code prepared Indian corporate for initial stage of preparation for more formal CG implementation by companies through formal listing obligation. The impact of the CII code was observable when in between 1998 and 2000 CII induced over 20 companies to disclose much greater information in line with the code. Annual Reports of these companies reflected greater disclosure, qualitative and quantitative, consequent upon CII code voluntary adoption. The impact of the CII code is better described by Sobham & Werner (2003) when they describe, “… A more subtle effect of the CII initiative was to create a trend among large listed companies to look positively towards corporate governance, instead of discounting as ‘the flavor of the month’.
The CII created the initial foundation for later stage development of corporate governance in India. The second major initiative toward good governance initiative came from SEBI who on May 7, 1999, constituted a committee, chaired by the noted industrialist, Mr. Kumar Mangalam Birla. In February 2000, the committee produced the **Kumar Mangalam Birla Report** with mandatory and non-mandatory provisions as it felt that some of the recommendations are absolutely essential for the framework of corporate governance while others could be considered as desirable. By the end of 2000 SEBI Board accepted the recommendations and adopted it through 'Clause 49' of the Stock Exchange listing agreements and asked listed companies to comply the same. The companies were required to disclose separately in their annual reports, a report on corporate governance detailing compliance with the recommendations. Non-mandatory recommendations were asked to comply as per company discretion. In case of non-compliance the reasons thereof and the extent of their non-compliance were asked to be highlighted. Thus in regard to non-mandatory clause it followed the Combined Code policy of 'comply or explain'. SEBI asked all the stock exchanges to get the implementation phase wise. Another initiative by Department of Company Affairs, GOI, took the shape in the form of formation of a **Task Force on Corporate Excellence**, to study and recommend measures to enhance corporate excellence which were considered essential with the opening of the Indian economy. The Task force highlighted several critical parameters of good governance, many of whom are also the subject of the current research. Growing international towards independent non-executive boards with binary format were highlighted. The issue of such importance as creation of pool of independent directors, Lead Independent Directors, Separation of roles, the need for Remuneration and Nomination Committee were the area of discussion. The Task Force recommended for majority of independent directors, separation of position of board chair and managing director, and formation of the minimum three essential committees: Audit, Remuneration and Nomination, with minimum three members all independent. The recommendation of the Task Force though recommendatory in nature, made the initial background for later committees to think upon seriously. The committee noted the growing international trend towards independent non-executive boards. The Task Force noted that whereas elsewhere in the developed world, non-executive directors, largely by definition were are also independent, the Clause 49 made a distinction between independent and non-
independent non-executive directors. The limited definition and less rigorous definition of independence adopted in KMB or in Clause 49 (of person having no material pecuniary relationship or transactions with the company, its promoters, its management, or its subsidiaries) as the Task force opined, was supposed to tide over practical difficulties in transforming overnight company boards into a binary executive/independent format. The Task Force highlighted that however there was no time frame, neither in KMB Report nor in the Listing Agreement, for review of this position. The Task Force further highlighted that a stricter definition at that time might have excluded most of the consultants, lawyers and public accountants, employees of promoters (including individual, groups, holding companies, and so on), besides representatives of other stakeholders like company employees(workers representatives), key vendors and customers. The task force while welcoming the suggestion of binary formats reasoned its practical difficulties in ‘accommodating’ certain family or group aspirations on the one hand, and on the other the likely paucity of competent non-executive directors who can qualify as independent. Later on developments on the matter of creation of pool for independent directors remained a matter of question. The Task Force recommendations were mainly advisory in nature.

Another initiative in the Indian context on improvement of corporate governance came though ‘The Consultative Group of Directors of Banks and Financial Institution’ Ganguly Committee Report which was set up by Reserve Bank of India in consultation with IBA under the chairmanship of Dr. A.S. Ganguly, Director, Central Board, RBI. The Committee recommended for separation of the post of Chairman and Managing Director of large sized Banks, training for directors in the area of latest management techniques and in the area of specialized interest. The group further came for the need for Nomination Committee for appointment of independent/non-executive director of Banks and agreed with the unquestionable role of Independent Directors in asking critical questions and seeks satisfactory reply. The committee further discussed upon the need of adequate and wholesome information flow. Company Secretary role and importance was also highlighted. The Ganguly Committee thus stressed upon most of the area of improvement in corporate governance currently deemed international practice on corporate governance. The RH Patil Advisory Committee was formed by RBI which delivered its Report in the year 2001. The committee highlighted the weakness of listing instruments in enforcing the
standards and the large number of non-listed companies having outside its gambit and recommended inclusion of provisions in Clause 49 (of listing agreement) and in the Companies Act and recommended for additional penal provisions. Among its other important recommendations were: Disclosure in the annual reports of all payments received by auditors over and above their fees, minimum strength of directors of companies with net worth of Rs 15 crore and above, and the nominee directors was recommended to be not included in the counting against independent directors, promoters to disclose direct, indirect and total holdings and any change in their controlling stake by 1% and more. In the year 2002 another major initiative on corporate governance came up in Indian context when DCA, GOI, set up the Naresh Chandra Committee on Corporate Audit and Governance (2002), under the Chairmanship of Naresh Chandra, former Cabinet Secretary, to examine various corporate governance issues. The committee was mandated to examine and recommend changes, if necessary, in such areas related to audit and role of independent Directors and how their independence and effectiveness can be ensured. The Naresh Chandra Report (2002) recommended for extension of independence to all listed and unlisted companies with a paid-up capital and free reserves of over Rs 10 crore or a turnover of at least Rs 50 Crore, to have half the board members as independent directors, whether or not the board has an executive or non-executive chairman. In the area of Audit there were several recommendations to maintain the audit integrity. Specifically the report recommended that, along with its subsidiary, associates or affiliates, an audit firm should not derive more than 25 percent of the business from a single corporate client. The partners and at least 50 percent of the audit team working on a company accounts be rotated every five years. CEO and CFO were further recommended for certification of the company accounts. Another and second major initiatives from SEBI came in the form of Narayan Murthy Report on Corporate Governance in February, 2003, which were mandated to review matters which enhances transparency and integrity of the market. The major mandatory recommendations of the Committee related to financial literacy of members of Audit Committee, Audit Report and Audit Qualifications, related party transactions, definition of related party, training of board members (non-mandatory), Code of conduct for executive management, Whistle-blower policy, performance evaluation of boards etc. Against the backdrop of recommendations of N.R. Narayan
Murthy Committee Report and Naresh Chandra Committee Report extensively revised the Clause 49 of the Listing Agreement in October, 2004. The Revised Clause became effective from 31st December 2005. The major changes included widening of definition of independent directors, strengthening the responsibility of audit committees, improving quality of financial disclosures including those pertaining to related party transactions and proceeds from public/rights/preferential issues, requiring boards to adopt code of conduct, CEO/CFO certification of financial statements, compensation to non-executive directors and non-executive directors not to hold office for more than nine years, improving disclosures to statutory authorities, practicing company secretaries recognition along with auditors to certify compliance of conditions of Corporate Governance as stipulated in Clause 49, qualification for Audit Committee members and review of information, disclosure of accounting treatment, whistle blower policy, certification by CEO/CFO and additional disclosure under non-mandatory requirement. Jain (2009), Secretary ICSI, posits, “The revised clause 49 of the listing agreements is most timely and provides much needed disclosure requirements, widened definition of independent directors, periodical review by independent director, whistle blower policy, quarterly compliance report in the prescribed format and issue of certificate of compliance”. The Expert Committee on Company Law was constituted on 2nd December, 2004 under the chairmanship of Dr. J.J. Irani, Director, Tata Sons with the task of advising the Government on the proposed revisions to the Company Act, 1956. The objective was the desire on the part of the Government to have a simplified compact law that will be able to address the changes taking place in the national and international scenario. Chapter IV of the report covered ‘Management and Governance’. The Irani Committee submitted its report (called Irani Panel Report on Company Law) to the Company Affairs Minister, Mr. Prem Chand Gupta, on May 31, 2005, and some of the recommendations of the committee were: A definition of independent directors should be incorporated in the Company Law, a minimum of one third of the total number of directors as independents should be adequate for a company having significant public interest, irrespective of whether the Chairman is executive or non-executive, independent or not, Nominee directors appointed by any institution or in pursuance of any agreement or Govt. appointees representing Govt. shareholding should not be deemed to be independent directors, the definition of an
Fig. 1.3: Corporate Governance Journey Path of India
independent Director should be provided in law and expanded the definition of an ‘independent director’, a non-executive director to be held liable only in respect of any contravention of any provisions of the Act which has taken place with his knowledge and where he has not acted diligently, or with his consent or connivance.

The Indian Corporate Governance initiatives on a Timeline has been shown (figures 1.3) which when compared with UK journey in historical context reveals that although several initiatives are observed in the Indian context to improve the corporate governance, several of its advisory committee reports and recommendations were advisory in nature and were ignored. The overall impact of this ignorance is seen on the matter of corporate governance immaturity and effectiveness vis-à-vis UK, unbalance board and Committee structure, immature development of Independent Director System and their enabling parameters and the like.

Structural aspects of The Combined Code and The Revised Clause 49

Close observation of the structural aspects of the Combined Code (UK) and The Revised Clause 49 reveals the respective country area of stress and concern on the matter of corporate governance. On the matter of Directors and their development the UK Combined Code has maximum number of Code provisions and puts these Code provisions at its foremost position in The Combined Code. The Combined Code contains rulings on Board (5 nos.), Chairman & Executive (2 nos.), Board Balance and Independence (3 nos.), appointment to the Board (6 nos.), Information and Professional development (3 nos.), Performance Evaluations (1 no), Re-election (2 nos.) (figure 1.3 & 1.4). Against this Indian Code has Code provision for Board composition (4 nos.), other provision on board and Committee (3 nos.). There is no ruling on role separation, appointment to the board, Information and Professional Development (non-mandatory), no code provision on performance evaluation, and nil on re-election. Indian Revised Clause however has an edge over the number of code provisions in its Audit Committee clause where it contains maximum of 15 nos. against 9 nos. in The Combined Code. The comparative emphasis placed by India and UK on the matter of corporate governance is, therefore, observable in her Codes and is a pointer of the respective area where there is further need of focused attention for the two countries. In this connection figures for structural components may be referred, presented in the chapter. (Figure: 1.4, 1.5, 1.6 & 1.7).
The Combined Code on Corporate Governance (UK)

Section 1: Companies

A: DIRECTORS

B: REMUNERATION

C: ACCOUNTABILITY AND AUDIT

D: RELATIONS WITH SHAREHOLDERS

E: INSTITUTIONAL SHAREHOLDERS

Section 2: Institutional Shareholders

Fig. 1.4: The Combined Code at a Glance (U.K.)
Fig. 1.5: The Revised Clause 49 at a glance (India)
UK listed Companies are required to comply only
Section-1 of the Combined Code
MP: Main Principles
SP: Supporting Principles
CP: Code Provisions [48 nos.]

The Combined Code

Section – 1 (Companies)

A: Directors
B: Remuneration
C: Accountability & Audit
D: Relation with Shareholders
E: Institutional Shareholders

Fig. 1.6: Structural Constituents of The Combined Code (U.K.)
The Revised Clause 49

Mandatory Clause

I. Board of Directors
   A. Composition of Board
   B. N. Executive Directors' Compensation & Disclosure
   C. Other Provisions as to Board and Committees
   D. Code of Conduct
II. Audit Committee
   A. Qualified and Independent Audit Committee
   B. Meeting of Audit Committee
   C. Powers of Audit Committee
   D. Role of Audit Committee
   E. Review of Information by Audit Committee
III. Subsidiary Companies
IV. Disclosure
   V. CEO/CFO Certification
   VI. Report on C.G.
   VII. Compliance

Fig. 1.7: Structural Constituents of The Revised Clause 49 (India)
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