Chapter-II

EVOLUTION AND DEVELOPMENT OF CORPORATE GOVERNANCE
Corporate governance is a central and dynamic aspect of business. The term 'governance' derives from the Latin 'gubernare', meaning 'to steer', usually applying to the steering of a ship, which implies that corporate governance involves the function of direction rather than control. There are many ways of defining corporate governance, ranging from narrow definitions that focus on companies and their shareholders, to broader definitions that incorporate the accountability of companies to many other groups of people, or 'stakeholder'. Chapter 1 discusses a large array of definitions, but, for the purposes of this introduction corporate governance is taken as the way in which companies are directed and controlled (Cadbury Report, 1992).

The importance of corporate governance for corporate success as well as for social welfare cannot be overstated. Examples of massive corporate collapses resulting from weak systems of corporate governance have highlighted the need to improve and reform corporate governance at an international level. In the wake of Enron, Parmalat and other similar cases, countries around the world have reacted quickly by pre-empting similar events domestically. As a speedy response to these corporate failures, the USA issued the Sarbanes-Oxley Act in July 2002, whereas in January 2003 the Higgs Report and the Smith Report were published in the UK, again in response to corporate governance failures. The difference between the rules-based approach to corporate governance adopted by the USA and the comply or explain approach chosen by the UK is discussed. The main aim is to consider why such initiatives are being pursued and why continuing refinement and fine-tuning of the corporate governance system in the UK and elsewhere is necessary. In this introduction, the scene is set by the evolution of corporate governance in its historical and theoretical context, focusing mainly on the UK and US cases. The contents of the chapters are now outlined in more detail.

Corporate Governance: Frameworks and Mechanisms

A number of theoretical frameworks that have been used in the literature to analyse corporate governance issues are discussed. The study of corporate governance throughout this text, however, the US and UK forms of capitalism
represent only one type of framework among many. There are as many variations of capitalism and corporate governance as there are countries in the world. However, corporate governance research has tended to focus predominantly on the Anglo-American (often termed the Anglo-Saxon) system of corporate governance, where companies are listed on stock exchanges and shareholders can trade freely in the shares. Traditionally, in this system, share ownership has been widely dispersed and management of companies has been distinctly separated from ownership. The development of the Anglo-American system of corporate governance is now discussed from a historical perspective.

A Historical Perspective

Corporate ownership structure has been considered as having the strongest influence on systems of corporate governance, although many other factors affect corporate governance, including legal systems, cultural and religious traditions, political stability and economic events. All business enterprises need funding in order to grow, and it is the ways in which companies are financed which determined their ownership structure. It became clear centuries ago that those individual entrepreneurs and their families could not provide the finance necessary to undertake developments required to fuel economic and industrial growth. The sale of company shares in order to raise the necessary capital was an innovation that has proved a cornerstone in the development of economies worldwide. However, the road towards the type of stock market seen in the UK and the US today has been long and complicated. Listed companies in their present form originate from the earliest form of corporate entity, namely the 'sole trader' (Farrar and Hannigan, 1998). From the middle Ages such traders were regulated by merchant guilds, which oversaw a diversity of trades. The internationalization of trade, with traders venturing overseas, led gradually to regulate companies arising from the mediaeval guild system. Members of these early companies could trade their own shares in the company, which led ultimately to the formation of 'joint stock companies' (Jill Solomon, 2007).
The first company to combine incorporation, overseas trade and joint stock was the East India company, which was granted a Royal Charter in 1600, for Merchants of London trading into the East Indies. The early governance structures of this company were reminiscent of corporate governance structures and mechanisms in today’s companies (Farrar and Hannigan, 1998; Cadbury, 2002). International trade and interest in investment overseas led to the infamous South Sea Bubble of 1720, where the general public in Britain, who had invested in ‘shares’ in the company of Merchants of Great Britain trading to the South Seas, realized they had lost their hard-earned money in the first stock market overvaluation and subsequent collapse. At one point during the Bubble’s growth the amount invested in companies involved in the South Seas reached £500 million, double the value of all those in England at that time. The Bubble Act, which followed the bursting of the South Sea Bubble, prevented companies from acting as a body corporate and from raising money by selling shares, without the legal authority of an Act of Parliament or Royal Charter. It was the development of the railway network in Britain in the 1800s that again instigated the development of companies.

A total of 910 companies were registered from the introduction of the first modern Joint Stock Companies Act in 1844 (Farrar and Hannigan, 1998). However, these companies were ‘unlimited’. This implied that their shareholders bore unlimited liability for their investee company’s debts and this was ‘not an effective means of encouraging people to place their monies into the hands of company management. A greater enticement was required. This came with the Limited Liability Act of 1855. Limited Liability implied that shareholders could only lose the amount they had invested in the company rather than be liable for their entire wealth, as had been the case with unlimited companies. These events represented a major breakthrough for the growth of capitalism. This was introduced as a progressive reform measure aimed at revitalizing British business, as, at that time companies were seeking incorporation in the USA and France in preference to the UK, in order to obtain limited liability for their shareholders. The number of incorporations rose drastically following these changes.

In the USA the managerially controlled corporation evolved at a similar time, following the Civil War in the second half of the 19th century. It was from this
time that the notorious ‘divorce’ of ownership and control began to emerge. This corporate malaise was first outlined in ‘Berle and Means’ (1932) seminal work, The Modern Corporation and Private Property, which showed that the separation of ownership from had little influence over company management and was rendered impotent by the wide dispersion of ownership and by a general apathy among shareholders towards the activities of investee company management. It was the dispersion of ownership that created the root of the problem rather than the separation per se. The influence of companies was growing at the time of ‘Berle and Means’ work and many feared the potential impact of their influence on society, unless their power was checked by their owners, the shareholders. They considered that companies were growing to such an extent that they were almost becoming ‘social institutions’. Yet, there was little incentive for shareholders to involve themselves in their investee companies. They held relatively small shares in a broad portfolio of companies. If they were dissatisfied with the companies’ behavior they could sell their shares. This approach to share ownership has been termed ‘exit’ as opposed to a more proactive approach of using their ‘voice’. The ‘problem’ revalued in Berle and Means formed the basis of the ‘agency problem’, where shareholders (the principals) struggle to control and monitor the activities of managers (the agents) in order to align managerial interests and objectives with their own. An important implication of these observations was to focus increasing attention on the role of companies’ boards of directors, as a mechanism for ensuring effective corporate governance.

Although the ownership structure underlying the traditional agency problem was prevalent in the USA, the situation was extremely similar in the UK, where share ownership flourished following the introduction of the joint Stock Companies Act of 1844 and the Limited Liability Act of 1855. Problems arising from separation of ownership and control were recognized in Adam Smith’s The Wealth of Nations (Smith, 1837). In his discussion of joint stock companies, he explained that company directors were the managers of their shareholder’s money, and not their owners. He considered it likely that these directors would be less concerned about someone else’s investment than they would be about their own and that this situation could easily result in ‘negligence and profusion’ in the management of company
affairs. Next, in his personal exposition of corporate governance, Sir Adrian Cadbury (Cadbury, 2002) pointed out that there were allusions to the ‘agency problem’ in the UK that predated ‘Berle and Means’ writing. Indeed, Cadbury explained that in the Liberal Industrial Inquiry of 1926-1928 in the UK, a significant problem was detected because management and responsibility; were in different hands from the provision of funds, the risk taking and the financial rewards. A study by Florence (1961) also suggested similarity between the UK system of corporate governance and that of the USA, as he showed that two-thirds of large companies were not controlled by their owners.

When companies within the capitalist system of the UK and the USA demonstrate effective systems of corporate governance, they can be productive and efficient and can have a positive impact on society as a whole. Efficiently functioning capital markets can, theoretically at least, lead to efficient allocation of resources and a situation of optimal social welfare. However, ineffective, weak corporate governance can have the opposite result. The ‘yin’ and yang’ of the capitalist system are widely known. On the positive side, capitalism is associated with wealth production, economic prosperity and corporate success. On the negative side, capitalism is associated with greed, despotism, abuse of power, opaqueness, social inequality and unfair distribution of wealth. The negative aspects of global capitalism and its impact on society have been explored at some length in the literature by Hutton, 1995; Hutton and Giddens, 2001. It is the functioning of internal and external corporate governance that determines whether a company, or even a country, displays more of the negative or the positive aspects of the capitalist system. The level of inherent trust within the business sector and within society as a whole has been questioned in recent times, with a general acknowledgement by sociologists of a decline in social cohesion (McCann et al, 2003) and community. Specifically, there has been a decline in society’s confidence in institutions, such as corporations and institutional investment organizations (Giddens, 1991). This decline in trust so prevalent in UK society and its implications for financial institutions are alluded to throughout this text as they represent one major driving force behind corporate governance reform. Many aspects of corporate governance reform may be interpreted as attempts to rebuild society’s trust in companies, investment institutions and other organizations.
The traditional Anglo-American system of corporate governance described above has not remained stable and has undergone dramatic changes in recent years. The main aspect of change has involved transformation of ownership structure in the UK and USA. The rise of the global institutional investor as a powerful and dominant force in corporate governance has transformed the relationship between companies from that described above. Ownership structure is no longer widely dispersed, as in the model presented by Berle and Means, but is now becoming increasingly concentrated in the hands of a few major institutional investors. Some of these dominant investment institutions may now be seen as insiders rather than outsiders, influencing company management directly.

**Corporate Governance Failures**

Corporate Governance failures and corporate collapses can happen even in the strongest companies. Investors, employees, and creditors can be seduced by a company's reputation and success and can throw caution to the wind. In economic and finance theory, this sort of blindness could never happen. But sometimes it does. Investors do not always behave rationally, and human behaviour and psychology are factors that are difficult to incorporate in finance models or in an economic theory. Polly Peck and Coloroll were cases of irrational behaviour in the UK in the 1980s, when investors missed vital information in the accounts of these companies, pertaining to huge contingent liabilities. As soon as this information became public knowledge, both companies collapsed (Smith, 1996b).

The need to strengthen corporate governance has been highlighted by a number of high-profile business failures in various parts of the world such as those of Guinness, Polly Peck, Maxwell, BCCI and Railtrack in the UK, and Enron, AIB, WorldCom, Xerox, Andersen, and Royal Ahold NV in the USA. These scams are briefly explained below:

**Corporate Governance Failures in UK**

**Guinness (1986)**

The illegal activities at Guinness were brought to the attention of the UK regulators after the arrest of a well-known figure in the USA financial world, Ivan Boesky. The share rigging was organised at the highest level within Guinness, and
also involved senior business people from outside, including Sir Gerald Ronson of Heron Corporation, the stockbroker Anthony Parnes and Sir Jack Lyons. Oliver Roux, Guinness’s finance director, had been seconded from the Bain Management Consultancies who were also heavily involved in the management of Guinness.

Senior managers from Guinness and their financial advisers were convicted in 1990 of – amongst other things – false accounting and breaches of the Companies Act. They had attempted to manipulate Guinness shares during a hard fought takeover battle with Argyll for another drinks company – Distillers.

**Causes for the failure of Guinness**

- Manipulation of accounting figures
- Disregard for stock exchange rules and company law
- Unethical behaviour of senior management
- Insensitivity to stakeholders (shareholders of both Guinness and its target)
- Lack of efficient leadership

**Polly Peck International**

Polly Peck International (PPI) was a conglomerate that grew rapidly in the 1980s under the leadership of Asil Nadir. At one time it was capitalised at £2 billion. In the autumn of 1989 the value quickly dropped from over £1 billion to less than half of that figure, forcing the London Stock Exchange to suspend trading in PPI shares. After the collapse, it was reported that there was evidence of insider trading, misleading presentation of the true financial position and an overstatement of the value of the businesses. Nadir was charged later with false accounting and theft, after the discovery of a £400 million discrepancy in PPI’s accounts.

**Causes for the failure of Polly Peck**

- Misleading accounting
- Fraudulent activities
- Unethical actions of senior management
Maxwell

The Maxwell publishing empire was the victim of a massive fraud by its founder and chief executive Robert Maxwell. In order to disguise losses in some areas of the business, funds were manipulated to give a false impression to the public of liquidity and viability. Although it is generally considered that the major player in the fraud was Maxwell himself, others involved in the management of the company included well-known former politicians and senior business people. The external auditors were Coopers and Lybrand (now part of PWC).

Causes for the failure of Maxwell

- Fraudulent management
- Lack of action by senior managers
- Insensitivity to stakeholders (in particular, the pensioners)
- Inaccurate communication
- Failure of external auditors to ascertain real situation with
- Maxwell’s private companies

Bank of Credit and Commerce International (BCCI)

On July 5, 1991, an incident that has been described as the biggest bank fraud in history came to a head when regulators in seven countries raided and took control of branch offices of the Bank of Credit and Commerce International (BCCI). Monetary losses from the scandal were huge, with estimates ranging from $10 billion to $17 billion though many billions have since been recovered for creditors by the banks liquidators, Deloitte & Touche.

The scandal had been developing for nearly two decades and encompassed an intricate international web of financial institutions and shell companies that had escaped full regulation. BCCIs activities, and those of some of its officers, included dubious lending, fraudulent record-keeping, rogue trading, flouting of bank ownership regulations and money laundering in addition to legitimate banking activities. The bank’s structure and deal making were so complex that, a decade after the institution was liquidated, its activities are still not completely understood.
One way to think of the BCCI saga is as an attempt to create the polar opposite of a firm with integrated risk management practices. In this case, certain senior bank personnel and interested parties did not simply overlook risks, but manipulated gaps in the bank's risk management structure and between its subsidiaries to serve various purposes. This put other shareholders at a disadvantage, some million or so small depositors around the world and certain institutional depositors attracted by BCCI's relatively high rates, who provided much of the bank's funding. Meanwhile, other bank officers had little understanding of the bank's structure and overall financial position, and were encouraged not to question bank practices or the reason for the flow of funds between bank entities.

Lessons learnt from the failure of BCCI

- The critical role of senior management and key investors in establishing an honest, open and prudent bank culture;
- The need for powerful executives and backers of institutions to be controlled within a secure enterprise-wide corporate governance structure, if the interests of other stakeholders, such as deposit holders, are to be safeguarded;
- The need for independent and unified regulation and auditing of complex financial conglomerates;
- The danger that attempts to preserve confidence in a bank, even when well-intentioned, will lead to further cover-ups inside and outside the bank;
- The oldest lesson of all: the ease with which massive bad loans and trading losses can be covered up in banks by extending further credit, failing to record deposits, and juggling accounts.

Railtrack

Railtrack was formed in 1994, as a result of the privatization exercise that divided the single nationalized railway company into nearly 100 separate companies. Its key business was to operate and maintain the track and infrastructure and its income was to result from fees charged to train operating companies. After a series of fatal crashes and poor financial performance, the company was forced to go into administration in 2001 with billions of pounds of debt and no immediate possibility of recovery.
Even those commentators sympathetic to privatization accept that the decision to float Railtrack as a private company was driven more by political expediency than for any genuine ability the new company may have had to survive and prosper. This precarious position was magnified by the recruitment of senior managers with no knowledge of the rail industry. Decisions made had failed to address engineering and maintenance issues as unavoidable safety critical activities; instead, maintenance and engineering was contracted out on a large scale.

In October 2001 Railtrack was effectively renationalized and although shareholders were to be compensated, the amount offered was a great deal lower than the initial price at flotation.

**Causes for the Failure of Railtrack**

- Poor management with little experience of managing railways
- Placing shareholder rewards above investment in safety
- Failure of regulation systems

**Corporate Governance Failures in USA**

**Enron**

The Enron Corporation was an American Energy Company based in Houston, Texas. It was named as “American Most Innovative Company” by Fortune magazines for six consecutive years from 1996 to 2001. It was one of the 100 Best Companies to Work for in America, listed in 2000. The Enron traded in more than 30 products, including Oil, Petrochemicals, Power, and Plastics etc. It achieved bad reputation at the end of 2001 when it was revealed that its *Reported Financial Condition* was sustained mostly by Institutionalized, Systematic, and Creatively Planned Accounting Fraud.

Many of recorded assets and profits of Enron were inflated or even wholly fraudulent and non-existent, by putting debts and losses into entities formed “offshore” that were not consolidated with the company’s financial transactions and in addition, by the use of other sophisticated and deep financial transactions between Enron and related companies formed to take unprofitable entities off the company’s
books. Arthur Andersen, who was the auditors of Enron, was also consultants of Enron. The result was that many of Enron’s debts and the losses that it suffered were not reported in its financial statements.

Collapse of Enron

After a series of scandals involving irregular accounting procedures bordering on fraud involving Enron and its accounting firm Arthur Andersen were revealed. It stood at the verge of undergoing the largest bankruptcy in history by mid-November 2001. The lawsuit against Enrons directors, following the scandal was so notable in the directors settled the suit by paying very significant amounts of money personally. The scandal caused the dissolution of the auditor of Enron – Arthur Andersen, leaving only four Big International Accounting Firms.

Enron’s collapse also contributed to the creation of the U.S.Sarbanes-Oxley Act (SOX), signed on July 30, 2002. Other countries also adopted new Corporate Governance legislation. This law provides stronger penalties for fraud and among other things, requires public companies to avoid making loans to management, to report more controversially, to report on how they have audited their financial internal control procedures (V.S.Datey. (2007).

Causes for the Failure of Enron

➣ Manipulation of accounting figures
➣ Unethical management
➣ Poor analysis of information

Allied Irish Bank (AIB)

The Allied Irish Bank subsidiary All First Financial was based in Baltimore, Maryland in the USA. In early 2002, AIB reported that one of its traders, John Rusnak, had made unauthorized transactions that led to a near $700 million loss. In much the same way as the Barings scandal seven years’ earlier, a lack of effective management control, coupled with inadequate auditing practice had allowed Rusnak to be able to make unauthorized trades for some five years before he was discovered.
As with Barings, a trader in what were perceived to be routine and low risk transactions, was responsible for huge losses. AIB did not monitor their Maryland activities as rigorously as in hindsight it can be seen was necessary. This was in part due to the conflicting responsibilities of the Allfirst treasurer, who was responsible for both trading profits and controlling trading activities.

**Causes for the failure of AIB**

- Manipulation of accounting systems
- Ignoring governance duties by AIB
- Poor audit practice

**WorldCom**

This company grew rapidly through take-overs from a small, local network provider to one of the largest players in the telecommunications industry. In 2002 after a change of senior management, the internal auditor was asked to review certain accounting transactions. She discovered that contrary to generally accepted accounting practices, corporate expenses were treated as capital investments.

This meant that instead of these transactions being charged against profits immediately they were spread over much longer time scales. The effect was to overstate profits, and hence the share value. WorldCom, a company that was valued at $180 billion in 1999 lost almost all of its value overnight. Like Enron, its external auditors were Andersen.

**Causes for the failure of WorldCom**

- Manipulation of accounting systems
- Poor analysis of information
- Unethical management

**Xerox**

This company once very successful was reported to have lost $38 billion of shareholder wealth in two years in the late 1990s and early 2000. Much of this was due to management failures, but accounting manipulation in its Mexican subsidiary and its main business also contributed to its decline. Xerox was found by the
Securities and Exchange Commission (SEC), the USA’s main regulatory body, to have overstated its revenues significantly. Through the use of what their management called ‘accounting actions and opportunities’ Xerox increased its revenue by $3 billion.

**Causes for the failure of Xerox**

- Manipulation of accounting systems
- Poor analysis of information
- Unethical management

**Andersen**

Until 2001 the international accounting firm Andersen was a highly regarded, ‘Big 5’ organisation. Despite the acrimonious split with their former consulting arm (now Accenture) they carried out auditing and other work for some of the world’s best known and apparently successful companies.

Unfortunately the news of the Enron collapse had extreme consequences for their reputation. Apart from the very close involvement of their Houston office with senior management from Enron, they were also brought to trial for the destruction of documentary evidence. It also emerged that they had responsibility for the internal audit activities too.

Enron was also not the only source of problems for them; by early 2002 they were defending approximately 40 lawsuits in the USA, with potential damages to be paid to shareholders of more than $32 billion. Even in this position there were many commentators who thought that Andersen would be able to survive, even if severely damaged. Then early in 2002 there were reports of another unprecedented corporate scandal, where basic accounting rules were broken or manipulated in WorldCom, another Andersen audit client. This time the damage to their reputation was terminal and irreversible.

**Causes for the failure of Andersen**

- financial and product performance
- legal and regulatory standards
Royal Ahold NV

Ahold’s American depository receipts, which are traded on the New York Stock Exchange, fell by 61 percent following the announcement about Anderson and have since fallen further. Ahold’s suppliers provided allowances to Ahold to promote the suppliers’ goods but the company apparently booked allowances which it never received or that it had received before the accounting period when it would be entitled to them. Consequent to this, affirming the Sarbanes-Oxley Act of 2002...

“This shows Sarbanes-Oxley is working as it should be,” said Alex Cohen, US securities partner at Latham & Watkins in London. “The company announced the problem, the chief executive officer and chief financial officer took responsibility, and the audit committee of the board launched an investigation. This is exactly what Congress would have wanted to happen.”

Consequent to the several incidents of corporate failures (as stated above), many countries in the world had felt the need for corporate governance code. Accordingly, the codes or principles have been drawn up on various aspects of corporate governance, like establishing directors CEO’s accountability, defining the roles and responsibilities of the board of directors (boards) and stakeholders and setting out guidelines for more effective and improved performance. By implementing the corporate governance code, the boards are now challenged to bring changes in the operating systems and improve face of relationship between supervisory and executive bodies. With a view to bringing in effective corporate governance practices in the corporate world, the present chapter presents an overview of some of the codes and regulations designed to improve corporate governance in UK and US. It reviews the recommendations of the various committees that were formed to intensify the practices of corporate governance. In this process it presents and reviews, the Cadbury Report, the Greenbury Report, the
Hampel Committee Report, the Turnbull Report, the Higgs Report, the Smith report and the Sarbanes-Oxley Act of 2002. Also the preset chapter covers the corporate governance theories and models around the world.

Developments in UK

In England, the seeds of modern corporate governance were sown by the Bank of Credit and Commerce International (BCCI) scandal. The Barings Bank was another landmark. It heightened people's awareness and sensitivity on the issue and resolved that something ought to be done to stem the rot of corporate misdeeds. These of examples of corporate failures indicated absence of proper structure and objectives of top management. Corporate Governance assumed more importance in light of these corporate failures, which was affecting the shareholders and other interested parties.

As a result of these corporate failures and lack of regulatory measures from authorities as an adequate response to check them in future, the Committee of Sponsoring Organizations (COSO) was born. The report produced in 1992 suggested a control framework and endorsed a refined practice in four subsequent UK reports: Cadbury, Ruthman, Hampel and Turnbull. There were several other corporate failures in the companies like Polly Peck, British & Commonwealth and Robert Maxwell's Mirror Group News International which were all victims of the boom-to-bust decade of the 1980s. Several companies, which saw explosive growth in earnings, ended the decade in an unforgettable memorably disastrous manner. Such corporate failures arose primarily out of poorly managed business practices.

The publication of a serious of reports consolidated into the Combined Code on Corporate Governance (The Hampel Report) in 1998 resulted in major changes in the area of corporate governance in the United Kingdom. The corporate governance committees of last decade analyzed the problems and crises besetting the corporate sector and the markets and sought to provide guidelines for corporate management. Studying the subject matter of the corporate codes and the reports produced by various committees they highlighted, the key practical problem and concerns driving the development of corporate governance over the last decade (A.C Fernando, 2006).
Developments in USA

Corporate Governance gained importance with the occurrence of the Watergate scandal in the United States. Thereafter, as a result of subsequent investigations, US regulatory and legislative bodies were able to highlight control failures that had allowed several major corporations to make illegal political contributions and to bribe government officials. This led to the development of the Foreign and Corrupt Practices Act of 1977 that contained specific provisions regarding the establishment, maintenance and review of systems of internal control. This was followed in 1979 by Securities and Exchange Commission's proposals for mandatory reporting on internal financial controls. In 1985, following a series of high profile business failures in the US, the most notable one of which being the savings and loan collapse, the Tradway Commission was formed to identify the main cause of misrepresentation in financial reports and to recommend ways of reducing incidence thereof. The Tradway Report published in 1987 highlighted the need for a proper control environment, independent audit committees and an objective internal audit function and called for published reports on the effectiveness of internal control. The commission also requested the sponsoring organizations to develop an integrated set of internal control criteria to enable companies to improve their control (A.C. Fernando, 2006).

The Cadbury Committee 1992

The Cadbury Committee was the first committee to be constituted to report on the financial aspects of corporate governance. It was set up in 1991 under the chairmanship of Sir Adrian Cadbury. The Cadbury Committee, which reported in 1992, acknowledged that the financial scandals and abuse of power as exposed in the Maxwell case were some of the reasons behind the setting up of the committee to report on corporate governance matters. Hence, the formation of the Cadbury Committee can be seen as reactive rather than proactive. However, it is important to remember that Cadbury Report was compiled on the basic assumption that the existing, implicit system of corporate governance in the UK was sound and that many of the recommendations were merely making explicit and a good implicit system (Cadbury Report, 1992, pg 12, para 1.7). The Cadbury Report and its
accompanying Cadbury Code (1992) derived their names from Sir Admin Cadbury, the council of the Stock Exchange and the Accountancy Profession set about establishing the Cadbury Committee, the committee on the Financial Aspects of Corporate Governance, which produced its report and accompanying Code of Best Practice at the end of 1992. The Cadbury Code was not legally binding on boards of the directors. Nevertheless, one of the rules in the Stock Exchange Yellow Book at the time of its publication was a statement of compliance with the Code. The result of this was that all companies, publicly quoted on the Stock Exchange, had to state in their annual reports whether or not they had implemented the Code in all respects. If they had not complied with the whole Code, then they were compelled to make a clear statement of the reasons while, detailing and explaining the points of non-compliance. The implication was that the companies' shareholders then had the opportunity of deciding whether or not they were satisfied with the companies' corporate governance systems.

The Cadbury Report and its accompanying Code covered three general areas namely: the board of directors, auditing and shareholders. The Cadbury Report focused attention on the board of directors as being the most important corporate governance mechanism, requiring constant monitoring and assessment. However, the accounting and auditing function were also shown to play an essential role in good corporate governance, emphasizing the importance of the corporate transparency and communication with shareholders and other stakeholders. Lastly, Cadbury's focus on the importance of the institutional investors as the largest and most influential group of shareholders has had a lasting impact. This more than any other initiative in corporate governance reform has led to the shift of directors' dialogue towards greater accountability and engagement with shareholders. Further, we consider that this move to greater shareholder engagement has generated the more significant metamorphosis of corporate responsibilities towards a range of stakeholders, encouraging greater corporate social responsibility in general. There is no denying about the substantial impact the Cadbury Code has had on corporate Britain and, indeed, on companies around the world. By the late 1990s there was strong evidence to show a high level of compliance with the Cadbury Code's recommendations (Conyon and Mallin, 1997), partly due to the UK's comply or explain approach (as explained in appendix Comply or Explain).
Central to the final report's recommendations was that boards of all listed companies registered in the UK should comply with the Code of Best Practice as stated out in the report. The code is given added weight by the disclosure requirement of the London Stock Exchange that companies must state in their annual report whether they are complying with the code or to give reasons for any aspects on non-compliance.

**Code of Best Practice**

At the time of publication of the Committee's final report Sir Adrian Cadbury said: The planks on which the code is based are the need for disclosure and for checks and balances. Disclosure ensures that all those with a legitimate interest in a company have the information they need in order to exercise their rights and responsibilities towards it. In addition, openness by companies is the basis of public confidence in the corporate system. Checks and balances guard against undue concentrations of power and make certain that all the interests which boards have a duty to consider are properly taken into account.

The code recommendations consist of 19 points set under the headings of: (1) The Board of Directors; (2) Non-Executive Directors; (3) Executive Directors; and (4) Reporting and Controls. The main points are summarized as follows:

**The Board of Directors**

1. The board should meet regularly, retain full and effective control over the company and monitor the executive management.

2. 'There should be a clearly accepted division of responsibilities at the head of the company, which will ensure a balance of power and authority, such that no one individual is vested with unfettered powers of decision.' Ideally the roles of Chairman and Chief Executive should be separated, although this may not always be practical, in which case there 'should be a strong and independent element on the board'.

3. The board should include non-executive director's 'sufficient caliber and number for their views to carry significant weight in the board's decisions'.

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Non-executive Directors

1. Non-executive or 'outside' directors as the committee's chairman preferred to call them, should 'bring an independent judgment to bear on issues of strategy, performance, resources including key appointments and standards of conduct'.

2. The majority of non-executive directors should be 'independent' of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgment, apart from their fees and shareholding.

3. Non-executive directors should be appointed by a formal process and their appointment should be a matter for the board as whole. Appointments should be for specified terms and re-appointment should not be automatic.

Executive Directors

1. Directors' service contracts should not exceed three years without shareholders' approval.

2. Directors' pay and emoluments, including pension contributions and stock options and the amount and the basis for any performance-related element, should be fully disclosed and subject to the recommendations of a remuneration committee consisting mainly or wholly of non-executive directors and preferably chaired by a non-executive director.

Reporting and Control

1. It is the board's duty to present a balanced and understandable assessment of the company's position.

2. The board should ensure that an objective and professional relationship is maintained with the auditors.

3. The board should establish an audit committee which should consist of at least three non-executive directors. Originally the committee referred to the annual audit as 'one of the cornerstones of corporate governance'.

4. The directors should report on the effectiveness of the company's system of internal control.
5. The directors should report that the business is a going concern, with supporting assumption or qualifications necessary (Geeta Rani & Mishra, 2008).

The Greenbury Report 1995

A particularly contentious aspect of corporate governance in recent years has been that of executive pay. In 1994-95 the seemingly endless escalation in executive pays, particularly in the newly privatized public utilities such as British Gas, caused a public outcry in the UK. It forced the British Prime Minister at that time, John Major, to denounce 'un-justifiable' increases in company executive pay in the House of Commons in November 1994. In response to such public concern, the Confederation of British Industry (CBI) recruited a committee of 11 top managers (mainly chairmen) from UK leading companies such as British Petroleum, British Telecommunications, GKN, Boots and Marks & Spencer PLC to conduct an inquiry into directors' remuneration. The committee was chaired by Sir Richard Greenbury, executive chairman of Marks and Spencer and became known as the Greenbury Committee. Its brief report was: 'To identify good practice in determining Directors' remuneration and prepare a Code of such practice for use by UK PLCs.

The committee published its report on 17th July 1995 and its key themes were: 'accountability, responsibility, full disclosure, alignment of Director and shareholder interests, and improved company performance' (Directors' Remuneration: Greenbury 1995). The Greenbury Committee was formed after widespread public concern over what were seen as excessive amounts of remuneration paid to directors of quoted companies and newly privatized companies. Recent concerns about executive remuneration have centered above all on some large pay increases and large gains from share options in the recently privatized utility industries. These increases have sometimes coincided with staff reductions, pay restraints for other staff and price increases... there have also been concerns about the amounts of compensation paid to some departing directors' (Greenbury Report, 1995:9). The Greenbury Committee were keen to ensure that directors' remuneration was linked to company performance, and the committee did not seem to see a problem with high levels of pay per se, as long as they were justified on the basis of the company's financial results.

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A key concern should be to ensure, through the remuneration system, that directors share the interest of shareholders in making the company successful. Performance-related remuneration can be highly effective in aligning interest in this way. In many companies, therefore, there will be a case for a high gearing of performance related to fixed pay. But there are two constraints on this. First, there will usually be a level of basic salary below which it will not be practicable to go. Second, the requirements and priorities of companies vary. The gearing, which suits one company, may be quite unsuitable for another (Greenbury Report 1995, 38).

The Greenbury Report also addressed the problem of departing directors whose performance had not been noticeably successful, but who still manage to leave the company with generous compensation for loss of office.

Compensation payments to directors on loss of office have been a cause of public and shareholders concern in recent times. Criticism has been directed at the scale of some of the payments made and at their apparent lack of justification in terms of performance. Some payments have been described, as 'rewards for failure' (Greenbury Report, 1995,45). When the Greenbury Report was published in 1995 it dealt specifically with the question of directors' remuneration and many of its recommendations were developed from the earlier Cadbury Report. The Greenbury Report recommended that the remuneration committee should consist exclusively of non-executive directors (the Cadbury Report had recommended wholly or mainly non-executive directors). These non-executive directors should have no personal financial interest, no potential conflicts of interest arising from cross-directorships and no day-to-day involvement in running the business.

In all, the Greenbury Report contained some 20 recommendations, the key elements of which are summarized below:

1. Remuneration Committees should consist only of non-executive directors. This should avoid pay being determined by directors with a direct financial interest. Remuneration committees should:

   i). Publish an annual report giving full disclosure of all the elements (basic pay, bonuses, share options, pensions and so on);

   ii). Relate incentives to demanding performance targets, in order to 'align directors' and shareholders' interests;
iii). Explain pay policy to shareholders and justify any unusual or exceptional awards;

iv). Have the committee chairman attend AGM to respond to shareholders questions.

2. Long-term incentive schemes to be approved by shareholders.

3. Discounted share options. No longer should directors be awarded share options at a discount to the prevailing market price (Geeta Rani & Mishra, 2008).

The Hampel Report 1998

The Hampel Committee was created in 1995 to review implementation of the findings of the Cadbury and Greenbury Committees. The Hampel Committee published its report in 1998. Most of the recommendations in the earlier reports were then published in 1998 by the London Stock Exchange as The Combined Code: Principles of Good Governance and Code of Best Practice. The Combined Code (although redrafted since its original publication) is the currently applicable code of best corporate governance practice for UK listed companies. The recommendations of Hampel were along similar lines and on similar issues to Cadbury. An important contribution made by the Hampel Report was the emphasis attributed to avoiding a prescriptive approach to corporate governance improvements and recommendations. The Cadbury Report highlighted the importance of focusing on the spirit of corporate governance reform and Hampel reinforced this by stipulating that companies and shareholders needed to avoid a 'box-ticking' approach to corporate governance. The Hampel Report emphasized the need to maintain principles-based, voluntary approach to corporate governance rather than a more regulated and possibly superficial approach. This is typical of the UK approach to corporate governance and accounting as opposed to the US style of legislation, the rules-based approach. Indeed, the report stated:

'Good corporate governance is not just a matter of prescribing particular corporate structures and complying with a number of hard and fast rules. There is a need for broad principles. All concerned should then apply these flexibly and with common sense to the varying circumstances of individual companies. This is how
the Cadbury and Greenbury Committees intended their recommendations to be implemented... Companies' experience of the Cadbury and the Greenbury Codes has been rather different. Too often they believe that the codes have been treated as sets of prescriptive rules. The shareholders or their advisors would be interested only in whether the letter of the rule had been complied with—yes or no. A 'yes' would receive a tick, hence the expression 'box ticking for this approach' (The Hampel Report, 1998, p. 10, paras 1.11-1.12 emphasis added).

In some ways (such as the role of institutional investors in corporate governance) Hampel could be interpreted as being less demanding than Cadbury. Indeed, there is a widely held perception that the report represented the interest of the company directors more than those of shareholders and that much of the positive impact from Cadbury Report was diluted by the Hampel Report. Certainly, in the area of corporate social responsibility and corporate accountability to a broad range of stakeholders, there was a significant change in fact between the Cadbury Report and the Hampel Report. The Hampel Report clearly felt the need to redress the balance between shareholders and stakeholders and made strong statements on these issues. For example, the Hampel Committee stated that:

The importance of corporate governance lies in its contribution both to business prosperity and to accountability. In the UK the later has pre-occupied much public debate over the past few years. We would wish to see the balance corrected. Public companies are now among the most accountable organizations in the society..., which strongly endorse this accountability and we recognize the contribution made by the Cadbury and Greenbury Committees. But the emphasis on the accountability has tended to obscure a board's first responsibility — to enhance the prosperity of the business over time. (The Hampel Report, 1998, p. 7, para. 1.1, emphasize added) (Solomon and Solomon, 2004).

An important contribution made by the Hampel Report related to pension fund trustees, as pension funds ate the largest group of investors. Pension fund trustees were targeted by the report as a group who needed to take their corporate governance responsibilities more seriously. In particular, pension funds (and their trustees) were encouraged by the Hampel Committee to adopt a more long-term approach to institutional investment, in order to avoid short-termism for which UK
companies are notorious. Pension funds were highlighted as the main culprits in placing short-term pressure on their investing companies. This discussion in the Hampel Report has been instrumental in encouraging an overhaul in the pension fund trustee's role, culminating in the recent Miners Review of the trustee's role and responsibilities (Myners, 2001).

The impact of the Combined Code (and its predecessors) on UK company directors and institutional investors has been far-reaching, especially in the area of investor relations and shareholder activism. In a decade, corporate attitudes towards their core investors have been transformed from relative secrecy to greater transparency. Similarly, the attitudes of the institutional investors have been transformed from relative apathy towards their investee companies' activities to an active interest. As was the case for Cadbury and Greenbury, the Hampel Report could also be seen as reactive rather than proactive as further significant UK corporate failures arose from weak corporate governance structures between the publication of the Cadbury Report and the Hampel Report. One of these was a fall of the major UK bank, Barings, that created shockwaves through the corporate and financial communities throughout the UK and, indeed, across the world.

The Turnbull Report 1999

The Combined Code (1998) dealt with internal control in Provisions D.2.1 and D.2.2. In these provisions the Code stated that company directors should conduct a review of the effectiveness of the internal control systems and should report this information to shareholders. The Turnbull Committee was established specifically to address the issue of internal control and to respond to these provisions in the Combined Code. The report provided an overview of the systems of internal control in existence in UK companies and made clear recommendations for improvements without taking a prescriptive approach. The Turnbull Report was revolutionary in terms of corporate governance reforms. It represented an attempt to formalize an explicit framework for internal control in companies. The aim was to provide companies with general guidance on how to develop and maintain their internal control systems and not to specify the details of such a system (Geeta Rani & Mishra, 2008).
Although the Cadbury Report and the Hampel Report stimulated substantial improvements in corporate governance in UK listed companies, certain areas have been highlighted for further examination. The fall of Enron spurred the UK and other countries into re-evaluating corporate governance issues, such as the role and effectiveness of non-executive directors. As evidenced from the Enron case, the non-executive directors were ineffective in performing their corporate governance role of monitoring the company's directors and were subject to conflicts of interest. Even though the emphasis on non-executive directors in the UK has represented an improvement in UK corporate governance, the UK government after post-Enron effect felt obliged to set up an enquiry to examine their effectiveness.

One reason why non-executive directors are not fulfilling their potential is the difficulty of retaining their position. For example, one pension fund director suggested that:

There is a feeling that somebody ought to exercise constraint on boards. I don't think the system of non-executive directors is terribly successful. It is very difficult being a non-executive director. One actually has to let the chief executive run the show, while one cannot keep interfering and that is the trouble. If they don't want to interfere, they will get themselves voted out.

The Higgs Report dealt specifically with the role and effectiveness of non-executive directors, making recommendations for changes to the Combined Code. The general recommendations included a greater proportion of non-executive directors on boards (at least half of the board) and more apt remuneration for non-executive directors. The report also concluded that stronger links needed to be established between non-executive directors and companies' principal shareholders. This would help to foster more effective monitoring of the notorious agency problem, as it would enhance the abilities of non-executive directors to represent shareholder interest and align the interest of shareholders and directors. One important recommendation of the Higgs Report was that one non-executive director should assume chief responsibility as a champion of shareholder interest (Geeta Rani & Mishra, 2008).
The Smith Report 2003

The UK Government in response to the Enron scandal commissioned this committee, inter alia, with the aim of examining the role of the audit committee in UK corporate governance. This report was published in 2003. The main issue is dealt within the report concerned the relationship between the external auditor and the companies they audit, as well as the role and responsibilities of companies' audit committees. The creation of audit committees was a recommendation of the Cadbury Report and represented a clear means of monitoring company directors' activities. In the case of Enron, the failure of the audit committee an internal audit function was one of the principal causes of the company's collapse. Improvements in this area represent one way of keeping a check on the production of reliable and honest accounts. Nevertheless, some have suggested that the report has not gone far enough. It has been suggested that a more prescriptive approach would have been preferable which would, for example, prevent auditing companies offering from other professional services, such as consultancy or IT services or to client companies that they audit. However, the Smith Report preserved the UK tradition of a principles-based approach, attempting not to create a 'one size fits all' set of rules for listed companies. This would be counterproductive as not all companies would be in a position to comply (Geeta Rani & Mishra, 2008).

The Tyson Report 2003

The Tyson Report on the Recruitment and Development of Non-Executives Directors, published in June 2003, was commissioned by the Department of Trade & Industry (DTI) following publication of the Higgs Review of the role and effectiveness of Non-Executive Directors in January 2003. The Higgs Report had called for a group to be created consisting of business leaders inter alia, who would examine ways in which companies could broaden the gene pool of board membership. As a result, the Department of Trade & Industry invited dean Laura D'Andrea Tyson, from the London Business School, to chair group. The resulting Tyson Report found that diversity in backgrounds, skills and experience of non-executive directors enhanced board effectiveness by bringing a wider range of knowledge and viewpoints to bear on issues relating to corporate performance,
strategy and risk. Further, the report indicated that greater boardroom diversity improved relationships with corporate stakeholders, such as customers, employees and shareholders. These groups would welcome broader board membership as it should imply that boards would have a better understanding of stakeholders needs and their importance to corporate success. In these ways, the Tyson Report emphasised the need for stakeholders inclusion in corporate decision-making (Tyson Report, 2003) (Solomon, J., 2007).

Redraft of the Combined Code 2003

In July 2003 the Financial Reporting Council approved a new draft of the Combined Code, as intended from the Higgs Report in January 2003. It was referred to as, 'the biggest shake-up of board room culture in more than a decade' (Tassel, 2003). Although the redrafted code was not as prescriptive as Higgs original recommendations, it retained much of the flavour of his concerns. Indeed, the redrafting was welcomed by both the corporate and institutional investment communities, despite their initial reactions to the Higgs Report. The revised code in fact retained almost all of the fifty recommendations contained in Higgs' original report. Only the language and the message were altered. The main reforms of the new Code included the following:

1. Atleast half the board of directors should comprise independent non-executive directors.

2. A company's chief executive should not become chairman of the same company, except in exceptional circumstances.

3. The board's chairman should be independent at appointment.

4. A senior independent director should be appointed to be available to the company's shareholders, if they have unresolved concerns.

5. Boards should undertake a formal and rigorous evaluation of their own performance, considering especially the performance and effectiveness of its committees and individual directors.

6. Institutional investors should avoid box ticking when assessing investee companies' corporate governance.
7. Companies should adopt rigorous, formal and transparent procedures when recruiting new directors.

8. Non-executive Directors should only be reappointed after six years service, following 'a particular rigorous review'.

9. Non-executive Directors can only continue after nine years service following annual re-elections and should be considered no longer independent.

10. Boards should not agree to a full-time executive director accepting more than one non-executive directorship, or chairmanship in a top hundred company.

One of the main targets of the redrafted Code was to readdress executive remuneration, as the new version of the code focused on forcing companies to avoid excessive remuneration, which displayed little relation to corporate performance. The revised Code also placed an emphasis on shareholder activism as a means of furthering corporate accountability and transparency (Geeta Rani & Mishra, 2008).

**OECD Principles**

The Organisation for Economic Cooperation and Development (OECD) was one of the earliest non-governmental organisations to work on and spell out principles and practices that should govern corporate in their goal to attain long-term shareholder value. The OECD Principles were oft-quoted and have won universal acclaim, especially of the authorities on the subject of corporate governance. Because of the ubiquitous approval, the OECD Principles are as much trendsetters as the Codes of Best Practices associated to the Cadbury Report. A useful first step in creating or reforming the corporate governance system is to look at the principles laid out by the OECD and adopted by its member governments. In sum, they include the following elements:

**The rights of shareholders:** The rights of shareholders include a set of rights to secure ownership of their shares, the right to full disclosure of information, voting rights, participation in decisions on sale or modification of corporate assets, mergers and new share issues. The guidelines go on to specify a host of other issues connected to the basic concern of protecting the value of the corporation.
Equitable treatment of shareholders: The OECD is concerned with protecting minority shareholders' rights by setting up systems that keep insiders, including managers and directors, from taking advantage of their roles. Insider trading, for example, is explicitly prohibited and directors should disclose any material interest regarding transactions.

The role of stakeholders in corporate governance: The OECD recognises that there are other stakeholders in companies in addition to shareholders. Banks, bondholders and workers, for example, are important stakeholders in the way in which companies perform and make decisions. The OECD guidelines lay out several general provisions for protecting stakeholder's interests.

Disclosure and transparency: The OECD lays down a number of provisions for the disclosure and communication of key facts about the company ranging from financial details to governance structures including the board of directors and their remuneration. The guidelines also specify that independent auditors in accordance with high quality standards should perform annual audits.

The responsibilities of the board: The OECD guidelines provide a great deal of details about the functions of the board in protecting the company.

The OECD guidelines are somewhat general and both the Anglo-American system and the Continental European (or German) system would be quite consistent with them. However, there is a growing pressure to put more enforcement mechanisms into those guidelines. The challenge will be to do this in a way consistent with market-oriented systems by creating self-enforcing procedures that do not impose large new costs on firms. The following are some ways to introduce more explicit standards:

- Countries should be required to establish independent share registries. All very often, newly privatised or partially privatised firms must dilute stock or should not fail to register shares purchased through foreign direct investment.
- Standards for transparency and reporting of the sales of underlying assets need to be spelled out along with enforcement mechanisms and procedures by which investors can seek to recover damages.
• The discussion of stakeholder participation in the OECD guidelines needs to be balanced by discussion of conflict of interest and insider trading issues. Standards or guidelines are needed in both the areas.

• Property rights and their protection.

• Internationally accepted accounting standards should be explicitly required and national standards should be brought into alignment with international standards.

• Internal company audit functions and the inclusion of outside directors on audit committees need to be made explicit. The best practice would be to require that only outside, independent directors be allowed to serve on audit committees.

These standards seem to be too heavily influenced by the Anglo-American tradition and may really be necessary in most countries. A study by the Center for European Policy Studies noted that the wider the distribution of shareholding the greater is the role of the market in the exercise of corporate control. Hence there is a greater need for corporate governance procedures in this type of economy than in one where shareholding is relatively concentrated. The report went on to note, however, that financial market liberalisation increased privatisation and the growing use of funded system to support pension rules driving European countries toward more explicit and more comprehensive rules on corporate governance. In short, globalisation is forcing convergence of different systems into an open and internationally accepted set of standards.

The reason why it is important to take note of the trends toward convergence is that many people have cited the European experience as proof that corporate governance issues apply to only countries that follow an Anglo—American tradition, such as India, for instance. Recent history would seem to show that without sound corporate governance procedures, including the larger institutional features mentioned earlier, economic crises in developing countries are likely to become more frequent. Many developing countries face rather stark choices: either create the type of governance procedures needed to participate in and take advantage of globalisation, run risk of severe (and frequent) economic crises or seek to build
defensive walls around the economy. It should be noted that the last option usually entails the risk of keeping out investors and new technologies and lower growth rates dramatically.

Another consideration in the debate over corporate governance system is the risk that individual firms face. Unless a company is able to build the kind of governance mechanisms that attract capital and technology, they run the risk of simply becoming suppliers and vendors to the multinationals (A.C.Fernando, 2006).

**McKinsey Survey on Corporate Governance**

There has been a continuing debate among those who hold divergent positions on corporate governance practices whether there is any quantifiable connection between good corporate governance and the market valuation of the company. In this regard, McKinsey, the international management consultant organisation conducted a survey with a sample size of 188 companies from 6 emerging markets (India, Malaysia, Mexico, South Korea, Taiwan and Turkey), to determine the correlation between good corporate governance and the market valuation of the company. The results of the survey pointed out to a positive correlation between the two. In short, good corporate governance increases market valuation in the following ways:

- Increasing financial performance.
- Transparency of dealing, thereby reducing the risk that boards will serve their own self-interest.
- Increasing investor confidence.

McKinsey rated the performance on corporate governance of each company based on the following parameters;

- **Accountability**: transparent ownership, board size, board accountability, ownership neutrality.
- **Disclosure and transparency** of the board: timely and accurate disclosure, independent directors.
- **Shareholder equality**: one share-one vote.
Through the survey, McKinsey found that companies with good corporate governance practices have high price-to-book values indicating that investors are willing to pay a premium for the shares of a well-managed and governed company. Additionally, the survey revealed that investors are willing to pay a premium of as much as 28 per cent for shares of such a corporate governance based company.

Companies in emerging markets often claim that Western corporate governance standards do not apply to them. However, the survey revealed that studies of the six emerging markets show that investors world over look for high standards of good governance. Additionally, they are willing to pay a high premium for shares in companies that meet their requirements of good corporate governance (A.C.Fernando, 2006).

Sarbanes-Oxley Act, 2002

Corporate America has been blotted with many scandals in the recent times. Despite the fact that there have been differences between the recent scandals and the earlier ones, there is a common thread running in between them. The common thread is that governance matters, that is, good governance promotes good corporate decision-making. The recent Sarbanes-Oxley Act is a step in this direction, which codifies certain standards of good governance as specific requirements. The Act calls for protection to those who have the courage to bring frauds to the attention of those who have to handle frauds. But it ensures that such things are not left to the individuals who may or may not choose to reveal them, it is better for the corporations to appoint an officer with the responsibility to oversee compliance and ethical issues. Unless corporate governance is integrated with strategic planning and shareholders are really willing to bear the additional expenses that may be required, effective corporate governance cannot be achieved.

The Sarbanes-Oxley Act (SOX Act), 2002 is a sincere attempt to address all the issues associated with corporate failures to achieve quality governance and to restore investor's confidence. The Act was formulated to protect investors by improving the accuracy and reliability of corporate disclosures, made precious to the securities laws and for other purposes. The Act contains a number of provisions that dramatically change the reporting and corporate director's governance obligations of public companies, the directors and officers.
Important provisions contained in SOX Act are briefly given below

Establishment of Public Company Accounting Oversight Board (PCAOB): The SOX Act creates a new board consisting of five members of whom two will be certified public accountants. All accounting firms will have to register themselves with this Board and submit among other details, particulars of fees received from public company clients for audit and non-audit services, financial information about the firm, list of firms' staff who participate in audits, quality control policies, information on civil, criminal and disciplinary proceedings against the firm or any of the staff. The Board will conduct annual inspections of firms, which audit more than 100 public companies, and once in 3 years in other cases. The board will establish rules governing audit quality control, ethics, independence and other standards. It can conduct investigations and disciplinary proceedings and can impose sanctions on auditors.

The Board reports to the SEC. The Board is required to send its report to the SEC annually, which will then be forwarded by the SEC to the Congress. The new board replaces the old one, which was funded by fees collected from public companies based on their market capitalisation.

Audit committee: The SOX Act provides for a "new improved" audit committee. The members of the committee are drawn from among the directors of the board of the company but all are independent directors as defined in the Act.

The audit committee is responsible for appointment, fixing fees and oversight of the work of independent auditors. The committee is also responsible for establishing and reviewing the procedures for the receipt, treatment of accounts, internal control and audit complaints received by the company from the interested or affected parties;

The SOX Act requires that registered public accounting firms should report directly to the audit committee on all critical accounting policies and practices and other related matters. Conflict of interest: Public accounting firms should not perform any audit service for a publicly traded company if the CEO, CFO, CAO, controller, or any person serving in an equivalent position was employed by such firm and participated in any capacity in the audit of that company during the one year period preceding the date of initiation of the audit.
Audit partner rotation: The SOX Act provides for mandatory rotation of the lead auditor, co-ordinating partner and the partner reviewing audit once every 5 years.

Improper influence on conduct of audits: It will be unlawful for any executive or director of the firm to take any action to fraudulently influence, coerce, manipulate or mislead any auditor engaged in the performance of an audit with the view to rendering the financial statements materially misleading.

Prohibition of non-audit services: Under the SOX Act, auditors are prohibited from providing non-audit services concurrently with audit financial review services. Non-audit services include: (i) book-keeping or other services related to the accounting records or financial statements of the client; (ii) financial information system, design and implementation; (iii) appraisal or valuation services, fair opinions; (iv) actuarial services; (v) internal audit outsourcing services; (vi) management functions or human resources; (vii) broker or dealer, investment adviser or investment banking services; (viii) legal services or expert services unrelated to the audit and (ix) any other service that the board determines, by regulation, is impermissible. However, the board has the power to grant exemptions. The Act also allows an accounting firm to "engage in any non-audit service including tax services", if it has been pre-approved by the audit committee of the firm concerned.

CEOs and CFOs required to affirm financials: Chief executive officers and chief finance officers are required to certify the reports filed with the Securities and Exchange Commission. If the financials are required to be restated due to material non-compliance "as a result of misconduct" of the CEO or CFO, then such CEO or CFO will have to return bonus and any other incentives received by him back to the company. This applies to equity-based compensation received during the first 12 months after initial public offering. False and/or improper certification can attract fine ranging from $1 million to $5 million or imprisonment upto 10 years or both.

Loans to directors: The SOX Act prohibits US and foreign companies with securities traded within the US from making or arranging from third parties any type of personal loan to directors. It appears that the existing loans are not affected but material modifications or renewal of loans and arrangements of existing loans are banned.
Attorneys: The attorneys dealing with the publicly traded companies are required to report evidence of material violation of securities law or breach of fiduciary duty or similar violations by the company or any agent of the company to the Chief Counsel or CEO and if the Counsel or CEO does not appropriately respond to the evidence, the attorney must report the evidence to the audit committee or the Board of Directors.

Securities analysts: The SOX Act has a provision under which brokers and dealers of securities should not retaliate or threaten to retaliate an analyst employed by the broker or dealer for any adverse; negative or unfavourable research report on a public company. The Act further provides for disclosure of conflict of interest by the securities analysts and brokers or dealers whether

a) The analyst has investments or debt in the company he is reporting on.

b) Any compensation received by the broker dealer or analyst is "appropriate in the public interest and consistent with the protection of investors".

c) The company (issuer) has been a client of the broker or dealer.

d) The analyst received compensation with respect to a research report based on investment banking revenues.

Penalties: The penalties prescribed under SOX Act for any wrongdoing are very stiff. Penalties for wilful violations are even stiffer. Any CEO or CFO providing a certificate knowing that it does not meet with the criteria stated may be fined upto $1 million and/or imprisonment upto 10 years. However, those who "wilfully" provide certification knowing that it does not meet the required criteria can be punished with a fine of $5 million and/or with prison term upto 20 years. These heavy penalties are bound to be a deterrent for wrongdoers.

Very importantly, the SOX Act provides for studies to be conducted by the Securities and Exchange Commission or the Government Accounting Office in the following areas:

i) Auditor's rotation.

ii) Off-balance sheet transactions.

iii) Consolidation of accounting firms and its impact on the accounting industry.
iv) Role of Credit Rating Agencies.


vi) SEC enforcement actions over the past 5 years.

vii) Role of investment banks and financial advisers,

viii) "Principle-based" accounting.

The SOX Act would certainly enhance accountability levels for directors, officers, auditors, security analysts and legal counsel involved in the financial markets. It would have far reaching implications worldwide particularly in areas of audit. The Act targets specifically publicly traded companies and do not distinguish between the US and non-US companies- It applies to all companies with a listing in the US.

But the most important aspect of the SOX Act is that it makes it clear that a company's senior officers are responsible for the corporate culture they create, and must be faithful to the same rules they set out for other employees. The CEO, for example, must be ultimately responsible for the company's disclosure, controls and financial reporting (A.C. Fernando, 2006).

Fundamental Corporate Governance Theories in the world

Agency Theory

Agency theory having its roots in economic theory was initiated by Alchian and Demsetz (1972) and further developed by Jensen and Meckling (1976). Agency theory is defined as "the relationship between the principals, such as shareholders and agents such as the company executives and managers". In this theory, shareholders who are the owners or principals of the company, hire the gents to perform work. Principals delegate the running of business to the directors or managers, who are the shareholder's agents (Clarke, 2004). Indeed, Daily et al (2003) argued that two factors can influence the prominence of agency theory. First, the theory is a conceptual and simple theory that reduces the corporation to two participants of managers and shareholders. Second, agency theory suggests that employees or managers in organizations can be self-interested.
The agency theory shareholders expect the agents to act and make decisions in the principal's interest. On the contrary, the agent may not necessarily make decisions in the best interests of the principals (Padilla, 2000). Such a problem was first highlighted by Adam Smith in the 18th century and subsequently explored by Ross (1973) and the first detailed description of agency theory was presented by Jensen and Meckling (1976). Indeed, the notion of problems arising from the separation of ownership and control in agency theory has been confirmed by Davis, Schoorman and Donaldson (1997).

In agency theory, the agent may succumb to self-interest, opportunistic behavior and falling short of congruence between the aspirations of the principal and the agent's pursuits. Even the understanding of risk defers in its approach. Although with such setbacks, agency theory was introduced basically as a separation of ownership and control (Bhimani, 2008). Holmstrom and Milgrom (1994) argued that instead of providing fluctuating incentive payments, the agents will only focus on projects that have a high return and have a fixed wage without any incentive component. Although this will provide a fair assessment, it does not eradicate or even minimize corporate misconduct. Here, a positivist approach is used where the agents are controlled by principal-made rules, with the aim of maximizing shareholders value. Hence, a more individualistic view is applied in this theory (Clarke, 2004). Indeed, agency theory can be employed to explore the relationship between the ownership and management structure. However, where there is a separation, the agency model can be applied to align the goals of the management with those of the owners. Due to the fact that in a family firm, the management comprises family members, the agency cost would be minimal as any firm's performance does not really affect the firms performance (Eisenhardt, 1989). The model of an employee portrayed in the agency theory is more of a self-interested, individualistic and is of bounded rationality where rewards and punishments seem to take priority (Jensen & Meckling, 1976). This theory prescribes that people or employees are held accountable in their tasks and responsibilities. Employees must constitute a good governance structure rather than just providing the need of shareholders, which may be challenging the governance structure.
Stewardship Theory

Stewardship theory has its roots from psychology and sociology and is defined by Davis, Schoorman & Donaldson (1997) as "a steward protects and maximises shareholders wealth through firm performance, because by so doing, the steward's utility functions are maximised". In this perspective, stewards are company executives and managers working for the shareholders, protects and make profits for the shareholders. Unlike agency theory, stewardship theory stresses not on the perspective of individualism (Donaldson & Davis, 1991) but rather on the role of top management being as stewards, integrating their goals as part of the organization. The stewardship perspective suggests that stewards are satisfied and motivated when organizational success is attained.

Agyris (1973) argues that agency theory looks at an employee or people as an economic being, which suppresses an individual's own aspirations. However, stewardship theory recognizes the importance of structures that empower the steward and offers maximum autonomy built on trust (Donaldson and Davis, 1991). It stresses on the position of employees or executives to act more autonomously so that the shareholders' returns are maximized. Indeed, this can minimize the costs aimed at monitoring and controlling behaviours (Davis, Schoorman & Donaldson, 1997). On the other end, Daly et al. (2003) argued that in order to protect their reputations as decision makers in organizations, executives and directors are inclined to operate the firm to maximize financial performance as well as shareholders' profits. In this sense, it is believed that the firm's performance can directly impact perceptions of their individual performance. Indeed, Fama (1980) contended that executives and directors are also managing their careers in order to be seen as effective stewards of their organization, whilst, Shleifer and Vishny
(1997) insisted that managers return finance to investors to establish a good reputation so that that can re-enter the market for future finance. Stewardship model can have linking or resemblance in countries like Japan, where the Japanese workers assume the role of stewards and take ownership of their jobs and work at them diligently.

Moreover, stewardship theory suggests unifying the role of the CEO and the chairman so as to reduce agency costs and to have greater role as stewards in the organization. It was evident that there would be better safeguarding of the interest of the shareholders. It was empirically found that the returns have improved by having both these theories combined rather than separated (Donaldson and Davis, 1991).

**Figure: 2.2 The Stewardship Theory**

Stakeholder Theory

Stakeholder theory was embedded in the management discipline in 1970 and gradually developed by Freeman (1984) incorporating corporate accountability to a broad range of stakeholders. Wheeler et al. (2002) argued that stakeholder theory derived from a combination of the sociological and organizational disciplines. Indeed, stakeholder theory is less of a formal unified theory and more of a broad research tradition, incorporating philosophy, ethics, political theory, economics, law and organizational science.

Stakeholder theory can be defined as “any group or individual who can affect or be affected by the achievement of the organization’s objectives”. Unlike agency theory in which the managers are working and serving for the stakeholders, stakeholder theorists suggest that managers in organizations have a network of relationships to serve – this include the suppliers, employees and business partners. And it was argued that this group of network is important other than owner-
manager-employee relationship as in agency theory (Freeman, 1999). On the other end, Sundaram & Inkpen (2004) contend that stakeholder theory attempts to address the group of stakeholder deserving and requiring management’s attention, whilst, Donaldson & Preston (1995) claimed that all groups participate in a business to obtain benefits. Nevertheless, Clarkson (1995) suggested that the firm is a system, where there are stakeholders and the purpose of the organization is to create wealth for its stakeholders.

Freeman (1984) contends that the network of relationships with many groups can affect decision making processes as stakeholder theory is concerned with the nature of these relationships in terms of both processes and outcomes for the firm and its stakeholders. Donaldson & Preston (1995) argued that this theory focuses on managerial decision making and interests of all stakeholders have intrinsic value and no sets of interests are assumed to dominate the others.

Figure: 2.3. The Stakeholder Model (Donaldson and Preston, 1995)

**Resource Dependency Theory**

Whilst, the stakeholder theory focuses on relationships with many groups for individual benefits, resource dependency theory concentrates on the role of board directors in providing access to resources needed by the firm. Hillman, Canella and Paetzold (2000) contend that resource dependency theory focuses on the role that directors play in providing or securing essential resources to an organization through their linkages to the external environment. Indeed, Johnson et al, (1996) concur that
resource dependency theorists provide focus on the appointment of representatives of independent organizations as a means for gaining access in resources critical to firm success. For example, outside directors who are partners to a law firm provide legal advice, either in board meetings or in private communication with the firm executives that may otherwise be more costly for the firm to secure.

It has been argued that the provision of resources enhances organizational functioning, firm's performance and its survival (Daily et al, 2003). According to Hillman, Canella and Paetzold (2000) that directors bring resources to the firm, such as information, skills, access to key constituents such as suppliers, buyers, public policy makers, social groups as well as legitimacy. Directors can be classified into four categories of insiders, business experts, support specialists and community influencers. First, the insiders are the current and former executives of the firm and they provide expertise in specific areas such as finance and law on the firm itself as well as general strategy and direction. Second, the business experts are the current and former senior executives and directors of other large for-profit firms and they provide expertise on business strategy, decision making and problem solving. Third, the support specialists are the lawyers, bankers, insurance company representatives and public relations experts and these specialists provide support in their individual specialized field. Finally, the community influencers are the political leaders, university faculty, members of clergy, leaders of social or community organizations.

**Transaction Cost Theory**

*Transaction cost theory* was first initiated by Cyert and March (1963) and later theoretically described and exposed by Williamson (1996). Transaction cost theory was an interdisciplinary alliance of law, economics and organizations. This theory attempts to view the firm as an organization comprising people with different views and objectives. The underlying assumption of transaction theory is that firms have become so large that they in effect substitute for the market in determining the allocation of resources. In other words, the organization and structure of a firm can determine price and production. The unit of analysis in transaction cost theory is the transaction. Therefore, the combination of people with transaction suggests that transaction cost theory managers are opportunists and arrange firms' transactions to their interests (Williamson, 1996).
Political Theory

*Political theory* brings the approach of developing voting support from shareholders, rather by purchasing voting power. Hence having a political influence in corporate governance may direct corporate governance within the organization. Public interest is much reserved as the government participates in corporate decision making, taking into consideration cultural challenges (Pound, 1993). The political model highlights the allocation of corporate power and profits and privileges are determined via governments' favor. The political model of corporate governance can have a deep influence on governance developments. Over the last decades, the government of a country has been seen to have a strong political influence on firms. As a result, there is an involvement of politics into the governance structure or firms' mechanism (Hawley and Williams, 1996).

**Popular Models for Governance**

The corporate governance structure of joint stock corporations in a given (America, German, Japan and India) country is determined by several factors: the legal and regulatory framework outlining the rights and responsibilities of all parties involved in corporate governance; the de facto realities of the corporate environment in the country; and each corporation's articles of association. While corporate governance provisions may differ from corporation to corporation, many de facto and de jure factors affect corporations in a similar way. Therefore, it is possible to outline a "model" of corporate governance for a given country. Corporate governance relates to the internal means by which corporations are operated and controlled. While government plays a central role in shaping the legal, institutional and regulatory climate within which individual corporate governance systems are developed, the main responsibility lies with the private sector.

The unique characteristics and distinctive features of four important models of corporate governance are detailed below.

- The Anglo-America Model
- The German Model
- The Japanese Model
- The Indian Perspective
The Anglo-America Model

In this model, the board appoints and supervises the managers who manage day to day affairs of the corporations. While the legal system provides the structural framework, the stakeholders in the company will be the suppliers, employees and creditors. However, creditors exercise their lien over the assets of the company. The policies are framed by the board of directors and are implemented by the management. The board oversees the implementation through a well-designed information system. The board of directors, being responsible to shareholders commits to them certain returns within the board contours of the market framework.

It will ensure an efficient organization for production, exchange and performance monitoring. However, there is no agreement on the cost effectiveness or efficiency of the model. The distinctive features are:

- Clear separation of ownership and management, which minimizes conflict of interests.
- Companies are run by professional managers who have negligible ownership stakes linked to performance. CEO has a major role to play.

Figure: 2.4 The Anglo-America Model

The German Model

In this model, although the shareholders own the company, they do not entirely dictate the governance mechanism. As shown in the figure 2.5, shareholders elect 50 per cent of members of supervisory board and the other half are appointed by labour unions. This ensures that employees and laborers also enjoy a share in the governance. The supervisory board appoints and monitors the management board. There is a reporting relationship between them, although the management board independently conducts the day-to-day operations of the company.

The distinctive features are:

> Banks and financial institutions have substantial stake in equity capital of companies.

> Labour Relations Officer is represented in the management board. Worker participation in management is practised.

> Both shareholders and employees have equal say in selecting the members of the supervisory board.

Figure: 2.5 The German Model

The Japanese Model

In Japanese model, the financial institution has an accrual role in governance. The shareholders and the bank together appoint board of directors and the president.

The distinctive features are:

- Inclusion of President who consults both the supervisory board and the executive management.
- Importance of the lending bank is highlighted

Figure: 2.6 The Japanese Model


The Indian Perspective (Governance in Public Sector)

India in its own right has a unique and epochal background of governance. In the ancient times, the King was always considered the representative of the people. The wealth of the State was not the personal wealth of the king. The principle of trusteeship was also followed. Various modern authors have also taken tips on good governance from Kautilya's Arthasastra.
The modern Indian corporates are governed by the Company’s Act of 1956 that follows more or less the UK model. The pattern of private companies is mostly that of those closely held or dominated by a founder, his family and associates. In respect of public enterprises, central/state government forms the board. The hold of the government constitutes is to be dominant. The distinctive features are:

- Equity shares are owned wholly or substantially (51 per cent or more) by the government.
- Good deal of political and bureaucratic influence over the management.
- Organization is often viewed as a social entity.
- The boards of directors are appointed by the controlling administrative ministry.
- Excessive emphasis on observing rules, regulations and guidelines.
- Efficiency and performance are sacrificed at the altar of propriety.

**Figure: 2.7 The Indian Perspective of Corporate Governance**

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<th>Regulatory Framework</th>
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<td>Directors executive</td>
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