CHAPTER – III
CORPORATE GOVERNANCE: CONCEPTION, HISTORY AND DEVELOPMENTS
3. Chapter 3: Corporate Governance: Conception, History and Developments .............................................................................................................. 44 – 92

3.1 Introduction .............................................................................................................. 44

3.2 Corporate Governance: A Conceptual Framework ............................................. 44
   3.2.1 Definition of Corporate Governance ......................................................... 44
   3.2.2 Significance of Corporate Governance ....................................................... 46
   3.2.3 Corporate Governance Principles ............................................................. 47
   3.2.4 Scope of Corporate Governance ................................................................. 48
   3.2.5 Corporate Governance Mechanisms ......................................................... 52
   3.2.6 Theories of Corporate Governance ............................................................. 52
   3.2.7 Models of Corporate Governance ............................................................... 56

3.3 History and Development of Corporate Governance: A Global Picture .................................................. 63
   3.3.1 History ...................................................................................................... 63
   3.3.2 Developments ......................................................................................... 66
   3.3.3 Major International Corporate Governance Committees and Codes ................. 66

3.4 History and Development of Corporate Governance: India’s Picture ..................... 79
   3.4.1 History ................................................................................................ 79
   3.4.2 Developments ...................................................................................... 81

3.5 Conclusion ............................................................................................................. 92
3.1 Introduction

The whole system of corporate governance centers mainly on board, management and shareholders, who are the three critical organs of company form of business. Different classes of stakeholders act as essential auxiliary part of the system. A company that has strong investor confidence can raise huge capital, have the benefit of reputation and can sustain for long period. The critical factor of investor confidence depends on governance and administration of the company. An efficient governance policy is derived from ethical, moral, transparent and fair principles of corporate governance. It requires corporations to pursue ethical and social objectives along with profit generation.

Company governance has become a vital issue of concern all over the world since past few decades. Though corporate governance is not a new concept, it drew attention of policy makers, economists, regulators, academicians and individuals recently. As a result, there has been a wide surge of reforms and developments in the area. What draws them for all the efforts so profoundly on this concept? In this section, we present the conceptual components of corporate governance, its global as well as Indian historical development and present scenario.

3.2 Corporate Governance: A Conceptual Framework

Conceptual understanding of corporate governance is essential for better understanding of the need and importance of this study. This conceptual build up includes definition, significance and principles of corporate governance, theories and models underlying corporate governance and scope of corporate governance.

3.2.1 Definition of Corporate Governance

There is no standard definition of corporate governance. The scope of corporate governance is very vast and includes functions that extend from formulating governance policies to making structural adjustments in organization to bring in efficient corporate management. Many scholars and academicians have given their own definitions of corporate governance, which were resulted from their extensive studies.
At the core of corporate governance, there is the principle of investor protection. Investors fund in the corporations must flow in productive channels in order to maximize the return and long-term wealth maximization.

Bruce Weber (n.d)\textsuperscript{51}, Dean of the Lerner College of Business at the University of Delaware, defines corporate governance as;

“Accountability to providers of capital”

Shleifer & Vishny (1997, p. 737)\textsuperscript{52} in their article- ‘A survey of Corporate Governance’ define corporate governance as;

“Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment. How do the suppliers of finance get managers to return some of the profits to them? How do they make sure that managers do not steal the capital they supply or invest it in bad projects? How do suppliers of finance control managers.”

Margaret M Blair (1996)\textsuperscript{53} defines corporate governance as;

“The whole set of legal, cultural, and institutional arrangements that determine what public corporations can do, who controls them, how that control is exercised, and how the risks and return from the activities they undertake are allocated”.

According to International Chamber of Commerce (McRitchie, 2017)\textsuperscript{54};

“Corporate governance is the relationship between corporate managers, directors and the providers of equity, people and institutions who save and invest their capital to earn a return. It ensures that the board of directors is accountable for the pursuit of corporate objectives and that the corporation itself conforms to the law and regulations”.

\textsuperscript{51} Corporate Governance. (n.d). Retrieved on 28\textsuperscript{th} December, 2016 from http://magpie73.livejournal.com/1663182.html.


3.2. 2 Significance of Corporate Governance

Companies have been in existence and their management and administration are practiced for centuries together. However, governance of companies has gained importance from last few decades. The governance reforms are not emerged overnight but are the result of the significant effects brought by better governance practices. Corporate governance is critical because of the following factors.

- **Long term value and profit maximisation:** A better managed company is half way through its success. The vision and objectives of the organisation should clearly indicate its employees their expected role in the organisation and policies and procedures should communicate fair ways of achieving those objectives. Transparent and ethical environment and fair disclosure will lead to reputation and longer sustainability in the market. It advances the growth in organisational value.

- **Shareholders and Stakeholder confidence:** Shareholders and stakeholders, irrespective of their quantum of interest in an organisation, get affected by each and every steps of the organisation. Thus, they keep close check on their firms issues and respond very quickly due to their exposure to speedy market information. So, better management is essential to gain and retain shareholders as well as stakeholder confidence.

- **Smooth and efficient functioning:** The effective corporate governance system smoothen the functioning of a business firm through delegation of authority and responsibility and well defined administrative procedures. This brings in coordination among all departments that contributes to the efficient work.

- **Cordial relationship:** The cordial relationship of the organization with shareholders and all stakeholders can be maintained, that will benefit in the long-term value of the business in the market.

- **Reach international audience:** An efficient management, administration, compliance with regulatory standards attract the foreign investors, MNCs, international collaborations. This leads to explore the benefits of global presence and more wealth creation for shareholders.
3.2. 3 Corporate Governance Principles

The principles of corporate governance comprises of ethical and legal aspects of governance. They are essential parts without which governance does not bring the fruits to the organization. Hence, the success of corporate governance system is largely depended on how well the governance practitioners will apply these principles into practice.

- **Honesty and Integrity:** The sense of honesty among directors and management keeps them committed to the organisational values. It contributes to the effective discharge of their duties and responsibility. This sets an example to other employees.

- **Trust:** Any relationship that builds on trust lasts for long. However, trust building and maintaining are two challenging tasks. The trustworthiness of companies attracts investor funds in capital market. Trust depends on the company’s management.

- **Transparency:** Transparency is a key ingredient of governance that brings shareholders trust. All material information, company’s financial statements and reports should be clear and free from falsified techniques and creative accounting which would otherwise lead to the bad reputation of the organization.

- **Accountability:** Board of Directors should be accountable to the shareholders for their actions. Accountability binds them to the results of their decisions and reduces the chances of misconducts.

- **Equity and Fairness:** An efficient system of corporate governance ensures fair and equitable treatment of all. The rules and policies are applicable in a same way to each of the constituent of the governance system.

- **Compliance with rules and regulations:** Companies need to follow applicable rules and regulations to avoid legal consequences. Compliance with corporate governance codes is essential to show domestic as well as international investors and regulators that the company is not deviated from legal requirements. It ensures the trustworthiness of the company.

- **Disclosure:** Communication of the relevant, material information to various interested parties is always preferred. Information needs various among
different class of participants. True and fair information is always essential for the decisions of different participants.

3.2.4 Scope of Corporate Governance

As understood from the above discussion, many individuals and group of individuals are involved in corporate governance. They are called stakeholders who have an interest in the organization. They can be grouped as internal stakeholders and external stakeholders (See figure 3.1). Internal stakeholders are from within the organization and they directly participate in corporate governance system. For example, directors and executives. Shareholders, creditors, customers, suppliers, government etc., are external to an organization. Constant interaction and effective relationship among them requires fairness and transparency. Lack of these two causes conflicts and unnecessary friction in their functioning.

**Fig. 3.1: Internal and External Stakeholders to Companies**
i. Internal Stakeholders:

Group of individuals who are closely associated with the company are called internal stakeholders. They have direct role in the management of the company. As can be seen in the above figure, Shareholders, Board of Directors, management and employees are considered to be the internal stakeholders.

- **Shareholders:** Shareholders are the real owners of the organization and commonly referred to as investors. They enjoy voting and residual property rights. A shareholder can be an individual, an institution, government or any group of people. Generally, total shareholding of a company will be combination of any or all of them.

- **Board of Directors:** A board is a panel of elected representatives of shareholders. Board’s leadership is vested with the chairman. Board sets the direction and strategies to accomplish organisational goals. It is constituted with executive as well as non-executive directors. Sometimes, few nominee directors are also placed on the board by some shareholder or stakeholders group.

- **Management:** The executive works in a company are carried out by management executives. These are appointed and controlled by the board. Chief Executive Officer is the head of the executive team. In some cases, leadership roles of board and management may both be assigned to a single person.

- **Employees:** Employees are workers who serve an organization in consideration for a sum called salary. Sometimes, they may also be entitled non-monetary benefits and stock options. They are accountable to management and they just carry out the work assigned to them.

ii. External Stakeholders:

External stakeholders are people who do not have direct participation in company management. However, they get influenced by company actions and vice versa. They stay out of the realm of the company management, but still have a contribution to the company’s success or failure.
- **Creditors:** Creditors are money lenders to the organization. A creditor may be an individual, a financial institution or a bank. Company is obligated to pay periodical interests and repayment of the principal to them.

- **Customers:** The final product i.e. goods or services, of an organization is intended to be sold to consumers. They are the end users of the product. They are concerned about the price, quality and quantity of the goods or service. Sometimes, customers act as an important determinate factor of price, quality or quantity in the market.

- **Competitors:** Other firms in the industry who compete for the factors of production and for the market are called competitors. Competition is a critical challenge to the firms survival. Each move and strategy of competitors influence the organizations decisions.

- **Suppliers:** Materials and resources are the essential factors of production. Their supply ensures uninterrupted production and continued supply of finished products to the market. Thus, suppliers role is significant in smooth functioning of the organization.

- **Government and Regulators:** Government is an important stakeholder of an organization. Various policies, programmes, rules are vital in governance of a company. Organization interacts with the government for various reasons. For example, tax levied by the government, industrial development programmes and schemes, political ideology of the ruling party etc.

  Regulators are the authorities responsible for exercising control over organisational conducts. Regulators may be government agencies, public authorities or statutory bodies who draw specified rules and regulations. They monitor the compliance status of the companies and have power to penalise the wrongdoings.

- **Intermediaries:** These are the links between a company and its customers. Wholesalers and retailers are the best examples of marketing intermediaries. A proper channel reduces the time gap and effectively reaches the consumers.

- **Auditors:** An auditor is an external agent appointed by the company to audit the financial statements and to express their opinion about the accuracy. Also, sometimes they check the effectiveness of the internal control systems of the company.
Other stakeholders: Society, public, media etc., are some of other external stakeholders who may have an interest in the running of the company. Some of them are the users of the financial information of the company.

Key Participants in Corporate Governance

Three internal stakeholders have a remarkable role to play in corporate governance. They are; Shareholders, Board of Directors and Management. They are regarded as the key participant in governance system.

Fig. 3.2: Key participants in Corporate Governance

Shareholders being the real owners of the business firm are the most important organ of corporate governance structure in any country. A group of elected members called board of directors represents them. Board assumes fiduciary role that sets strategic direction for the organization. Administration and management work are delegated to executive managers by the board and they are accountable to the board in turn. It is hardly possible for shareholders to take part in all managerial functions of the firm. They exercise their right through voting in general body meetings. All three participants have reciprocal relationship among them.
3.2.5 Corporate Governance Mechanisms

Corporate governance mechanisms consist of various governance aspects, which can be divided as internal mechanisms and external mechanisms. Internal governance mechanisms include ownership structure, board and board committees’ composition and working, functions of board chairman and CEO, disclosure practices and internal control and audit system etc. Internal corporate governance mechanisms have inherent association with firms. They are prominent factors in deciding the outcome of firm management. Internal governance can be improved with emphasis on shareholder activism, independent boards, effective committees, improving transparency in disclosures, ensuring 100 percent compliance with regulations etc.

External governance mechanisms are the controlling mechanisms exercised by the people who are external to the company. Regulatory control, market for takeovers, mergers and acquisitions etc. are some of the important external mechanisms. The threat of takeover by a potential acquirer acts as a factor of corporate control. However, the market for corporate control is underdeveloped in many developing and underdeveloped countries and external corporate control mechanisms are last resorts which come into play when internal governance mechanisms fail and no way left. And by that time, much of the shareholders wealth and interest will be eroded. Hence, it is necessary to strengthen internal governance practices and avoid being threatened by hostile takeovers. Sometimes, companies may end up in collapse of stock prices and capital market confidence.

3.2.6 Theories of Corporate Governance

A theory is a supposition on something. It results from an observation and study, which draw a set of concepts and principles that help for better understanding. There are various theories that underlie the concept corporate governance (Abdullah & Valentine, 2009)\(^5\). Abdullah and Valentine discuss the evolution of corporate governance along with the discussion on evolution of various traditional corporate governance theories like agency theory, stewardship theory, stakeholder theory, resource dependency theory, transaction cost theory, and political theory as well as ethics theory such as business ethics theory, virtue ethics theory, feminist ethics theory and discourse ethics theory. These theories highlight different contexts of

governance. Here we have a discussion on important theories of corporate governance.

i. Agency Theory

The separation of owners (shareholders who invest money in return for long term wealth maximization) and managers (who manage and control the business activities in return for compensation) is a general set up in joint stock form of organisations. ‘Principal-agent relationship’ emerges between shareholders and managers in such set up. The agency theory is based on the assertion that management is the agent of shareholders to work for them channelizing resources to profitable ventures in the interest of principals i.e. owners. And there is divergence between the interests of shareholders and the interests of management. Wide spread investor base and the lack of active part of shareholders in monitoring day-to-day businesses make managers opportunistic. The separation of ownership and control and diversified ownership have resulted in ineffective check upon the executive autonomy of corporate managers (The Theories Behind Corporate Governance, havingtheircake.com)\textsuperscript{56}. Owners’ funds can be exploited to serve their self-interests such as signing a deal with their relative firm though not profitable. That gives way to ‘agency problems’- the problems that result from conflicts of interests between shareholders and managers. Shareholders need to incur some costs to keep management committed to shareholders’ goals. This cost is called ‘agency cost’, which may take the form of performance linked compensation, non-monetary rewards, recognition of ethical acts and rewarding such acts etc. They aim to align managers’ interests with shareholders interests. Although agency problems have been prevalent since the emergence of separation of shareholders and managers, the quantum of problem and newer ways of exploitation are ever increasing and becoming more severed. There are governance practitioners who stand different from crowd with their principles, values and ethical conscience. They show exemplary conduct on their profession. However, the reports of white collar crimes now and then make one apprehensive. Moreover, it is indeed, necessary to understand the context of agency conflicts, costs and remedies.

Conflicts arise when there is a friction in the priorities of two persons or parties. According to Thomsen, S. and Conyon, M. (2012), there are three types of conflicts between owners and managers. Type 1 is common in economies of dispersed ownership. Type 2 conflicts are seen commonly in countries with concentrated ownership and type 3 conflicts are seen in both categories of countries. In case of dispersed ownership, as discussed above, investors with small holdings do not monitor and control daily affairs of the business which is obviously not beneficial for them. Concentrated ownership may result in the conflicts among shareholders. Blockholders embezzle the money keeping the small investors interests at stake. Blockholders have more incentives in the management and the inability of small holders to take part in control is an added advantage in this regard. There are some other types of conflicts that exist in both kind of ownership pattern due to various other reasons. The absence of proper surveillance on their actions, possession of a large amount of fund and availability of manipulative accounting techniques are the important motives for managers to extract private benefits out of investment pool. Further, the process and time for ratification of decisions from shareholders is too lengthy and information asymmetry give managers power to abuse the rights of shareholders.

Due to their inability to participate in management and to have proper control over management, shareholders appoint board of directors. A blend of shareholders representatives and outside professional experts on the board will benefit the organisation. Representative shareholders represent the shareholders interests and outside directors bring in impartial judgment over strategic decisions direct the companies. Further, transparent disclosure will ensure the proper management.

The agency theory is a fundamental theory of corporate governance which conceptualizes the core elements of governance. Evolution of corporate governance goes hand in hand with the emergence of new theories that elaborate the scope of corporate governance.

ii. Stewardship Theory

The theory proposes that managers are ethical and highly inclined to values and self-reputation. Managers act in the best interests of the owners though left free form shareholders check and control. The executives and management are committed

to organizational goals. Close watch on management may be counterproductive as assumed in this theory. This theory upholds the managers’ role as stewards. Sumeet Khurana (2011)\textsuperscript{58} has drawn up the difference in managers need priorities between agency theory and stewardship theory. In agency theory management is presumed to be motivated by safety needs while esteem and self-actualization needs motivate management in stewardship theory.

iii. Shareholder Theory

Shareholder theory embraces the shareholder dominance principles. Milton Friedman is the proponent of shareholder theory according to whom, any objective other than profit maximization is wrong in business firms. This theory prioritizes the objective of maximizing profit as the ultimate goal of any business organisation. Shareholders wealth is at the centre and social responsibilities of business are not given importance. Milton Friedman (2007)\textsuperscript{59}, in his article ‘The Social Responsibility of Business is to Increase its Profit’ called the executives who pursued other goals than making profits as ‘unelected government officials’. His proponent was so strong that he argued that corporations are artificial persons and as whole businesses cannot have social responsibilities. There is an interconnection between agency theory and shareholder theory. He says executives of firms are employees of the owner. Thus, their responsibility is to increase as much return as possible and to maximize shareholders wealth. It is evident from these that, corporation is a means just to create and maximize shareholders wealth. In his opinion, in the name of the social responsibility, a corporate executive would spend stockholder’s, customer’s and employee’s money which is an unwelcomed thing. This would be a kind of tax burden on them.

Management and executives are responsible only for shareholders. They have a fiduciary duty towards shareholders. Their money and interests should be safeguarded. Other stakeholders such as customers, employees, society, government etc are the means in realization of the goal of getting higher return to shareholders. Customers get product or service for what they pay, employees get compensated for their work, society would be benefited with employment generation, business


\textsuperscript{59} Friedman, M. (2007). The social responsibility of business is to increase its profits. In Corporate ethics and corporate governance, 173-178. springer berlin heidelberg.
activities would contribute to country’s economy and therefore, business entities need not to consider additional social responsibilities.

iv. Stakeholder Theory

Unlike the shareholders theory wherein organizational resources being used only for the fulfillment of shareholder objective, stakeholder theory advocates the need for wealth creation for stakeholders. This theory places the importance not only on shareholders but also on stakeholders in an organization and various responsibilities towards them. This theory ethically binds corporations for the responsibilities towards stakeholders. The shareholder theory limits the organizational purpose with a focus only on shareholders. On the other hand, stakeholder theory proposes long term value creation for all those who are associated with an organisation. The sustainability of any corporation depends on how contented the stakeholders are about the company’s performance. Value creation for different stakeholders establishes a strong reputation.

Edward Freeman’s, an American philosopher and professor, work is notable in stakeholder theory. His book- ‘Strategic Management: A Stakeholder Approach’ is noteworthy in this regard. Agency theory and stewardship theories endorse ethics on management to safeguard and maximize shareholders wealth. Conversely, stakeholder theory focuses on ethical code of conduct for managers for stakeholder value creation. Thus, organizational actions are morally binding on different groups of stakeholders.

3.2.7 Models of Corporate Governance

A model of corporate governance is the structural interaction between different governance participants. The models are determined by the country or region specific contexts and factors. They include ownership structure, investor protection, and activism, role of boards and management, legal system in the country and regulatory aspects. There are four major corporate governance models around the world viz., Anglo-American model mostly found in America, Britain, Canada and Australia, German model found in continental European countries such as Germany, Holland, France etc. thirdly Japanese model and Indian model.

Each model has advantages and disadvantages of its own. In following sections, we discuss about these models in detail.
i. Anglo-American Model

This model is known as Anglo-Saxon model of corporate governance. This model is seen in US, Britain, Canada, and Australia and in some commonwealth countries. Here we find unitary board and dispersed ownership. Individual and institutional shareholders are treated alike and it is shareholder oriented model. Shareholders elect the boards who in turn appoint management executives to look after the day to day business activities. Although there is separation of ownership from management, majority of directors are not independent of management. Key decisions are taken with shareholders approval through voting and the existence of strict legal system protects the interests of small shareholders. This system advocates comprehensive disclosure norms and penalty for breaching of organizational code of conduct.

The constituents of the model

The model is constituted by following various groups, each having unique relationship with organisation and each contributing to its success differently. These relationships can be pictorially depicted (Fig. 3.3).

- **Shareholders**: Shareholders are the key component of the model. They elect the board of directors and have voting rights over organisation decisions.
- **Stakeholders**: These are the groups who may directly or indirectly associate with the organisation and who would be affected by its acts.
- **Board of Directors**: This is the elected representative body of shareholders blended with executive and non-executive directors.
- **Others**: These include creditors, government, legal and regulatory systems etc.
ii. German Model

German model is a two tier model where supervisory board monitors the management board. Supervisory board is the apex body constituted with representatives of shareholders and employees. Management board, constituted with insiders and distinct from supervisory board, subordinates the supervisory board. This model is commonly seen in continental European countries such as Germany, Holland, and France. Employee and labour union are given equal representation in par with shareholders.

The laws such as the German Stock Corporation Act and SE Regulations signify the bifurcation between the duties and responsibilities of supervisory and management boards and prohibits any person from holding membership in two boards simultaneously (SE, 2000). The number of supervisory board members to be elected by labour unions and shareholders is determined by the Industrial Democracy Act and the Law on Employee Co-determination and alteration must also be done through law.

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The disclosure norms and enforcement are not very stringent as compared to Anglo-Saxon model although there are a number of regulations in the German model countries.

**The constituents of the model**

As shown in the diagram (Fig. 3.4), German model comprises various key players.

- **Shareholders:** Shareholders have right to elect their representatives to supervisory board and they own organisation. As observed in the Japanese model, German model too has banks as a major group of shareholders.

- **Employees and Labour unions:** Unlike the Anglo-American model, labour unions have rights over other stakeholder groups to elect their representative members to supervisory board. Legal regulations also put more importance on protection of the interests of employees and labour unions.

- **Supervisory Board:** The apex board in the two tier structure of German model is the supervisory board with members elected by shareholders and labour unions. Usually, the board is diverse, independent and comprised with affiliated outsiders and experts from different fields. Supervisory board has rights to appoint a team of executives known as ‘management board’ to look after the daily businesses of the firm and has the responsibility to monitor that team. Generally, supervisory board does not interfere in the day-to-day business matters. However, some of the significant matters that are specified in Article of Incorporation which need to be consulted by supervisory board have to be tackled with the notice and consent of supervisory board.

- **Management Board:** This is a body of executives of the organisation responsible for its management. All members of the management board are insiders to the organisation. And hence, this board is not an independent body.

- **Others:** Banks who hold the shares, lend money sometimes and other group of shareholders do also play a key role as representatives or affiliated outsiders.

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iii. Japanese Model

Japanese model is a structure of corporate governance that revolves around organization, central bank, industrial affiliations and management. It is also called ‘business network model’. This model chiefly found on the ‘Keiretsu’ relationship that found in Japan. It is a business link usually through cross-shareholdings among various firms. The main bank in Japan is major role player with stake in a majority of organizations. This bank lends money, holds shares and provide other services which is less or not seen in Anglo-American model.

The model is mainly featured with a supervisory board having members elected by shareholders. Outside shareholders who are not affiliated with the organization are not given importance and any rights to appoint directors. Thus, in this model boards are formed with insiders and block-holder representatives. And also most of the directors are executives which make board rarely independent of management.

There is a similarity in German and Japanese models in the dominance of banks and financial institutions. In addition, this factor distinguishes it from Anglo-Saxon model.
The constituents of the model

- **Shareholders**: This model, predominantly, has interlocking and cross-shareholdings by banks, financial institutions and other institutional investors. They elect the board of directors.

- **Banks and Financial Institutions**: Japanese companies are largely funded by the main bank through security investments and lending. We can also find a huge number of financial institutions.

- **Supervisory Board**: It is a body of members elected by shareholders and the main bank. The boards are, generally, comprised of inside executives who concurrently head various business divisions. Therefore, the boards’ functions are combined with management functions.

- **President**: In this model president acts as a middleman between supervisory board and executive management, usually board of directors. He is consulted by management for decisions which are later ratified by supervisory board.

- **Management Board**: They manage the organizations. They generally consult president who is a mediating factor between management and supervisory board.

**Fig. 3.5: Japanese Model of Corporate Governance**
iv. Indian Model

Indian model of corporate governance is largely drawn from Anglo-American model and German model of corporate governance. Nevertheless, Indian model stands different because of its unique corporate structure. The Anglo-American model of corporate governance signifies shareholder activism; German model is stakeholder centric while Japanese model signifies business relationships in their model. Different from all these models, Indian model is characterized with family and promoter dominance.

Indian companies’, whether private or public, ownership is a combination of different kinds of shareholders. Families and promoters hold a dominating share in that. And the business environment consists of variety of internal and external stakeholders.

- **Internal environment**: The owners (shareholders such as family members, promoters, general public, banks & financial institutions etc), the board, management, employees closely associate with the organization and have a prominent impact on its functioning.

- **External environment**: External environment is heterogeneous and uncontrollable. Organization bylaws, financial policies, personnel policies, transactions depend on the changes occurring in the external environment such as economic, socio, cultural, regulatory etc. Business firms should update and be aware of this environment.

**Fig. 3.6: Indian model of Corporate Governance**
3.3 History and Development of Corporate Governance: A Global Picture

3.3.1 History

The history of corporate governance is a prerequisite for understanding the contexts of corporate governance developments and reforms that took place over a period of time. The history of corporate governance speaks about the history of ownership of large corporations and the relationship among different groups of people involved in governance of an organization. Corporate governance history in different countries is dealt with individually. The inclusion of a country is based on factors such as history of its industrialization, size of the economy etc.

i. United States

The history of corporate governance in the United States can be traced back to the beginning of twentieth century where many large US firms were held and managed by small number of prosperous entrepreneurs. Later, during 1930s the ownership in US corporations got spread widely which enabled the bifurcation of ownership from management. This led to potential agency problems. Management took the opportunity for serving its own interests and boards which usually had associated with management had very less interference in management acts. Executive pay, lowered corporate earnings were some of the agency issues that found in US. There have been a number of enactments of laws to trouble shoot the governance problems that resulted from changing governance structures and issues over the time. The great US stock market crash of 1929 worried the US government about restoring investor confidence in the stock market, which consequently caused the enactment of Securities Act, 1933, and the Securities Exchange Act, 1934. This act established the Securities and Exchange Commission in June 6, 1934. This aims to protect the interests of all investors irrespective of their quantum of holdings. However, the increased accounting frauds, white collar crimes during 2000s such as Enron required establishment of Sarbanes-Oxley Act in 2002 (these acts are detailed in next sections of the chapter).
ii. United Kingdom

Financial Reporting Council (FRC) body in UK seeks to ensure better corporate governance in companies and thereby safeguarding the interests of the investors. The number of developments in UK corporate governance is result of scandalous acts during 1980s and 1990s in corporate sector. UK stands first compared to any other countries in the number of corporate governance reforms, its wide scope and importance of its coverage.

The UK has a developed market with a wide range of shareholders. Individual as well as institutional shareholders are active participants in UK capital market with varying degrees of involvement. And agency problems are in existence in UK companies.

iii. Germany

German corporations have two tire-board structures. The capital is hugely financed by banks. And banks do play the role of shareholders through their shareholdings. The equity financing was relatively low. However, with the passage of time the equity market has seen an upward movement, reducing the proportion of bank finance in capital structure.

German corporate governance structure has supervisory board (known as Aufsichtsrat) and management board (known as Vorstand). Supervisory board is a group of elected representatives of shareholders and employees. It directs the management board, which is a body of appointed executives. Management of organisation is the duty of management boards. Banks tend to have their representations on the supervisory board due to their huge corporate funding and long term relationship with the firms. An important element of differentiation of German corporate governance system from that of Anglo-Saxon or other unitary board system is employee representation on supervisory board.

In January 2000, the Frankfurt Principles Commission for Corporate Governance developed best corporate governance practices. In May 2000, the German Commission chaired by Professor Theodor Baums was set up the Federal Chancellor to carry study on management and supervision of German companies to suggest for regulatory system reforms on capital market. This commission recommended its German Corporate Governance code to the Federal Government of Germany in 2002.
Same year, in the month of June the Initiative Group developed German Code of Corporate Governance based on current issues on management studies.

Companies’ mismanagement in Germany too called for a relook on the regulations and laws governing the companies’ management. The German Stock Corporation Act made companies binding to submit annually a compliance report on German Corporate Governance Codes. The German Corporate Governance Code has been amended many times to upgrade the codes to suit to the present governance needs and to remove loopholes if any.

iv. France

French government was a significant stakeholder in French public companies, the share of which declined after privatization. Christine A. Mallin (2010)\textsuperscript{62} states that the governance system in France is formulated in civil law context and thus minority shareholders are not well protected. We can see unitary board structure in France and the provision for employee representation on the board. The development in corporate governance sector is marked with the publication of Vienot Committee and Vienot Committee II reports in 1995 and in 1999 respectively. The ‘new economic regulations’ were introduced in 2001. Later in 2002, working group on corporate governance chaired by Daniel Bouton, issued its report. Bouton working group mainly dealt with the role and operations of the board, board composition, evaluation of board of directors, various board committees and other social and environmental issues of corporate governance.

v. China

Governance set up in China had state ownership structure. State Owned Enterprises are in common. Government intervention in firms’ management and controlling were major drawbacks of China’s governance system and ignorance of minority investor’s interests were major drawbacks. Ensuring minority shareholders protection and accurate and timely disclosure are considers to be the essential steps to attract foreign and institutional investors and to have better corporate governance in the country. In January 2001, China Securities Regulatory Commission issued Corporate Governance Code applicable to Chinese listed companies. Practitioners and

academicians took up studies on corporate governance issues. And due to regulatory changes there has been steady and constant evolution in China’s governance structure.

3.3. 2 Global Developments

There are a number of committees and laws enacted on corporate governance in different parts of the world at more or less same time period. The latter half of twentieth century and the beginning of the twenty first century can be undoubtedly called ‘a golden period of corporate governance reforms’. The financial crisis, stock market crash and corporate scandals owe the reasons for developments. The following section is dedicated to major corporate governance laws, regulations and codes which are landmark developments in different parts of the world over a period of time.

3.3. 3 Major International Corporate Governance Committees and Codes

There is a need of laws to check the behavior of individuals and the society at large. In the absence of a set of acceptable behavior, each individual would behave the way he wishes. That would lead to anarchy in the society and the regular lives would be hampered. Similarly, behavior of firms and employees need to be regulated in order to create smooth working environment. Organizational policies and rules serve this purpose. The popular principles and laws of corporate governance originate from significant committees and other institution recommendations. There are committees on corporate governance which laid down structures, principles and governance framework through their extensive studies in the field. The governance reforms evolved with the time and with the requirements of the changing scenario of corporate management. Here we give a picture of some noteworthy international committees, institutions and governments work on corporate governance.
<table>
<thead>
<tr>
<th>Si. No</th>
<th>Committee/ Code</th>
<th>Sponsoring Institute/ Regulatory Authority</th>
<th>Year</th>
<th>Country</th>
</tr>
</thead>
<tbody>
<tr>
<td>i.</td>
<td>Cadbury Committee On Financial Aspects of Corporate Governance</td>
<td>FRC, LSE and Accountancy Profession</td>
<td>1992</td>
<td>United Kingdom</td>
</tr>
<tr>
<td>ii.</td>
<td>Greenbury Committee On Directors’ Remuneration aspect of Corporate Governance</td>
<td>CBI</td>
<td>1995</td>
<td>United Kingdom</td>
</tr>
<tr>
<td>iii.</td>
<td>Hampel Committee on Corporate Governance To review the implementation of Cadbury and Greenbury committees recommendations</td>
<td>FRC, LSE, CBI, IOD, CCAB, NAPF and ABI</td>
<td>1995</td>
<td>United Kingdom</td>
</tr>
<tr>
<td>iv.</td>
<td>The Combined Code on Corporate Governance Codes of Best Practices as listing requirement</td>
<td>FRC</td>
<td>1998</td>
<td>United Kingdom</td>
</tr>
<tr>
<td>v.</td>
<td>Organisation for Economic Cooperation and Development (OECD) Relates to different aspects of Corporate Governance</td>
<td>OECD</td>
<td>1999</td>
<td>Inter-governmental organisation</td>
</tr>
<tr>
<td>vi.</td>
<td>Blue Ribbon Committee To improve the effectiveness of corporate audit committee</td>
<td>SEC, NYSE and NASD</td>
<td>1999</td>
<td>United States</td>
</tr>
<tr>
<td>vii.</td>
<td>Sarbanes-Oxley Act To strengthen auditor independence and financial reporting</td>
<td>US Congress</td>
<td>2002</td>
<td>United States</td>
</tr>
</tbody>
</table>
a. FRC: Financial Reporting Council
b. LSE: London Stock Exchange
c. CBI: Confederation of British Industry
d. Institute of Directors
e. CCAB: Consultative Committee of Accountancy Bodies
f. NAPF: National Association of Pension Funds
g. ABI: Association of British Insurers
h. OECD: Organisation for Economic Cooperation and Development
i. Securities Exchange Commission
j. NYSE: New York Stock Exchange
k. NASD: National Association of Securities Dealers

i. Cadbury Committee, 1992

The Financial Reporting Council, the London Stock Exchange and accountancy profession constituted a ‘Committee on Financial Aspects of Corporate Governance’ in May, 1991. This committee was chaired by Sir Adrian Cadbury and thus referred to as Cadbury Committee. This is the first committee in UK. The committee report-'Financial Aspects of Corporate Governance' was published in December 1992. The Code of Best Practices is the recommendations of the committee.

Committee recommendations

Following are the important recommendation of the Cadbury Committee.

- **Separation of the roles of CEO and board chairman:** The committee opined that the combination of these two roles lead to the imbalances in power and accountability in the organization and give a single person unrestricted power to take decisions. Hence, separation of the head of the company (Chief Executive Officer) and the head of the board (chairman) is desirable as per the committee report.

- **Recommendation on the number of minimum non-executive directors in the board:** Outside (Non-executive directors) directors from diversified communities of the society and with professional and specific expertise bring in independent judgment in business decisions. This will lead to avoidance of
abuse of power by executives. Committee recommended the appointment of at least three non-executive directors.

- **Formulation of an audit committee:** It is recommended by the committee to have an audit committee formed with at least three non-executive directors to look into the accounting and auditing affairs independently. The terms of references of the committee is also considered to be necessary to outline the duties and responsibilities of the committee.

- **Role of institutional investors:** Companies in UK are largely dominated by institutional investors with greater ratio of their shareholdings. However, there found lax control exercises from these institutions. The committee supports the report of the Institutional Shareholders Committee and signifies the role that institutional investors can play through their voting rights in bringing an effective corporate governance system in companies.

- **Compliance with the code:** Annual reports of all listed companies should include a statement on compliance with the code. And non-compliance with any of the code provision must be explained with reasons thereof.

- **Directors remuneration:** All emoluments paid to directors including chairman must be disclosed in the annual reports along with details of salary and performance related payments.

- The board is responsible for presenting a balanced and understandable assessment of company’s position.

### ii. Greenbury Committee, 1995

Greenbury committee was established by the Confederation of British Industry on Corporate Governance. Sir Richard Greenbury, chairman of Marks & Spencer, chaired it. It published its report in the year 1995. Director remuneration and their disclosure were the main concern of the committee.

**Committee Recommendations**

- **Remuneration Committee:** A company must formulate a remuneration committee of non-executive directors to determine executive directors pay. They recommend the appointment of only non-executive directors in order to avoid financial dependency of directors and to avoid their involvement in organization’s management. The annual reports should include the details of
remuneration and the chairman of the committee should attend annual general meeting to attend to the shareholders queries.

- **Disclosure and Approval Provisions:** The remuneration committee is vested with responsibility to report to shareholders through disclosure of remuneration policy and details of remuneration in the annual reports. Annual reports are perceived to be the only means of accountability to shareholders. In case of a service contract which lasts more than one year must be explained with reasons thereof.

- **Remuneration Policy:** Committee’s recommendation on remuneration policy is comprehensive and include following major aspects. Director’s remuneration must be fixed in such a way that it must attract and retain good talent in their boards. However, it should not be too high than others in the industry. Remuneration policy must ensure that performance related pay is in line with members interests. The remuneration committee should consider the provision of annual bonuses and other long term benefits to be extended to directors.

- **Service Contracts:** This recommendation strongly suggests avoiding as much as possible the long service contract periods (more than one year). However, fresh appointments of outside directors can be accompanied by three years contract and subsequently with short service contracts (one year or less than that). In addition, the recommendation embraces the compensation to be paid in case of termination before completion of contract or termination after completion of the contract.

### iii. Hampel Committee on Corporate Governance, 1998

In November 1995 the chairman, Sir Sydney Lipworth of the Financial Reporting Council established the ‘Committee on Corporate Governance’ under the chairmanship of Mr. Ronald Hampel, chairman of ICI Plc. London Stock Exchange, Confederation of British Industry, the Institute of Directors, the Consultative Committee of Accountancy Bodies, the National Association of Pension Funds and the Association of British Insurers sponsored the committee. The aim of the committee was to review the implementation of the recommendations of the Cadbury Committee. The committee gave its final report in January, 1998 which was resulted
from a fresh overview of corporate governance and a review of Cadbury and Greenbury reports. As stated in the report, this committee has touched upon new governance issues and those aspects which took different stand from that of the earlier committees.

**Corporate governance principles**

Unlike the guidelines prescribed by Cadbury and Greenbury committees, Hampel committee gives some principles which can be recognized as good practices. In the committee’s opinion, guidelines measure the compliance whereas; principles narrate how the best practices can be applied in practice. The principles of corporate governance as given in committee report are as under;

- **Directors**
  - Each listed company should have an effective board to lead the company.
  - The decision to combine the roles of chairman and executive head in one individual should be explained publicly.
  - Board should have a proper combination of executive and non-executive directors.
  - Communication of information in appropriate form and quality to the board to enable timely decisions.
  - The existence of a formal and transparent procedure for the appointment of directors to the board.
  - Re-election of directors at regular intervals or at least after every three years.

- **Directors’ remuneration**
  - All directors should be rewarded sufficiently in order to attract and retain directors. And the remuneration should be linked to the corporate performance.
  - There should be a formal and transparent procedure on establishing remuneration policy and to fix remuneration to executive directors.
  - The annual reports of the companies should disclose remuneration policy of the companies and the details of the remuneration of all directors.

- **Shareholders**
  - Institutional shareholders are responsible for making use of the voting rights vested with them.
There should be provision for a dialogue between companies and institutional investors on mutual understandings.

Institutional investors must give weight to all relevant governance arrangements especially relating to board structure and composition of their companies.

Annual general meetings should be used as platform to communicate with private investors and to encourage their active participation in company affairs.

- Accountability and audit
  - The board should present balanced assessment of company’s performance and position through financial reporting.
  - The board should have a sound internal control system to safeguard investor investments and interests.
  - The board should establish arrangements to maintain appropriate relationship with auditors.
  - External auditors should independently report to the shareholders in accordance with statutory and professional requirements. And also it should remind the board of its responsibilities for financial reporting and internal controls.

iv. The Combined Code on Corporate Governance, 1998

The guidelines of Cadbury and Greenbury committees on governance matters were voluntary in nature. The UK government and regulators were pressurized by investing public for a set of mandatory codes on corporate governance. A committee was set up by London Stock Exchange in 1998 and was asked to review earlier committee recommendations and to come up with corporate governance principles applicable to companies listed in London Stock Exchange in the form of listing agreement. Hence, these codes are developed through the reference and consultation of past developments. The codes are based on ‘comply or explain’ principle. It is stated by Financial Reporting Council (2016)⁶³ that, the comply or explain approach is the trademark of corporate governance in UK. On 17th June, 2016 the recent, new

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UK Corporate Governance Code was published which is applicable to listed companies on or after 17th June, 2016.

The Combined Code 1998 had two sections. Section one related to the provisions for companies which include directors, remuneration, relationship with shareholders and audit and accountability. Section two was about provision for institutional shareholders. The codes were revised and updated over different time periods. Combined Code 2003, Combined Code 2006 and the combined code 2008 were important among them. Present study considers the recent code ‘The UK Corporate Governance Code’, April 2016 and the provision of the same have been mentioned here.

- **Leadership**
  - Every company should be headed by an effective board which is collectively responsible for the success of the company.
  - There should be clear division between the responsibilities of the head of the board and head of the business.
  - The chairperson is responsible board leadership and should ensure board effectiveness in all aspects.
  - Non-executive directors should challenge and constructively develop proposals on strategies.

- **Effectiveness**
  - The board and board committees have an appropriate balance of skills, experience, expertise, independence and knowledge of the company to effectively discharge their duties and responsibilities.
  - There should be formal and transparent procedure for the appointment of new directors to the board.
  - All directors should allocate sufficient time for matters and to discharge responsibilities.
  - New directors should be inducted and existing directors should be regularly trained and updated with necessary skills and knowledge.
  - Board should get timely information in a form and of quality in order to discharge its duties.
  - Boards should annually take up rigorous performance evaluation of individual directors, board committees and board as a whole.
All directors are subject to re-election at regular intervals.

- **Accountability and Audit**
  - The board should provide a balanced and understandable evaluation of the company’s position.
  - Board is responsible for determining the nature and extent of risks the organization is willing to take up to achieve its objectives and it should have a risk management and internal control system.
  - Board should establish formal arrangements for applying its risk management, internal control principles and for maintain an appropriate relationship with auditors.
  - There should be a sound internal control system to safeguard the shareholders interests and organization assets.
  - The board should establish an audit committee at least with three independent directors with terms of reference.

- **Remuneration**
  - Executive directors’ remuneration should be designed in such a way that leads to the long term success of the company and performance related elements should be transparent and rigorously applied.
  - There should be a formal and transparent procedure for developing policy on fixing remuneration packages for individual directors. And no director should be involved in determining his or her own remuneration.

- **Relationship with Shareholders**
  - The board is vested with the responsibility to ensure a satisfactory dialogue between organization and institutional shareholders.
  - Board should use Annual General Meeting as a medium of communication with investors and to encourage their participation.

v. **OECD Principles of Corporate Governance, 1999**

Organization for Economic Co-operation and Development (OECD) has developed some principles which have been received positively all around the world as ‘OECD Principles of Corporate Governance’. OECD developed these principles that can reach out to the international groups for adoption. OEEC (Organisation for European Economic Co-operation) was established in the year 1948, which was
reconstituted as OECD in 1960 when the Convention on OECD was signed on 14\textsuperscript{th} December, 1960 in Paris. It is a group of countries who come together to discuss the problems faced in the member countries and to develop policies. The policies are prescriptive in nature, the governments or semi-government or policy makers can make use of them in order to formulate regulation. At present there are 35 members in OECD. Austria, Belgium, Canada, Denmark, France, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States were founding member countries of OECD. Japan, Finland, Australia, New Zealand, Mexico, the Czech Republic, Hungary, Poland, Korea, Chile, Estonia, Israel, Latvia, Slovak Republic and Slovenia joined subsequently (OECD). Also other emerging nations such as India, Africa and Brazil closely work with the organisation.

In 1998, the OECD council was called upon to develop non-binding principles of corporate governance in consultation with governments and other private sector institutions. A task force was set up which gave the corporate governance principles. These principles are foundations for policy makers for further contemplation in respective countries and these principles are benchmark to the investors and market players to analyze the companies’ governance status. The principles relate to the rights of shareholders, their equitable treatment, stakeholder rights, disclosure and transparency and the responsibilities of the board.

- **Protection of shareholders rights:** Shareholders enjoy certain rights over the property and share in the profit, communication of company information etc. Management should act as trustees of the shareholders money in true spirits and must ensure systems to safeguard the shareholders rights. Securing methods of ownership registration, transfer of shares, timely and regular information on corporation, voting in general shareholders meetings, right to elect the board members and share in the company’s profit are the fundamental rights of shareholders.

- **Equitable treatment of shareholders:** All shareholders of an organization should be treated alike without any discrimination such as minority or foreign shareholders. At the same time, in case of violation of their rights, shareholders should be given an opportunity to seek effective redressal.

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\textsuperscript{64} OECD. List of OECD Member Countries. Retrieved from [www.oecd.org](http://www.oecd.org) on 22\textsuperscript{nd} November, 2016.
legal procedure against the violation of rights should not be complex and time consuming that may discourage lawsuit against management or board for violation. Custodians of investors should inform the shareholders, whose shares are held by them, about the options of their voting rights. Insider trading must be prohibited and directors are required to disclose their interests in the transactions that affect the company.

- **Rights of stakeholders:** An effective corporate governance system must ensure that stakeholder rights (as recognized by law) are recognized and protected. There should be a redress system for violation of stakeholders’ rights. Organisation and stakeholders’ co-operation must be encouraged to create wealth, jobs and sustainable corporation. Further encouragement to stakeholder participation in corporate governance should be permitted in governance system and all participating stakeholders allowed access to relevant information.

- **Disclosure and transparency:** A governance framework should ensure timely and fair disclosure of information on ownership and ownership rights, financial and operating results, organization policies and commitments, board members, executives and their remuneration, risks faced by the company and government policies etc. It is opined that, a strong disclosure is key factor in market-oriented monitoring system and shareholders voting is depended on company disclosure. The information should be audited by and independent auditor and the disclosure should follow a high standard which is cost-effective, disseminate timely and easily accessible.

- **The responsibilities of the board:** Directors should act in good faith, in best interest of the shareholders and must exercise due diligence and care and treat all shareholders fairly. They should be well informed about all material facts about the organization. It is obligatory on directors’ part to comply with all applicable rules and regulations. They must devote sufficient time to effectively discharge their function as specified in the articles of the company. Board actions independent of management is a good sign of governance.
vi. Blue Ribbon Committee, 1999

The Blue Ribbon Committee was set by the Securities Exchange Commission, New York Stock Exchange and the National Association of Securities Dealers on 6th October, 1998. The committee was headed by John Whitehead and Ira Millstein. It submitted its report on Improving the Effectiveness of Corporate Audit Committees in the year 1999.

Recommendations of the committee

Following are the major recommendation of the blue ribbon committee report.

- **Composition of audit committee:** Audit committee should have at least three directors all of whom should be independent directors. Also, each member of the committee should be financial literate and at least one of the members must possess accounting and related financial expertise.

- **Audit committee charter:** The written charter of the audit committee and compliance with charter should be disclosed in the proxy statement for annual general meeting of shareholders.

- **Outside auditor appointment and accountability:** The audit committee charter should specify the outside auditors’ accountability to the board and to the audit committee. Further, the audit committee shall hold the authority to propose outside auditor’s appointment and replacement.

- **Discussion with outside auditors:** Outside auditors are required to discuss their judgment about the quality of accounting principles applied by the company in its financial reporting with the audit committee.

- **Chairman certificate:** The chairman of the audit committee must certify the following aspects in the corporate governance report.
  - Should certify that the company management has reviewed the audited financial statements with audit committee.
  - Should certify that the outside auditors have discussed with the audit committee their judgment on quality of the applied accounting principles.
  - Should certify that the information provided to the audit committee have been discussed by audit committee members among themselves without the participation of management in the discussion.
Should certify that the committee believes that the financial statements are presented in conformity with Generally Accepted Accounting Principles.

The recommendations of Blue Ribbon Committee report are mainly contributory to strengthen the audit committee’s role in controlling unlawful financial and auditing practices in US companies.

i. Sarbanes- Oxley Act, 2002

The fall of major corporate undertakings in the United States caused the enactment of Accounting Industry Reform Act, 2002 popularly known as Sarbanes-Oxley Act, called after its sponsors Paul Sarbanes and Michael Oxley, the then senators. The aim of the act is to protect investor interests by regulating the financial disclosure and independent auditing of the company accounts.

Sarbanes- Oxley Act with the purpose of regulating the audit practices in US companies, established Public Company Accounting Oversight Board (PCAOB), a private body of auditors of listed US companies. This is one of the significant outcomes of the Sarbanes-Oxley Act provision. All auditors of listed companies in US have to register themselves with the PCAOB and follow its regulations. Securities Exchange Commission (SEC) has monitoring control over the board and it lays down the rules and regulations for the board. The concerns of PCAOB encompass the matters of increasing audit quality by bringing professionalism.

Other major provisions of the act include:

- CEO and CFO should certify that the annual and quarterly reports submitted by the company are in compliance with the securities laws and they give a fair picture of the company. CEO and CFO’s failure to company with this provision calls for penalty and imprisonment.
- Mandatory rotation and review of auditors by companies at least in every five years.
- Prohibition on certain specified non-audit services and requirement of approval of audit committee for any non-audit service that is not specified.
- Audit service to a company is prohibited if any of the senior management members is associated with the audit committee.
• Forfeiture of bonuses, compensation and stock sale profits in case of restatement of financial statements due to non-compliance with financial reporting provisions.
• Securities Exchange Commission can remove any officer who, it feels unfit to serve and prohibits directors and executives from trading during blackout periods.
• Granting personal loans to executives is prohibited with relaxation to few exceptional cases.
• Disclosure of material changes in financial condition and/or operation is made obligatory.
• Disclosure of off-balance sheet transactions, code of conduct for senior executives and the acting financial expert in audit committee are mandated.

3.4 History and Development of Corporate Governance: India’s Picture

3.4.1 History

The concept of corporate governance, though not a new term in Indian business context, got to be considered with due care from 1990s onwards when India became one of the investors destinations after the economic reforms. The origin of corporate governance in India can be dated back to the periods of Mauryan and Guptha’s empire (Kaushik, N. R., n.d). The Maurya and Guptha’s regime were regarded as the periods of ‘good governance’ and ‘golden period of Ancient India’ respectively. Many governance issues like ethical leadership, societal welfare objectives, selection and placement of right person on the right place on administration, etc., can be seen in Kautilya’s Arthashastra in Chandra Guptha Maurya’s empire.

During the British rulings in India, many British entrepreneurs started commercial and industrial activities. Subhash Chandra Das in his study ‘Corporate Governance in India- An Evaluation’, groups the historical developments in India’s corporate governance under three heads. They are, managing agency system, promoters model and Anglo-American system. The governance systems followed

65 Kaushik, N. R. Corporate governance-its origin in ancient India. DRIEMS business review, 1, 44-50.
until the latter half of the 20th century were Managing Agency system (dominant until 1950s) and Promoters model (dominant until 1990s). In managing agency system, business firms were initially promoted and developed by agents and later shareholdings of which were sold to outside investors. Yet, agents were assigned with managerial functions of the business due to their managerial abilities. Moreover, since the Indian money and capital market were underdeveloped at that time and managing agents were successful in securing finance, investors depended on managing agency system. But, managing agents resorted to multiple and interlocking directorship and inter-corporate investments which gave them high controlling rights and restricted shareholders activism. This system criticized as an irrational system because of the time devoted by agents in managing a large number of organizations simultaneously. The Independent India enacted the Companies Act in 1956 in order to effectively address the managing agency problems. On the recommendations of I.G. Patel committee, The Companies (Amendment) Act 1969 abolished the managing agency system with effect from April 1970 (Das, 2009).

After the introduction of Companies Act 1956, the era of promoter system or model of governance begun to occupy the Indian economic system. In promoter’s model, few strong groups of entrepreneurs promoted new companies with their initial equity investments, raising the balance of the capital from external public groups. Such groups were called promoters. Most of the promoter groups were Indian families and the system dominated by family controlled firms. New regulatory aspects were introduced such as board of directors, appointment of nominee directors, disclosure norms etc., with the objective to protect shareholder rights. However, the problems of inter-locking directorships, inter-corporate investments, and minority shareholders exploitation by controlling shareholder groups were continued and the boards were constituted with the family group members. During the period, Government offered financing schemes through its various agencies such as State Finance Corporation, The Industrial Finance Corporation of India, Industrial Development Bank of India etc. to cater the need for industrial finances. Many commercial banks were also extended the financial services. The significant feature of the promoter system was government intervention in industrial activities through stringent economic and

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industrial policies restricting the functions of the industries. But after liberalization and globalization in the country during 1999s domestic entities started to gain advantage of the policy reforms. And there was a shift from Promoters model towards the Anglo-American model of corporate governance.

After privatization and liberalization move by Indian Government, the Indian economy witnessed increased inflow of foreign firms and capital into India. There were fresh investments and also addition to the existing investments. Strategic alliances, mergers and acquisitions with the global counterparts were common. This caused a change in the governance system. Indian companies too stepped out to international markets. There emerged a need to keep abreast of the global standards. Indian governance standards are greatly influenced and more similar to the Anglo-American system. Confederation of Indian Industry, Securities and Exchange Board of India and many started to work on the reform of corporate governance. The wheel of reforms is yet evolving and continuing to suit the changing needs of the country. In the following section we can see an elaborated discussion on corporate governance developments.

3.4.2 Developments

Confederation of Indian Industry (CII), Securities and Exchange Board of India (SEBI) and Government of India pioneered the work on corporate governance. Various committees set up by these regulatory authorities are the landmark developments in this front. The recommendations of the committees guide corporate entities towards the institutionalization of good governance system. Following table gives a picture of the committees and corporate governance codes prescribed by them.
### Table 3.2:

**Committees/ Codes on Corporate Governance in India**

<table>
<thead>
<tr>
<th>Si. No.</th>
<th>Committees/ Codes</th>
<th>Sponsoring Institute/ Regulatory Authority</th>
<th>Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>i.</td>
<td>Desirable Corporate Governance Code</td>
<td>Confederation of Indian Industry</td>
<td>1998</td>
</tr>
<tr>
<td>ii.</td>
<td>Kumara Mangalam Birla Committee</td>
<td>Securities and Exchange Board of India</td>
<td>1999</td>
</tr>
<tr>
<td>iii.</td>
<td>RBI Report on Corporate governance</td>
<td>Advisory Board of Reserve Bank of India</td>
<td>2000</td>
</tr>
<tr>
<td>iv.</td>
<td>Naresh Chandra Committee</td>
<td>Department of Company Affairs (Government of India)</td>
<td>2002</td>
</tr>
<tr>
<td>v.</td>
<td>Narayan Murthy Committee</td>
<td>Securities and Exchange Board of India</td>
<td>2003</td>
</tr>
<tr>
<td>vi.</td>
<td>J.J. Irani Committee</td>
<td>Ministry of Company Affairs, Government of India</td>
<td>2005</td>
</tr>
</tbody>
</table>

Apart from these committees, many amendments were also made to Companies Act 1956 to ensure and safeguard the interest of minority shareholders and to induce transparent and fair dealings on part of the directors. Many of these committees’ guidelines and recommendations were in line with the international corporate governance practices and they made all efforts to bring in a good system of governance in corporate sector. SEBI’s Clause 49 of the Listing Agreement was implemented in the year 2000 by SEBI as per the recommendations of Kumara Mangalam Birla committee. It contains provisions and guidelines on corporate governance which must be followed by companies listed in Bombay and National Stock Exchanges. This clause was amended in 2004 and new provisions came into existence with effect from 31\textsuperscript{st} December 2005 (See Annexure for clause 49 provisions).

i. **Desirable Corporate Governance Code- Confederation of Indian Industry**

Confederation of Indian Industry is a not-for-profit organisation working as business association. This association was established in 1895. It has nearly 8000 members which include SMEs, MNCs and also has more than two lakh enterprises with indirect
membership. CII works with Government and industries for the development of the nation.

In the year 1995, CII took an initiative to form a task force with Mr. Rahul Bajaj (Ex-President of CII and Chairman, Bajaj Auto Ltd.) being the chairman to develop and promote codes for best corporate governance practices for Indian business firms. In April 1997 the task force presented its draft code on corporate governance in the National Conference and annual session of CII and was subsequently subject to public debates and suggestions. After considering the suggestions and suitable modifications, the final code was published in the year 1998. These codes were called ‘Desirable Corporate Governance- A Code’ which were voluntary in nature.

The recommendations of CII’s Desirable Corporate Governance embrace the aspects of board of directors, re-appointment of board members, key information to be placed before the board, audit committee composition and its role, disclosure of financial information, CEO and CFO certification and others like capital market issues, creditors’ rights, financial institution and nominee directors.

**Major Recommendation of CII**

- An efficient single-tire board can maximize shareholder value as well as two or multi-tire boards
- Listed companies with turnover of more than Rs. 100 crores should have competent, non-executive directors in the ratio 1/3 if board chairman is a non-executive director and 1/2 if the chairman of the board holds the position of managing director.
- It requires non-executive directors to have clearly defined responsibilities and to participate in the board matters actively. Further, non-executive directors should be able to read and understand the accounts and financial statements. And boards should be supplied with all material information about the company.
- It put ceiling on the maximum number of directorships that can be held by a single director. It is prescribed to hold directorships in ten listed companies excluding directorship in subsidiary and associated companies.
Number of board meetings to be held is six with a time gap of two months between two meetings with having agenda items to be discussed. Reappointment of a director should be based on the board meeting attendance of that director. A director who does not have 50% of the attendance is not eligible for reappointment.

Payment of commission on current profits to non-executive directors over and above the sitting fees and to provide stock options to link performance with long term firm value.

Compulsory formulation of audit committee by listed companies with turnover of Rs. 100 crores or with paid capital of Rs. 20 crores, having at least three directors all non-executive and being knowledgeable in finance, accounts and company law.

There should be a clear terms and references for audit committee. Committee is required to assist board in accounting and finance aspects apart from its interaction with statutory and internal auditors.

Disclosure on average high and low share prices in a stock exchange and details about business segments are mandated in ‘Additional Shareholder Information Segment’.

Disclosure of consolidated accounts of the group was made optional.

Stock exchanges were asked to insist on the listed companies to provide compliance certificate signed by CEO and CFO.

Companies were not allowed to accept further deposits until the defaults on fixed deposits are made good.

ii. Kumar Mangalam Birla Committee Recommendations

Securities and Exchange Board of India set up a committee in 1999, which was chaired by Shri Kumar Mangalam Birla. There is a great influence of these recommendation on the Clause 49 of the listing agreement. The recommendations are classified as Mandatory and Non-mandatory recommendations.

Mandatory Recommendations: These include recommendations on essential aspects of governance. Adoption of the same is mandated to have minimum standards of governance in place. These include;
A board should have a minimum of 50% of non-executive directors and the proportions of independent directors being 1/3 in case of non-executive Chairman and 1/2 in case of executive chairman.

Setting up audit committee with minimum three members, majority being independent directors and independent chairman and company secretary acting as committee secretary. At least one member should have accounting and financial knowledge.

Audit committee should meet at least three times in a year. It should meet once to finalise the company accounts. Two members or 1/3rd of the members, whichever is higher must be quorum of the committee.

Audit committee is allowed to approach outside experts for help. Also the committee is required to analyse the reasons for companies defaults in their payments to creditors, shareholders, etc.

Minimum number of board meetings is set at four in a year with a maximum time gap of four months between two meetings.

The limits on committee membership and chairmanship of each and director is set at ten and five respectively across all the companies. Each director must inform the company about his or her membership positions in other companies.

Management is required to disclose its personal interests in the company affairs to the board.

Shareholders should be provided with the details of the directors at the time of their appointment or reappointments.

Board is entrusted the task of determining non-executive directors remuneration. Disclosure of detailed remuneration package in the annual reports is mandated. Further, directors report should include management discussion and analysis report.

A committee should constitute a committee to look into shareholders grievance redressal committee.

- **Non-mandatory Recommendations**: These are some recommendations compliance with which are not mandatory but are desirable.
  - Separation of the roles of CEO and chairman of the board.
Organisations should have a remuneration policy for the determination of remuneration of directors.

Declaration of half-yearly financial performance, encouragement for shareholder participation in AGM and usage of postal ballot etc.

iii. RBI Advisory Group Recommendations

Standing Committee on International Financial Standards and Codes of Reserve Bank of India formed an Advisory Group on Corporate Governance, headed by R. H. Patil. It was constituted in 2000 and submitted its report in 2001. The group considered the corporate governance models and practices of other countries and studied the status of corporate governance in Indian public and private sector companies. It reviewed some international codes such as Combined Code of London Stock Exchange, Cadbury and Greenbury recommendations, to name few. However, OECD principles were taken as benchmark to compare the governance practices in Indian companies.

iv. Naresh Chandra Committee Recommendations

It was set up in 2002 by the Department of Company Affairs, Ministry of Finance and Company Affairs, Government of India. The report of the committee is referred to as ‘Corporate Audit and Governance Report’. The principal objective of constituting this committee was to give recommendations on corporate auditing.

Major Recommendations of the committee

The committee recommends,

- The relationship between auditor and the company is a crucial aspect which would hamper the independence of auditors. Certain non-audit services from statutory auditors are prohibited and any business or personal relations with auditors are also prohibited.
- Committee report included a list of non-audit and disallowed services.
- Management should give disclosure of its contingent liabilities that are viewed by the auditor and auditor should make proper and adequate disclosure of audit findings.
- There was recommendation on appointment and rotation of audit partners and audit firm is required to give its certification of independence annually.
Certification of company annual accounts by CEO and CFO is recommended.

It recommended to set up three independent quality review boards, each for ICAI, ICSI and ICWAI for periodical review of audit and secretarial practices.

It recommended the procedure and disciplinary mechanism for auditors actions.

The report gave recommendations on minimum proportion of independent directors on audit committee and the chairman of the committee is required to certify the extent of fulfillment of committee charter guidelines annually.

One of the significant recommendations is to insert provisions to exempt the non-executive and independent directors from criminal and civil liabilities.

Department of Company Affairs was recommended to provide training to independent directors.

Other important recommendations of the committee are related to appointment of independent directors, minimum board size, disclosure on board and committee meetings, provision of tele and video conferencing for directors.

v. Narayana Murthy Committee Recommendations

This committee on Corporate Governance was constituted by the Securities and Exchange Board of India. It was chaired by Mr. N R Narayana Murthy. The committee submitted its report in February 2003. The reasons behind constitution of this committee are firstly, to evaluate the existing corporate governance practices in India and secondly, to improve the existing standards.

Major recommendations of the committee

- Mandatory Recommendations
  - Audit committee should compulsorily review financial statements, management discussion and analysis reports, compliance reports, letters of internal control weaknesses and related party transactions reports.
  - All members of the audit committee should be financially literate and at least one member should be expert in finance or accounting field.
  - If any accounting treatment used by the company is different from the prescribed standard, then the management should justify the use of alternative treatment. Also, the alternative treatment should be explained in the financial statement’s footnotes.
All related party transactions should be placed before the audit committee for its approval and ratification. This must also include an explanation justifying a transaction which is not in an arm’s length basis.

A mandatory provision is recommended to have procedures to inform board members about risk assessment and minimisation procedures.

The uses of fund collected through IPO should be disclosed to audit committee on quarterly basis and a statement of utilisation of the funds for any purposes other than that specified in the prospectus should be prepared and certified by the independent auditor of the company on annual basis.

Board of directors are required to lay down a code of conduct for directors and senior management which has to be posted on company website. Director and management should affirm compliance on the code annually and CEO and COO should provide declaration on the same.

It suggested to exclude nominee directors from the definition of independent directors.

It gave recommendations on compensation philosophy, non-executive directors compensation and stock option grants ect.

Employees of a company should be made aware of whistle blowing and be given access to audit committee to report the observed unethical practices or wrongdoings.

This report recommended on the board composition, its functions and auditing of subsidiary companies.

- Non-mandatory Recommendations

Other non-mandatory recommendations of the committee include,

- Companies can move towards the regime of an unqualified financial statements.
- Board members may be trained on business model, risk profile of the company, their responsibilities and the effective ways to discharge them.
- Board may constitute a peer group of directors to review the performance of a non-executive director excluding the director being reviewed and this review may be based on for extension of his or her terms of appointment.
vi. J. J. Irani Committee Recommendations

The Ministry of Company Affairs, Government of India set up a committee on corporate governance in the year 2004. Dr. J. J. Irani, former MD of TISCO was head of the committee. The committee was set up with the objective to advise the government on the new company law.

Major Recommendations of the committee

The report of the committee, submitted in 2005, stated the following recommendations.

- Recommended to have at least one third independent directors on the board.
- The recommendations aimed at protection of shareholders rights especially minority shareholders and shareholders are enabled to encourage transparency.
- Transparent disclosure of financial information is recommended.

vii. Naresh Chandra Task Force Recommendations

Confederation of Indian Industry gave desirable code of corporate governance in 1998 which were also been incorporated by other committees. In 2009, CII formed a task force under the chairmanship of Mr. Naresh Chandra.

The objective of the task force is to give voluntary recommendations to companies to boost up the standard of corporate governance practices. The then president of CII, Venu Srinivasan says that mandatory laws and regulations can just be a boundary to be worked within, but most of the best-in-class practices are voluntary (Desirable Corporate Governance- A Code)\(^67\). Hence, CII Task Force aims to give voluntary recommendations. The elements of governance considered in this report are Board of Directors, the auditors, regulatory agencies and external institutions.

Recommendations

- Recommended to constitute a nomination committee to appoint non-executive directors who possess required qualification. And it is recommended to issue letter of appointment to all directors. And letter should include terms of appointment.

- Task force recommends not linking the remuneration of non-executive directors and independent directors to net profit of the company as even well talented directors of startups cannot be paid because of loss in spite of their efforts and talents. Further, the report says, whether remuneration is based on profit or fixed, it must be transparent and disclosed properly.

- Remuneration Committee be set up with at least three non-executive directors, majority with independent directors. It should be delegated with the authority to fix level and structure of compensation for all executive directors including senior management officials one level below the board. And also committees terms of reference, role of the committee, etc., should be disclosed in the annual reports.

- In order to make internal and external auditors independent, it is desirable to have non-executive directors in audit committee.

- It is recommended to separate the two roles of chairman and CEO as the Indian companies are predominantly owned and managed by promoters.

- Task force allows directors to participate in meetings through teleconferencing and video conferencing.

- Independent directors (without executive directors and any executive officer) should meet to openly discuss and check the management of the company. Executive sessions must be regularly convened to hold such meetings. Audit committees should also have executive sessions with internal and external auditors and with management.

- All related party transactions which are not in ordinary course of business, those which are not in arm’s length or any changes to the related party transaction must be kept before the committee for its approval.

- It put ceiling on audit fees audit to be collected from clients. And a company must obtain a certificate of independence from the audit firm regarding not
providing any kind of non-audit services to the company and the revenue earned by audit firm.

➢ The auditor is held responsible for the negligence of duty which is also to be prescribed to the listed companies. While the individual partner will have unlimited liability, all other members of the audit firm will have limited liability to the extent of their paid-up capital.

➢ It is the responsibility of the audit committee to scrutinize the profile of the audit firm, the qualification and experience of audit partners before their appointment. The important roles of audit committee are, a. to check the authenticity of the documentation and certificate of independence, b. to discuss the annual work program with auditors and c. to recommend board the appointment, reappointment or removal of existing auditors and auditors’ remuneration.

➢ This recommendation is for the Institute of Chartered Accountants of India, requiring them to constitute a committee of government directors and experts to standardize the language of disclaimer by auditors stating their qualification. Auditor needs to give explanation in case of deviations or being out of the scope of the disclaimer.

➢ It recommended to have a whistle blower policy in the company for reporting misconducts to the concerned authority by any employee who witnessed it. It also recommends adding a provision in the listing agreement which provides statutory protection to the whistle blowers. This shows the concern for whistle blowers and also encourages them not to tolerate mis-behaviors.

➢ There must be a risk management mechanism in the company. The board, audit committee and executive management should identify potential risks to the company and disclose the process adopted for risk identification, minimization and risk management policy.

➢ Task force suggests government to intervene in the ICAI’s functioning to strengthen the audit quality review mechanism by setting up a committee like PCAOB in the US.

➢ Institutional investors must actively participate in the management and oversee the corporate conduct through their nominees. Minority shareholders too should analyse and review company policies and actions in general meetings by assuming a responsible role.
3.5 Conclusion

The origin of corporate governance is deep-rooted in the historical evolution in different countries across the world. The scope of corporate governance is very vast and includes various mechanisms, which are based on principles of transparency, fairness and ethics. Governance practices have been constantly reviewed and reformed. The efforts of international and Indian regulators and various institutions have been successful in dealing with the important aspects of the area. They encompass aspects of directors’ duties and responsibilities, their remuneration, proportion of non-executive and independent directors, terms of reference of audit committees, ownership, investor protection etc. In this chapter, an attempt has been made to give an elaboration on the concept of corporate governance and its historical developments.