LANDMARKS IN THE EMERGENCE OF CORPORATE GOVERNANCE

OBJECTIVES

Corporate governance as a desideratum for orderly development of an economy has evolved over the past three decades, and, in its present system and structure, is the outcome of studies, research and the sum total of responses by regulators of corporate scams and debacles. This chapter traverses through the history of evolution of the concept and system of corporate governance over the years, both in the West and in India.

Introduction

There has been a perceptible change in people's minds as to the objective of a corporation - from one which was intended to benefit exclusively the shareholders to one which is expected to benefit all its stakeholders. The corporate scams and frauds that came to light have brought about a change in the thinking of advocates of free enterprise that the system was not self-regulatory and needed substantial external regulation, which should penalise the wrongdoers while those who abide by the rules of the game are amply rewarded by the market forces.

Introduction (contd)

All these measures have brought about a metamorphosis in corporations that realised that the people who invest in corporations are pretty serious about corporate governance; hence they started internalising these values and later adopting them, initially *albeit* selectively and sporadically.

Developments in the USA

Corporate governance gained importance with the occurrence of the Watergate scandal in the United States. Thereafter, as a result of subsequent investigations, the US regulatory and legislative bodies were able to highlight control failures that had allowed several major corporations to make illegal political contributions and to bribe government officials. In *1979 by the Securities and Exchange Commission's* proposals for mandatory reporting on internal financial controls.

Developments in the USA (contd)

In 1985, following a series of high profile business failures in the USA, the most notable one being the Savings and Loan collapse, *the Treadway Commission* was formed to identify the main causes of misrepresentation in financial reports and to recommend ways of reducing incidence thereof. *The Treadway Report* published in 1987 highlighted the need for a proper control environment, independent audit committees and an objective internal audit function and called for published reports on the effectiveness of internal control.

Developments in the UK

In England, the seeds of modem corporate governance were probably *sown by the BCCI scandal*. BCCI was a global bank, constituting multiple layers of entities related to one another through an impenetrable series of holding companies, affiliates, subsidiaries, banks-within-banks, insider dealings and shareholder (nominee) relationships. With this corporate structure of BCCI and shoddy record-keeping, regulatory review and audits, the complex BCCI family of entities was able to evade ordinary legal restrictions on the movement of capital and goods as a matter of daily practice and routine.

Cadbury Committee on Corporate Governance, 1992

The stated objective of the Cadbury Committee was "to help raise the standards of corporate governance and the level of confidence in financial reporting and auditing by setting out clearly what it sees as the respective responsibilities of those involved and what it believes is expected of them".

Cadbury Committee on Corporate Governance, 1992 (contd)

The Cadbury Code of Best Practices had 19 recommendations.

Relating to the board of directors, the recommen-dations are:

- The Board should meet regularly, retain full and effective control over the company and monitor the executive management.
- There should be a clearly accepted division of res-ponsibilities at the head of a company, which will ensure balance of power and authority, such that no individual has unfettered powers of decision.

Cadbury Committee on corporate Governance, 1992 (contd)

- The board should include non-executive directors of sufficient calibre and number for their views to carry significant weight in the board's decisions.
- All directors should have access to the advice and services of the Company Secretary, who is res- ponsible to the Board for ensuring that board procedures are followed and that applicable rules and regulations are complied with. Any question of the removal of company secretary should be a matter for the board as a whole.

Cadbury Committee on corporate Governance, 1992 (contd)

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Cadbury Committee on corporate Governance, 1992 (contd)

Relating to the non-executive directors the recommendations are:

- **Non-executive directors should bring an independent judgment to bear on issues of strategy, performance, resources, including key appointments, and standards of conduct.**
- **Non-executive Directors should be appointed for specified terms and reappointment should not be automatic.**
- **Non-executive Directors should be selected through a formal process and both, this process and their appointment, should be a matter for the Board as a whole.**

On reporting and controls, the Cadbury Code of Best Practices stipulate the following:

- It is the Board's duty to present a balanced and understandable assessment of the company's position.
- The Board should ensure that an objective and professional relationship is maintained with the Auditors.
- The Board should establish an Audit Committee of at least 3 Non-Executive Directors with written terms of reference, which deal clearly with its authority and duties.
- The Directors should explain their responsibility for preparing the accounts next to a statement by the Auditors about their reporting responsibilities.
- The Directors should report on the effectiveness of the company's system of internal control.

Sarbanes-Oxley Act, 2002

The Sarbanes--Oxley Act (SOX Act), 2002 is a serious attempt to address all the issues associated with corporate failures to achieve quality governance and to restore investor confidence. The Act contains a number of provisions that dramatically change the reporting and corporate directors governance obligations of public companies, the directors and officers.

Sarbanes-Oxley Act, 2002 (contd)

Important provisions contained in SOX Act are briefly given below:

Establishment of Public Company Accounting Oversight Board (PCAOB)

All accounting firms will have to register themselves with this board and submit among other details particulars of fees received from public, company clients for audit and non-audit services, financial information about the firm, list of firms staff who

Sarbanes-Oxley Act, 2002 (contd)

participate in audits, quality control policies, information on civil criminal and disciplinary proceedings against the firm or any of the staff.

The board will conduct annual inspections of firms, which audit more than 100 public companies, and once in three years in other cases. The board will establish rules governing audit quality control, ethics, independence and other standards. It can conduct investigations and displinary proceedings and can impose sanctions on auditors. The board reports to SEC.

Indian Committees and Guidelines

Working Group on the Companies Act, 1956.

The government accordingly set up a Working Group in August 1996 for this purpose.

The Working Group on the Companies Act has recommended a number of changes and also prepared a working draft of Companies Bill 1997. The Bill was introduced in the Rajya Sabha on 14 August 1997, containing the following recommendations.

SEBI's Initiatives

- **The Securities and Exchange Board of India (SEBI) appointed a committee on corporate governance on May 7, 1999, with eighteen members under the Chairmanship of Kumar Mangalam Birla to promoting and raising the standards of corporate governance.**

Kumar Mangalam Birla Committee

- **The Committee's recommendations consisted of (i) mandatory recommendations, and (ii) non-mandatory recommendations.**

Mandatory Recommendations

1. **Applicability**

- **Applicable to all listed companies with paid-up share capital of Rs. 3 crore and above**

2. **Board of directors**

- **The Board of Directors of a company must have an optimum combination of executive and non-executive Directors. The number of independent Directors should be at least one-third in case the company has a non-executive Chairman and at least half of the Board in case the company has an executive Chairman.**

Mandatory Recommendations (contd.)

3. **Audit Committee**

The Audit Committee should have a minimum 3 members.

The Chairman should be an independent Director and must be present at the Annual General Meeting to answers shareholders' queries.

Remuneration Committee of the Board

The Board of Directors should decide the remuneration of non-executive directors.

Full disclosure of the remuneration package of all the directors covering salary benefits, bonuses, stock options, pension fixed component, performance linked incentives along with the performance criteria, service contracts, notice period, severance fees, etc., is to be made in the section on corporate governance of the annual report.

Board Procedures

- The Board meeting should be held at least four times a year with a maximum time gap of four months between any two meetings.

Management

- Management discussions and analysis report covering industry structure, opportunities and threats, segment-wise or product-wise performance outlook, risks, internal control systems, etc. are to form a part of Directors Report or as an addition thereto.

Shareholders

- **In case of appointment of a new Director or re-appointment of existing Director, information containing a brief resume, nature of expertise in specific functional areas and companies in which the person holds Directorship, Committee Membership, must be provided to the benefit of shareholders.**

Shareholders (contd.)

- **A Board committee under the chairmanship of a non-executive director is to be formed to specifically look into the redressing of shareholder complaints of declared dividends etc.**

Shareholders (contd.)

- **In order to expedite the process of share transfers, the Board should delegate the power of share transfer to an officer or a committee or to the Registrar and share transfer agents with a direction to the delegated authority to attend to share transfer formalities at least once in a fortnight.**

Non-mandatory Recommendations

1. **Chairman of the Board**

The Chairman's role should in principle be different from that of the Chief Executive, though the same executive can perform both the roles.

Non-mandatory Recommendations (contd.)

2. **Remuneration Committee**

   The Board of Directors should set up a Remuneration Committee to determine on their behalf and on behalf of the shareholders with agreed terms of reference the company's policy on specific remuneration packages for executive directors including pension rights and any other compensation payment.

Non-mandatory Recommendations (contd.)

3. **Shareholders' Rights**

   Half-yearly declaration of financial performance including summary of the significant events in the six months should be sent to each of the shareholders.

4. **Postal Ballot**

NARAYANA MURTHY COMMITTEE REPORT, 2003

The Committee on Corporate Governance set up by SEBI under the Chairmanship of N.R.Narayana Murthy which submitted its Report in February, 2003

NARAYANA MURTHY COMMITTEE REPORT, 2003 (contd.)

The Committee's report expresses its total concurrence with the recommendations contained in the Naresh Chandra Committee's report on

- **Disclosure of contingent liabilities**
- **Certification by CEO and CFO**
- **Definition of independent directors**
- **Independence of audit committees**

Mandatory Recommendations

Audit Committee:

An Audit Committee is the bedrock of quality governance.

The Committee recommended a bigger role for the audit committee.

Narayana Murthy’s Committee has not taken a view on rotation of auditors

Related Party Transactions

A statement of all transactions with related parties including their bases should be placed before the audit committee for formal approval/ratification

Proceeds from Initial Public Offerings

Companies raising money through initial public offering should disclose to the audit committee the uses and application of funds under major heads on a quarterly basis.

Risk Management

- The Committee has deemed it necessary for the boards of companies to be fully aware of the risks involved in the business and that it is also important for shareholders to know about the process by which companies manage their business risks. The mandatory recommendations in this regard are:

Risk Management (contd.)

- "Procedures should be in place to inform board members about the risk assessment and minimisation procedures. These procedures should be periodically reviewed to ensure that executive management controls risks through means of a properly defined framework."

Risk Management (contd.)

- **Management should place a report before the entire board of directors every quarter documenting the business risks faced by the company, measures to address and minimise such risks and any limitation to the risk-taking capacity of the corporations. The board should formally approve this document.**

Code of Conduct

- The Committee has recommended that it should be obligatory for the board of a company to lay down a code of conduct for all board members and senior management of the company. This code should be posted on the company's website

Nominee Directors

- **The Committee recommended doing away with nominee directors. If a corporation wishes to appoint a director on the board, such appointment should be made by the shareholders.**