

# CORPORATE GOVERNANCE CODES AND STANDARDS

17

## INTRODUCTION

**17.1** The confidence of investors in 1990's was adversely affected by several corporate scandals including the collapse of Asil Nadir's Polly Peck, the pension scandal of Robert Maxwell's Mirror Group and Barings Bank collapse. The need for principles/standards for good corporate governance was felt in light of these corporate scandals Three significant UK government committees (Cadbury, Greenbury and Hampel), were commissioned during the 1990s to address the issues related to governance.

## CADBURY REPORT (UK), 1992

**17.2** Cadbury Report titled, *Financial Aspects of Corporate Governance*, was produced under the chairmanship of Sir Adrian Cadbury. It aimed at improving disclosure of information to shareholders, reinforce self-regulation and suggest measures to ensure auditor's independence. It gave the Cadbury Code of Best Practice.

Summary of the recommendations is as follows:

Aspect	Recommendation
<b>Role of Board of Directors and composition of the Board</b>	<ul style="list-style-type: none"> <li>◆ The board should meet regularly, retain full and effective control over the company and monitor the executive management.</li> <li>◆ The board should include qualified and experienced non-executive directors in adequate number and their views should carry significant weight in the board's decisions.</li> <li>◆ All directors should have access to the advice and services of the experts, if necessary, and that of company secretary as well. He is responsible for ensuring that board procedures are followed and applicable rules and regulations are complied with. Any question of the removal of the company secretary should be a matter for the board as a whole</li> </ul>
<b>Role of non-Executive Directors</b>	<ul style="list-style-type: none"> <li>◆ Non-executive directors should be independent of management and should have no conflict of interest with the company.</li> <li>◆ They should be appointed for specified terms and reappointment should not be automatic.</li> <li>◆ They should be selected through a formal process and both this process and their appointment should be a matter for the board as a whole.</li> </ul>
<b>Role of Executive Directors</b>	<ul style="list-style-type: none"> <li>◆ Directors' service contracts should not exceed three years without shareholders' approval.</li> <li>◆ There should be full disclosure of directors' total emoluments in the company's Annual Report.</li> <li>◆ Remuneration Committee consisting of Non-executive directors or a majority of them should recommend the pay for executive directors</li> </ul>
<b>Reporting and control mechanism</b>	<ul style="list-style-type: none"> <li>◆ It is the board's duty to present an assessment of the company's position which is a balanced and easily understandable.</li> </ul>

Aspect	Recommendation
	<ul style="list-style-type: none"> <li>◆ Each listed company should constitute Audit Committee with a minimum of three non-executive directors.</li> <li>◆ Auditors should be rotated.</li> <li>◆ The directors should explain their responsibility for preparing the accounts next to a statement by the auditors about their reporting responsibilities.</li> <li>◆ The directors should report on the effectiveness of the company's system of internal control.</li> <li>◆ The directors should report that the business is a going concern, with supporting assumptions or qualifications as necessary</li> </ul>
Separation of roles	<ul style="list-style-type: none"> <li>◆ A single person should not be vested with the decision-making power <i>i.e.</i>, the role of chairman and chief executive should be separated clearly.</li> </ul>
Shareholders	<ul style="list-style-type: none"> <li>◆ Institutional investors/shareholders should take positive interest in the board functioning and make judicious use of their voting rights</li> </ul>

### GREENBURY REPORT (UK), 1995

17.3 In order to identify good practice in determining directors' remuneration, the Confederation of Business and Industry (CBI) established a Study Group on Directors' Remuneration under the chairmanship of Sir Richard Greenbury. The majority of the recommendations were incorporated in Listing Rules of London Stock Exchange.

It submitted its report in 1995 and some of its important recommendations are as follows:

- (i) **Remuneration Committee** - BOD of each company should have a remuneration committee composed of non-executive directors. Remuneration Committee should be responsible to determine the remuneration of CEO and executive directors.
- (ii) **Remuneration Policy** - Responsibility of the committee in determining the remuneration policy.
- (iii) **Disclosure** - Information on remuneration policy should be disclosed in the annual report and accounts.
- (iv) **Service contracts** - Contracts with directors should be renewable each year rather than three years as suggested by Cadbury.
- (v) **Annual Compliance Statements** - UK PLCs should implement the Code and make Annual Compliance Statements including explanations if it is not complied with.

### HAMPEL REPORT (UK), 1998

17.4 The Hampel Committee was established under the chairmanship of Sir Ronald Hampel to review and revise the earlier recommendations of the Cadbury and Greenbury Committees. Some of the important recommendations of Hampel Committee were:

- (i) **Combined Code** - It suggested that all the Cadbury and Greenbury principles be consolidated into a "Combined Code".
- (ii) **Disclosure of Remuneration** - All kinds of remuneration including pensions should be disclosed.
- (iii) **Approval of Directors' Remuneration** - Hampel emphasised that directors' remuneration should not be a matter of shareholder approval in general meeting.
- (iv) **Separation of chairman and chief executive posts** - The role of Chairman and Chief Executive should not be performed by same person, preferably.
- (v) **Executive and non-executive directors** - There should be a balance between executive and non-executive directors and no group should dominate the other. The BODs should be provided with suitable and necessary information on a timely basis.

### 17.5 OTHER IMPORTANT REPORTS

- (i) **The Turnbull Committee Report 1999** - This report recommended that the board of directors should be more actively involved in internal control procedures and risk management.
- (ii) **The Higgs Report 2003** - The Higgs Report was UK's response to Enron disaster in the USA. It emphasized that the non-executive directors should play an increasingly important role in the running of a company.
- (iii) **The Smith Report 2003** - The Smith Report formulated guidelines to help audit committees perform their role effectively.

### THE SARBANES-OXLEY ACT OF 2002 (USA)

**17.6** The collapses of energy giant Enron and telecom major Worldcom shook public confidence in US large corporations. In order to restore public confidence and trust in capital markets, the US government introduced the Sarbanes-Oxley Act of 2002 drafted by US Senator Paul Sarbanes and US Congressman Michael Oxley. It has been said to be most dynamic securities legislation in recent times. Some of the main areas of the Act are:

- (i) **Public Company Accounting Oversight Board** - It was created to oversee the audit of public companies. All accounting firms that audit publicly traded companies must register with the Oversight Board. It also has the power to establish and amend rules and standards; enforce compliance and penalise them in case of non-compliance.
- (ii) **Auditor Independence** - It has given a list of non-audit services (such as book-keeping, financial information systems design, actuarial services, internal audit) that cannot be taken up for the client by the auditor. Non-audit services (such as tax services) which do not fall in the specified list, are not banned but must be pre-approved by audit committee. The Act has imposed a one-year waiting period for such employees of audit firm who leave it to become an employee for a former client.
- (iii) **Corporate Responsibility** - Companies must constitute audit committee comprising board members who do not have financial ties with it. CEOs and CFOs must certify the truthfulness and accuracy of financial statements underlying audit reports.
- (iv) **Enhanced Financial Disclosures** - All off-balance sheet transactions that may affect financial status must be disclosed in periodic reports. Personal loans from a corporation to its CEOs and CFOs are now largely prohibited (limited exceptions include company credit cards). Annual reports must contain report which state that management is responsible for establishing internal control and ensuring their effectiveness - this fact must be attested to by the auditor.
- (v) **Analyst conflict of Interest** - It stresses the need for code of conduct for securities analysts and requires them to disclose known conflict of interest. The analyst has to report whether he or she holds any securities in the company or has received corporate compensation. Brokers and dealers are also required to disclose if the public company is their client.
- (vi) **Corporate and Criminal Fraud Accountability** - Manipulating, destroying, concealing or falsifying records or documents with the intention of obstructing federal investigation invites fines and imprisonment up to 20 years. Work papers must be retained by the auditor for at least 5 years. The Act provides protection for whistle blowers.

### G20/OECD PRINCIPLES OF CORPORATE GOVERNANCE

**17.7** Organisation for Economic Cooperation and Development (OECD) Principles of Corporate Governance ("the Principles") were first published in 1999. These were updated in 2004 and have been revised in 2015. The current review has been carried out by the OECD Corporate Governance Committee with all G20 countries invited to participate. Experts from key international institutions, like the Basel Committee and the World Bank Group have also participated actively in the review.

The Principles are non-binding. They are intended to "provide a robust but flexible reference for policy makers and market participants to develop their own frameworks for corporate governance".

The Principles provide guidance through recommendations across six areas:

- (i) **Effective corporate governance framework** - The corporate governance framework should
  - ◆ promote transparent and fair markets
  - ◆ the efficient allocation of resources
  - ◆ be consistent with the rule of law and
  - ◆ support effective supervision and enforcement.
- (ii) **The rights and equitable treatment of shareholders** - The corporate governance framework should
  - ◆ protect and facilitate the exercise of shareholders' rights
  - ◆ ensure the equitable treatment of all shareholders, including minority and foreign shareholders
  - ◆ provide for effective redress for violation of their rights.
- (iii) **Institutional investors, stock markets and other intermediaries** - The corporate governance framework should ensure that
  - ◆ institutional investors act in a fiduciary capacity
  - ◆ intermediaries act with integrity and
  - ◆ there is fair and effective price discovery in stock markets
- (iv) **Stakeholders** - The corporate governance framework should recognise the rights of stakeholders and encourage active co-operation between corporations and stakeholders.
- (v) **Disclosure and transparency** - The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.
- (vi) **The responsibilities of the Board** - The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the Board, and the Board's accountability to the company and the shareholders.