**Corporate Governance - The ABC of It**

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In recent years, there have been perceptible changes in the corporate ownership on account of exponential growth of capital market activities, and active monitoring of corporate activities by financial institutions. The globalization efforts have rendered overall corporate scenario complex and challenging necessitating urgent review of the system of corporate governance with particular emphasis on reporting and accountability, the role of financial institutions, non-executive directors, managing directors, chairman and audit committee, and the relationship between stock exchanges and companies and also companies and investors.

Corporate Governance, a phenomenon of recent origin in the wake of increasing competition and globalization, stipulates parameters of accountability, control and reporting functions of the Board of Directors and encompasses the relationship among various participants in determining the direction and performance of the corporation, the Board, management team, shareholders and other stake-holders

Historical Perspective

The seeds of modern Corporate Governance were probably sown by the Watergate scandal in the United States. As a result of subsequent investigations, US regulatory and legislative bodies were able to highlight control failures that had allowed several major corporations to make illegal political contributions and to bribe government officials. This led to the development of the Foreign and Corrupt Practices Act of 1977 in USA that contained specific provisions regarding the establishment, maintenance and review of systems of internal control.

This was followed in 1979 by the Securities and Exchange Commission of USA's proposals for mandatory reporting on internal financial controls. In 1985, following a series of high profile business failures in the USA, the most notable one of which being the Savings and Loan collapse, the Treadway Commission was formed. Its primary role was 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. It called for published reports on the effectiveness of internal control. It also requested the sponsoring organisations to develop an integrated set of internal control criteria to enable companies to improve their controls.

Accordingly COSO (Committee of Sponsoring Organisations) was born. The report produced by it in 1992 stipulated a control framework which has been endorsed and refined in the four subsequent UK reports: Cadbury, Rutteman, Hampel and Turnbull. While developments in the United States stimulated debate in the UK, a spate of scandals and collapses in that country in the late 1980s and early 1990's led shareholders and banks to worry about their investments. These also led the Government in UK to recognise that the then existing legislation and self-regulation were not working.

Companies such as Polly Peck, British & Commonwealth, BCCI, and Robert Maxwell's Mirror Group News International in UK were all victims of the boom-to-bust decade of the 1980s. Several companies, which saw explosive growth in earnings, ended the decade in a memorably disastrous manner. Such spectacular corporate failures arose primarily out of poorly managed business practices.

Efforts by London Stock Exchange Cadbury Committee

It was in an attempt to prevent the recurrence of such business failures that the Cadbury Committee, under the chairmanship of Sir Adrian Cadbury, was set up by the London Stock Exchange in May 1991. The committee, consisting of representatives drawn from the top levels of British industry, was given the task of drafting a code of practices to assist corporations in U.K. in defining and applying internal controls to limit their exposure to financial loss, from whatever cause.

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".

The Committee investigated accountability of the Board of Directors to shareholders and to the society. It submitted its report and associated "Code of Best Practices" in Dec 1992 wherein it spelt out the methods of governance needed to achieve a balance between the essential powers of the Board of Directors and their proper accountability

The resulting report, and associated "Code of Best Practices," published in December 1992, was generally well received. Whilst the recommendations themselves were not mandatory, the companies listed on the London Stock Exchange were required to clearly state in their accounts whether or not the code had been followed. The companies who did not comply were required to explain the reasons for that.

The Cadbury Code of Best Practices had 19 recommendations. Being a pioneering report on Corporate Governance, it would be in order to view a brief gist of the Recommendations of Cadbury Committee given in the column to the right

Cadbury Committee and After

It would be interesting to note how the corporate world reacted to the Cadbury Report. The report in fact shocked many by its boldness, particularly by the Code of Practices recommended by it. The most controversial and revolutionary requirement and the one that had the potential of significantly impacting the internal auditing, was the requirement that ' the Directors should report on the effectiveness of a company's system of internal control.' It was the extension of control beyond the financial matters that caused the controversy.

Paul Ruthman Committee constituted later to deal with this controversy watered down the proposal on the grounds of practicality. It restricted the reporting requirement to internal financial controls only as against the 'the effectiveness of the company's system of internal control' as stipulated by the Code of Practices contained in the Cadbury Report.

It took another 5 years to get the original Cadbury recommendations on internal control reporting re-instated. Public confidence in U.K. continued to be shaken by further scandals and Ron Hampel was given the task of chairing the 'Committee on Corporate Governance' with a brief to keep up the momentum by assessing the impact of Cadbury and developing further guidance.

The Final Report submitted by the Committee chaired by Ron Hampel had some important and progressive elements, notably the extension of Directors' responsibilities to 'all relevant control objectives including business risk assessment and minimising the risk of fraud…'

The Combined Code was subsequently derived from Ron Hampel Committee's Final Report and from the Cadbury Report and the Greenbury Report. (Greenbury Report, which was submitted in 1995, addressed the issue of Directors' remuneration). The Combined Code is appended to the listing rules of the London Stock Exchange. As such, compliance is mandatory for all listed companies in the U.K.

The stipulations contained in the Combined Code require, among other things, that the Boards should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets and that the Directors should, at least annually, conduct a review of the effectiveness of the Group's system of internal control and should report to shareholders that they have done so and that the review should cover all controls, including financial, operational and compliance controls and risk management.

Subsequent developments with regard to Corporate Governance in U.K. led to the publication of Turnbull Guidance in September 1999, which required the Board of Directors to confirm that there was an on-going process for identifying, evaluating and managing the key business risks. Shareholders, after all, are entitled to ask if all the significant risks had been reviewed (and presumably appropriate actions taken to mitigate them) and why was a wealth-destroying event not anticipated and acted upon?

In this context, it was observed that the one common denominator behind the past failures in the corporate world was the lack of effective Risk Management. As a result, Risk Management subsequently grew in importance and is now seen as highly crucial to the achievement of business objectives by the corporates.

It was clear, therefore, that Boards of Directors were not only responsible but also needed guidance not just reviewing the effectiveness of internal controls but also for providing assurance that all the significant risks had been reviewed. Furthermore, assurance was also required that the risks had been managed and an embedded risk management process was in place. In many companies this challenge was being passed on to the Internal Audit function.

Indian Experience

The corporate world in India could not remain indifferent to the developments that were taking place in the U.K. In fact the developments in U.K had tremendous influence on our country too. They triggered the thinking process in our country, which finally led us to laying down our own ground rules on Corporate Governance.

As a result of the interest generated in the Corporate sector by the Cadbury Committee's report, the issue of Corporate Governance was studied in depth and dealt with by the Confederation of Indian Industries (CII), the Associated Chamber of Commerce and the Securities and Exchange Board of India (SEBI). Though some of the studies did touch upon shareholders' right to `vote by ballot' and a few other issues of general nature, none can claim to be wider than the Cadbury report in scope.

The stress in the Cadbury report is on the crucial role of the Board and the need for it to observe a Code of Best Practices. Its important recommendations include the setting up of an Audit Committee with independent members. The Cadbury model is one of self-regulation. It was recognized that in the event British companies failed to comply with the voluntary code, legislation and external regulation would follow.

Some of the important initiatives taken in our country to frame the ground rules on Corporate Governance are described in the book

In India, the emphasis during the past few years has been limited to only some of the recommendations of the Cadbury Committee -- such as the role and composition of the Audit Committees and the importance of making all the necessary disclosures with annual statements of accounts, which are considered important for investors' protection. More about Indian experiments and ongoing development of the philosophy of Corporate Governance in business and in banks discussed in subsequent pages.

\Basic Facts About Corporate Governance

Corporate Governance is a voluntary ethical code of business of companies. According to Cadbury Committee on financial aspects of Corporate Governance: it is a system by which companies are directed and controlled. The board of directors is responsible for the governance of their companies. The shareholders role in the governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place.

Governance in relation to business organization concerns with the intrinsic nature, purpose, integrity and identity of the organization and focuses primarily on the relevance, continuity and fiduciary aspects of the organization. It involves monitoring and overseeing strategic direction, socio-economic and cultural context, externalities and constituencies of the organization. Hence corporate governance may be called as an umbrella term encompassing specific issues arising from interactions among senior management personnel, shareholders, board of directors, other constituencies and the society at large. It deals with the exercise of power over the directions of enterprise, the supervision of executive actions, acceptance of a duty to be accountable and regulation of the affairs of the corporation.

Corporate Governance & its Mission

Corporate Governance is a process or set of systems and processes to ensure that the company is managed to suit the best interests of all. The systems which can ensure this may include structural and organizational matters. The stakeholders may be internal stakeholders (promoters, members, workmen and executives) and external stakeholders (shareholders, customers, lenders, dealers, vendors, bankers community and regulators). Corporate Governance is concerned with the establishment of a system, whereby the directors are entrusted with responsibilities and duties in relation to the direction of corporate affairs. It is concerned with the accountability of persons who are managing it towards the stakeholders. It is concerned with the morals, ethics, values, parameters, conduct and behaviour of the company and its management.

Emphasis on Transparency, Integrity and Accountability of the Management

It is a system of making management accountable to the shareholders for effective management of the companies, in the interest of the company and also with adequate concern for ethics and values. Corporate governance recognizes issues like maintaining continuity of succession planning, identifying opportunities, facing challenges and managing changes with the business and allocation of resources towards the right priority.

Corporate Governance mainly consists of two elements, namel

1. A long-term relationship, which has to deal with checks and balances, incentives of managers and communication between management and investors.
2. The second element is transactional relationship involving matters relating to disclosures and authority.

Corporate Governance deals with laws, procedures, practices and implicit rules that determine a company's stability to take managerial decision vis-à-vis its elements, particularly its shareholders, creditors, state and employees. Corporate governance refers to an economic, legal and institutional effort that allows companies to diversify, grow, restructure and exit and do everything necessary to maximise long-term shareholders value.

With increasing awareness, investors will no longer depend on regulators to protect them. They will on their own shifty allegiance and do so overnight to companies which maximise shareholder value. The key differentiation, with everything being common, will be the ability to create self-driven, self-assessed, self-regulated organization with a conscience. That ultimate of what corporate governance in India has to be all about.

Corporate Governance and Corporate Management

The difference between Corporate Governance and Corporate Management is clearly activity oriented. Governance with an external focus and open system is strategy oriented, while management being task oriented is a closed system with internal focus. Thus Corporate Governance is a process, structure and relationship through which a board of directors oversee what its executives do, whereas the Corporate Management concerns with what the executives do to define and achieve the objectives set out by the top management. Corporate Governance and Corporate Management is an integrate system and professionalisation may act a vehicle for better Corporate Governance and ultimately better management.

Corporate governance is a wider term than the corporate management and cannot be seen as synonymous with the latter. Apart from the core promoters and directors, there are some other persons acting in their independent capacities such as auditors, secretaries, advisors etc, who also ought to be held responsible for greater transparency in the corporate affairs

Role of Shareholders under Corporate Governance

Maximizing shareholders' wealth is the corner stone of corporate governance. The large and professional investors like institutional investors, mutual funds and pension funds have analytical skill and business acumen and can play a vital role in corporate governance, because such investors and shareholders would have the same objective of maximizing the shareholders wealth.

World Bank Report on Corporate Governance

The report (of World Bank) recognizes the complexity of the very concept of corporate governance and therefore focuses on the principles on which it is based. These principles such as transparency, accountability, fairness and responsibility are universal in their application. The way they are put into practice has to be determined by those with the responsibility for implementing them. What is needed is a combination of statutory and self-regulation, the mix will vary around the world, but nowhere can statutory regulation alone promote effective governance. The stronger the partnership between the public and private sectors, the more soundly based will be their governance structures. Equally, as the report emphasizes, governance initiatives win most support when driven from the bottom up rather than from the top down.

It could be argued that international investors and capital markets are bringing about a degree of convergence over governance practices worldwide. But the standards which they are setting apply primarily to those corporations in which they invest or to which they lend. These standards set the target but it is one which, at present, is out of reach for the majority of enterprises across the world. In the past these standards might have become diffused by a gradual process of economic osmosis. However, the pace of change today is such that to leave the raising of governance standards to natural forces might put areas of the world, where funds could be put to best use, at a competitive disadvantage in attracting them. Adoption of the report's proposals offers enterprises everywhere the chance to gain their share of the potentially available funds for investment.

Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations and society. The incentive to corporations and to those who own and manage them to adopt internationally accepted governance standards is that they will help them to achieve their corporate aims and to attract investment. The incentive for their adoption by states is that they will strengthen their economics and discourage fraud and mismanagement.

The foundation of any structure of corporate governance is disclosure. Openness is the basis of public confidence in the corporate system and funds will flow to those centres of economic activity which inspire trust. This report points the way to the establishment of trust and the encouragement of enterprise. It marks an important milestone in the development of corporate governance.