A Brief History Of Corporate Governance

Corporate Wrongs Over the Recent Past

Over the past two decades, the investment world has seen a large number of scandals relating to companies which are attributed to failure of governance.

These have been caused by a combination of number of factors, principally the three corporate sins, leading to such things as:

- Company mangers (principally the executive directors) lost sense of business or corporate ethics.
- Earnings become the prime measure of a company's success. Directors were not prepared to show low profits or losses. This led to the use of unethical practices (like creative accounting, falsification of books etc.) to increase or show higher earnings.
- Boards were generally ineffective and played into the hands of executive directors, approving improper financial statements and condoning unfair corporate decisions.
- Mangers awarded themselves huge bonuses and stock options, often at the expense of other shareholders.

- Company concentrated on short term gains and showing higher current profits, often sacrificing the long term objectives.
- Auditors colluded or failed to stop the executive directors from using improper accounting policies. In the process they lost their independence which they surrendered for getting higher audit fees.
- The disparity in remunerations between higher and lower level employees grew to uncomfortable levels. A culture of greed developed among senior managers.
- Most small investors lost interest in long term investments and concentrated on short term gains through share price movements.

Some Major Corporate Tragedies Arising out Of Poor Governance in USA

- **WorldCom**

This Phone and Communications company used age-old technique of using improper accounting policies to misallocate $3.8 billion in expense and treated them as assets, thereby inflating profits and awarding huge bonuses to executive directors. Its Chairman borrowed over $408 million from the company to cover personal debts.

- **Enron**

This energy company created outside partnerships that helped it to hide its poor financial conditions. It regularly misstated its earning and assets. Executive paid themselves huge bonuses and also earned billion of dollars selling company's share, given to them as part of their remuneration package. The company eventually went bankrupt.

- **Waste Management**

This waste management company misstated its earnings by $17 billion over six years period (1992-97). Its directors were ultimately sued for accounting fraud.

Tyco

The Chief executive of this company, Dennis Kozlowiski was charged with deliberately dodging sales tax on purchase of artwork for his personal residence, routing it through company books.

Some Major Corporate Tragedies Arising out Of Poor Governance in UK

- **Barings Bank**

The management of this bank failed completely in its internal controls, letting a single employee cause a loss of $1.4 billion in stock trading. When Nick Leeson, its head of settlements department was made of trading, he was not asked to relinquish the former charge. This was a fatal internal control failure that allowed his activities go completely unchecked. The bank never questioned the legitimacy of huge payments authorized by Leeson to Singapore Money Exchange (SIMAX) and Osaka Stock Exchange (OSE). The bank with 233 years history and considered one of Britain's best merchant banks eventually had to close its operations in Singapore.

- **Mirror Group of Newspapers**

Robert Maxwell, born in Czechoslovakia, became a naturalized British. He rose from extreme poverty to being a very influential businessman. His many investments included Mirror Group of Newspaper. He is presumed to have fallen overboard from his luxury yacht and his body was subsequently found floating in the Atlantic Ocean. It was in October 1991 when the exposure of his frauds became inevitable. It was subsequently found that he had misappropriated hundreds of millions of pounds from his various companies, even from the pension fund of Mirror Group. The Group was declared bankrupt as were his sons.

Evolution of Corporate Governance

- The world reaction to these corporate wrongs was massive and led to the development of laws and codes for better corporate governance.

- Some of the international initiatives on governance are:

Cadbury Report 1992 (UK)

- Following serious financial scandals and collapses (e.g. BCCI and Mirror Group), and a perceived general lack of confidence in the financial reporting of many UK companies, ***the Financial Reporting Council, the London Stock Exchange and the Accountancy Profession*** established the Committee on the Financial Aspects of Corporate Governance, in May 1991. It was chaired by Sir Adrian Cadbury and came out with its landmark report in Dec. 1992, recommending a Code of Best Practice with which the boards of all listed companies should comply.

Greenbury Report 1995 (UK)

- The Greenbury Committee was formed to look into the directors' remuneration packages and disclosure about it in the annual reports.

The Combined Code 1998 (UK)

- This report combined the recommendations of Cadbury report, Greenbury report and Hampel report into one code. It has two sets of recommendations: one for the company and other for the institutional investors. It promotes the principle of comply or explain for the directors. It laid emphasis on maintenance of good internal controls, covering all aspects of company's' operations, reviewing the controls systems atleast annually and informing shareholders about its efficacy.

Turnbull Report 1999 (UK)

- Chaired by Nigel Turnbull, this committee was set up by the Institute of Chartered Accountants in England and Wales to provide guidance to its members who prepare or audit financial statements for companies, on the implementation of the internal control requirements of the Combined Code.

OECD Principles of Corporate Governance, 1999

- The organization of Economic Cooperation and Development (OECD) published its principles of Corporate Governance in 1999. Prior to its issuance, the document was discussed with the governments of members countries, private sector and relevant international organizations like the World Bank. The main principles ordained by the document are:
- 1. The rights of shareholders must be protected.
- 2. All shareholders should be equitably treated.
- 3. All stakeholders should be allowed to play their role as provided in the law.
- 4. Importance of timely and accurate disclosures to promote transparency.
- 5. Accountability and responsibility of the board of directors.

- 1. It placed considerable responsibility on CEO and CFO in relation to accuracy and completeness of the company's annual report.
- 2. It strengthened the independence of external auditor.
- 3. The audit committees were required to have at least one financial expert, who should be clearly named as such.
- 4. It set up a new regulatory body, called Public Company Accounting Oversight Board, for auditors of US listed firms.

Emergence of Corporate Governance Models

- Corporate Governance refers to the way companies are financed and structured in an economy in terms of entrepreneurial and functional decision-making. Over the past forty years or so, three main models of corporate governance have been emerged in the world. Most of countries in the world have one or other of these models. These are:

- 1. Anglo-American Model (AAM)
- 2. Japanese Model (JM)
- 3. German Model (GM)

Salient Features of Anglo-American Model

- This model is based on free-economy theory and operates essentially on the premise that the free inter-play of market forces sets the price for capital as well as decides who gets to run a company. Companies in this model operate to maximize the wealth of its shareholders who decide who to assign the responsibility of running the company. The prime measure of the efficiency of the BoD is the rate of return earned on the investors. The AAM works on a triangular (Principle-Watchdogs-agent) relationship comprising of shareholders, BoD and the managers.

- Under AAM, the bulk capital is provided by the institutional investors.
- Only 25% of total equity is owned by managers.
- Company relies on a combination of debt and equity.
- The shareholders do not bother the board for as long as their interest is served.
- This lead towards non-interference in election of Directors.
- Thereby, the executive directors elect their own nominees to serve as non-executive directors, who fail to exercise due control over the conduct of their appointer executive directors.
- This has been the prime cause of most governance problems faced in USA and UK.

Salient Features of Japanese Model

- The Japanese companies most follow the keiretsu system, which by definition means a group of associated or related companies having inter-locking directorates and shareholding. Typically, a group has a number of companies, some operating in the same industry, other in the different industries.

- The capital for these companies is provided by banks through equity and debt. Quite often banks are also part of the group performing the task of gathering funds for the group through their deposits. Some of the better known keiretsu groups in Japan are Mitsubishi, Mitsui, Sumitomo, Toyota and IBJ.

- The bank providing debt and equity also paly a dominant role on selecting the BoDs for their group companies. Their hold on the board is quite firm and therefore can influence the decision-making processes of the group companies according to the group interest.
- For quality governance, the groups seek and appoint good professionals as non-executive directors of the group companies. The high level of interaction between the funding bank and investee companies keep the boards on their toes.

Salient Feature of German Model

- Quite like Japanese model, institutional investors, including both public and private sector banks, play a very important role in the German companies and their corporate governance model. The boards of German companies have a significant number of nominees from financial institutions who look into the interests of all stakeholders.

- The most apparent difference in the German model lies in composition of board of directors, comprising of two tiers by law. The lower tier called Management Board comprises entirely of executive directors.
- The upper tier is non-executive supervisory board having compulsory representation from institutional investors. No one can serve at both tiers of the board.

- The supervisory board can summon members of lower tiers for clarifications at its meetings.

- However, the strict role of institutional investors allows the companies to have a much higher debt to equity levels.
- The individual ownership of shares in German companies is relatively lower than in USA or UK companies.