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Editorial

Corporate Governance — The Execution Gap

There is an enormous increase in the rhetoric on corporate governance. Mr Higgs has fuelled a lively debate. Almost everyone has a piece of advice. The latest is the revolt of FTSE 100 chiefs. The value of the report stems from the very reasons, which have made FTSE 100 chiefs oppose it. The competitive advantage comes today not from consensus but dissent, not from unity but diversity. Mr Higgs' is a very well researched and reasoned document. We now know why the top 10 countries with the least disparity between men and women do not include Britain. Less than 1% of chairmen of UK listed companies are female. Only 4% of the executive director and 6% of non-executive director posts are held by women. We also know why there is a lethargy of innovation in British industry and why there is a mismatch between company expectations and customer aspirations. There is no clash of cultures that would sprout new ideas. Only 1% of non-executive directors are from black and ethnic minorities and company boards are tired. Average age of FTSE 100 non executive directors is 59 with over 75% of them 55 or above while today's markets are being driven by customers in their teens and twenties. The good thing about the recommendations is that there is less of box ticking and more of uncommon practical sense. It adopts the principle of "comply or explain".

It is now widely recognised that we do not need new legislation to improve governance. Existing laws are enough even for enforcement action as has been demonstrated in the US. Eliot Spitzer, the New York State Attorney General, who is feared by corporate America more than even Bin Laden or Saddam Hussain, was able to nail down America's iconic financial giants like Citibank, Merryll Lynch and Credit Suisse First Boston in a far more effective manner without the help of draconian Sarbanes Oxley laws passed in July 2002. These investment firms were made to pay $1.4 billion in three tranches in a historic settlement - $900m in penalties, $450m to buy independent research and $85 million for investor education. All we need is will and determination in execution of what we preach.

To think that Enron, Worldcom, Vivendi or Merryll Lynch are simply isolated cases where corporations have cheated the innocent public is to show evidence of extreme naiveté. In an article in this issue, Dr Ivor Francis has referred to a TV interview given by Lynn Turner, Chief Accountant of the SEC from 1998-2001 who was earlier a partner of Coopers & Lybrand. She admitted on the Australian TV, that all the Big Five accounting firms helped Wall Street investment banking firms to engineer hypothetical transactions to make companies look better than they actually were. So, instead of bashing Enron we should be grateful to it for throwing open the murky world of corporate and public misgovernance. The nexus between the two is what breeds corruption. Today, it is the economic agenda that drives politics. Extensive growth in the power of various lobbies has made governance failures the norm rather than an exception. Deceit, translucence and greed have become the hallmark of those controlling resources. Even Columbia's loss was a governance problem. Lessons of Challenger's crash 17 years ago were ignored due to powerful contractors' lobby.

As we dig deeper, it comes home to us, loud and clear, that the significant problems that we face today of poverty, inequality, deprivation, environmental degradation, the economy of bust and boom and even terrorism stem from the governance failures. The US and the UK governments are heading towards a catastrophic war against Iraq regardless of UN sanctions despite visceral opposition from those who elected them. Evidence can be planted to suit designs. Mohammed al-Baradei, the head of the International Atomic Energy Agency (IAEA) told the Security Council on 7 March 2003 that British and US documents showing Iraq's attempts to smuggle uranium out of Niger were fake.

For corporate governance to succeed we have to go through a profound metamorphosis from inside out. We have to change our metaphors of success from "winner takes all" and "success at all costs" to develop an inner value system which prides on ethics, morality, equity, legitimacy, transparency, diversity and most of all courage to own genuine failures. As Archbishop of Canterbury, Dr Rowan Williams, said in the context of Iraq debate: "The key question is whether all parties to the debate are being honest." Good corporate governance will be achieved not by rhetoric or legislation but honest execution of what is just and fair.

Madhav Mehra

Corporate Governance:

Key to Value Creation
Experience of Hindustan Levers

M S Banga*

At the outset let me say that I totally welcome this cry for enhancing the level of Corporate Governance not just in India but all over the world. Its all too easy to see this particular topic in an extremely narrow sense and move towards more rules, more audits, more controls. One example of this is the recent move in the United States to get CEO's of companies to sign that their accounts are accurate. Are we to believe that a second signature apart from the signature on the balance sheet means anything more? Is there any guarantee? We need to take a much broader view of governance than that kind of approach.

Governance is about creating outperforming organizations. Dr. Mehra highlighted the need for innovative organizations. I am referring to exactly the same thing but I am talking about in a slightly different language. These are organizations that must succeed consistently in the market place. They must gain a greater share of market relentlessly, day after day, quarter after quarter, year after year, thereafter sustainably driving their top and bottom line. But they must do much more. Those are real stakes.

They must also recognize that shareholder value is not the only measure of a company's success, its impact, or indeed its contribution to society. The growing power of financial markets in the last decade has led to a very sharp focus on shareholder value as a key measure of success. Most businesses, companies and CEO's spend a lot of time worrying about their stock price. Is that appropriate? I believe that companies need to do much more than merely look at their stock price and their shareholder value. Each of us have got several stakeholders apart from shareholders – our suppliers, the trade, customers, the community at large; all these are our stakeholders, and good governance is about behaving in a manner in which the organisation is able to positively impact each of these stakeholders.

If each one of us does that then collectively all of us representing the companies in this room and other rooms like this would make a huge impact on society, and I dare say, even the nation at large. Now of course I could continue to talk about this at a very conceptual plane but I think I would prefer to illustrate this and bring it to light with a few examples from my own company Hindustan Lever. Let me begin by consumers.

> ***"They must also recognize that shareholder value is not the only measure of a company's success, its impact, or indeed its contribution to society."***

Our objective is of course to provide them with the very best value. The key question however is, how do you do this from time to time? Remember that our management comes from the urban educated elite, and our consumers are the entire spectrum of the billions in India. The diversity of religion, geography, ethnicity and income. We have to cater to all of that. How do we do it? That is one of the biggest challenges. Some of the things we have done : Every trainee who joins the company is sent to work for 3 months in a village to align and work, and the only task they have to perform there is to contribute to the community in the village. I have done it myself and I can tell you it was one of the most wonderful learning experiences of my life, and all our young people do it even today. Let me move to another stakeholder, the government.

Hindustan Lever has always believed and practised a very simple axiom – whatever is good for the country is good for HLL." We were the first company to voluntarily divest 10% of our holding in the fifties at the time Unilever held 100% of Hindustan Lever. In the fifties we divested 10% voluntarily to bring in local Indian shareholders. We have progressively carried on this divestment till a situation today whereby Unilever retains majority control at 51%. The rest 49% is held by 350,000 local shareholders and of course financial institutions. Now we believe that having local shareholders brings us enormous benefits.

First and foremost, it helps us to identify totally with the national interest and secondly, very much to the point of today it brings very true financial accountability and responsibility to the markets and the local country. Another example is of course our commitment to growing exports. Historically we had to do this because there was FERA and there were many other legislative reasons. Today none of these exist but they have a very simple principle, and it is this. "We must make sure that Hindustan Lever exports as much at least as we want to import" If we want the nation to have a foreign exchange surplus, we must begin with ourselves.

We cannot ask the nation to have a foreign exchange surplus and actually deplete it as a company, and therefore we are totally committed to being forex positive; and that has led us to a situation today where we have an export turnover of over 1500 crores and have been a super star Trading House for many years. A third example. We were the first company to avail of the disinvestment programme of the government when we took over Modern Foods, an ailing and sick unit three years ago. I am very happy to be able to tell you that we have made significant progress in enhancing its sales and reducing its cost structure and we are very confident that we should be able to restore that business to health in the near future.

Another major stakeholder is the community at large. Over the last several years we have established 15 factories in backward areas. I have personally selected many of these sites. When we went there it was barren land with no infrastructure. Today when you go there it is wonderfully energizing to see vibrant units with ancillaries, people with skills being employed by those factories. Importantly, these units are not just the leading edge in India. We have benchmarked them against the best in the world and we are totally competitive with any that can operate anywhere else. I could go on like this talking about our various stakeholders, but that would take up a lot of time and I don't intend to do that, let me move on. I have thus far been talking about what we have done as a company and how we have approached our stakeholders. Let me shift gears a little bit and instead address another question.

How do we actually, in a company, create a climate which fosters good governance? To us this is all about building the right culture. And what is culture? Culture is about a value system. A value system itself is a framework, a set of rules that binds people together, that encourages a particular type of person to aspire to join a particular organisation because his individual values fit those of the organisation, and more importantly, to stay in that organisation as people like me have done for over 20 years. At Hindustan Lever we have 4 clear values which we espouse – Truth, Courage, Action and Caring. Let me just pick up one of these and illustrate a little bit about it. Truth.

At one level this word sounds very naïve. Its often used but I tell you that when you begin to think deeply about it, and we encourage our people to think deeply about it.

"Remember they have only one life. And they are spending a lot of it with you. I think we owe it to each of ourselves and to every single person who works in the company to be completely transparent and honest in every feature."

We all know about shareholders wanting more information. Many see this as a complete intrusion. Is it an intrusion? Of course not. They are the owners. If they want the information we have to provide it. The debate that we had in our company on the need for segmental reporting was the shortest I have even seen. We have moved into full segmental reporting. We have disclosed all our results as transparently as possible because I believe and all of us believe that our shareholders have the right to know how we are running their company, how we are protecting their interests. We have analyst meets, investor meets, we talk to them about our strategy, we invite them into the company we are available to be seen and they can ask us any questions and any issues can be discussed. Incidentally this particular feature is not merely true for the large investor. Our smaller investors also have enough opportunity to engage with the management on issues of governance, or indeed issues of strategy or operational implementation. Our annual General Meeting is attended by at least ten to twelve thousand people every year our audit runs into eight or nine hours, and the reason is very simple. We have a culture that says that any question that is raised from the floor will be answered in full. And it can often take eight or nine hours. But this is about Truth to the external world.

Equally it is important to be truthful to your employees. You have to tell them exactly where they stand, exactly what you think of them, exactly what their future potential is. Remember they have only one life. And they are spending a lot of it with you. I think we owe it to each of ourselves and to every single person who works in the company to be completely transparent and honest in every feature. Now once again I could talk to you about values for a long time. Let me move on. How do we as a business entrench these values of Truth, Courage etc., How do we make sure they live within the organisation? Because remember the organisation is 40,000 people in 80 locations. How do we make sure they demonstrate these values every day, every moment in every decision? We have enunciated a very strong code of business principles. This is in black and white on a piece of paper. This is given to every employee the day he joins. He has it with him. It's a reference document and if even he is in doubt he is encouraged to ask. We have had many times when such issues came up, difficult issues in the country. Let me give you one example, A few years ago the terrorist influence came to our plantations in the northeast and they demanded "Predation money". It did not take us as a company more than a few moments to decide that there was absolutely no question of succumbing to those demands. And instead we took a chartered plane in, flew out our management and shutdown the plantations. We went back in after several months when we were assured that it was safe to conduct our operations lawfully. Now

I give you this example because it was a very painful experience. It cost us a lot and indeed all such examples cost the company a lot in the short term. But what you win is very substantial in the longer term. The most important win that you have is that you cement the values that I have been talking about in the business.

In conclusion, then, let me say this : Corporate Governance is not merely about rules, Boards Committees, Controls. Its much more. Its about creating outperforming organisations. Organisations that consistently succeed in the marketplace against competition. Organisations that recognize that they have more thanjust shareholders as stakeholders. In such organisations governance is the responsibility of the leader. It is he who must set the tone. It is he or she who must "Walk the talk" to set the values and be seen to live them" Let me tell you one short story which always sticks in my mind, Many of you would remember Prakash Tandon. He was the first Indian Chairman of Hindustan Lever in the sixties. Someone once asked him, " Prakash, what are the qualities you would look for when you appoint your successor? Prakash did not take a second to answer. He said "Character". One word. That is what leadership is about, Indeed that is what good governance is about, good character. ■

> ***"Corporate Governance is not merely about Rules, Boards Committees, Controls. Its much more. Its about creating outperforming organisations. Organisations that consistently succeed in the marketplace against competition. Organisations that recognize that they have more than just shareholders as stakeholders."***

***Keynote address at the 3rd International Conference on Corporate Governance, New Delhi, India by M S Banga, Chairman, Hindustan Lever Ltd.**

Book Reviews

Excellence in the Boardroom: Best Practices in Corporate Directorship

William A. Dimma (Author)

Hardcover: 288 pages; Price: $24.47
Publisher: John Wiley & Sons

What goes on behind the closed doors of corporate boardrooms is a mystery to most of us. In a complex and volatile business environment where news of corporate disasters is all too commonplace, shareholders, the media, and the general public are increasingly asking, "Where were the directors?"

Directorship may be more of an art than a science, but good boards really matter and do make a difference to corporate performance. Better boards make stronger companies. But what role do directors really play, what should they be doing, and what constitutes good corporate governance?

Bill Dimma draws on his vast experience as a director to shed light into the insufficiently lit boardroom of the business world. Excellence in the Boardroom assembles the collected wisdom and best practices of his distinguished forty-year career, serving on more than fifty corporate boards and another forty not-for-profit boards.

Excellence in the Boardroom offers a uniquely first-hand perspective on how boards actually operate and how they should function. It explores the causes and components of good governance, and examines the key issues and controversies that boards generally have to face.

Refreshing, engaging, and practical, this book offers views and opinions from a veteran director on what works and what doesn't in real board situations. These lively and prescriptive tales from the corporate boardroom offer a wealth of knowledge and advice to current and future directors everywhere. ■

Accounting Irregularities and Financial Fraud: A Corporate Governance Guide

Michael R. Young (Editor)

Hardcover: 337 pages; Price: $129.00
Publisher: Aspen Publishers, Inc

This book is an extremely useful tool directed to a problem that should be foremost in the minds of board members, audit committee members, senior executives, accountants, and their lawyers.

This is the first "how to" book on dealing with and preventing a professional disaster. You'll learn the origins of accounting irregularities, how fraud goes undetected, what to do when problems surface, and how to prevent inconsistencies. All relevant material is covered, including the recent initiatives by the SEC, recommendations of the Blue Ribbon Committee on corporate audit committees, and real-world instances of financial fraud.

Michael R. Young is a litigation partner of Willkie Farr & Gallagher where he head's the firm's Accounting Irregularities Practice Group. ■

The Value-Adding Board :
Activities and Structures

Ivor Francis*

Fraud or Incompetence? Has the System Failed?

In the past months there have been stories of billion-dollar corporate disasters such as Enron, Worldcom, Tyco, and the dot-com wrecks in the U.S., and Australia's own HIH, GIO, BHP, NAB, OneTel, and Ansett. Most of the *headlines* point to cases of outright fraud, but many of the *stories* appear to be the result of incompetence on the part of the leadership of the companies.

Several years ago, when interviewing some two hundred directors in Australia, the US, Europe, and Japan for my book *Future Direction: The Power of the Competitive Board*,I asked each director, "What should the directors of a successful company be doing now to ensure that in ten years' time it has not suffered a major decline?"

Included among my interviewees were several directors of one of the Australian companies noted above as having recently lost billions of dollars. At the time of the interviews, the company and its CEO were seen as being extremely successful, so much so that one of the non-executive directors claimed that the company was successful "in spite of the board" and that the board had little to do with the success. At the time the company was in the process of making a dramatic strategic move, but this director said, "the board really doesn't have a lot to say in corporate strategy other than to say 'yes"'.

Now, six years later, the company has incurred billions of dollars in losses stemming from the failure of this strategy. It is clear from this director's own admission at that time that the board had neglected its duties of oversight of strategy and operations. Yet no one is calling the directors or executives to account.

In either case, fraud or incompetence, malfeasance or misfeasance, the governance of these companies has failed. Remember, to "govern" is to "steer" a ship, with *dual* objectives: to steer away from dangerous waters and, at the same time, to steer towards a desired goal. A fully effective system of governance must ensure the dual objectives: *conformance* with the law as well as sustainable operational *performance.* But recent or proposed changes in the corporations law have focused solely on one of these, protection from fraud. I want to address the other one: performance.

> ***But it is not just directors who are to blame. The system of governance includes auditors and investment bankers***

In April, Lord Young, the retiring President of the Institute of Directors in London, reacting to the "period of collective madness in the mid-nineties' and the subsequent wave of proposals for governance reform, delivered a scathing attack on the British system of corporate governance and proposed his own remedy, get rid of non-executive directors:

"Let us go back to where we once were. Let all the directors in a listed company work in the business ... Make all information about remuneration transparent - make it a criminal offence if necessary - so that all shareholders will know every penny of what directors get."

But it is not just directors who are to blame. The system of governance includes auditors and investment bankers.

On August 20, 2002 SBS TV rebroadcast a PBS program, "Bigger than Enron". It included an interview with Lynn Turner, Chief Accountant of the SEC from 1998 to 2001, formerly a CFO of a major US corporation and a partner at Coopers & Lybrand (now PriceWaterhouseCoopers). Part of that interview was as follows:

Q: *Well, what about in your accounting practice? You worked at Coopers & Lybrand. What kind of things were being done when you were working on Wall Street for an accounting firm? I don't mean specific cases, but the technique.*

A: All the Big Five accounting firms have a group of accountants kind of like a financial services group, and that group of accountants works with Wall Street. In my prior life, we actually had a retainer arrangement with each of the major Wall Street investment banking firms under which we would help them financially engineer or structure hypothetical transactions for finding financing, keeping it off balance sheet, making companies look better than, quite frankly, they really were.

Q: *You mean doing the kinds of things that Enron and Andersen did?*

A: Yes. Exactly.

Q: *So there's a whole system that does this?*

A: There is a system that turns around and does it. Without a doubt.

Q: *And all the big accounting firms have that?*

A: Yes. Every one of the big accounting firms has such a group.

Q: *And all the big investment banks have that group?*

A: Yes, investment-banking groups — in fact, they make good money trying to figure out how to structure these transactions.

Q: *So, in Enron, we haven't just stumbled into something that may have happened. We've run into something that is a fairly common practice?*

A: This is day-to-day business operations in accounting firms and on Wall Street. There is nothing extraordinary, nothing unusual in that respect with respect to Enron.

The System is the Star

I would expect that almost everyone knows the name of the recently retired CEO of General Electric. But I doubt that how many know the name of the CEO of Toyota Motor Corporation. In recent decades the American corporate world has been obsessed with the myth of the "CEO as Superstar". The most obscene example of this was the case of Lee Iacocca, who promoted himself as the person single-handedly responsible for saving Chrysler, as recorded in his autobiographical hagiography *Iacocca*. Another example well known to Australian business is that of Al (Chainsaw) Dunlap, and his book *Mean Business*. His star has now fallen. He has recently been fined tens of millions of dollars and is currently being investigated by the SEC for possible fraud while CEO at Sunbeam. According to this myth, the individual chief executive is responsible for, and takes credit for the successes (but not the failures) of a company.

A variant of this myth is the Talent Myth, so called by Malcolm Gladwell in his *New Yorker* article. Promoted aggressively by McKinsey and Company as *The War for Talent*, both in its own hiring practices and in its clients', this "Talent mind-set" is based on the "deep-seated belief that having better talent at all levels is how you outperform your competitors." This "new orthodoxy of American management" is the "intellectual justification for why such a high premium is placed on degrees from first-tier business schools, and why the compensation packages for top executives have become so lavish."

No company adopted McKinsey's talent mind-set more closely than did Enron, "where McKinsey conducted 20 separate projects, where McKinsey's billings topped $US10 million dollars a year, where a McKinsey director regularly attended board meetings, and where the CEO himself was a former McKinsey partner." (Some might wonder why McKinsey did not suffer the same fate as Andersen.)

Enron's failure exposed the myth:

"The broader failing of McKinsey and its acolytes at Enron is their assumption that an organisation's intelligence is simply a function of the intelligence of its employees.

> ***"The most dramatic finding was that the activities of a company's directors have a major impact on the company's performance, accounting for more than 50% of that performance, for better or worse"***

They believe in stars, because they don't believe in systems. In a way, that's understandable, because our lives are so obviously enriched by individual brilliance ...".

"But *companies* work by different rules. They don't just create; they execute and compete and coordinate the efforts of many different people, and the organisations that are most successful at that task are the ones *where the system is the star."*

The talent myth assumes that people make organisations smart, but more often than not it is the other way around: organisations make people smart. Gladwell cites some of America's most successful companies where the system is the star, like Southwest Airlines, which pays its managers modestly and gives raises according to seniority, Wal-Mart and its inclusive culture, Procter & Gamble and its carefully conceived managerial system.

In I950 the renowned American statistician, Dr. W. Edwards Deming, encouraged the leading Japanese executives to view a company's operations as a system embracing all the activities of the company. It is this principle that provided the foundation for the quality revolution, first in Japan and then in the U.S. and other Western countries in the I980s.

The most comprehensive implementation of this principle is to be found in the Toyota Production System (TPS) which, because of the example it has provided to industry in Japan, the U.S. and elsewhere, has been called "the machine that changed the world." This system has been built up over decades and is continuously being improved. It is this production system that delivers Toyota's unparalleled quality and performance, regardless of the individual in charge, and regardless of the suppliers being used. The value of the intellectual capital captured in the TPS is incalculable.

A System of Governance

In Australia we have seen many manifestations of the Talent Myth, for example in the case of AMP's former CEO George Trumble, and other expensive imports. But, more relevant to the point of this article, we see it blatantly expressed in the make-up of the boards of Australia's major companies. The boards of these companies are dominated by a handful of elderly men, who arrogantly believe in their own abilities in running their companies while denying the abilities of others to do as well. This is a perfect example of what has been called the Narcissist manager, described by Gladwell.

The system of *competitive* governance, is derived from the observation that directing a company is, like management, a job that can be learned, that requires skills and knowledge, that does not require heavenly connections but can be undertaken successfully by mere mortals.

A complete governance system consists of two parts encompassing (I) *process* and (2) *people*. The *process* part describes what outcomes are to be achieved and what activities must be undertaken in order to achieve these outcomes. The *people* part describes who is to do what.

The *process* part will produce a comprehensive list of activities that must be undertaken in directing a company: providing the purpose of the business, making executive appointments, developing policies and strategies, managing relations with shareholders, bankers, and other stakeholders, assuring the capabilities of the business, overseeing performance, and assuring the long-term prosperity of the company.

The *people* part will examine the make up of a board, the roles of directors versus management, the structure of a board and committees, distribution of power and accountability, access to information, managing conflicts of interest, skills and capabilities of directors, appointment, induction, and succession of directors, etc.

The process part of the system of governance, the required *activities* of directing in successful companies, appears to be common across all jurisdictions. On the other hand, the *people* part, the *structure* of boards and the delegation of power and accountability, varies widely for successful companies across and within jurisdictions.

The most dramatic finding was that the *activities* of a company's directors have a major impact on the company's performance, accounting for more than 50% of that performance, for better or worse. (Other research attributes 30-40% to industry effects and I0-20% to economic changes.')

On the other hand, the *structure* of companies' boards appears to have little impact on a company's performance. However the structure of a board can have a major impact on a company's *conformance*.

The Process Part: The Complement of a Company's Activities

To oversee, manage, audit, or assure the health of a company's activities requires a comprehensive list of the company's activities and of their relationships. This must be generic, derived externally from the company, so that any activities that may be missing from the company can be detected. In practice such a list will contain hundreds of activities which will overwhelm most non-executive directors, unless structured in a reader-friendly way.

The comprehensive list that appears in my book *Future Direction*, derived from examining a company as a living system, emerged by exploring two questions:

What outputs (and inputs) are required of a company in order that it can be successful long-term?

These can be depicted as in the simplified representation of the functioning of a company. The six generic outputs can be loosely characterised as adding either Shareholder or Customer Value:

> ***"The essential value-creating dynamics of the company as a system can now be seen in terms of the logical Cycle of Sustainable Growth"***

Six Generic Outputs of a Company

Shareholder value

1. Assets
2. Organisation
3. Profits

Customer value

1. Value
2. Products
3. Innovation

What activities, therefore, must necessarily be performed?

From this long list of necessary activities thus derived those that are related to each other can be grouped together, to create six high-level generic activities, comprising both corporate and operational activities:

Six Generic Activities of a Company

Corporate Capabilities

1. Provide Direction and Oversight
2. Manage (External Partners) Relationships and Compliance with Providers and Regulators
3. Plan and Coordinate Operations, Finance, and Performance

Operational Capabilities

4. Provide Operational Capacity and Capability (including engineering, human resources, R&D, product development, and information services)
5. Conduct Marketing, Sales, and Customer Service
6. Execute Operations

The essential value-creating dynamics of the company as a system can now be seen in terms of the logical Cycle of Sustainable Growth ;

- Corporate Capabilities enable
- Operational Capabilities, which create
- Customer Value, which creates
- Shareholder Value, and this, in turn, enhances
- Corporate Capabilities,
- and so on.

A more detailed representation of this Cycle, one that includes not only its activities but also the items of added value provide the linkages between the activities, the Value-Creating System for a Company.

The system provides a template, for use by directors or investors, for assessing both the internal and external effectiveness of the company: the degree to which an output from one activity meets the requirements of the next activity provides a measure of the capability of the former activity. External measurements (of outputs) provide a measure of *current* performance in the hand of shareholders or customers. Internal measurements, on the other hand, provide measures of the internal health of the company, and so are indicators of potential for *future* performance.

The complete company system comprises six sub-systems, each of which can be explored in greater detail. The first of these, “Provide Direction and Oversight”, represents the *governance* system of the company. It consists of six generic sub-activities.

Six High-level Activities of Directing

1. Set policies in regard to purpose, Partnerships, and ethical behaviour.

2. Manage the directors’ agenda, (executive) appointments, accountabilities, and communications.

3. Determine strategic and tactical directions and alliances.

4. Assure the capability of the company’s operational and financial management functions.

5. Constructively oversee the company’s operating performance and improvement.

6. Ensure corporate learning, renewal, evolution, and succession.

These Activities of Directing, along with their linkages, we called “Blueprint for a Competitive Board.’ Finally, these six high-level activities of directing can be explored in still more detail, for example as twenty-two activities listed in **Table 1.**

An operational picture of directors at work, not only does list the activities, but it also identifies internal effects or outcomes that result from these activities and links them together causally. The quality of these outcomes as received by the next activity enables an assessment to be made of the health of the governance system. In particular it explains the sequence of activities that enables directors to understand the business and its key performance measures with which to assure the capabilities of the company and oversee its performance.

Earlier I noted that the capabilities of directors account for more than 50% of the performance of their companies. The influence of directors on company performance, however, flows not from compliance and control, nor from the structure of the board and its committees, but from directors understanding their company’s business and actively assuring the health of its financial *and operational* management processes.

This was recognised by the NSW Supreme Court (Court of Appeal, Judgment, I5 May I995) when it ruled that directors are expected to inform themselves of not only the financial results but also the processes that produce them:

> *“Because directors are bound to exercise ordinary care, they cannot set up as a defence lack of the knowledge needed to exercise the requisite degree of care ... Directors are under a continuing obligation to keep informed about the activities* [sic] *of a corporation.”*

“In the wake of the recent corporate failures, we are hearing the call for still more independent non-executive directors in Australian and U.S. companies. But independent directors may have little understanding of a company’s operations”

Disturbingly, however, our research demonstrated that Australian directors tend to deny responsibility for these operational assuring activities.

Don Argus, Chairman of BHP Billiton, has publicly put a dollar value on sound board processes, or lack of them, and the cost of poor governance at BHP: $3.2 billion! He told financial journalists of a project that we were conducting to improve its corporate governance practices. He said that the board had put in place processes that should avoid a repeat of the disastrous acquisition of Magma Copper.

The People Part: The Structure of Boards and Auditors

Most of the noise in the ongoing debates about corporate governance relates to the power structure in a company: how the various corporate agents should relate to each other, who reports to whom, who shall have what information, the delegation of power and accountability, managing conflicts of interest, and setting compensation.

If the greatest value that directors can add comes from them understanding the company’s business, and actively assuring the health of its financial *and operational* management processes, the chosen power structure should facilitate this.

The usual power structure in Australian listed companies consists of a unitary board on which non-executive directors, including a non-executive chairman, have controlling power. These non-executive directors, therefore, are expected, whether they like it or not, by the public, by politicians, by investors, and increasingly by the courts, to exercise that power in overseeing the management of their company and to be held accountable for the outcomes. In the U.S. model, the power is likely to be concentrated in a chairman who is also CEO.

In the wake of the recent corporate failures, we are hearing the call for still more independent non-executive directors in Australian and U.S. companies. But independent directors may have little understanding of a company’s operations. The more independent a director is, the more ignorant that director is! *This is the fundamental dilemma of the Australian system of governance.* The chief executive of one of Australia’s major insurance companies told me that his non-executive directors knew “zilch” about the insurance business. What chance is there that they could detect the operational problems that eventually brought down HIH or GIO? (The answer is and was: None, unless they had a disciplined system of governance to help them.)

The problem is that the power of these non-executive directors is not matched by a corresponding level of *informed* accountability. In most cases these directors have neither the time nor the depth of understanding, knowledge, experience or background to match that of a full time executive with years of experience in the business.

The conclusion must be that the typical operating practices of the Australian unitary board are failing to achieve the dual objectives of governance. Most directors are doing their best but are failing to provide a competitive service.

Quality in the Boardroom

This crisis in governance today is reminiscent of the crisis in Western manufacturing twenty five years ago. Local manufacturers had been protected, for the most part, from real competition by import restrictions, tariff walls, or by the fact that the manufacturing infrastructure in many countries was still recovering from the effects of war. In the I970s and I980s however, as these barriers were gradually removed, it became obvious that the quality of locally-made products was not competitive against imports. Without dramatic improvements in quality and productivity, these local manufacturers would be driven out of business. (Some local industries, such as the Australian car industry, are still protected.)

It was only then that Western manufacturers began to learn with the help from Deming and others, how to manage for continuous improvement of quality. The old quality-control method of inspecting each item produced, and then accepting or rejecting items according as they met or did not meet specifications, resulting in enormous waste or rework, was shown to be an impenetrable barrier to quality improvement. Mistakes - rejections and rework - were the norm.

Under the pressure from competition, the cry went up to "Get it right the first time." This required a new quality methodology. The focus had to change from inspecting and rejecting the finished product, *to improving the process that produced it.* Furthermore, the responsibility for quality moved from the workers on the production line to the manager who owned the process. This new approach to managing for performance is simply stated:

– To improve results, look upstream to the process that produces them
– Hold whoever owns the process accountable for the capabilities of the process. (Eliminate Management by Objectives.)

Today, quality process management is being recognised once again as a powerful competitive advantage, sometimes re-badged as a "Six-Sigma" management system, notably at General Electric where it is applied to all processes, both production and service, throughout the company, notably at GE Capital. And just as it helped to relieve the crisis in manufacturing,' so it can help relieve the crisis in governance and achieve Quality in the Boardroom.

> ***"Self-regulation will release the entrepreneurial spirit to create wealth, while a complex system of checks and balances will bog business down in bureaucracy"***

Separation of Powers

In any human endeavour involving more than one person, conflicts of interest inevitably arise. The measure of our civilisation is the degree to which we are able to resolve conflicts not by means of superior physical might, but by reference to the rule of law. Revolutions have been fought to redress inequities, but any gains were insecure until codified in a written document, such as Magna Carta, the Code Napoleon, or the U.S. Constitution. These documents mark the great leaps forward in the history of our civilisation. "My real glory," Napoleon reminisced, "is not the forty battles I won - for my defeat at Waterloo will destroy the memory of these victories ... What nothing will destroy, what will live forever, is my Civil Code."

James Madison, framer of the U.S. Constitution, was all too aware of the conflicts that had to be managed. He saw the human species as highly factional, addicted to forming tightly knit groups that in turn struggle with other groups. His solution was a complex system of checks and balances in government, with a careful separation of powers - legislative, executive, and judicial - into different groups.

Over the past decade there has been a crescendo of voices calling for changes in corporate governance. The main cause has been the rise in power of institutional investors and the political power of retirees. Factional wars have broken out. As noted earlier, the retiring British IoD President has hoisted the white flag (or was it the Jolly Roger?): do away with corporate governance and let shareholders look after themselves.

One suspects he had his tongue firmly planted in his cheek when he made those remarks, but he certainly injected a wonderful breath of fresh air into the debate. His proposal had the great merit of simplicity, rather like a proposal to replace our complex system of parliamentary government by a benign dictator.

Madison's arguments in favour of the separation of powers of government in order to manage different factional interests are compelling also for corporate governance. Arguments *against* separating powers in corporate governance come primarily from those who currently enjoy dominant power, the club of high profile chief executives and company directors (former chief executives). They, their professional interest groups, and their government lobbyists, proclaim their preference for self-regulation rather than laws and sanctions. Self-regulation, they say, will release the entrepreneurial spirit to create wealth, while a complex system of checks and balances will bog business down in bureaucracy.

Fortunately, recent corporate scandals in the U.S. have exposed the shortcomings of self-regulation. And "independence" is now everyone's solution, independent directors, independent chairman, independent auditors, independent regulatory board for the auditing profession, auditors independent of investment bankers, investment advisers independent of underwriters.

Furthermore, the complex system of checks and balances in the U.S. government can hardly be said to have curbed the entrepreneurial spirit in the U.S., the most powerful nation in history, compared with that in countries that enjoy more efficient systems of government such as Cuba, Iraq or Zimbabwe.

Yet although separating powers of governance is desirable, having more independent directors has the potential to make things worse. We are still faced with the dilemma that the more independent a director is, the more ignorant that director is!

Resolving the dilemma : Three Options

What these company failures clearly demonstrate is that to uphold investors' interests, truly independent directors need greater understanding of operational processes. Being independent *in law* - that is having no material personal interest in the matter — is not the answer. Rather they must have sufficient understanding and information about the business to be independent *in action*. There are three options open to directors who wish to resolve this dilemma.

1. The Expert Board

One way to get operational knowledge on to the board is to appoint operational experts as directors. For example, in the wake of last year's sharp decline in their company's fortunes the directors of Amazon.com Inc. were criticised for being too small and lacking retail experience and independence. In response, CEO Jeff Bezos announced plans to add one or two new board members to increase the operational expertise on the board.

But this option encounters several difficulties. The first is the availability of people with the appropriate expertise. Second, the board may need quite a number of experts to cover all areas of need. Third, an expert on the board can still be misled unless appropriate support and relationships are established. And fourth, it may be seen as directors usurping the role of management.

2. Compound Boards

Australian, British, and U.S. boards are mostly unitary boards, with all the inherent conflicts of interest. Other jurisdictions favour compound boards, where the powers and functions are separated. German companies have a management board and a supervisory board. In Spain they have watchdog boards.

"If you want to influence an outcome, you must understand the processes that produce it"

Japan warrants special mention in view of the proposal of the British IoD President. He proposed that all directors should be executives, and make all information about remuneration transparent (not all information, only *all* information about *remuneration*.)

Typically the directors of a Japanese company are all executives. Toyota Motor Corporation, for many years the benchmark Japanese company, has some 50 directors, all executives.

At Canon Inc., which has tripled its profits and market capitalisation in the past five years despite the steady decline of the Japanese sharemarket, the President Fujio Mitari rejects pressure to appoint outside board members, arguing that they contribute little. Instead, he has given more power to auditors to ensure that the board adheres to good governance practices. He says employees are more valuable than investors. He bases pay on merit, but promises lifetime employment.

But Japanese companies have a second board, a Kansayaku board, called in English the Board of Statutory Auditors. These are not financial auditors. They audit the directors. They audit the operations. This board must contain at least one member from outside the company. At Toyota that member was the Prosecutor-General of Japan. But most members would be former executive directors, even former chairmen, who know the company, its operations and where any skeletons are buried, and for whom these are the last appointments in their company careers. Like directors, they are appointed by the shareholders and report to them.

Some commentators argue that the conflicts inherent in the Australian unitary corporate governance model can only be properly resolved by a similar separation of governance powers to be managed by different bodies. In their minority report on the Company Law Review Bill I997, the Australian Democrats advocated the use of Corporate Governance Boards to separate the corporate governance and business management powers of directors. It has also been proposed that a third body - a Council of Stakeholders - is needed to channel information on operational matters to the Board of Directors.

But while compound boards may be the best solution to the Australian dilemma, their widespread adoption would have to overcome many hurdles. For this reason the Democrats limited their recommendation to newly listing companies. In the meantime, for other companies another more pragmatic solution is available, an assuring board.

3. An Assuring Board – the Value-Adding Board

Directors add most value by assuring themselves and those whom they represent that the processes by which the company creates value are healthy. For directors and executives who are committed to working together in advancing the fortunes of their company, its shareholders and all its constituencies, there exists a third option: an assuring board.

It provides a solution that is both *effective* in delivering to directors the factors that determine the company's performance, and *efficient* in the time required by both executives and directors to execute it. It respects the division of roles between directors and management, and provides both directors and executives with protection from liability for reasonable business decisions.

It is rooted in the fundamental principle of rational analysis: if you want to influence an outcome, you must understand the processes that produce it. It is based on a methodology well proven in decades of use in business, industry, and science: process management.

The process approach is particularly valuable for non-executive directors who devote only a few days a month to the company, and who in many cases have little experience with operations in the industry of the company. John Ralph, formerly CEO of CRA, now Chairman of CBA, has explained the essence of process assurance for boards:

> *"The big changes that have to occur are for the board to make that transition, to understand the role of processes and to make sure that you are taking a process approach to work ... There are very few jobs where there are more than six variables that are important in getting up close to optimal results. And if you control those five or six variables you control the process... [The board must] ensure there are [management] processes in place and then to have [board] processes to monitor that they are being followed."*

Bob Joss, then Managing Director of Westpac, emphasising the need for directors not to stand over and second-guess management, agreed that assurance is what non-executive directors should do:

> *"Assurance is a good word. The assurance is that I [as a non-executive director] assure myself that it's a good business, well managed, in the right direction, and adding value to the shareholders."*

Don Argus, then Managing Director of National Australia Bank, described his version of an assuring board:

> *"I have a view that those boards ... should allocate tasks to two or three board members to be responsible for a certain element of the business — retailing, marketing, strategic direction, where the business is going. I think the boards need to have a real specific knowledge of the company that they're sitting over the top of ... What I had in mind was the directors involved to work with the person that's got the responsibility for the key value drivers, so they can give full support to the submission to the board."*

> **"The World Council for Corporate Governance recognises the nexus between quality products and quality governance, and sees sound governance and transparency as the means of spreading the benefits of stakeholder capitalism"**

By contributing to directors' understanding of their companies' operations, effective board processes reduce the risks of unexpected operational outcomes. In addition, they provide protection for "reasonable" directors. The Corporations Law states that directors must "inform themselves about the subject matter of the judgment to the extent they reasonably believe to be appropriate."

Courts have traditionally given directors the benefit of the doubt if they acted in a "reasonable" way, and now the statutory Business Judgment Rule provides further clarity of what constitutes reasonableness in regard to directors' duties of care and diligence. If company directors use a substantively effective formal process in making decisions, these decisions can be eligible for protection under the business judgment rule when the results of the decisions are not favourable.

Investors too now recognise the value of operational as well as financial oversight by boards. Richard Koppes, as General Counsel of CalPERS, referring to the assessment process that we use in conducting a business capability audit, said:

> *"A 'business capability audit' is simply examining the decision-making processes within the company... We, as shareholders, should not tell our managers what the processes for their particular company should be.. But, we can certainly insist that the processes exist."*

While this third option does not solve the separation-of-powers issue as cleanly as Option 2, a measure of separation can be achieved in an assuring board through board committees, for example by assigning one group of directors (the Corporate Governance Committee) to assume the responsibilities of the Corporate Governance Board, and another (the Operational Assurance Committee) to be responsible for assuring the operational health of the company, just as the Audit Committee assures its financial health.

Assessing a Competitive Board - A Business Capability Audit

In the wake of the scandal at Enron, Worldcom and elsewhere, U.S. regulators and politicians have swung into action. Never before have the politicos faced the wrath of so many disaffected investors. Their Australian counterparts are watching closely.

Treasury Secretary Paul O'Neill has been charged by President Bush with introducing reforms in corporate governance. O'Neill wants to hold both corporate CEOs and auditors responsible for ensuring that investors are fully informed. CEOs will have to sign off on a checklist of corporate health indicators—the 5 to 10 key factors affecting a company's future.' Top company officials would be personally liable if the list were incomplete or misleading.

The activities identified in **Table 1** provide the framework for the oversight of both the financial and the operational aspects of a company. And so they

Table 1 : Generic Functions and Sub-Functions of a Competitive Board

	Function		Function
1.	*Set Company Policies*	*4*	*Assure Capabilities of Management*
SM	Set Mission of the Company	UV	*Understand Company's Value-Creating Process*
SS	Set Structure of the Business	RM	*Maintain a Relationship of Trust with Management*
SV	Set Policies re Values, Risk, Compliance	AA	*Assign Accountabilities of Directors*
		AF	*Assure Financial Management*
		AO	*Assure Operational Management*
2.	*Manage Board and Executive Appointments*	*5*	*Oversee Company's Performance*
MA	*Manage Board's Agenda*		
AC	*Appoint CEO*		
EM	*Ensure Executive Management*	RR	*Establish a Regime for Management Reporting*
OC	*Oversee Communications*	MR	*Monitor Results and Performance*
EB	*Evaluate the Board*	SI	*Support Improvements*
3	*Determine Strategies and Alliances*	*6*	*Ensure Corporate Renewal*
AD	*Approve Long-Term Directions*	MK	*Maintaining Knowledge of the Industry & Economy*
FP	*Approve Financial Policies & Alliances*	EV	*Examine Vitality and Potential of the Company*
AS	*Approve Strategies*	EO	*Evolve Management & Board Organisation*

provide a framework for Treasury Secretary O'Neill's 5 to 10 health indicators.

As noted earlier, Don Argus put a dollar value of billions of dollars on sound board processes and disclosed that the BHP Board was using an outside consultancy to improve its governance practices. We conducted the project using this *Competitive* Board framework. We are now assisting a growing number of companies in this way.

Peter Clapman, Senior Vice President and Chief Counsel, Investments, at the giant TIAA- CREF fund (US$290 billion under management and an active advocate of good governance in its investments) says evaluations by consulting firms could indicate whether boards were functioning effectively. "The number of companies that do this is in a minority, in part because directors resent being judged. But there is a growing number that do it at the total board level." (*The New York Times*, 29 April 2001.)

Peter Drucker's 1991 prediction - that within ten years investors would not invest in companies unless they submitted to a business audit as well as a financial audit - is coming true. Just as independent accounting firms audit a company's finances, so independent consulting firms like ours are assessing and enhancing a company's competitiveness in management and governance. The increasingly common boilerplate governance statements and board *self* - assessments will satisfy neither investors nor the courts. But investors will reward companies that provide evidence that their business processes are sound.

Let me conclude with a look into the future. Widespread share-ownership and stakeholder capitalism is now a major force along with political democracy in progressive world governance. The World Bank and the O.E.C.D. are both actively promoting good corporate governance and transparency. The World Council for Corporate Governance, of which I am a governor, recognises the nexus between quality products and quality governance, and sees sound governance and transparency as the means of spreading the benefits of stakeholder capitalism to emerging economies, and so being a force for global economic and social advancement.

I concluded my book *Future Direction* with a personal statement about governance that was made to me by Treasury Secretary Flaul O'Neill when he was CEO of Alcoa. It combines the practical with the ethical to provide a vision of the future:

> *"I think if you do things right, over time the shareholders will be well compensated ... But there's a sense of doing right that stands on its own. You can lay down the attributes of what that is. It's about telling the truth, as you understand it. It's about not harming human beings. It's about creating value somehow, and it results in a series of things that are good for all these other constituencies. If you do all these things right, you create employees, you create a contribution to the community, either directly or indirectly. You create a contribution to customers, to the future, to suppliers, to lenders, and to the nation."*

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*Edited from the paper by Ivor Francis, Director, ActiveCapital at Corporate Governance World, Sydney 2002.

Can law improve ethics

Giving conscience to the corporations

Dr A M Singhvi*

As a lawyer myself I cannot but start by saying that both lawyers and corporations are viewed by society as necessary evils, barely tolerable and the subject of numerous causeticisms. On the one hand you have heard of the lawyer being described as a learned gentleman who rescues his clients' estate to keep it for himself or alternatively as a person who is trying to get on and then get honour and then get honest, in that order. In tandem, Corporations have been defined in the Devils Dictionary as an imperious device for obtaining individual profit without individual responsibility. And there is in legal literature the famous quotation from Lord Thurlow when he said, *"Did you ever expect a corporation to have a conscience when it has no soul to be damned and no body to be kicked?"* He was in fact echoing the words of the English Jurist Edward Cook who said some two hundred years ago. *"Corporations cannot commit treason nor be outlawed, for they have no souls to be ex-communicated.* In a sense this whole movement, this whole plethora of literature, legal and non-legal and all kinds of publications on corporate governance, this great interest in this subject in the last decade, and the Cadbury Report in England, the Govt. of India study to the Amendments of the Companies Act in India, the Kumarmangalam Birla Committee Reports, the recommendations of the Iradi committee, are all really to be seen as an attempt not only to provide corporations with a conscience but to police their heart and soul and kick them if all else fails. It is to achieve Aristotle's golden mean of transparency, of self regulation, of policing with the primary focus on the average citizen, the small man, the small shareholder or the small investor. And since we are at the threshold of a new era – the knowledge era, the I.T. era, the dawn of that era must be accompanied by an exponential growth in professionalism, in objectivity and good governance in the Corporate arena.

If we talk of value based politics for example or of citizenship values there is absolutely no reason to exempt the corporate sector from these concepts of value based governance. This key concept is based on the core concepts of transparency, of accountability, of integrity, of equity and of responsibility. Now since the subject is really vast, I propose to try to touch ten or twelve points and address some legal aspects, not technical legal aspects but broad legal aspects to illustrate how we can move in the direction of improved corporate governance for wealth creation for better results. Of course after major Corporate explosions in the past few months from Enron to Arthur Anderson to Worldcom to Tyco, people say that if Corporate Governance had been a tune, it would have been on "top of the pops" in the music charts. There are few key areas, which require attention. First is the area of Insider Trading. We cannot talk of improved and better form of Corporate Governance without addressing directly this core issue of Insider Trading, which is dealt exclusively in the Kumarmangalam Birla Second Report. This, in many cultures and societies, is not even perceived as an infringement of the Corporate Governance principles.

> ***"If we talk of value based politics for example or of citizenship values there is absolutely no reason to exempt the corporate sector from these concepts of value based governance"***

Of course, it has a lot of issues and is by itself a very vast subject, legal and otherwise, so I don't propose to address the entire subject. But we realize to start a culture of Insider Trading policing which is at the threshold of being implemented and, in a voluntary sense, is already under implementation. It really talks of the creation of these codes for different sectors where Insider Trading is a major issue. These include voluntary codes for analysts, investors, consultants and, of course, for corporates and it deals with issues like, for example, creating effective Chinese Walls within corporates and corporations. Chinese Walls which would separate and demarcate those areas and those persons who routinely have access to confidential information, the so called "Insider Areas" from others who may do other aspects of running the Corporation. We suggested issues like "disclosure" only on "need to know basis", designation of specific trading windows. For example price sensitive periods are to be designated periods when trading windows will be closed, financial results, periods of declaration of 'quarterly results, half yearly results', declaration of dividends etc. These are periods which are highly price-sensitive and a restriction on the trading window during these periods is desirable. There are suggestions for designated officials to oversee compliance with all the Insider Trading codes and there is a whole host of other things provided. This exercise is undertaken after examining the existing SEBI codes which have universally been acknowledged to be insufficient. Indeed in the few prosecutions launched by SEBI under those regulations they have been found wanting. There are gaps, there are lacunae and there is some ambiguous drafting. Ultimately an exercise has to be undertaken to amend the statue itself and the regulations. But the starting point, even before the amendment, to create a culture of policing, a culture of compliance a culture of self regulation, was to start this practice of Voluntary Codes. Now the interesting thing, of course, is that they are voluntary, they do not carry any immediate punishment. But it is interesting to note that ever since they have been announced there has been a very positive and largescale response from a number of corporates who have taken it upon themselves to demonstrate, to declare, to proclaim to the world, almost as a sign of brand excellence, that we are following these codes and the blue chip corporates take pride in taking over these codes, adapting them to their companies and following them scrupulously, and SEBI is having a series of reports from a large number of corporates in India which I think is a very good sign. Naturally, this is a very early stage and this was really happening only in the last few months. As the culture grows, I think, it will be combined with legislative action, which is also on the anvil. But there will certainly be a far greater degree of acceptability when this culture of self-policing gets more established. So that is the first and the most important issue on Insider Trading. The second, and which is linked to the first, is the provision of greater powers to the market policeman, the mega policeman we have in this country, SEBI. It is astonishing how it is the sole market policeman and has extremely truncated powers. SEBI has the Brahmastra of Section 11B which is a "catch-all" omnivorous provision but does not have simple powers like impounding documents, obtaining information from public sectors or from banks. It has no provision of imposing penalties. It has no provision like the very effective US counterpart has – provision of treble damages to disgorge damages and penalties amounting three times. So when we talk of Corporate Governance, Insider Trading or a culture of compliance we have to revisit this issue of giving far more powers to SEBI. The good thing is that changes are on the anvil for greater enhanced powers to SEBI and hopefully that will happen soon.

SEBI has announced a welcome "5 pronged Strategy" which is directly linked to Corporate Governance and is very desirable. And the 5 prongs of this SEBI's proposed strategy are, first, investor education i.e. a nation wide campaign to spread awareness amongst investors – seminars, road shows, training programmes, etc. Second, Information Dissemination i.e. requiring Corporates to disclose all information in friendly, easy formats and not in jargons. Third, is the requirement that certain basic Corporate Governance norms must be followed by all companies listed by all stock exchanges, and they must be declared and submitted to SEBI on a periodic basis. The fourth is strict enforcement which SEBI has announced, tracking cases and trying to implement action in a non-discriminatory fashion, and which is significant and desirable to have an advanced ruling system if a leading corporate or a multinational for example is doing something which might impinge on the takeover code. An ex-post facto action against that corporation would have disastrous consequences after the entire deal has been consummated. So there is a proposal in the Income Tax Act for an advanced ruling system. For certain aspects of these, like takeovers or mergers, SEBI would be entitled to give an advanced ruling on proposals submitted to it. It has worked rather successfully in the Income Tax area and it is certainly a novelty which is proposed for SEBI and I think it is a very welcome change. Of course, in the ultimate analysis, it is wishful thinking to think that codes of ethics or voluntary codes will change things fundamentally.

"A number of corporates who have taken it upon themselves to demonstrate, to declare, to proclaim to the world, almost as a sign of brand excellence, that we are following these codes"

In the Webster's Dictionary, "Ethics" is defined as a matter of daily practical concern. Ethical Codes are good to assuage consciences, only where such consciences exist. For those areas where consciences do not exist such codes are useless, and for the latter class there is only one remedy, instilling the fear of God, which translated on earth means the mortal fear of the law, which brings to the fourth point, 'punishment'. This unfortunately is a word missing from the Indian Corporate Commercial legal lexicon. Where it exists in paper, it exists only on paper. We have had a very poor record of actual punishment right from the UTI of 1993 to the UTI of 2001. A Japanese Prince in a famous Code on Corporate Governance in 600 AD said, *"Do not forget to bestow a reward nor to impose a punishment"*. So it is important to keep that balance and that is an area which we need to address carefully alongwith the related area of creating some "whistle blower" statutes. It is a subject which is completely alien to India. It is interesting and most people I meet have not noticed this. The person who blew the whistle on Enron were three persons, three employees of Enron. All three were women of course. They blew the whistle and they are now seeking and getting protection under some "Whistle Blowers Statutes" in America. Of course after that happened, somebody did a cartoon saying *"Are women the fairer sex when it comes to wrong doing in high places?" and fairer was the pun.*

The other crucial area of Corporate Governance on which, our entire new legislative reform in India is based, and in fact globally, is the concept of Non-Executive Directors. A desirable welcome concept, a salutary concept and the intention is clear you have a breath of fresh air from outside, a degree of independence, an objective non partisan view – all very good. However, there is the syndrome of the left hand not knowing about the right hand because in India this very good provision for Non-Executive Directors is substantially impaired in practice by other provisions of law, which have never been attended to when enacting this Non-Executive Directorship concept. For example, the Section 138 we have in this country is for bouncing of cheques. It is a good provision, a potent provision and if a cheque bounces and if a complainant files a complaint against somebody from Kashmir to Kanyakumari, the directors of the company are hauled up and rightly so, but nobody has thought of Non-Executive Directors. I would hate to be on a company where a hundred rupee bounced cheque could lead me to a criminal court in Kerala. So this harmonization of different laws is important to ensure that what you try to create with the left hand does not get diluted or mollified with the right hand.

The other issue of Corporate Governance, which is very important, and not addressed here, but is being addressed slowly in other parts of the world, is the field of auditing and accounting standards. We all know of the Sarbanes Oxley Act passed a few months back in the USA. It is an example of how quickly systems move to impose huge punishments, in fact, I think almost excessive punishments upto a maximum penalty of ten years behind bars, million dollar penalties in US and are mostly focused on auditors. Incidentally, the US Act does not apply to US companies alone. It applies to all companies listed in the US Stock Exchanges, many of which are Indian companies. Now this is a good development but I think similar issues need to be addressed in India. Take for example the Auditor's Standards, Accounting Standards in the area of sick companies. The sick companies legislation in this country has been described by many as a refuge for crooks because whenever you want to avoid creditors you become sick and the moment you become sick you get a huge umbrella of protection under a statute known as the Sick Industrial Companies Act of India (1985). That is under repeal for the last three years. A recommendation of a detailed Iradi Committee Report recommending its revision and substantial repeal of large parts. The recommendation has not been enacted into law for about 2-3 years because our Parliament has not found time for it.

But even as it exists, neither the existing statutes nor the proposed amendments address the issue of Accounting Standards. The reason why a healthy prosperous company this afternoon can become a sick negative net worth company tomorrow afternoon, and seek the protection of this Act and, therefore, avoid creditors is simple. Because the Accounting Standards permit you to describe certain items in two or three ways each of which are equally valid. Take for example, depreciation: Depreciation can be described by the WDVM, the written down value method or by the SLM method, the straight-line method. Now depending on which way you use the system you may be able to increase the depreciation tremendously and thereby make a narrow positive net worth into a negative networth. The same applies to Accounting Standards with Interest, Borrowings and other issues. I think this issue has to be addressed in consultation and conjunction with the Accounting Institutes, with the professional bodies so as to achieve uniformity and prevent abuse. There is of course in law this quaint old common notion which we have borrowed from England, and which has no relevance even in England and much less in India that "auditors of public duties owe no duty of care to members of the public at large who rely on their documentation or Accounts to buy Shares in the company". Indeed the common law of India has gone as far as to say that the auditors do not owe even a duty of care to the existing shareholders. Now this is of course nonsense in the contemporary arena where you have these series of scams, and although the scams are called the Enron or the Tyco Scams most of them are based upon Auditing frauds as well. Auditors in judgements hundreds of years back have been described as watchdogs not bloodhounds, and this reminds me of one of Sherlock Holmes story where the Chief of Police asks: "Mr Holmes is there any point where you would like to draw my attention to?" And Mr Holmes puffing on his pipe says, "Yes, to that curious incident of the dog and the night". To which the chief of Police says, "But Mr Holmes, the dog did nothing in the night time". To which Mr Holmes says, "Ah, that is the curious incident." So, regrettably, the auditors have become from bloodhounds to watchdogs, and as somebody described now to lapdogs of CEO's, and that is the larger issue which has to be addressed in the wake of the recent scams. This issue is linked to the even larger issue and significant issue of fundamental conflicts of interests between management consultants and auditors. As we all know now, Arthur Anderson would hardly do a hardnosed audit of Enron if that audit would lead to its sacking because the fees it got from that auditing was an infinitesimal fraction of the fees it collected from Enron as a management consultant. So if its audits were inconvenient, its sacking would lead to a huge loss as far as management consultancy was concerned.

> ***"Ethical Codes are good to assuage consciences, only where such consciences exist. For those areas where consciences do not exist such codes are useless, and for the latter class there is only one remedy, instilling the fear of God, which translated on earth means the mortal fear of the law, ie. 'punishment'"***

In US there are now new codes being developed on these fundamental conflicts of interests situations, and a time may come when there may even be a bar to be an auditor and a management consultant. In fact some of the big five auditing firms have already tried to create separate corporate entities, distinct and separate, independent to deal with management consultancy on the one hand, and auditing on the other. Because really at the root of corporate frauds lies this very important task of auditors.

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Unleashing the Power of India's Corporate Boards

Dr Madhav Mehra*

One of the biggest problems in India's corporate boards is the lack of independent directors. Boards in India have been largely selected by promoters. With the exception of institutional nominees, the vast majority of board members are there at the behest of management, in particular, the CEO.

Like elsewhere in the world, the Indian corporate sector has had to live with a tradition of boards dominated by promoters. The boards have been shaped by a culture of deference in an economy where value comes from difference. The most serious criticism levelled at Adrian Cadbury's report on corporate governance was that it failed to address the 'inherent conflict of interest caused by non-executive directors being both an integral part of the management team and also monitors of their executive colleagues on the board'. Though there have been several reports thereafter, such as Greenbury, Hampel, the Combined Code, the issue of the conflict of interest has remained as poignant as ever. Hence, the UK appointed Derek Higgs, Chairman of Partnerships UK plc to lead an independent review into the role and effectiveness of non-executive directors. Higgs recommendations have been widely acclaimed.

The application of ideas and practice of corporate governance in India has depended largely on the initiatives of individual companies and institutional investors. There has been a noticeable increase in institutional interventions in the last two years. On the other hand, there is a powerful business lobby which seeks to restrain the extent of institutional intervention. The clearest formal expression of this lobby was the Confederation of Indian Industry's (CII) Code of Corporate Governance, which was only finally published in 1998. The codes of both CII and the Securities and Exchange Board of India (SEBI) claim descent from Cadbury, but it is worth noting that their stances on the rights of institutional shareholders depart significantly from Cadbury's.

> ***"The application of ideas and practice of corporate governance in India has depended largely on the initiatives of individual companies and institutional investors"***

There is considerable variation in the quality of individual boards in India. Most non-executives would fail to qualify on the standard tests of independence. SEBI's compositional stipulations are unlikely to have much effect unless managements decide that a strong board is essential to the strategic capabilities of the company and important to its corporate image. This is largely the same as saying that 'Voluntary codes mean nothing unless they change corporate culture'.

Looking at the 15 codes of corporate governance worldwide as a whole, international best practice recommendations can be broadly classified into three areas:

– the independence of the board,

– the responsibilities of institutional investors or shareholders, and

– the transparency of business structure and operation.

Almost all codes are agreed on the need for the board to have a substantial degree of independence from management. Where they differ is in the details and how tightly or loosely they define the independence of so-called independent directors. SEBI's definition is rather loose because it restricts itself to only one feature, namely, whether directors have 'any material pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries' which (in the opinion of the board) may affect their independence of judgement. But if the issue is independence of judgement, this can surely just as well be affected by a director having no such relationship but being, for example, a former executive of the company or a member of the immediate family of an individual who has been an executive in the recent past.

Secondly, almost every code recommends nomination committees to control the selection of the board. The SEBI Code omits any recommendation of this sort and does not even raise the issue, despite its own clear assertion that 'Till recently, it has been the practice of most of the companies in

India to fill the board with representatives of the promoters of the company, and independent directors if chosen were also handpicked thereby ceasing to be independent' (Code, 6.4). This is one of the most interesting omissions in our code and will surely be looked at in any future review of the guidelines.

Third, almost every code recommends the setting up of remuneration committees so that the pay of CEOs and senior management is not self-determined and there is transparency in the policy governing executive pay. SEBI makes this a non-mandatory recommendation, i.e. desirable but not essential, although disclosure of the compensation package *is* mandatory. Again, this looks like a compromise between conflicting pressures.

All codes of corporate governance recommend the establishment of audit committees but few jurisdictions have so far actually made them legally mandatory. In most markets the listing rules of the stock exchange require companies to disclose compliance with a code of best practices, which includes having an audit committee.

In India, audit committees are now required by both statute and the listing requirements. SEBI's recommendation involves the setting up of audit committees composed only of non-executive directors, of whom the majority are 'independent'. The interesting issue here is whether SEBI's definition of 'independent' is sufficiently tight to make the compositional requirement at all meaningful. It may also be helpful to note at this stage that though the publicly stated aims of the audit committee are to help ensure a high quality of financial reporting, to increase the credibility of audited financial statements, and to protect auditor independence, the academic discussion of their effectiveness has been described as 'limited and inconclusive'.

Finally, coming to transparency and disclosure, three areas are particularly important:

– transparency of ownership,
– directors' interests in transactions or matters affecting the corporation, and
– a substantial discussion of business issues in the form of Management Discussion & Analysis. Of these three areas, two, fortunately, *are* covered by mandatory recommendations in the code, namely, the second and third. Transparency of ownership is, curiously, omitted.

> ***"Although companies such as Infosys have pioneered higher reporting standards and shows growing willingness to 'try out' US GAAP many companies still remain translucent in their reporting."***

Lack of transparency is endemic to the way Indian business has been structured, and bringing disclosure up to international standards will require a sustained push.

This is particularly true of the disclosure and reporting standards. Although companies such as Infosys have pioneered higher reporting standards and shown growing willingness to 'try out' US GAAP many companies still remain translucent in their reporting. It is, therefore, doubtful whether corporate governance élitism will make much difference to the mainstream of Indian businesses, large and small. There is also the wider (or deeper) problem of whether constructing a formal architecture of corporate governance does address the underlying issue of corporate accountability, such as, the problem of the limitations of the Cadbury model. There is a widespread view that corporate governance should be left 'to the market'.

In February 2000 the (SEBI) Securities and Exchange Board of India issued a letter to all the stock exchanges proposing that 'a new clause, namely clause 49, be incorporated in the listing agreement'. Clause 49, called 'Corporate Governance', contains eight sections dealing with the Board of Directors, Audit Committee, Remuneration of Directors, Board Procedure, Management, Shareholders, Report on Corporate Governance, and Compliance respectively. The salient features are as follows:

– In future at least one-third of the board should consist of independent directors, 'independence' being defined as any material, pecuniary relationship or transactions with the company, other than the director's remuneration, which in the judgement of the board may affect a director's independence of judgement
– Companies shall have a 'qualified and independent' audit committee with a majority of independent directors
– The Annual Report shall disclose details of the remuneration of directors
– The Annual Report should contain a Management Discussion and Analysis 'as part of the director's report or as an addition thereto'.
– Annual Reports shall contain a separate section on Corporate Governance detailing compliance with the mandatory and non-mandatory requirements proposed by SEBI.

While the letter to the stock exchanges describes the various provisions as 'requirements', both the draft and the final report of the Kumar Mangalam Birla Committee refer to them as 'recommendations'. The Committee saw itself drafting recommendations, presumably because it saw itself pursuing an exercise in voluntary compliance ('self-regulation').

However, taken together these proposals may not go far in bringing about the kind of reform that can bring the mainstream of businesses in India into line with best practice in corporate governance. There are at least three reasons why this is so. *First,* the SEBI Code itself departs from international best practice in key respects which are outlined below. (A realist theory of regulation would argue that regulators do not work in a vacuum but are subject to powerful pulls and pressures within the domestic market.)

Second, it is still too early to say how far listing agreements can be an effective mechanism of compliance with a code of best practice. The fact that SEBI has since suggested to the government that 'the listing agreement be substituted by listing rules which are statutory in nature' suggests that the exchanges may not want or be able to play the role of compliance monitors. Indeed, there is considerable scepticism on this score.

Third, the Cadbury model, which is the ostensible inspiration behind SEBI's code, is itself open to a number of criticisms.

In Cadbury-style corporate governance that benchmark is a system of rules and principles of good corporate governance, which are expressed in a formal way in codes of best practice. Such codes are self-regulatory, with one important qualification, namely, that amendments are made to the listing agreement to create an obligation on companies to state how far they comply with the code.

Secondly, Cadbury acknowledges the strategic disparity between classes of shareholders, namely, the ability of institutional investors to influence corporate behaviour by contrast with the relative apathy and or impotence of small shareholders. Finally, the codes themselves are largely about defining and formalising management's accountability to the board, and, through the board, to the shareholders as a whole. Central to the professional character and independence of boards is the role the independent non-executive directors are expected to play and the formal mechanisms (i.e. board committees) through which such directors are expected to supervise management. The existence of board committees controlled by independent directors creates a presumption of formality and transparency in the procedures for appointing new directors to the board and developing a policy on executive pay. Cadbury assigns special importance to audit committees, since a major part of the brief of independent directors is the ability to exercise financial supervision over companies and reassure investors that the company's 'financial controls and accounting systems are of a high standard'.

> ***"If there is one lesson to be learnt from the high profile corporate failure of ENRON, Worldcom, Marconi et al, it is that we must move away from the western model of a box ticking approach to corporate governance"***

If there is one lesson to be learnt from the high profile corporate failure of ENRON, Worldcom, Marconi et al, it is that we must move away from the western model of a box ticking approach to corporate governance. Enron had ticked every box. The chairman of its audit committee was a person of irreproachable reputation and no less than the Dean of Stanford Business School.

The heart of corporate governance is the independence of directors. A number of analysts have attempted to establish criteria for independence in non-executives. The recent report of Naresh Chandra Committee on Corporate Governance has given a comprehensive definition of who can or can't be an independent director. Their Recommendation 4.1 defines an independent director as follows:

1. Apart from receiving director' s remuneration, does not have any material pecuniary relationships or transactions with the company, its promoters, its senior management or its holding company, its subsidiaries and associated companies;
2. Is not related to promoters or management at the board level, or one level below the board (spouse and dependent, parents, children or siblings);
3. Has not been an executive of the company in the last three years;
4. Is not a partner or an executive of the statutory auditing firm, the internal audit firm that is associated with the company, and has not been a partner or an executive of any such firm for the last three years. This will also apply to legal firm(s) and consulting firm(s) that have a material association with the entity.
5. Is not a significant supplier, vendor or customer of the company;
6. Is not a substantial shareholder of the company, i.e. owning 2 per cent or more of the block of voting shares;
7. Has not been a director, independent or otherwise, of the company for more than three terms of three years each (not exceeding nine years in any case);
   – An employee, executive director or nominee of any bank, financial institution,

corporations or trustees of debenture and bond holders, who is normally called a 'nominee director' will be excluded from the pool of directors in the determination of the number of independent directors. In other words, such a director will not feature either as the numerator or the denominator.

– Moreover, if an executive in, say, Company X becomes an non-executive director in another Company Y, while another executive of Company Y becomes a non-executive director in Company X, then neither will be treated as an independent director.

– The Committee recommends that the above criteria be made applicable for all listed companies, as well as unlisted public limited companies with a paid-up share capital and free reserves of Rs.10 crore and above or turnover of Rs.50 crore and above with effect from the financial year beginning 2003.

Though the list is so exhaustive like the Indian constitution, there are several situations that cannot be covered as is indicated by the following example:

An Indian company whose CEO wants to forge a strategic alliance with, or possibly sell the company to, a much larger American firm has appointed a director of the American firm to his board as a non-executive. Clearly, were an offer to be made, the non-executive in question could have no part in any discussion of bids or counter-bids. However, his absence would reduce the number of independent directors available to make recommendations to shareholders. Furthermore, he would by that point be well known to fellow directors, many of whom might have cause for gratitude to him as a member of the remuneration committee, to which he would no doubt have imported American notions of directors' compensation. The argument that long-term shareholders interests would be better served by rejecting the bid– because the sector is currently on the down swing and the US company is highly overvalued and poorly managed might not win the consideration it deserves. In the example at the time of his appointment the American non-executive appeared to warrant a tick in every box, making him an exemplary independent director.

> ***"Quarterly profits are not the only parameter of a company's success"***

Another example of apparently impartial, but in reality compromised, non-executive directorship emerges when a 'golden triangle' is created-whether by accident or design. These occur when a director of company A sits on the board of company B, while a director of company B sits on the board of company C. Once a director of C is appointed to the board of A, the triangle is complete. This is called a 'golden triangle' because non-executives appointed in this way invariably turn up on remuneration committees.

Worldcom's board comprised an architect who had designed CEO's house, the principal of his daughter's school principal and an actor friend. They would all be termed as "independent directors". All this brings into process the irrelevance of a box ticking approach to corporate governance which indeed has become disastrous for US corporate governance.

Naresh Chandra's committee by and large has done an excellent job. It has not succumbed to the pressure of auditing firms in prohibiting non-audit work. It has not gone far enough in recommending the US type oversight boards. It is badly required in India where the influence of accountancy profession is no less than what Arthur Levitt lamented about in the US.

What we must realize is that Corporate Governance guidelines and rules only focus on structural fixes and do not effect changes below the surface. Real change comes from choosing Boardroom Practices that focus on how to ask tough questions, challenge assumptions, conventional wisdom, probe assessments and broaden the perspective to ensure collective learning that gives the company a competitive advantage. The issues that truly board performances are the board dynamics, quality of dialogue, flow of information, power play, schedules and agendas for meeting and even the way seating is arranged. These issues can create or destroy the board's competitiveness.

Few people realize the untapped potential of corporate boards in creating value for the company. It is unfortunate that the CEOs have so far treated the boards as an interference in their work and something that diminishes their power. As Jay Lorsch of Harvard Business School and an authority on corporate governance asserts this is a serious misconception. His studies of the companies where directors have been empowered to monitor corporate and management performance, there is no evidence that the CEO and other top level managers have their power to lead the company diminished. Instead they have found that directors are better informed, communicate their ideas more effectively and provide better advice. In this way they can make a good CEO perform better. A board can be a true coach, counsellor and sounding board.

There is a general feeling that involving board and especially the non-executive directors slow down the decision making. Regard, therefore, has to be given to the recruitment of the directors. If independent directors themselves have experience of managing companies as CEOs they would know the cost of procrastination. We are living in a highly competitive world of radical change. Today's chief executives face a bewildering mosaic of wrenching change, uncertainty, stiff competition in a world of unprecedented opportunity for growth. His most important job is to manage discontinuities. The margin of error in today's markets has been reduced to razor thin. A slightly wrong decision can decimate stock price. Boards of today have to be proactive and not pliant, intrusive and not quiet, innovative and not incremental, radical and not staid. Bausch & Lomb suffered a $1 billion loss in market value and a permanent decline in its core contact lens business under CEO Daniel Gill when the company lost to Johnson & Johnson's drive into disposable contact lens. Apple Computers failed to regain its dominance in software driven competitive industry under 3 successive CEO's.

What we need is an absolute transparency in the decision making process of the board. These are issues of culture and law will not be able to change such an attitude. The taboos against candor and open discussion are so strong that we need to take some heroic steps to break them. There are three major reasons why boards even with independent directors, are not working:

(i) Failure to recognize that failure to deliver profits every quarter is not something to be ashamed of. Indeed it could have lessons that are value enhancing and asset creating.

(ii) Failure to recognize the value in the board is created by keeping it diverse as possible and conformity in the board is value destroying.

(iii) Failure to recognize that the "independent outside directors" who owe their appointment or reappointment to CEO and look upon him for remuneration fee and travel allowance cannot be truly independent.

The centrality of Corporate Governance is transparency. In an economy driven by innovation where companies have to constantly try out new models and where you are hitting a revolving target, every shot cannot be a bull's eye. Indeed success every time should be regarded as suspect. In any case quarterly profits are not the only parameter of a company's success. But if you have whetted shareholders appetite by managing earnings and showing profits each quarter, you require tremendous courage to admit you have failed this time. Our task is two fold – we have to educate the board to have the pride in admitting mistakes and educate investors to make them realize that in the innovation economy results are bound to be volatile. Indeed anything other than that may be deception. What we need is a culture where both board and management freely admit failures and explain to investors how, these have helped them change track and thus create value for the corporation.

> "*Independence of directors is a truly complex subject. Most of us would hesitate to raise awkward questions in a board meeting when we have to go to the same CEO to collect the remuneration cheque*"

The secret of world's most successful management innovation – ISO 9001 Quality Management System – over a million companies have been certified against the standard – is its recognition of failure and hence, focus on self-audit and corrective action. The purpose of self-audit is not simply to show the form but satisfy the auditors and provide them evidence that the system is robust enough to detect errors and take corrective action. The emphasis has to be on the process and not result.

Secondly just as conformance added value in the industrial economy, the value in the knowledge economy stems from diversity. A diverse board composed of a range of backgrounds and experience with gender, age and ethnic balance is far more valuable today that the board of former Stephenians of Free Masons. The best solutions come from clash of ideas and not through yesmanship. Recognition of this concept has a transformational value for the whole nation. There is a lot more value in associations, which are heterogeneous than homogenous. We should not cling to our caste, class or community. Never again we should defend a villain just because he happens to be "our own scoundrel" simply because he/she is from my caste/ region or religion.

Independence of directors is a truly complex subject. Independence lies in the state of ones' mind. Yet none can deny that most of us will hesitate to raise awkward questions in a board meeting when we have to go to the same CEO to collect the remuneration cheque or depend on him for reappointment. The answer lies in having a separate agency, for appointment and pay remuneration to the directors. The agency should have its own pool of independent directors selected through an elaborate proven system. The directors would receive the fee directly from that agency and will owe nothing to the company they are working for. This is a radical solution, but intricate problems such as these do require a radical solution. ■

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Corporate Governance and Firm Valuations in China

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1. Introduction

The Asian financial crisis has rekindled worldwide interest in the issue of corporate governance by academics, media, regulatory authorities, corporations, institutional investors, international organizations and shareholder rights watchdogs. Numerous initiatives have also been proposed by Asian countries to enhance their corporate governance practice, for example, new listing/disclosure rules, mandatory training for board directors, enforced codes of governance etc. International organizations are also very keen on governance issues. The International Monetary Fund has demanded that governance improvements should be included in its debt relief program. In 1998, the Organization of Economic Cooperation and Development (OECD) issued its influential *OECD Principles of Corporate Governance*, which are intended to assist member and non-member countries in their efforts to evaluate and improve the legal, institutional and regulatory framework for better corporate governance. In addition, private companies, such as Standard & Poor, California Public Employees' Retirement Pension System (CalPERS), CLSA, and McKinsey, are also calling for sweeping reforms of governance practice in emerging economies.

Corporate governance has also gained importance in China. The Chinese government opened stock exchanges in the early 1990s in order to raise capital and improve operating performance for state-owned enterprises (SOEs). In fewer than 12 years, China's stock markets have grown into the eighth largest in the world with market capitalization of over US$500 billion. Although the regulations over stock markets have been evolving to address the trade-off between growth and control they are still tightly controlled compared to other Asian markets. As controlled as it is, poor governance practice is still rampant among the Chinese listed companies. In 2001, the largest shareholder of Meierya, a one-time profitable listed company, colluded with other related parties and collectively embezzled US$ 44.6 million,

> **“Numerous initiatives have also been proposed by Asian countries to enhance their corporate governance practice, for example, new listing/disclosure rules, mandatory training for board directors, enforced codes of governance”**

41% of the listed company's total equity; in the same year, Sanjiu Pharma's largest shareholder extracted US$ 301.9 million, 96% of the listed company's total equity.

While Chinese companies, especially the SOEs, acquire a huge amount of capital from the public through either banking systems or capital markets, they remain extremely inefficient. For example, recent official statistics suggest that about one-third of all SOEs are loss-makers, another third either break even or are plagued with implicit losses, while the remaining one-third are marginally profitable. Ineffective governance system has been widely believed as the root cause of corporate China's lackluster performance.

Does a firm's corporate governance practices affect its market value? The answer seems to be positive. Recently, McKinsey has conducted a series of surveys on institutional investors and private equities with investment focus on emerging markets and found that 80% of them are willing to pay a premium to well-governed firms. Several other studies have also documented a positive correlation between performance measures and governance level. In this study, we intend to answer this question for the largest transition and developing economy – China. We attempt to address the following more interesting and challenging questions: what exactly are Chinese companies' corporate governance problems? Are there any implementable actions that could be taken to raise Chinese companies' governance standard? However it offers, for the first time, the corporate governance-rating index, the G index, for Chinese listed firms. We believe that the governance variables used in the construction of the G index have effectively captured the corporate governance practice of the Chinese listed companies. They may serve as the basis of governance practice code for corporate China. In China, given the strong influence of various levels of government in determining the governance practices of listed firms, often on arbitrary basis, we believe that the endogeneity problem in estimating the effect of governance practices on firm valuation is not important.

2. Corporate Governance Mechanisms

Over three hundred years ago, in his masterwork *"The Wealth of Nations*", Adam Smith raised the issue of the separation of ownership and stewardship in joint-stock corporations. It was therefore suggested that a set of effective mechanisms should be in place to resolve the conflict of interest between firm owners and managers. Modern academic literature on corporate governance stems from the seminal book by Berle and Means (1932), who argued that, in practice, managers of a firm pursued their own interests rather than the interests of shareholders. The contractual nature of the firm and the principal-agent problem highlighted by Berle and Means led to the development of the agency approach to corporate finance. Over the years, in particular in the last quarter of the 20th century, there has been rapid growth in both the theoretical and empirical studies.

The agency approach to corporate governance attempts to provide answers to the key question – "How can shareholders ensure that non-owner managers pursue their interests?" (see Allen and Gale, 2001). However, in recent years, another form of conflict of interest – controlling shareholders take actions that are for their own benefits at the expense of minority shareholders - has drawn upon much attention. As La Porta, Lopez-de-Silanes, and Shleifer (1998) assert, "…the central agency problem in large corporations around the world is that of restricting expropriation of minority shareholders by controlling shareholders…" Such an expropriation from minority shareholders by controlling shareholders takes a variety of forms, such as excessive executive compensation, loan guarantees, dilutive share issues, etc. Johnson, La Porta, Lopez-de-Silanes, and Shleifer (2000) use the term "tunneling" to describe the transfer of resources out of firms for the benefits of their controlling shareholders. Much evidence emerging during the Asian financial crisis shows that "tunneling" is a much more serious agency problem in emerging markets. The recent debacles of Enron, Worldcom, and Global Crossing convince people that "tunneling" is also possible even in a developed economy.

Taking various forms of agency problems into account, corporate governance has a new and more comprehensive meaning. As suggested by Dennis and McConnell (2002), corporate governance is the set of mechanisms – both institutional and market based – that induce the self interested controllers of a company (those that make decisions regarding how the company will be operated) to make decisions that maximize the value of the company to its owners (suppliers of capital)…" Practitioners seem to share the same view. For example, TIAA-CREF defines corporate governance as "…the set of mechanisms that maintain an appropriate balance between the rights of shareholders… and the needs of the board and management to direct and manage the corporation's affairs."

> ***"Good corporate governance is a set of mechanisms that assure suppliers of finance get a return on their investment"***

Thus, good corporate governance is a set of mechanisms that assure suppliers of finance get a return on their investment. Having said that, our next question naturally arises: what are the set of mechanisms that should be in place to govern a company? There are two competing views: market based governance model popular in US and UK vis-à-vis control based model common in emerging economies, Japan and the continental Europe. The market based governance model has the characteristics of an independent board, dispersed ownership, transparent disclosures, active takeover markets, and well-developed legal infrastructure. On the contrary, control model emphasizes the values of insider board, concentrated ownership structure, limited disclosure, reliance on family finance and banking system, and etc. Although academic research up to date has yielded mixed results regarding the superiority of the two models, more developing countries seem to favour the market-based model.

In this paper, we choose to focus on the set of mechanisms that help resolve a variety of agency problems for Chinese companies. We then assess a company's performance in each category, based on which we come up with an overall governance score.

Broadly speaking, there are two types of mechanisms that help resolve the two sets of conflict: between owners and managers; and between controlling shareholders and minority shareholders. The first type is internal mechanisms (e.g., ownership structure, executive compensations, board of directors, financial disclosure), while the second is external mechanisms (e.g., external takeover market, legal infrastructure, protection of minority shareholders, etc.). In this paper, we consider and assess each of them.

2.1 Internal Mechanisms

There are four internal governance mechanisms: board of directors, executive compensation, ownership structure, and financial transparency.

(1) The board of directors

In theory at least, the board of directors is the first instrument through which shareholders can exert considerable influence on the behavior of managers in order to ensure that the company is run in their interests. Empirical studies, however, are complicated by the fact that due to the well-known historical, political, social, economical, cultural and legal differences across countries, the structure of boards is significantly different. Nevertheless, the evidence available suggests that countries share common features with regard to this mechanism.

The empirical literature on the relationship between board composition and firm performance obtains the following findings: (1) Firms with boards containing a majority of independent directors do not perform better than firms without such boards; (2) A moderate number of inside directors is associated with greater profitability; (3) In Japan, although the presence of outside directors on the board has no effect on the sensitivity of CEO turnover to either earnings or stock-price performance, concentrated equity ownership and ties to a main bank do have a positive effect; and (4) There is a strong inverse relationship between CEO turnover and firm performance in some countries.

(2) Executive compensation

The second mechanism that ensures that managers pursue the interest of shareholders is to structure compensation appropriately, where the measures used to motivate managers include both stock valuations and accounting based performance measures. Although most of the empirical studies are constrained by data availability, the limited finding seems to suggest that there is a positive relationship between executive pay and performance in the US, Germany and Japan.

(3) Ownership structure

It is believed that one of the most important ways through which a firm maximizes its value is through well-designed ownership structure of the firm's shares. In general, concentrated equity ownership is regarded as a bad mechanism in corporate governance since it gives the largest shareholders more discretionary powers of using firm resources in the areas that only serve their own benefits. Claessens, Djankov and Lang (2000) find that cross-holding and pyramidal ownership have been common in Asian economies. One consequence of such ownership arrangement is that the controlling shareholders are able to obtain more control at minimal capital expense, which makes "tunneling" much easier. Although cross-holding, pyramidal schemes, and deviations from one-share-one-vote are not common in China, listed companies normally have one ultimate owner who holds a significant percent of total shares. The existence of such a controlling shareholder makes transferring resources out of listed companies into parent or other related parties' accounts possible. Several recently disclosed corporate scandals in China's capital markets were all about unconstrained large shareholders misusing firm's resources. On the other hand, since tunneling is usually inefficient for the firm as a whole, if the shareholding of the largest shareholder is very large and therefore there is high degree of congruence between his interest and the firm's interest, then ownership concentration may have a positive effect. In summary, the relationship between firm's performance and ownership concentration is expected to be U-shaped.

"Several recently disclosed corporate scandals in China's capital markets were all about unconstrained large shareholders misusing firm resources."

(4) Financial transparency and adequate information disclosure

There is no doubt that financial transparency and adequate information disclosure are of ultimate importance in all countries, particularly developing ones. Managers play a vital role in securing the interests of not only the existing owners but also potential investors. Honest managers will attempt to provide sufficient, accurate and timely information regarding the firm's operations, financial status, and external environment.

2.2 External Mechanisms

(1) Market for corporate control

It is generally believed that the existence of an active market for corporate control is essential for efficient allocation of resources. It allows inefficient managers to be removed and replaced with able managers who can gain control of large amounts of resources in a short period of time. The market for corporate control can operate in three ways: proxy contests, friendly mergers and hostile takeovers.

Proxy fights do not usually unseat the existing board of directors successfully because share holdings are often spread among many shareholders. Friendly mergers and takeovers occur in all countries and account for most of the transaction volume that occur. In some developed countries, it ranges from 60% to 90%. For hostile takeovers, they do occur fairly frequently in the US and UK, however, much less so in Germany, France and Japan. Empirical studies suggest that takeovers in the past did significantly increase the market value of target firms, although the increase in value for bidding firms was zero and possibly even negative. Studies using accounting data find that changes and improvements in operations can at least partially explain takeover premia.

(2) Legal infrastructure and protection of minority shareholders

A series of studies by La Porta et al (1997, 1998, 2002) emphasize the role played by legal framework and legal foundation in disciplining managers and controlling shareholders' opportunistic behaviors. They find that in countries with common law tradition, governance standards are generally higher and minority shareholders are relatively better protected. In contrast, countries pursuing continental law systems normally have poor minority shareholder protection and practice lower governance standards. Interestingly, they find that cross-country differences in equity valuation, cost of capital and magnitude of external financing could be explained by a country's legal origin. Obviously, legal infrastructure is an effective external mechanism that assures that investors get a fair return on their investment.

Chinese listed companies are regulated by the uniform legal system, therefore, this mechanism plays little role in explaining cross-sectional differences in governance practices. However, it has to be kept in mind that many Chinese companies do have shares listed and traded on stock exchanges where different jurisprudences prevail (e.g., H shares, ADRs, etc).

(3) Product market competition

Another powerful mechanism for solving a variety of agency problems is competition in product markets. If the managers of a firm waste resources, the firm will eventually fail in product markets. Hence, increased competition reduces managerial slack and may be helpful in limiting efficiency losses. The same logic implies that product competition helps curtail the "tunneling" activities of the controlling shareholder.

In sum, good corporate governance helps protect investors and ensures that investors get a fair return on their investment. The mechanisms we specified above play their roles in different ways. An effective combination of the above internal and external mechanisms, to us, delineates the essence of good corporate governance. Our assessments of Chinese companies' governance practice, therefore, are undertaken along with the two mechanisms respectively.

3. The Construction of Governance Measure - the G Index

The main purpose of this project is to quantify and evaluate the relative quality of corporate governance practice for each of the public company listed on Shanghai and Shenzhen Stock Exchanges. To accomplish this, we assess each company's governance performance in each category and construct an overall corporate governance index - the G Index. We then rank the companies by their G Index scores. In the process of the construction of the G index, we consider various factors that best reflect corporate governance standards in China. The choice of the variables is based on the corporate governance mechanisms discussed in Section 2. We make an effort to cover as many mechanisms as data would allow. We believe that we have worked out a set of governance measures that truthfully reflect Chinese listed companies' governance practice.

3A Definition of Variables

(1) Board of directors

(i) The CEO is the chairman or a vice chairman of the board of directors – ceo_is_top_dir.

(ii) The board of directors should play a role of a monitor of the management.

> ***"In countries with common law tradition, governance standards are generally higher and minority shareholders are relatively better protected"***

When the top manager, the CEO, controls or partially controls the board, it is hard for the board to play an independent and active monitoring role. As many studies have shown, the best practice is that board should be outsiders-dominant. Our measure, ceo_is_top_dir, therefore, is expected to have negative impact on a company's governance level.

(ii) The proportion of outsider directors – out_ratio

It is defined as the ratio of the number of directors without pay with respect to the total number of directors. Paid directors are often members of the management team who are delegated by the controlling shareholder. If they dominate the board, the board is not expected to play an effective monitoring role.

(2) Executive compensation

Stock options are rare in China. Also, the information on executive pay is not complete, and in majority cases inaccessible. However, we come up with the following alternative variable to capture executives' alignment of interest with other shareholders.

(iii) Shareholding by the top five executives of the firm – top5

The interests of the top managers are better aligned with the interests of other shareholders if the former have more stakes in the firm.

(3) Ownership variables

(iv) Shareholding of the largest shareholder – top1

This variable potentially has two conflicting effects on the quality of corporate governance, both related to the potential of tunneling. When the largest shareholder increases his holding, the constraints from other shareholders become weaker and therefore the largest shareholder is better able to engage in tunneling activities. On the other hand, when the largest shareholder holds close to 100 percent of the firm, his interest and the firm's interest are highly congruent and therefore he has little incentive to engage in inefficient tunneling. We expect that the negative effect is the more important effect because the positive one only kicks in when the largest shareholding is exceedingly large.

(v) The firm has a parent company – parent dummy

If the largest shareholder is another firm, the scope for tunneling is wider.

There are many more channels for a company than an individual to tunnel. The parent company can expropriate other shareholders of the concerned firm through various business dealings between them, or connected transactions. The most commonly observed are guaranteed loans, preferential transfer prices, the dumping of non performing assets from parent company to listed company.

(4) Financial transparency

We don't have a good measure for financial transparency. As most Chinese listed companies are audited by local accounting firms, there is no reliable information about which accounting firm is more reputable. In spite of the fact that a number of companies have shares listed on Hong Kong or New York stock exchanges and therefore have big 5 (unfortunately, big 4 now) firms audit their financial statements, foreign auditors seldom have access to the information about those listed companies' domestic operations – due to very complicated financing and ownership arrangements.

(5) The market for corporate control

(vi) Concentration of shareholding in the hands of the second to the tenth largest shareholders – cstr2_10

It is defined as the *logarithm* of the sum of squares of the percentage shareholding by the 2nd to the 10th largest shareholders. This variable should have a positive effect through three channels. First, other large shareholders are the obstacles to the tunneling activities by the largest shareholder. Second, they enhance the efficiency of the market for corporate control. When the management under-performs, these large shareholders can either initiate a fight for corporate control or help an outsider's fight for control. Third, these large shareholders also serve as monitors of the management. Overall, the higher is the concentration of shareholding in the hands of these large shareholders, the stronger these roles are.

(6) Legal framework and protection of minority shareholders

(vii) hbshare dummy

As explained before, the Chinese listed companies are unanimously regulated by Chinese jurisprudence with just a few exceptions: the firms with shares listed on Hong Kong and New York stock exchanges. The dummy variables for a listed company to have cross-listing in Hong Kong or New York will be used as a proxy for the effect of legal environment in enforcing corporate governance.

(7) Product market competition variable

Unfortunately, we don't have any measure for this mechanism. It has been widely believed that most of the listed companies, especially SOEs, are from protected industries or received preferential governmental treatment. However, the situation is changing very quickly since more and more non-SOEs are becoming public either through IPOs or purchasing a listed company.

> **"*Increased competition reduces managerial slack and may be helpful in limiting efficiency losses*"**

(vii) so_top1 dummy

Finally, in addition to the above seven measures of corporate governance derived from economic theory, we also consider one additional measure – the dummy variable that measures whether the controlling shareholder is the government or not.

It is believed that government may have goals such as maintaining employment and social stability rather than profit-maximization. The controlling government may use the listed company as a vehicle to meet these other policy goals that may conflict with shareholders' interests. Additionally, it has been argued that soft budget constrain is a major problem facing many SOEs in transition economies. We believe the problem may be more serious for listed companies whose controlling shareholders are governments at all levels. Therefore, we use this variable to capture its potential impacts on governance practice.

3B Summary Statistics

We studied all listed companies on both the Shanghai Stock Exchange and Shenzhen Stock Exchange during the year of 2000. We eliminated those firms with missing data for the eight variables and the remaining sample size is 1006 firms, representing more than 95% of listed firms in the two exchanges. The data source is *China Stock Market & Accounting Research Database (CSMAR)*, compiled according to the format of *CRSP* and *Compustat* by Hong Kong Poly University and GTA Information Technology Company Limited in Shenzhen.

In panel A, we present the summary statistics of the eight variables used in forming the corporate governance ranking. It is interesting to note that there are a number of distinctive features on the governance structure for Chinese firms: (1) More than a third of CEOs in China's listed companies are also the chairman or a vice chairman of the board of directors, blurring the monitoring role supposedly played by the board of directors; (2) The proportion of the number of outsider directors in the board for the sample companies is surprisingly high, with mean of 48.45% and standard deviation of 27.36%; (3) Top managers typically own very little of their companies' shares. The mean of *top5* variable is 0.02% with standard deviation of 0.1432%; (4) On average, the largest shareholder in each firm holds a significantly large portion of shares. Note that the mean of the top shareholder's holding, *top1*, is 45.26%, with highest value more than 88%; (5) A large majority of the publicly listed firms in China (78%) have a parent company. This can be seen from the mean for the dummy variable *parent*, which is 0.78; (6) There is a big variation of concentration of shareholding in the hands of the second to the tenth largest shareholders in China. The mean and the standard deviation for the concentration of the second to the tenth largest shareholders, *cstr2_10*, are 3.20 and 2.79, with lowest at -6.25 to highest 7.27; (7) Dual listing or multiple listing is not common for Chinese firms, with only less than 10% of them having the privilege; and (8) a large majority of companies, more than two thirds, are controlled by the government.

3C Ranking Methodology

According to our theoretical analysis, we divide the variables used in empirical ranking analysis into two broad sets. The first set includes variables that have negative impact on a company's governance level: (1) the CEO is the chairman or a vice chairman of the board of directors, *ceo_is_top_di;* (3) shareholding of the largest shareholder, *top1*; (2) the firm has a parent company *parent* dummy; (4) *so_top1*, that the largest shareholder is the state. The higher is the value of each variable, the lower the rank of corporate governance will be.

The second set includes variables that have positive impact on governance: (1) the proportion of outside directors, *out_ratio*; (2) shareholding by the top five officials of the firm, *top5*; (3) concentration of shareholding in the hands of the second to the tenth largest shareholders, *cstr2_10*; (4) the dummy that captures whether a company has overseas listings or not, *hbshare*. The lower is the value of each variable, the lower the rank of corporate governance will be.

We sort the variables in the first set in descending order, and the variables in the second set in ascending order. Then the ranking of the companies is generated accordingly. Specifically, we rank each company according to each of the 8 variables.

After obtaining the ranking according to each variable, we divide it by the total number of available observations in the study and multiply the resulting measure to obtain a normalized value from 0 to 100. Finally, the G index is constructed as the equally weighted average of the individual rankings for each company. We use equal weighting because, *a priori*, it is not clear what weights are more appropriate.

4. Empirical Results on Corporate Governance, Performance and Valuations

We rank all companies according to the G formula (1). The company with the highest G index is ranked number one, while the company with the lowest G is ranked as 1006th. The details of all the rankings of individual variables and the overall ranking according to the total score are available upon request.

In theory, good corporate governance should be related to high corporate valuation. A number of empirical studies on emerging markets have found that investors are willing to pay a premium averaging 10% to 12% for good corporate governance. It would be interesting to see whether better-governed Chinese companies, measured by our measure of corporate G index, are associated with higher corporate valuations.

"In theory, good corporate governance should be related to high corporate valuation"

5. Conclusion

The main findings of the study can be summarized as follows :

(1) We identify several important corporate governance mechanisms stemming from the agency theory and the more recent theory of tunneling in corporate governance. The seven mechanisms are classified into internal and external dimensions. Among others, the ownership and the board structure, executive compensation, the market for corporate control, and the financial transparency are found to be the most important factors in influencing corporate governance.

(2) Based on our theory and understanding of China's capital market, we construct variables that represent each of the internal and external governance mechanisms. We then rank our sample companies according to the logical impact of each variable. After assigning equal weights to the ranks of these variables, we obtain an index, called the G index, to reflect the overall level of governance practice for China's listed companies.

(3) We explore the possible links between corporate governance and corporate stock valuations. We find that better-governed companies are indeed associated significantly with higher stock market valuation as measured by Tobin's q and the ratio of market value and book value of the total asset. We conclude that corporate governance matters greatly in China's emerging market and Chinese investors are willing to pay a significant premium for better governance standard.

Our findings, albeit tentative, have valuable implications for both the security regulators and listed companies in China. It is known that many security regulators in the world, have recognized the importance of corporate governance in enhancing firms' investment values. They have proposed various ways, known as the best practice codes, to improve a firm's overall governance standard and align the behavior of its insiders along governance-related dimensions. It is our belief that our construction of the G index together with the significantly positive governance-valuation relationship will shed more light into the compilation of the best practice codes in China. Our study identifies a set of governance mechanisms that have the most significant impact on firm's governance practices and stock market valuation. It provides guidelines for Chinese regulatory authorities to design the best practice codes tailored to the Chinese institutional background and current capital market development level. In addition, should firms strive for improving their market performance and maximizing shareholders' wealth, they would attempt to follow the general practices engaged by market leaders, make noticeable improvement in the areas that will have the largest impact on their relative corporate governance standing. There is a significant payoff for climbing up the governance ladder. ■

***Condensed from the paper submitted by Chong-En Bai, Qiao Liu, Joe Lu, Frank M. Song, and Junxi Zhang, Faculty of Business and Economics, The University of Hong Kong.**

Trends and Developments in Top Management Teams:

Evidence from UK Panel Data

Annita Florou*

Introduction

The UK corporate governance codes recognise the directors' board not only as the cornerstone of a successful corporate governance regime but also as a fundamental prerequisite for the integrity of the corporations' accounting and financial reporting systems (e.g. Cadbury Report, 1992; the Combined Code, 1998). This public interest in turn has resulted in a number of academic papers focusing on several board issues.

For example, Westphal (1998), Charan (1998) and others focus on demographic diversity in the boardroom. A considerable amount of studies concentrate on the level of women participation in the boards (e.g. Conyon and Mallin, 1997; Holton, 2000; Singh, Vinnicombe and Johnson, 2001). Several studies review annual reports or conduct questionnaire surveys in order to gain insights into the composition of the directors' board (e.g. Conyon and Mallin, 1994; Doble, 1997; Dedman, 2000a), the size of the board or the level of directors' stock ownership (Dedman, 2000b, Dahya, McConnell and Travlos, 2001).

In a similar vein, a relatively limited number of studies focus on different board leadership structures, i.e. separate vs. joint CEO/Chairmanships (Dahya, Lonie and Power, 1996; Daily and Dalton, 1997; Dedman, 2000a). Existing evidence, however, regarding the implications of the above alternative leadership scenarios is conflicting.

Whilst the board of directors has been the focus of a number of studies, less research attention has been given to the *top management team*. Moreover, even less academic interest has been shown in the *CEO* or the *individual leader*. Stated otherwise, in contrast with boards, little is known about the way top management teams are structured (i.e. the number of CEO vs. MD positions, the number of executive vs. non-executive Chairmanships etc.) or about the profile of top managers, (i.e. age, tenure, and stock ownership).

One of the main reasons for the lack of analysis in the above areas has been the considerable difficulty of collecting the appropriate data. A rigorous investigation of the above issues requires detailed information on the identities of top managers, whereas data based on a limited number of years can be limited in its attempt to cast new light on particular time-series patterns. Moreover, as explained in the following sections, the identification of the leading executive in UK firms is a particularly complicated task. Accordingly, the analysis undertaken in this paper is among the first to utilise a rich source of panel data, representing a key contribution to the UK corporate governance literature.

In particular, drawn on the top 460 UK listed companies by market capitalisation over the period 1990-1998, the contribution of the current study is three-fold. Firstly, it reports certain developments in the composition of UK top management teams over the last decade. Secondly, it yields new evidence on the controversial issue of CEO duality by investigating the extent to which different leadership structures may imply different levels of firm performance or managerial entrenchment. Finally, it documents several stylised facts regarding the profile of both all senior managers and the individual leaders in UK companies.

The study's main findings can be summarised as follows. Firstly, UK companies are more likely, nowadays than in the past, to: a) adopt the "CEO" title (as opposed to the "Group Managing Director" title) in order to signal the top corporate position; b) have non-executive Chairmen (as opposed to executive Chairmen), and; c) separate the roles of CEO/MD and Chairman. Secondly, joint CEO(MD)/Chairpersons own a higher proportion of the company's equity than their counterparts who do not hold combined roles; yet, company performance is not significantly different under alternative leadership structures. Finally, UK leading executives tend to be younger and hold a larger proportion of the firm's equity compared with the rest of the senior managers whereas on an aggregate level executive stock compensation (both ordinary and option holdings) has declined during the 1990-1998 period.

The remainder of the paper continues as follows. The next section illustrates the sample selection process. Section 3 describes the collection of the data. Results are presented and discussed in Sections 4, 5 and 6. Finally, Section 7 summarises and concludes the paper.

The Sample

The study was based on a sample of the top 460 UK companies listed on the London stock market over the period 1990-1998. The companies were selected as follows. Using Datastream and excluding all investment trusts and the repetitions of those firms that had two classes of shares listing on the London

Stock Exchange (e.g. B or Non-Voting shares), the top 300 UK companies ranked by market capitalisation on 1st January each year were included. In each of the separate years over 1990 to 1998 the largest 300 companies have, of course, changed as some companies exited the list (e.g. through take-over, death or decline in capitalisation) and other firms entered. The selection procedure resulted in the main data set that consists of an unbalanced panel of 460 UK companies quoted on the London stock market over the period 1990-1998.

In addition to Datastream, the Changes of Names 1965-1998 (1999) was also used to identify companies that changed their name during 1990-1998 and the London Share Price Database Reference Manual, 1997 (LSPD) to identify the first date on which the company was listed on the London Stock Exchange (birth date) and the day on which the company ceased to exist (death date) due to take-over, merger or liquidation. In these cases, top management information was not entered, for the years preceding the birth date and/or the years following the death date.

Data Assembly

Identifying Top Managers

The names and the type of position, i.e. executive or non-executive, of each company's Chief Executive Officer (CEO), Chairman, and group Managing Director (MD) - wherever applicable - were manually recorded from the September issue of the PriceWaterhouseCoopers (PWC) Corporate Register (Companies Section). This procedure was repeated for each September edition of the PWC Corporate Register from 1990 to 1998. Information was supplemented from a number of other sources, such as Annual Company Accounts (provided by LASER D) and Extel Financial UK Quoted Companies – Annual Cards.

A valuable contribution of this study is the documentation of trends and developments regarding not only UK *top management teams* but also UK *leading executives*. Specifically, identifying the most senior executive in UK firms is a complicated task since the title "Chief Executive Officer" has only comparatively recently been used to signal the top corporate position. Other titles such as Chairman and Managing Director are also used - especially in earlier periods. This paper presents new evidence on the profile of the company's Most Senior Executive (hereafter denoted as MSE), who - for each year and each company - was taken to be the CEO if such a role existed. When no CEO existed the Most Senior Executive was taken to be either the Executive Chairman or the group Managing Director.

> ***"UK companies have gradually adopted the title "Chief Executive Officer" to signal the top corporate position. During the early years, alternative titles such as "Chairman" or "Managing Director" were actually more often used"***

Stock Ownership

The number of ordinary and option holdings of each company's CEO, Chairman, and Managing Director were manually recorded from the September issues of the PWC Corporate Register (Companies Section). This procedure was repeated for each edition of PWC Register from 1990 to 1998. Information on top managers' equity was supplemented from other issues of the PWC Corporate Register and Annual Company Accounts.

Birth Dates

The birth dates of the sample's top managers were mainly collected from three sources: a) various issues of the PWC Corporate Register (Directors' and Officers' Section), b) the Directory of Directors (1999), and c) the Companies House in Birmingham.

Tenure

The appointment dates of each company's CEO, Chairman, and Managing Director at the particular position were recorded from the September issue of PWC Corporate Register (Directors' and Officers' Section) for each year of the 1990-1998 period. A number of sources were used to gather the missing appointment dates. These include other PWC Corporate Register, Extel Financial UK Quoted Companies – Annual Cards, Annual Company Accounts, Financial Times Archive, and a mail survey followed up by a phone call or fax.

Company Variables

Two measures of company performance were used in this study; company stock returns and return on assets. The return on the company's stock is calculated as the log of (RI_{t+1}/RI_t), where RI stands for Return Index on 1st January [1]. The return on assets is calculated as the level of accounting earnings before interest and tax divided by the book value of the firm's total assets in the beginning of the year. Size is measured as the log of the market value of the company. The above data was obtained from Datastream. The 3-digit and 1-digit industrial classification codes and industry description were then recorded based on the company's entry in the PWC Corporate Register in September, 1995. Finally, the total number of ordinary shares in issue of each company for each year over the period 1990-1998 was manually recorded from the September issues of the PWC Corporate Register (Companies Section). Similar to top managers' equity, information regarding the company's share capital was supplemented from other issues of the PWC Corporate Register and company accounts.

Changes in the Structure of UK Top Management Teams

Overall, the sample consists of 1385 different top managers that were in office during 1990-1998. **Tables 1 & 2** illustrate several developments regarding the composition of top management teams in the UK. The first one presents the total

Table 1

Chairman, CEO and Group MD Positions by Year, Time-Period: 1990-1998, Sample: Top 460 London Stock Exchange Firms

Year	Chairmen	CEOs	Group MDs
1990	374	223	165
1991	386	223	177
1992	386	240	161
1993	390	256	130
1994	390	270	124
1995	394	281	114
1996	387	282	101
1997	380	284	84
1998	362	278	78
Total	**3449**	**2337**	**1134**

number of CEO, Chairman and group MD positions by year. The second one presents the number of executive and non-executive Chairman positions as well as the number of cases in which the company's Chairman holds a combined role, i.e. he is also the CEO or the group Managing Director.

As already highlighted, UK companies have gradually adopted the title "Chief Executive Officer" to signal the top corporate position. During the early years, alternative titles such as "Chairman" or "Managing Director" were actually more often used. The pattern that emerges from both tables confirms this argument. As shown in **Table 1,** the number of CEO positions has increased from 223 in 1990 to 278 in 1998 whilst the number of group Managing Director posts has decreased from 165 in 1990 to 78 in 1998. In contrast, **Table 1** demonstrates that there is no monotonically time-series trend in the total number of Chairman positions.

Nevertheless, a striking observation made from **Table 2** is that the number of executive Chairmen has decreased by more than 42% over the period 1990-1998 whereas the number of non-executive Chairmen has increased by 97% during the same period. This finding reinforces the argument that as the CEO title is increasingly used to denote the company's leading executive, there is a shift in the Chairman's responsibilities who now becomes less involved with "steering the ship", i.e. running the company, and more involved with "setting the tone and blowing the whistle", i.e. running the board and monitoring the CEO, (Financial Times, 2001).

Table 2 illustrates that in 1990 108 UK companies (29% of the total sample) had a Chairman-CEO/MD dual position whilst in 1998 only 21 companies (6% of the total sample) kept these roles combined. Consequently, there has been approximately an 81% fall in the number of cases in which the positions of the Chairman and CEO or group Managing Director are held by a single individual. Bearing in mind that the first Code of Best Practice in corporate governance, published by the Cadbury Committee in December 1992, recommended that companies separate the two roles, evidence suggests that companies seem to have complied with these proposals (although it should be noted that, as shown, the declining trend had already started taking place prior to 1992).

The results can be compared with the empirical evidence of two prior studies. In the first one, Conyon (1994) employs a sample of roughly 400 UK quoted companies and finds that the percentage of large quoted UK companies in which the roles of Chairman and CEO were not combined rose from 57% in 1988 to 77% in 1993. In the second one, Dahya, McConnell and Travlos (2001) report that prior to Cadbury, the Chairman of the board also held the position of top manager in 36.5% of the companies; after Cadbury, that fraction dropped to 15.4%.

Finally, a striking feature of the data is that female top managers account for less than 0.7% of the total. This is consistent with a number of previous studies who also document cases of serious under-representation of women in the boardroom and in particular, cases of low incidence of female executive directors in UK firms (Conyon and Mallin, 1997; Holton, 2000; Singh, Vinnicombe and Johnson, 2001).

Joint Versus Separate CEO/ Chair Roles

A topic central to the issue of corporate governance has been that of separating the roles of Chairman and CEO. Following the recommendations of the UK Cadbury Report (1992) that these

Table 2

Executive Chairmen, Non-Executive Chairmen and Combined Roles by Year, Time-Period: 1990-1998, Sample :Top 460 London Stock Exchange Firms

Year	Executive Chairmen	Non-Executive Chairmen	Combined Roles
1990	269	105	108
1991	280	106	96
1992	253	133	82
1993	240	150	62
1994	214	176	47
1995	205	189	36
1996	176	211	33
1997	173	207	30
1998	155	207	21
Total	**1965**	**1484**	**515**

Industry Sector	Number of Companies	Combined Roles
Mineral Extraction	18	7 (39%)
General Manufacturers	140	55 (39%)
Consumer Goods	56	16 (29%)
Services	130	49 (38%)
Utilities	44	11 (25%)
Financials	72	16 (22%)
Total	**460**	**154 (33%)**

Table 3

Characteristics of Dual CEO(MD)/Chairman Positions Versus Non-Dual Positions, Time-Period: 1990-1998, Sample: Top 460 London Stock Exchange Firms

Average	Dual	Non-Dual	p-value
Ordinary Holdings (% of Common)	5.16%	0.57%	0.000
Option Holdings (% of Common)	0.16%	0.26%	0.209
Age	56.1	51.1	0.000
Tenure as CEO/MD	9.84	3.43	0.000
Stock Returns	0.038	0.067	0.135
Return on Assets	0.114	0.114	0.959
Size (log of market value)	6.32	6.57	0.000

roles should remain distinct and separate, a number of academic studies focused on the implications of different leadership structures. Nevertheless, existing evidence is both sparse and inconclusive.

For example, Dedman (2000a) documents significant differences between combined and non-combined positions in certain variables - such as age, ownership and tenure - suggesting that joint CEO/Chairpersons are more likely to entrench themselves. She does not find any evidence, however, that this is detrimental to firm performance. On the other hand, Daily and Dalton (1997) report that separate Chairpersons have actually longer tenures as CEO and hold a larger percentage of the firm's equity compared with their joint CEO/ Chairperson counterparts whereas Dahya et. al. (1996) find that following the adoption of a dual CEO position, the accounting performance of companies appears to decline.

Table 3 provides additional evidence on the controversial issue of CEO duality. Specifically, it documents certain differences in both managerial and firm characteristics between those CEOs/MDs who are also Chairmen and their counterparts who do not hold combined roles.

As illustrated, joint CEO(MD)/Chairman executives are significantly older, stay longer in office, and own a larger fraction of the company's equity (but not a larger proportion of option holdings); the p-value of the t statistic for the difference in the averages of all the above variables is 0.000. Furthermore, the data indicate that the size of companies with joint leadership structures is smaller than those with separate leadership structures. Finally, firm performance - both stock-based and accounting-based - is not significantly different between the two groups. Overall, evidence suggests that joint CEO(MD)/Chairmen may be associated with different levels of managerial entrenchment but not with different levels of firm performance[2].

The Profile of UK Top Management Teams

The analysis finishes with the discussion of several stylised facts regarding the profile of top management teams in UK companies. In particular, **Tables 4, 5 & 6** report descriptive information on three main managerial attributes: a) age, b) organisational tenure, and c) stock-based compensation.

Stock-based compensation provides a direct link between shareholder wealth and CEO wealth, because each pound increase in the stock price increases the value of ordinary shares, stock options etc. Accordingly, agency scholars argue that stock-based compensation can provide financial incentives for managers to take actions that increase shareholder wealth, and to avoid actions that decrease shareholder wealth (Jensen and Murphy, 1990; Murphy, 1999; Conyon and Murphy, 2000a). **Table 4** shows that the leading executive of a UK company (i.e. Most Senior Executive) has both higher ordinary and option holdings than the rest top executives (2.37% and 0.24% as opposed to 1.55% and 0% respectively). Bearing in mind that organisational theorists (e.g. Glover, 1976; Hofer, 1980; Steiner, Miner and Gray, 1982) have largely agreed that CEOs are the principal individuals responsible for the company's economic status, the above finding is in line with the argument of tying CEO compensation to stock price.

Moreover, as indicated the leading executives in UK companies are also younger compared to the rest top managers. The average age of a leading executive is approximately 53 whilst non-Most Senior Executives are about 58 years old; the p value of the t-statistic for the difference in mean stock-based compensation and age of MSE and non-MSE is 0.00, indicating its statistical significance. Finally, data reveal that on

Table 4

MSE and Non-MSE Stock-Based Compensation, Age and Tenure, Time-Period: 1990-1998, Sample: Top 460 London Stock Exchange Firms

Average	MSE	Non-MSE	p-value
Ordinary Holdings (% of Common)	2.37%	1.55%	0.000
Option Holdings	0.24%	0.00%	0.000
Age	53.6	57.9	0.000
Tenure	5.42	5.37	0.758

Table 5

Most Senior Executive Stock-Based Compensation by Year, Time-Period: 1990-1998, Sample: Top 460 London Stock Exchange Firms

Year	Ordinary Holdings (% of Common)	Option Holdings (% of Common)
1990	3.25%	0.16%
1991	3.15%	0.16%
1992	2.74%	0.19%
1993	2.43%	0.30%
1994	2.38%	0.34%
1995	2.00%	0.19%
1996	2.37%	0.40%
1997	1.77%	0.21%
1998	1.20%	0.25%

Table 6

Top Management Stock-Based Compensation, Age and Tenure by Industry Sector, Time-Period: 1990-1998, Sample: Top 460 London Stock Exchange Firms

Industry Sector	Ordinary Holdings (% of Common)	Option Holdings (% of Common)	Age	Tenure
Mineral Extraction	1.19%	0.12%	54.9	4.05
General Manufacturers	2.11%	0.20%	56.3	5.80
Consumer Goods	1.80%	0.17%	55.2	4.48
Services	2.84%	0.16%	55.2	5.89
Utilities	0.20%	0.00%	56.8	2.83
Financials	1.14%	0.18%	56.0	6.07

average both the Most Senior Executives and the rest non-MSE executives serve in office for about 5 years.

The analysis of managerial stock compensation is continued in **Table 5,** which presents time-series data on the fraction of both ordinary and option holdings of the leading executives. As reported, ordinary MSE holdings (as a % of common equity) have declined from 3.25% in 1990 to 1.20% in 1998. The fraction of option holdings owned by the company's leading executive in 1994 was two times as much as that in 1990 whilst in 1998 it fell by 26% (when compared with 1994). This evidence is consistent with the findings of Main (1999) who - based on data provided by a large compensation consulting firm - demonstrates that the prevalence of option schemes in the UK grew dramatically from the mid-1980s to the early 1990s to fall again in the mid-1990s. In particular, in 1978 only 10% of UK companies offered options to their top executives, by 1983 over 30% of companies had established option schemes, and by 1986 this figure had increased to almost 100%. However, the use of share options in the UK fell substantially in the mid-1990s whilst by 1997 only 68% of companies were in a position to offer options to their top executives.

Finally, **Table 6** depicts the fraction of stock-based compensation, the age and the tenure of *all* UK senior managers by industry sector. Two very interesting observations are derived from this table. Firstly, the utilities sector has the oldest top managers with the least tenure in office and the lowest fraction of stock-based compensation (both ordinary and option holdings). The latter finding is consistent with that of Conyon and Murphy (2000b) who, based on a sample of the largest UK companies in 1997, report that the proportion of share holdings and option holdings (as a % of common equity) for utilities is 0.01% and 0.03% respectively and the lowest compared with the rest industry sectors. Taken together, the above confirm Smith and Watts (1982) who argue that stock-based compensation is predicted to be less prevalent in regulated industries (i.e. industries where it is more difficult to alter the risk of investment).

Secondly, general manufacturers have the highest top managerial option holdings and the second highest top managerial ordinary holding (0.20% and 2.11% respectively). This in turn, is in line with a stream of literature, which reports that high-growth firms (e.g. chemicals, electrical equipment etc.) have a significantly higher incidence of stock-based compensation and in particular, of stock option plans (Smith and Watts, 1992; Gaver and Gaver, 1993; Collins, Blackwell and Sinkey, 1995; and Baber, Janakiraman, Kang, 1996).

Concluding Remarks

While too much weight has been placed on boards of directors, very little attention has been drawn to the top management team, a group with unique and distinctly different roles from the restof the company directors. Using data from the top 460 UK companies by market capitalisation over a nine-year period (i.e. 1990-1998) the aim of this paper was to gain valuable insights into: a) the structure of UK top management teams, b) the implications of CEO duality, and c) the profile of both all senior managers and the individual leaders of British companies.

This paper has added to the UK corporate governance literature in the following three ways.

Firstly, results indicate that over the last nine years there have been significant changes in the structure of UK top management teams, which tend to consist of more CEO titles, less executive Chairmen and less combined roles.

Secondly, it was documented that CEOs/MDs who are also Chairmen own a larger fraction of the company's equity than those who do not hold combined roles whilst the firm's performance is not significantly different under alternative leadership structures.

Finally, it was reported that the individual leaders (MSEs) tend to be younger and owners of a larger fraction of the firm's equity than the restof the senior managers; nevertheless, the use of MSE managerial stock compensation has declined during the last decade.

Notes

1. A company's return index shows the growth in the share value and the value of the dividends. The relevant formula is: RIt = RIt-1 * (Pt+Dt)/Pt-1, where Pt = price on ex-date (i.e. the day dividend payments become certain), Pt-1 = price on previous day and Dt = dividend payment associated with ex-date t.
2. Of course, it should be noted that the current findings are just indicative and not conclusive.

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Higgs' Report

Derek Higgs report on the role of effectiveness of non-executive directors commissioned by Secretary of State Patricia Hewitt and Chancellor Gordon Brown directors in April 2002, has been released. It recommends changes to the Combined Code to incorporate greater transparency and accountability in the boardroom and closer relationships between non-executive directors and shareholders. A summary of recommendations are given below.

The board

- The board is collectively responsible for the success of the company. A description of the role of the board is proposed for incorporation into the Combined Code.
- The number of meetings of the board and of its main committees should be stated in the annual report.
- The board should be of an appropriate size. At least half the members of the board, excluding the chairman, should be independent non-executive directors.

The chairman

- The chairman has a pivotal role in creating the conditions for individual director and board effectiveness.
- The roles of chairman and chief executive should be separated and the division of responsibilities between the chairman and chief executive set out in writing and agreed by the board.
- A chief executive should not become chairman of the same company. At the time of appointment the chairman should meet the test of independence set out in the Review.

Role of the non-executive director

- A description of the role of the non-executive director is proposed for incorporation into the Code.
- The non-executive directors should meet as a group at least once a year without the chairman or executive directors present and the annual report should include a statement on whether such meetings have occurred.
- Prior to appointment, potential new non-executive directors should carry out due diligence on the company to satisfy themselves that they can make a positive contribution to the board.

The senior independent director

- A senior independent director identified as one who meets the test of independence. He should be available to shareholders, if they have concerns that have not been resolved through the normal channels of contact with the chairman or chief executive.

Independence

- All directors should take decisions objectively in the interests of the company.
- A definition of independence has been proposed for incorporation into the Code.

Recruitment and appointment

- There should be a nomination committee of the board to conduct the process for board appointments and make recommendations to the board.
- The nomination committee should consist of a majority of independent non-executive directors. It should be chaired by an independent non-executive director.
- The nomination committee should evaluate the balance of skills, knowledge and experience on the board and prepare a description of the role and capabilities required for a particular appointment.
- On appointment, non-executive directors should receive a letter setting out what is expected of them.
- The nomination committee should provide support to the board on succession planning.
- Chairmen and chief executives should consider implementing executive development programmes to train and develop suitable individuals in their companies for future director roles.
- The board should set out to shareholders why they believe an individual should be appointed to a non-executive director role.
- A small group of business leaders and others will be set up to identify how to bring to greater prominence candidates for non-executive director appointment from the non-commercial sector.
- The Review offers guidance on the process for the appointment of a new chairman.

Induction and professional development

- A comprehensive induction programme should be provided to new non-executive directors.
- The chairman should address the developmental needs of the board as a whole with a view to enhancing its effectiveness.
- The performance of the board, its committees and its members, should be evaluated at least once a year.
- Supported by the company secretary, the chairman should assess what information is required by the board. Non-executive directors should satisfy themselves that they have appropriate information of sufficient quality to make sound judgements.
- The company secretary should be accountable to the board through the chairman, on all governance matters.

Tenure and time commitment

- A non-executive director should normally be expected to serve two three-year terms.
- On appointment, non-executive directors should undertake that they will give sufficient time taking into account their other commitments.
- The nomination committee should annually review the time required of non-executive directors.
- A full time executive director should not take on more than one non-executive directorship, nor become chairman, of a major company. No individual should chair the board of more than one major company.

Remuneration

- The remuneration of a non-executive director should be sufficient to attract and compensate high quality individuals.

- Non-executive directors should not hold options over shares in their company.

Resignation
- Where a non-executive director has concerns about a course of action proposed by the board, these should be raised with the chairman and their fellow directors. They should ensure their concerns are recorded in the minutes of the board meetings if they cannot be resolved.
- On resignation, a non-executive director should inform the chairman in writing, for circulation to the board, of the reasons for resignation.

Audit and remuneration committees
- The remuneration committee should comprise at least three members, all of whom should be independent non-executive directors.
- The remuneration committee should have delegated responsibility for setting remuneration for all executive directors and the chairman.
- No one non-executive director should sit on all three principal board committees (audit, nomination and remuneration) simultaneously.

Liability
- The Government is recommended to consider the principles set out by the Company Law Review in considering criminal sanctions in relation to directors.
- A company should be able to indemnify a director in advance against the reasonable cost of defending proceedings from the company itself, without trying to establish in advance the prospects of success of the case.
- Companies should provide appropriate directors' and officers' insurance and supply details of their insurance cover to potential non-executive directors before they are appointed.

Relationships with shareholders
- All non-executive directors, and in particular chairmen of the principal board committees, should attend the Annual General Meeting (AGM) to discuss issues that are raised in relation to their role.
- The senior independent director should attend sufficient regular meetings of management with a range of major shareholders. He should communicate his views to the non-executive directors and to the board.
- Boards should recognise that non-executive directors may find it instructive to attend meetings with major investors from time to time and should be able to do so if they choose.
- On appointment, meetings should be arranged for non-executive directors with major investors, as part of the induction process.
- The Review endorses the Government's approach to more active engagement by institutional shareholders with the companies in which they invest, and the Institutional Shareholder Committee's (ISC) code of activism.

Smaller listed companies
- The recommendation that no one individual should sit on all three principal board committees at the same time should not apply to smaller listed companies.

■

Contd. from P16

There are other issues including the issue of the absence of a comprehensive Bankruptcy Code. I think there are a few countries which have addressed the issue of Bankruptcy Codes, in particular this new emerging phenomenon of cross-border insolvency. How to create structures, legislation to provide for initiating bankruptcy proceedings, appointment of trustees, empowerment of trustees. Bankruptcies and insolvencies in cross border between different companies have disastrous ruinous effect on ordinary shareholders. Even within his own domestic jurisdiction the shareholder has very limited remedies in winding up insolvency proceedings. In cross border ones he has virtually none or very difficult proceedings. They are very expensive ones. So I think it is time that countries start looking at the excellent UNC trial model code on cross border insolvency and bankruptcy because that would be a key to good corporate governance if it is adopted in certain legal systems.

The issues are many and large, but if we take care of the specifics of the smaller things perhaps the larger things will take care of themselves. It is important to keep the larger concept in view – Corporate Governance, wealth creation, the need to bring in ethics into Corporates, but it is necessary to take these large concepts along with the specifics, because unless we take care of the nitty-gritty of changes not only in law but in practice, in procedure, in voluntary codes, in the running of companies, we are not likely to achieve real change. I can do no better in emphasizing the object of good corporate governance for wealth creation than to quote from the Birla Committee on Corporate Governance which said: *"Strong Corporate Governance is thus indispensable to resilient and vibrant capital markets, and is an important instrument for investor protection. It is the blood that fills the veins of transparent corporate disclosure and high quality accounting practices. It is a muscle that moves a viable and accessible financial reporting structure, a structure without which capital markets would collapse. In other words, in a nutshell, no capitalism without a conscience, no wealth without character"*.

We would conclude with Lord Thurlow's understandably pessimistic view when he said, *"Did you event expect a corporation to have a conscience when it has no soul to be damned and no body to be kicked?"* . The only fitting answer to Lord Thurlow was provided by the French philosopher Henri Thoreau when he said. *"It is truly enough said that a Corporation has no conscience. But a corporation of conscientious men is a corporation with a conscience"*.

■

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News

FTSE 100 chiefs oppose Higgs reforms

Controversial moves to boost the powers of independent non-executive would undermine company chairmen and divide boards, according to an overwhelming majority of heads of FTSE 100 groups.

Eighty-two percent of FTSE 100 chairmen believe that their ability to run an effective board would be damaged by proposals to beef up the role of senior independent directors, a CBI poll revealed today.

More than 60 chairmen respondent to the survey and many others have sent letters expressing their concern in the clearest sign of wide- spread concern about crucial parts of Derek Higgs' government commissioned review of boardroom independence.

But in contrast to the CBI's concerns, Warren Buffett, the influential US investor, attacked American corporate governance rules, saying reforms there did not go far enough. He blamed the cosy "boardroom atmosphere" as the main cause of lax supervision of US companies.

The CBI poll saw even a higher proportion of chairmen opposing Mr Higgs' proposal for an independent non-executive to chair the directors nomination committee. Eighty-seven per cent disagreed – and 61 per cent strongly disagreed - the move will strengthen the independence of the board.

Digby Jones, the CBI director-general, said "What the chairmen are saying is that they need to have unified boards, especially in difficult economic times."

The CBI said the concerns were shared by high-profile figures such as Lord Sterling at P&O, Sir David Lees at GKN, Sir George Bull at J. Sainsbury, Sir George Mathewson at Royal Bank of Scotland and Sir John Bond at HSBC.

Mr Jones called on ministers to pay heed to the concerns raised by so many of the country's top business figures. But government officials have indicated they will stand firm on the core proposals. Patricia Hewitt, the trade and industry secretary, is unlikely to permit barring chairman for heading the nominations committee. The government is also unsympathetic to pleas to allow non-executive directors to serve a maximum of nine, rather than six years.

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Infosys a Model for Disclosure: Nasdaq

Infosys Technologies remains in limelight at the global level. The company's disclosure and corporate governance practices are now being taken up as a role model by companies in the US. Indeed, Nasdaq itself has selected two companies - Infosys Technologies and USA Networks - as the "best value reporters".

"Multinational companies have started studying Infosys as a role model for disclosures. The company gives details about everything related to it under the sun in seven international languages, making it most investor friendly," Ghanshyam Dass, Director (South Asia), Nasdaq, said.

In its presentation on Infosys titled "This is not Fantasy", Nasdaq has pointed out that the company provides segmented information to not only the shareholders and other stakeholders but also customers, clients, suppliers, media and analysts. "Infosys has maintained transparency beyond regulatory reporting requirements," Nasdaq adds.

Infosys' annual report and the disclosure of information on the company's website have become benchmarks of transparency. "For Infosys, maintaining the highest standards of corporate governance is not a matter of form but of substance. It is an article of faith, a way of life, an integral part of the company's core values," the company has said.

As a part of Infosys' commitment to adhering to global best practices, this chapter also discloses the company's compliance with the 'Euroshareholders Corporate Governance Guidelines 2000' and the Blue Ribbon Committee recommendations, and Infosys' adherence to the UN Global Compact Programme.

■

Agency for Appointment of Non-Executive Independent Directors (NEID)

"The World Council For Corporate Governance is planning to set up an independent body charged with maintaining a panel of independent directors and the appointment of non-executive directors. This will ensure not only the availability of a pool of qualified and competent directors but also their independence from management". This was stated by Dr Madhav Mehra, the president of the council. He added "at the core of Corporate Governance lies the independence of the board of directors. Non-executive Directors of companies who have to look upon the company management for their remuneration, allowances and reappointment cannot be regarded as independent."

The basic requirement for the independent directors is that they must not have any pecuniary relationship with the company management. This conflict of interest is the biggest hurdle in ensuring independence of directors. It is difficult to ask awkward questions if we know it is the same CEO who will clear the remuneration fee and will have a say in reappointment.

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CalPERS retires Indian foray plans

CalPERS (California Public Employees Retirement System), the largest US pension fund ruled out investing in some of the world's largest countries including China, India, Indonesia and Russia, and decided against returning to Malaysia and Thailand. The decision, which came in response to a proposal by California state treasury executive Phil Angelides, was based on an assessment of the stability and transparency of those countries, including such criteria as accounting standards and labour law.

In a move that set the stage for an overhaul of its emerging markets investment policies, the board of CalPERS, voted against stock investment in 12 developing countries including Morocco, Sri Lanka, Egypt, Pakistan, Colombia and Venezuela. CalPERS, which has some $ 133 billion in assets, had been expected to put Thailand and Malaysia back on its list of approved markets, but voted for tighter standards.

Under the revised standards, investment was cleared for 14 emerging markets, including South Korea, Poland and Israel. The others are the Czech Republic, Hungary, Taiwan, South Africa, Chile, Mexico, Jordan, Peru, Argentina, Turkey and Brazil. Brazil is the cut-off point. ■

Unease in boardrooms over Corporate Governance scrutiny in Australia

Draft proposals to tighten the way public companies are run have attracted some radical suggestions. Reports and recommendations on corporate governance are now pouring in following last year's parade of corporate scandals. The Australian Stock Exchange's corporate governance council has draft recommendations which, if adopted, would change the balance of power in boardrooms. Both propose solutions that would send a shudder through the old-boy network and in some quarters, go down like a brick parachute.

The corporate governance council's draft recommendations, for instance, aim to create more independent boards. Company directors would be required to adopt formal definitions of independence. Each independent director would be required to affirm his or her independence yearly and listed entities would have to tell the market when a director was no longer deemed to be independent. Non-executive directors would also be required to hold regular no-holds-barred reviews without the CEO present.

The aim is to develop guidelines that would require a "comply or explain" approach. Companies would be required to state whether they adhered to the guidelines, and if not, where they strayed from them and why they did so. In some areas, Higgs goes even further than the council. He has proposed that non-executive directors meet without the chairman or executive directors present.

More controversially, he has suggested a new role of a senior independent director who would chair those meetings and also act as a conduit for disgruntled shareholders. There is evidence to show the regimes in Australia and the UK need to be tightened. Australia's small Noah's Ark economy (two of everything), explains why 52 per cent of Australia's company secretaries, according to a recent survey, thought it too restrictive. Given the small talent pool, it's no surprise that the council can't agree on how many directors should be independent. One group wants a majority of independent directors, another wants non-executive directors with one-third of them independent.

According to Korn/Ferry International's annual board of directors' study in Australia and New Zealand, the average age for company directors is 57. In the UK, according to the Higgs report, the average director is a 59-year-old white male and almost 40 per cent were 65 and older. Only 1 per cent came from black and ethnic minorities, only 6 per cent were women.

In Australia, women held just over 8 per cent of board directorships, according to the federal Equal Opportunity for Women in the Workplace Agency. Higgs suggests widening the corporate pool by having chairmen that encourage senior managers to take on one non-executive position on non-competitor boards, and recruit non-executive directors from private companies and the non-commercial sector, including charities and the public sector. Whether it happens remains to be seen. ■

Asian corporate governance improves

Entitled 'CG Watch - Make me holy... but not yet!' - the CLSA report affirms the truism that companies that have good management also have good share price performance. The report grades companies in Asia as well as those in Latin America and Emerging Europe, Middle East and Africa according to seven key criteria, which measure each company's overall corporate governance. These are discipline, transparency, independence, accountability, responsibility, fairness and social responsibility.

The report found that the companies with the highest scores also had the best stock market performance. The top quartile of companies in the CG rankings beat their respective country indices in nine out of ten Asian markets. "Better companies and better markets tend to outperform," says Amar Gill, head of Hong Kong research at CLSA and the author of the report. Topping the table in terms of best CG practices among Asian companies was Infosys, with TSMC, HSBC and Kookmin Bank following closely behind.

More importantly, the report found that the overall environment for CG in Asia has improved markedly over the past year. Most of this improvement has come from changes to the regulatory environment in each Asian market, as opposed to wholesale adoption of good CG by Asian companies.

"Since the Asian crisis, a lot of the worst cases of corporate governance have come to light and the regulators have got the message from investors that they should tighten up," says Gill. "There has almost been a race by various regulators to improve the regulations in their countries [ahead of the other countries]." Furthermore, increasing instances of shareholder activism such as the HAMS proposal in Hong Kong and the Minority Shareholder Watchdog Group in Malaysia have added a further impetus to improving CG over the last year. ■