DegreeLive

BBA | Semester II | UK2DSCMGT103

Business Ethics and Corporate Governance

Course Code: UK2DSCMGT103 • Module 4 Notes

Module 4: Corporate Governance Principles, Codes and Regulations

Course: Business Ethics and Corporate Governance (UK2DSCMGT103) • Semester II • BBA FYUGP Kerala University

1. Conceptual Foundations and Theoretical Models of Corporate Governance

In contemporary business administration, **Corporate Governance** refers to the formal system of structures, principles, operational processes, and legal rules by which corporations are directed, administered, and controlled. It establishes the institutional framework through which corporate objectives are set, performance is measured, and risks are monitored. At its core, corporate governance articulates the dynamic balance of power, rights, and fiduciary responsibilities among the three primary organs of the joint-stock enterprise: the **Shareholders** (equity capital providers), the **Board of Directors** (the governing fiduciary trustees), and the **Executive Management** (the operational executive leadership).

The Cadbury Committee (1992) provided the classic, authoritative definition: *"Corporate governance is the system by which companies are directed and controlled."* Effective corporate governance aligns executive self-interest with long-term shareholder equity, protects minority investors against predatory promoter expropriation, ensures transparent financial reporting, and fulfills corporate obligations to wider society.

Theoretical Frameworks of Corporate Governance

Scholars analyze corporate governance dynamics through several competing theoretical perspectives:

1. Agency Theory (Jensen and Meckling)

Formulated by economists **Michael Jensen and William Meckling** (1976), **Agency Theory** serves as the dominant theoretical foundation of modern corporate finance and governance jurisprudence:

- In a modern publicly listed joint-stock corporation, an inevitable **Separation of Ownership and Control** exists (first highlighted by Adolf Berle and Gardiner Means in 1932). The equity shareholders act as **Principals** who commit financial risk capital, delegating daily operational control to professional corporate managers who act as **Agents**.
- Agency theory assumes human beings are self-interested, opportunistic, and boundedly rational wealth-maximizers. Consequently, an inherent **Principal-Agent Problem** emerges: corporate managers may pursue self-aggrandizing goals (such as empire-building acquisitions, lavish corporate perks, executive jets, and excessive compensation) that destroy shareholder wealth.
- To mitigate opportunistic managerial behavior, principals incur **Agency Costs**, which encompass three operational components:

Degreelive

- **Monitoring Costs:** Expenditures incurred by shareholders to monitor executive behavior (e.g., hiring external statutory auditors, establishing independent board committees, publishing quarterly reports).
- **Bonding Costs:** Resources spent by agents to demonstrate their fidelity to principals (e.g., contractual non-compete clauses, tying executive compensation to long-term equity stock options).
- **Residual Loss:** The inevitable dollar reduction in shareholder welfare resulting from the divergence between managerial decisions and pure shareholder wealth maximization.

2. Stewardship Theory (Donaldson and Davis)

In direct contrast to agency theory's cynical behavioral assumptions, **Stewardship Theory** (Lex Donaldson and James Davis) posits that corporate executives are not inherently opportunistic self-seekers, but responsible, intrinsically motivated organizational "stewards" whose personal identity and psychological fulfillment are aligned with organizational success and long-term institutional health.

Stewardship theory argues that excessive monitoring, rigid compliance policing, and independent board interference merely stifle managerial innovation and demoralize leaders. Governance should focus on empowering executives with structural autonomy, visionary leadership roles, and integrated board chair/CEO structures to facilitate rapid, decisive strategic execution.

3. Stakeholder Governance Theory

Rooted in R. Edward Freeman's work, **Stakeholder Governance Theory** asserts that the corporate enterprise is an expansive social organism operating through implicit and explicit social contracts with diverse societal constituencies: employees, customers, suppliers, creditors, local communities, and the natural environment. Governance architectures must provide formal institutional representation to non-shareholder constituencies (such as the German co-determination model mandating 50% employee worker representation on supervisory boards).

4. Resource Dependence Theory (Pfeffer and Salancik)

Developed by Jeffrey Pfeffer and Gerald Salancik, this theory views the corporate Board of Directors as an essential strategic instrument designed to manage environmental uncertainty and co-opt critical external resources (debt capital, raw materials, political influence, regulatory intelligence). Board members are recruited for their external prestige, governmental connections, and access to elite commercial networks.

2. Evolution of Global Corporate Governance Codes and Milestones

Modern corporate governance standards did not develop in tranquil academic settings; they were forged in the crucible of catastrophic international corporate failures, accounting fraud, and shareholder wipeouts.

1. The Cadbury Report (United Kingdom, 1992)

Triggered by major British corporate insolvencies (the collapse of Polly Peck International, Coloroll, and the Robert Maxwell pension looting scandal), the UK government established the Committee on

the Financial Aspects of Corporate Governance, chaired by **Sir Adrian Cadbury**. The 1992 **Cadbury Report** revolutionized global governance jurisprudence by introducing the voluntary **Code of Best Practice** and the revolutionary regulatory philosophy of **"Comply or Explain"**:

- **Separation of Board Chair and CEO:** The positions of Chairman of the Board of Directors and Chief Executive Officer should ideally be held by separate individuals to prevent dangerous concentration of unchecked executive power in a single person.
- **Independent Non-Executive Directors (INEDs):** Boards must comprise a significant caliber of independent directors who possess no financial or employment ties to the company, bringing impartial, objective judgment.
- **Audit Committee Mandate:** Boards must establish an independent Audit Committee comprising a majority of non-executive directors, responsible for directly liaising with external statutory auditors and reviewing internal controls.
- **"Comply or Explain":** Rather than imposing rigid, one-size-fits-all statutory legislation, listed firms must either comply with the governance code or provide a detailed, reasoned public explanation to shareholders in their annual report justifying why non-compliance is appropriate for their specific corporate circumstances.

2. The OECD Principles of Corporate Governance (1999, 2004, 2015, 2023)

The **Organisation for Economic Co-operation and Development (OECD)** formulated international benchmark principles endorsed by the G20, providing a universal blueprint for corporate governance across sovereign nations. The OECD principles encompass six core pillars:

1. **Ensuring the Basis for an Effective Corporate Governance Framework:** Promoting transparent, efficient capital markets and a clear division of regulatory responsibilities.
2. **The Rights and Equitable Treatment of Shareholders and Key Ownership Functions:** Protecting fundamental shareholder rights, facilitating proxy voting, and ensuring equitable treatment of foreign and minority shareholders.
3. **Institutional Investors, Stock Markets, and Other Intermediaries:** Addressing conflicts of interest among proxy advisory firms, rating agencies, and asset managers.
4. **The Role of Stakeholders in Corporate Governance:** Recognizing legal rights of stakeholders and encouraging active cooperation in creating wealth and employment.
5. **Disclosure and Transparency:** Mandating timely, accurate disclosure on all material matters, including financial results, company objectives, major share ownership, governance structures, and ESG metrics.
6. **The Responsibilities of the Board:** Ensuring strategic guidance of the company, effective monitoring of executive management, and accountability to the enterprise and its shareholders.

3. The Sarbanes-Oxley Act (SOX, United States, 2002)

Enacted by the US Congress following the catastrophic multibillion-dollar accounting collapses of **Enron, WorldCom, Tyco, and Global Crossing**, the **Sarbanes-Oxley Act (SOX)** abandoned

voluntary self-regulation in favor of draconian federal statutory mandates backed by severe criminal penalties:

- **Section 302 (Executive Certification):** Mandates that the CEO and CFO personally sign and certify the accuracy of quarterly and annual financial statements, facing up to 20 years in federal prison for willful fraudulent certification.
- **Section 404 (Internal Financial Controls):** Mandates that management and independent external auditors formally audit, assess, and attest to the effectiveness of the enterprise's Internal Controls over Financial Reporting (ICFR), radically expanding corporate auditing costs.
- **Section 802 (Criminal Penalties for Document Alteration):** Imposes severe fines and up to 20 years imprisonment for altering, destroying, mutilating, or concealing financial documents or audit workpapers to obstruct a federal investigation (remedying the Arthur Andersen shredding scandal).
- **Establishment of the PCAOB:** Created the Public Company Accounting Oversight Board (PCAOB), an independent regulatory body overseeing, registering, and disciplining auditing firms.

3. Evolution of Corporate Governance in India

Following the 1991 economic liberalization, India transitioned from the colonial-era "Managing Agency" system and state-dominated corporate regimes toward modern international governance standards, catalyzed by influential government and regulatory committees:

Committee / Code	Year	Sponsoring Body	Key Recommendations & Landmark Contributions
CII National Task Force Code (Rahul Bajaj)	1998	Confederation of Indian Industry (CII)	First voluntary governance code in India; recommended that for listed companies with non-executive chairmen, at least 30% of the board be independent; if chairman is executive, at least 50% be independent.
Kumar Mangalam Birla Committee	1999	SEBI	Landmark milestone; led to the historic insertion of **Clause 49** into the Equity Listing Agreement; classified recommendations into Mandatory (Audit Committee, Independent Directors, board composition) and Non-Mandatory provisions.
Naresh Chandra Committee	2002	Ministry of Finance / DCA	Focused on Auditor-Company Relationship and corporate auditing integrity following Enron; recommended mandatory audit partner rotation, strict prohibition of non-audit services by statutory auditors, and qualification standards for independent directors.

Committee / Code	Year	Sponsoring Body	Key Recommendations & Landmark Contributions
Narayana Murthy Committee	2003	SEBI	Comprehensive overhaul of Clause 49; strengthened Audit Committee financial literacy requirements, mandated formal risk management frameworks, codified whistleblower mechanisms, and regulated related-party transactions (RPTs).
Uday Kotak Committee	2017	SEBI	Modernized governance for modern corporate realities; recommended separating Board Chair and MD/CEO positions, mandating at least six directors on boards of top 2,000 listed firms, requiring at least one independent woman director, and expanding the role of the Nomination and Remuneration Committee.

4. The Indian Regulatory Framework: Companies Act 2013 and SEBI LODR

The contemporary Indian corporate governance architecture is governed by two foundational regulatory instruments: the **Companies Act, 2013** (enforced by the Ministry of Corporate Affairs, MCA) and the **SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015** (SEBI LODR, replacing Clause 49 for publicly listed companies).

Key Governance Provisions under the Companies Act, 2013

- **Statutory Codification of Directors' Duties (Section 166):** For the first time in Indian corporate history, the fiduciary duties of a company director were codified into statutory law. A director must act in good faith to promote the objects of the company for the benefit of its members as a whole, and in the best interests of the company, its employees, the shareholders, the community, and for the protection of the environment.
- **Mandatory Independent Directors (Section 149):** Every listed public company must have at least **one-third (1/3)** of the total number of directors as Independent Directors. An independent director cannot hold any pecuniary relationship with the company, its promoters, or its subsidiaries during the preceding three financial years.
- **Women Directors on Boards:** Every listed company and public company with paid-up share capital of ₹100 crore or turnover of ₹300 crore must have at least **one woman director**. SEBI LODR further mandates that the top 1,000 listed entities must appoint at least **one independent woman director**.
- **Mandatory Vigil / Whistleblower Mechanism (Section 177):** Every listed company and prescribed public company must establish a vigil mechanism for directors and employees to report genuine concerns, with direct access to the Chairman of the Audit Committee.
- **Strict Regulation of Related Party Transactions (RPTs, Section 188):** Prohibits contracts between a company and related entities (promoters, directors, relatives) without explicit Audit Committee approval and, for transactions exceeding prescribed thresholds, prior approval by minority shareholders where related parties are legally barred from voting.

DegreeLive

5. Board Architecture, Director Typologies, and Specialized Committees

The **Board of Directors** functions as the supreme governing organ of the corporate enterprise, legally vested with stewardship authority to supervise executive management and protect enterprise assets.

Director Typologies within the Corporate Board

- **Executive Directors (Inside Directors):** Full-time working directors employed by the corporation who receive executive salaries and hold operational management portfolios (e.g., Managing Director, Chief Executive Officer, Chief Financial Officer, Whole-Time Technical Director).
- **Non-Executive Directors (NEDs):** Directors who are not involved in day-to-day operational management. They may represent promoter groups, major institutional investors (Nominee Directors), or independent professionals.
- **Independent Directors (IDs):** Non-executive directors who satisfy strict statutory criteria of independence. Under Indian jurisprudence, an Independent Director:
  - Is a person of integrity possessing relevant expertise and experience.
  - Is not, and has not been, a promoter of the company or its holding/subsidiary entities.
  - Has no material pecuniary relationship with the company, its promoters, or directors.
  - Holds a maximum term of two consecutive periods of five years each, requiring a special resolution and a mandatory three-year cooling-off period before re-appointment.
- **Nominee Directors:** Appointed to the board to represent specific institutional lenders, public financial institutions, or private equity investors to monitor debt covenants and financial investments.

Specialized Mandatory Board Committees

To ensure rigorous oversight over high-risk corporate functions, governance regulations mandate delegating detailed scrutiny to specialized board committees composed primarily of independent directors:

Committee	Statutory Composition	Primary Fiduciary Responsibilities
1. Audit Committee (Section 177)	Minimum 3 directors; two-thirds (2/3) must be Independent; all members must be financially literate, with at least one accounting/financial expert; chaired by an Independent Director.	Overseeing financial reporting processes; reviewing quarterly and annual financial statements; appointing statutory and internal auditors; approving audit fees; inspecting internal financial controls (ICFR); approving Related Party Transactions (RPTs); monitoring whistleblower mechanisms.
2. Nomination & Remuneration	Minimum 3 non-executive directors; at least 50% (or two-thirds under SEBI LODR)	Formulating criteria for determining qualifications, positive attributes, and independence of directors; identifying

Committee	Statutory Composition	Primary Fiduciary Responsibilities
Committee (NRC, Section 178)	Independent; chaired by an Independent Director.	candidates for board seats and C-suite leadership; structuring executive compensation policies (aligning performance with pay while curbing predatory short-term greed); conducting annual board evaluation.
3. Stakeholders Relationship Committee (SRC, Section 178)	Chaired by a Non-Executive Director; minimum 3 directors with at least one Independent Director.	Resolving grievances of security holders (shareholders, debenture holders), including transfer of shares, non-receipt of declared dividends, annual reports, and general shareholder communications.
4. Risk Management Committee (RMC, SEBI LODR)	Mandatory for top 1,000 listed entities; majority board members with at least one Independent Director.	Formulating corporate risk management frameworks; monitoring macroeconomic, cybersecurity, financial liquidity, and ESG climate risks; stress-testing corporate resilience against external operational shocks.

6. Board Evaluation, Liabilities, and Defense: The Business Judgment Rule

Independent directors face increasing scrutiny regarding their legal liabilities when corporate fraud or operational catastrophes occur on their watch:

Statutory Liability of Independent Directors

Under Section 149(12) of the Indian Companies Act 2013, an Independent Director or non-executive director is held legally and criminally liable **only in respect of such acts of omission or commission by a company which had occurred with their knowledge, attributable through board processes, and with their consent or connivance, or where they had not acted diligently**. To protect themselves, independent directors must ensure their active dissents and challenging questions are formally recorded in the official written Board Minutes.

The Business Judgment Rule

Derived from US Delaware corporate jurisprudence and adopted internationally, the **Business Judgment Rule** is a vital judicial presumption protecting corporate directors from personal liability for business decisions that result in corporate financial losses. The rule presumes that in making a business decision, directors acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company, provided they had no personal conflict of interest and did not act with gross negligence.

7. Comparative International Corporate Governance Models

Corporate governance structures do not operate uniformly across the globe; they are fundamentally shaped by a nation's legal jurisprudence, historical capital market development, and cultural

traditions. Comparative governance scholars distinguish three dominant global governance paradigms:

1. The Anglo-American (Market-Based / Outsider) Model

Prevalent in the United States, the United Kingdom, Canada, and Australia, the Anglo-American model operates upon the following structural characteristics:

- **Dispersed Share Ownership:** Equity shares of public corporations are widely held by hundreds of thousands of individual retail investors and institutional funds (pension funds, mutual funds), with no single shareholder possessing a controlling block.
- **Unitary (Single-Tier) Board of Directors:** A single governing board comprising a mix of executive inside directors and non-executive independent directors, responsible simultaneously for strategic guidance and managerial oversight.
- **Active External Market for Corporate Control:** If corporate managers underperform or engage in value-destroying empire-building, the share price declines, exposing the firm to hostile takeovers, corporate raiders, and proxy fights. This external threat disciplines management.
- **Primary Objective:** Uncompromising focus on maximizing shareholder financial returns and equity share price valuation.

2. The Continental European (Bank-Based / Two-Tier / Co-Determination) Model

Dominant in Germany, Austria, and parts of Northern Europe, this model reflects a stakeholder-centric, coordinated market economy:

- **Concentrated Institutional Ownership:** Commercial "universal banks" (Hausbanks) hold substantial equity blocks and long-term debt positions in industrial corporations, exercising direct monitoring oversight.
- **Dual (Two-Tier) Board Architecture:** Mandates two completely separate governing bodies:
  - **The Management Board (Vorstand):** Composed entirely of executive managers responsible for running daily operational business affairs.
  - **The Supervisory Board (Aufsichtsrat):** An independent non-executive body that appoints, evaluates, monitors, and fixes the compensation of the Management Board. The Supervisory Board reviews annual ledgers and major strategic capital investments.
- **Mitbestimmung (Co-Determination):** By federal German statute, in enterprises employing more than 2,000 workers, **exactly 50% of the seats on the Supervisory Board must be democratically elected by the company's labor workforce and trade unions**. This institutionalizes worker voice in corporate governance, prioritizing employment stability and long-term industrial investment over volatile quarterly earnings.

3. The Japanese Keiretsu Governance Model

In Japan, governance centers on vast industrial networks termed **Keiretsu**—conglomerate alliances of independent corporations bound together through extensive cross-shareholding, reciprocal

DegreeLive

commercial ties, and shared access to a central "Main Bank" and trading house (Sogo Shosha; e.g., Mitsubishi, Mitsui, Sumitomo):

- Hostile corporate takeovers are virtually unheard of because friendly keiretsu partners hold interlocking shareholdings, insulating executive management from external market pressures.
- Governance prioritizes long-term institutional survival, supplier relationships, continuous technological refinement (Kaizen), and lifelong employee welfare over short-term shareholder dividends.

4. The Indian Governance Reality: Concentrated Promoter Ownership

Unlike the dispersed ownership of the Anglo-Saxon model, the defining structural hallmark of the Indian corporate landscape is **Concentrated Promoter Ownership**. The vast majority of listed Indian enterprises (including major private conglomerates like Tata, Reliance, Birla, and Adani) are controlled by founding families or promoter groups who typically hold between 40% and 75% of total equity shares.

Consequently, the primary corporate governance challenge in India is not the classical Anglo-Saxon *Principal-Agent Problem* (shareholders vs managers), but rather the **Principal-Principal Problem**: the grave risk that powerful, controlling majority promoters will exploit corporate assets to the detriment of vulnerable public minority retail shareholders through abusive Related Party Transactions, preferential asset transfers, and opaque corporate restructuring schemes.

8. Forensic Case Autopsies of Landmark Governance Scandals

The imperative for corporate governance regulations is best understood through the forensic analysis of landmark corporate collapses that exposed systemic governance failures:

1. The Satyam Computer Services Scandal (India, 2009)

Frequently dubbed "India's Enron," the Satyam scandal shocked the nation's financial system in January 2009 when founding Chairman B. Ramalinga Raju confessed to orchestrating a massive, multi-year accounting fraud exceeding ₹7,000 crore ($1.4 billion):

- **Modus Operandi:** Raju created thousands of fictitious customer invoices, recorded non-existent sales revenues, fabricated bank fixed deposit certificates to display ₹5,040 crore of non-existent cash balances on the balance sheet, and created over 7,500 "ghost employees" whose monthly salaries were siphoned into promoter-controlled real estate entities (Maytas).
- **Governance Breakdown:** The Board of Directors—comprising prominent international management scholars and former senior civil servants—passively approved promoter proposals without rigorous scrutiny. The statutory independent audit firm, Price Waterhouse, completely failed to verify bank confirmations directly with commercial banks for nearly eight consecutive years.
- **Regulatory Aftermath:** Catalyzed the comprehensive overhaul of Indian corporate law, directly shaping the stringent auditor independence, ICFR certification, and fraud penalty mandates embedded into the Companies Act, 2013 and SEBI LODR.

DegreeLive

2. The IL&FS Systemic Collapse (India, 2018)

Infrastructure Leasing & Financial Services (IL&FS), a premier Indian systemic non-banking financial conglomerate boasting premier institutional backing (LIC, ORIX, SBI), collapsed in late 2018 under a debt mountain exceeding ₹91,000 crore:

- **Root Causes:** Catastrophic Asset-Liability Mismatches (financing long-term 20-year infrastructure toll road construction using short-term 90-day commercial paper), aggressive promoter bonuses despite crashing cash flows, and severe conflicts of interest among credit rating agencies that assigned AAA ratings to IL&FS paper right up to the eve of default.
- **Regulatory Intervention:** The Ministry of Corporate Affairs invoked emergency statutory powers under Section 241/242 of the Companies Act to supersede the existing board and appoint an eminent independent board led by Uday Kotak to orchestrate a transparent resolution.

9. Shareholder Activism and the Rise of Institutional Governance

Historically, minority shareholders dissatisfied with corporate management practiced the passive **"Wall Street Walk"**—simply selling their shares in the open stock market. In the contemporary capital market environment, shareholders increasingly exercise active **"Voice"** through **Shareholder Activism**.

Mechanisms of Modern Shareholder Activism

- **Voting on General Meeting Resolutions:** Institutional investors (mutual funds, insurance funds, pension funds, and foreign institutional investors) actively cast negative votes against excessive executive compensation proposals, questionable promoter re-appointments, and abusive Related Party Transactions. In India, SEBI legally mandates that asset management companies publicly disclose their voting rationale on all corporate resolutions.
- **The Critical Role of Independent Proxy Advisory Firms:** Specialized governance advisory firms—such as **Institutional Investor Advisory Services (IiAS)**, **Stakeholders Empowerment Services (SES)**, and **InGovern** in India, and ISS and Glass Lewis internationally—conduct forensic analyses of corporate resolutions, providing unbiased voting recommendations to institutional shareholders.
- **Class Action Suits (Section 245 of Companies Act, 2013):** Empowers a prescribed minimum number of minority shareholders or depositors to file collective legal actions before the National Company Law Tribunal (NCLT) against directors, auditors, or management to claim monetary damages for misleading financial disclosures or fraudulent corporate conduct.

10. Board Diversity, Director Onboarding, and Succession Planning

To preserve strategic dynamism and avoid cognitive stagnation, contemporary corporate boards must institutionalize rigorous processes for director selection, continuous professional education, and orderly executive succession.

The Mandate for Cognitive and Demographic Board Diversity

DegreeLive

Modern corporate governance recognizes that homogeneous corporate boards—frequently comprising elderly individuals from identical educational, socio-economic, and ethnic backgrounds—suffer from pervasive **Groupthink**, failing to detect emerging technological disruptions and societal shifts. Robust board governance mandates:

- **Demographic Representation:** Ensuring equitable representation of women, younger digital leaders, and international directors who mirror the diverse global customer base.
- **Cognitive and Functional Breadth:** Assembling a strategic matrix of competencies spanning digital technology, cybersecurity, ESG climate transitions, forensic finance, global geopolitical intelligence, and human capital strategy.

Director Familiarization Programs and Board Evaluation

Under SEBI LODR mandates, listed enterprises must conduct formal, structured **Familiarization Programs** for incoming independent directors. These encompass comprehensive factory visits, deep-dive briefings on corporate business models and regulatory risk exposures, and unscripted meetings with frontline operating executives. Furthermore, boards must conduct mandatory **Annual Board Performance Evaluations**—assessing the collective effectiveness of the board, specialized committees, and individual peer contributions through structured self-evaluation questionnaires and external third-party governance audits.

CEO Succession Planning and Mitigating Key-Person Risk

One of the supreme fiduciary responsibilities of the Board of Directors is orchestrating orderly **CEO Succession Planning**. Unforeseen executive departures, health emergencies, or sudden terminations create severe "Key-Person Risk" that can destabilize enterprise operations and trigger precipitous market capitalization crashes. The Nomination and Remuneration Committee must maintain an active, confidential succession pipeline—identifying and mentoring high-potential internal leadership talent alongside benchmarking external executive talent pools to ensure seamless, orderly leadership transitions.

DegreeLive