ACHIEVING CORPORATE GOVERNANCE WITH THE IMPLEMENTATION OF THE CODES OF CONDUCT

The concept of corporate governance has been discussed for decades to be achieved effectively. Many definitions have been made throughout the history and basically it is a controlling or direction system of companies.[1] However it is not that simple, it also means separation of ownership and control, responsibilities of board of directors, duties of auditors and democracy in the public or private entities. Sir Adrian Cadbury (2000) defined corporate governance with a social perspective at the Global Corporate Governance Forum of the World Bank;

"Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The corporate governance framework is there to encourage the efficient use of resources and equally to require accountability for stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations and society."[2]

The development of corporate governance in UK has started with Cadbury Report (1992), where Code of Best Practise is drawn up to raise the standards of corporate governance which has set an example of many corporate governance codes in the world.[3] In addition to Cadbury Report following years many codes were released such as Hampel Report (1998), Combined Code (1998), Higgs (2003), Stewardship Code (2010) and UK Corporate Governance Code (2012). UK Corporate Governance Code is also a guide of effective corporate governance based on comply or explain approach. These sets of codes are sort of Codes of Conduct and they play a crucial role while achieving corporate governance. Codes of Conduct, which is also named as Codes of ethics, are a set of binding rules regulating the duties and responsibilities within the organization or public or private entities. It is written to have high ethical standards and effective corporate governance.

[1] *Report of the Committee on the Financial Aspects of Corporate Governance* (Cadbury Report Gee & Co. Ltd 1992)
[2] Bob Tricker, *Corporate Governance Principles, Policies, and Practices* (2nd edn, Oxford University Press 2012) 31
[3] Christine A. Mallin, *Corporate Governance* (4th edn., Oxford University Press 2013) 27

This article will examine effectiveness of Codes of Conduct critically in achieving corporate governance by referring to Cadbury Report (1992) and UK Corporate Governance Code (2012).

The history of Codes of Conduct date back to before World War II. Johnson & Johnson's Credo was one of the earliest code which embraces corporate social responsibility.[4] In 2004, Revised Federal Sentencing Guidelines set conditions for companies "*to promote an organizational culture that encourages ethical conduct and commitment to compliance with the law*", by this condition Codes of Conduct have become integral part of company's culture.[5] Throughout the evolution, Codes of Conduct have become significant because the impact and success is unignorable. Complying Codes of Conduct now show that the relationship between business partners with employees have been strengthened and it has also improved employee's motivation which is essential for job satisfaction.[6] Lasting improvement of Codes of Conduct is to ensure effective corporate governance, because many financial scandals and collapses have been seen around the world in the last few years. According to the Charles Chatterjee, Democracy, accountability, fairness and transparency are the four fundamental principles of the corporate governance (Chatterjee C. International Corporate Governance, 29 September 2014). Corporate democracy is an internal issue of companies that is possible with the participation of employees to the governance which also means horizontal administration. Good governance also requires accountability and transparency because board of directors must be accountable to shareholders and each transaction and financial situations should be transparent.

Over the last 150 years, apparent improvements have been seen in the \`size\`, \`complexity\` and \`globalization\` of the companies. Today many shareholders see themselves as an \`investor\` rather than \`owners\`.[7] As a result of these alterations in the company structure, necessity of concrete steps has arisen. In order to make the targets of board definite and functional, developing company Codes of Conduct have been found beneficial from many companies which is based on high

[4] 'Our Credo Values, *Credo*' http://www.jnj.com/about-jnj/jnj-credo accessed 29 October 2014
[5] LRN, 'The Impact of Codes of Conduct on Corporate Culture' (2006) http://www.ethics.org/files/u5/LRNImpactofCodesofConduct.pdf accessed 29 October 2014
[6] LRN, 'The Impact of Codes of Conduct on Corporate Culture' (2006) http://www.ethics.org/files/u5/LRNImpactofCodesofConduct.pdf accessed 29 October 2014
[7] J. P. (Ian) Percy, 'The Cadbury Report and corporate governance in the U.K' (2013) *65*(5) CPA Journal 464-470

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professional standards.[8] To begin with the Cadbury report, Sir Adrian Cadbury leaded the committee to form a framework for good governance which is called as Code of Best Practice. Code of Best Practice is the keystone of the Codes of Conduct in the UK which was made obligatory for the listed companies by the London Stock Exchange after June 1993. This obligation increases the effectiveness of codes of best practise because every listed company must comply with rules listed otherwise, they have to explain that why it is not complied with. By this way many companies have strengthen their control mechanisms on their businesses and they provide the expected standards of corporate governance.[9] In addition to the listed companies everyone should consider it. Before explaining the recommendations of the report, three principles of the code of best practice should be mentioned. These are `openness', `integrity` and `accountability` which briefly mean disclosure of information, completeness and accountable board of directors to shareholders.[10] As we can see that these principles are the indispensable factors of each company because it is required to establish high corporate standards. For example, board of directors are liable to account for shareholders, this situation definitely affects the quality of decisions which are taken on behalf of the company while they could maximize the profit at the end. Broadly speaking the recommendations in the Cadbury Report are focusing the duties of board of directors (both executive and non-executive directors) and the objective and effective auditing process of the company. Basically, the code called for:

- the extensive use of independent non-executive directors;
  This approach implies that these non-executive directors will bring an independent judgement to the issues of resources, key appointments, performance, strategy, and standards of conduct because their points of views about these issues are important in board's decision making process.[11]

- introduction of board's audit committee with independent members;

[8] Organisation For Economic Co-Operation And Development, *OECD Principles of Corporate Goverance* (OECD, 2004)
[9] *Report of the Committee on the Financial Aspects of Corporate Governance* (Cadbury Report Gee & Co. Ltd 1992)
[10] *Report of the Committee on the Financial Aspects of Corporate Governance* (Cadbury Report Gee & Co. Ltd 1992)
[11] Bob Tricker, *Corporate Governance Principles, Policies, and Practices* (Oxford University Press 2012) 12

The duties of audit committee are to make recommendation to the board about audit fee, and appointment of the external auditor and they also provide review of annual financial statements, company statement, and any important findings of domestic investigations. This committee definitely plays a significant role because they provide non-executive directors to make contribution to independent judgment and they directly connect the auditors with them.[12]

- the separation of duties between the chairman of the board and the chief executive;
  There should be a clear division because it will make certain the authority and the balance of power in the corporate entity by this way no one has unrestrained decision power.[13]

- Supervising executive rewards by board's remuneration committee;
  Cadbury Report strongly recommends that boards should assign remuneration committees to supervise executive rewards. The main purpose behind this idea is to take executive directors out of their own remuneration process in order to obtain a fair decision.

- offering new board members by the nomination committees with independent directors;
  Nomination committees support boards to make board appointments and also assisting them with the liability of offering new members to the board.[14]

- 'Comply or Explain' the code of best practise.
  As it is mentioned above, according to the Cadbury Report each company, who are listed, must comply with the Code of Best Practise or they must explain why they could not comply with it. This obligatory rule enables companies to obey the code because this is not just a guideline about corporate governance so it should also include some coercive principles.

Within this framework, Cadbury Report provides the essentials of corporate governance and it is easy to understand that Codes of Conduct have become more significant and they are not soft law

[12] *Report of the Committee on the Financial Aspects of Corporate Governance* (Cadbury Report Gee & Co. Ltd 1992)
[13] *Report of the Committee on the Financial Aspects of Corporate Governance* (Cadbury Report Gee & Co. Ltd 1992)
[14] *Report of the Committee on the Financial Aspects of Corporate Governance* (Cadbury Report Gee & Co. Ltd 1992)

they have coercive effects. Moreover, in terms of the accountability of companies, audit committee brings transparency by this way, any possible corruption or money laundering is prevented by the code. Financial statements are the one of the most significant aspect of the companies all over the world because it is only possible in this way to predict the future of the company. In addition to the accountability, it also establishes a trustful environment for the current and the future investor of the companies. Investor, as it is understood from its name, is looking for potential profits all around the world but the investor never invests that much money in unreliable conditions, thus code of best practise provide a trustful investing environment and attract investors all around the world. Especially the independent members of the committee will enable the company to be more reliable than before because independent members do not take the benefit of acting on the advantage of the companies.

As it is mentioned before, the main aim of the corporate governance is to align the interests of the 'individuals', 'corporations' and 'society'. This implies that corporate governance is not just a management method for corporations but it also minds the benefits of whole society and individuals. We should also bear in mind that high level of public awareness is required while achieving corporate governance. It concerns the society as a whole, that's what corporate governance is about. Moreover, Cadbury Report, with the code of best practise, is definitely provides the essentials of the corporate governance by this way. Non-executive directors, independent members of the audit committee and remuneration committee will affect the power of the decision because no one individual has powers of decision and also contributes discipline to the corporate governance by its transparency. Balance of power enables the horizontal management where the employees also participate. In addition, independent members of audit committee obviate the potential client pressure on the financial reports due to the suppression of the contradictions between independent auditors and dependent auditors of the company. By the implementation of the code of best practise, listed companies will reinforce both their management over their company and their 'public accountability' and corporate standards as well.[15] It is also important that high level of public awareness is required for corporate governance principles. Although the Cadbury Report is not a complete code of conduct, it is the first identifiable codified report with the

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[15] *Report of the Committee on the Financial Aspects of Corporate Governance* (Cadbury Report Gee & Co. Ltd 1992)

principles of ‘openness/transparency’, ‘integrity’ and ‘accountability’. Most significantly the ‘comply or explain’ rule enables companies to adopt the principles of code of best practise to contribute the efficient corporate governance.

The UK Corporate Governance Code, which is also named as Combined Code, establishes standards of decent practise with respect to ‘board leadership’ and ‘effectiveness’, ‘remuneration’, ‘accountability’ and ‘relations with shareholders’.[16] It was first produced by the Cadbury Committee in 1992 (the Code).[17] It is necessary for every company, which are listed to London Stock Exchange in the United Kingdom, to inform how they applied the Code in their ‘annual report’ and ‘accounts’ or they should comply with the provisions of the Code, if they don’t they should provide explanation.[18] One of the key feature of the Code is:

“The Code has been enduring, but it is not immutable. Its fitness for purpose in a permanently changing economic and social business environment requires its evaluation at appropriate intervals.”[19]

According to this feature of the Code, it is durable against time. Even it is reviewed each year by the Financial Reporting Council, it sometimes falls behind time. However, the code is compatible with economic and social change. Evaluation of the code will definitely provide the essentials of corporate governance and being a code of conduct also requires it. It is known that soft laws are set of recommendations that are not binding but soft laws have become harder than hard law. To give an example from the UK Corporate Governance Code, listed companies should adopt the provisions of the Code or comply and if they do not, they should explain why they could not comply with it. Furthermore, Codes of Conduct are designed to achieve effective corporate governance again by concerning the interest of shareholders, individuals and society together.

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[16] ‘UK Corporate Governance Code’ https://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code.aspx accessed 05 January 2015

[17] UK Corporate Governance Code 2014 (The Financial Reporting Council Limited 2014) 1

[18] Bob Tricker, *Corporate Governance Principles, Policies, and Practices* (Oxford University Press 2012) 122

[19] UK Corporate Governance Code 2014 (The Financial Reporting Council Limited 2014) 1

When the UK Corporate Governance Code 2014 is examined, we could easily see the broad principles and also specific provisions. Five main principles are found in the Code which are:

1. ***"Leadership***
2. ***Effectiveness***
3. ***Accountability***
4. ***Remuneration***
5. ***Relation with shareholders"***[20]

Before we examine critically the main principles of the UK Corporate Governance Code 2014, it could be seen that there are common principles with the Code of Best Practise and also with the corporate governance. These principles are prerequisite for effective corporate governance. Cadbury report was not complete at the beginning but by the 2014 the Code includes much more than Cadbury Report by considering the leadership also.

1. Leadership

As it is usual every company should be directed by the board for the steady success of the company where they are responsible from. In addition there should be a chairman who is responsible from the board and its' effectiveness.[21] Previously we talked about the balance of power and again in the Code, it is required that individuals should not have directionless power on decision making. Non-executive directors also assume some supporting responsibilities as part of their role and they play crucial role while the processes of remuneration appointment etc. The qualities of the leader is also important because a leader should have managing principles, must command respect, be coercive and knowledgeable. In order to ensure effective corporate governance there should be a leader to manage the firm because corporate success is significant for the future of the company and it is possible with chief, even the employees participate the management. As a result of this principle, there should be hierarchy with the balanced power.

[20] Bob Tricker, *Corporate Governance Principles, Policies, and Practices* (Oxford University Press 2012) 122-123
[21] UK Corporate Governance Code 2014 (The Financial Reporting Council Limited 2014) 6

2. Effectiveness

Beside the achievement it also should be effective. This principle considers the board and it members generally. The board and the committees should be well-equipped and they also should be appointed in 'formal' and 'transparent' way.[22] Moreover directors should improve their management style and there should be performance statement for the reappointment of the board. As it is seen this principle considers the sustainable performance of the board by trying to develop the skills of the members in order to achieve effective management.

3. Accountability

Accounting is the life-blood of the companies because financial statements of the company determine the current and future situation of the companies and it must be reliable. At this point, the Code makes the board to assume more responsibility. Some of those are, board should submit explanatory statement of the companies' position, board should overcome the potential risks with strategical targets and board should collaborate with the company's auditor in order to implement the corporate principles.[23] Companies should be accountable to shareholders, company and wider community. By this way good corporate governance is achieved.

4. Remuneration

This principle was rearranged in 2014 version of the Code. According to this section, remuneration of the executive directors should encourage the long dated success of the company. Most significantly, the process of remuneration should be official and transparent and no member of the company should be included in his or her own remuneration in order to prevent undeserved gain.[24] Remuneration increase the commitment to the company and also increase the performance of the directors who puts the company over the top.

5. Relations with the shareholders

The board of the corporate firm should not cut the communication between the owners/shareholders. In order to contact with the 'investor' and attendance of them board should

[22] UK Corporate Governance Code 2014 (The Financial Reporting Council Limited 2014) 6
[23] Ibid 7
[24] UK Corporate Governance Code 2014 (The Financial Reporting Council Limited 2014) 7

run general meetings.[25] By this way, there will be reciprocal understanding of targets while performing on behalf of the company.

Critical analysing of the main principles shows the similarities between Codes of Conduct. The main objective of the UK Corporate Governance Code 2014 is also to ensure the effective corporate governance but these provisions should be applicable for the listed companies of the London Stock Exchange. When we examine the 5 provisions of the Code, we could easily understand why British companies attract investor all around the world. By the implementation of the Code, companies have become more reliable the economy has become stable for many years. Leadership principle clearly defines the duties of chairman, board and non-executive directors because they are the people who govern the company for its success. In addition to this, the board should be effective and in order to ensure effective board, directors and members should provide the essentials of being member of the company by developing themselves with new knowledge and improve themselves according to the annual or monthly satisfactory statements. And most significantly, accountability is also considered in the Code. The board should submit statements about the position of the company and should collaborate with the company's auditor and the relation between board and shareholders should not be ignored. In total, the Code establishes a comprehensive set of rules for the companies in the UK with the provisions relating to the effective corporate governance.

On the other hand, Financial Reporting Council published a 'best practice note on audit tendering' in July 2013 to support companies in the application of the Code.[26] UK is not just drafting Codes of Conduct, UK also support companies to implement the Code easily.

The word of soft law is used for set of non-binding rules and it is generally based on the voluntarily compliance. In general Codes of Conduct are also a kind of soft law because it is also improved and applied by private, i.e. 'non-state actors' and they are not drafted to be 'legally

[25] UK Corporate Governance Code 2014 (The Financial Reporting Council Limited 2014) 7

[26] Financial Reporting Council, *Developments in Corporate Governance 2013 The impact and implementation of the UK Corporate Governance and Stewardship Codes*, (The Financial Reporting Council Limited 2013) 10

binding'.[27] However, throughout the development of the soft law regime in the recent past, it has achieved 'specific salience' and 'flourished' in global platform and now the governments of countries are focusing on the soft law formula.[28] As a result of this tendency of the states, Codes of Conduct attain a place in public international law. Non-negligible developments of the Codes of Conduct has increased its' bindingness and surely Codes of Conduct contribute to signal an adaptation between corporate operations and communal values and anticipations.[29]

At this point, we could easily see the importance of non-governmental bodies because states do not pass a legislation which is totally binding relating to the Codes of Conduct. For example, both Cadbury Report and UK Corporate Governance Code 2014 are designed by the independent committees. For sure there is a support for the non-governmental bodies but basically, they are independent authorities. The essentials of corporate governance are taken into consideration by the non-governmental bodies because public awareness is very important while achieving corporate governance. These kinds of organizations consist of private people and they could easily notice the requirements for both companies and the society and also, they could foresee the forthcoming issues for the companies. In addition, the members of these non-governmental bodies are experts on their field which enable to achieve it effectively.

Both Cadbury Report and UK Corporate Governance Code show similarities because the main purpose of the both codes is to achieve effective corporate governance. As for that, Corporate Governance is a controlling or direction mechanisms of the companies. In order to ensure effective corporate governance, Codes of Conduct should consider the main principles of corporate governance. As it is mentioned before, corporate governance is holding the balance between economic and social goals and moreover between individual and communal goals. For this reason, these Codes of Conduct should also consider the expectations of the society as a whole in their codes. Moreover, good governance is only possible with the participation of the employees because management also means participation. When the governance is hierarchical, corporate governance

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[27] Helen Keller, 'Codes of Conduct and their Implementation: the Question of Legitimacy' (2008) Legitimacy in International Law http://www.yale.edu/macmillan/Heken_Keller_Paper.pdf accessed 6 January 2015

[28] Ibid

[29] Ibid

may not be achieved. In order to achieve corporate governance, companies should not disregard employees at the down. Therefore, the shareholders of the corporate entities should be knowledgeable. Employees are the basis of the corporations and by the participation of them democracy within the company will be supplied. Cadbury Report was the beginning and cornerstone of the Codes of Conduct but it is not a complete version but UK Corporate Governance Code 2014 is a more comprehensive code than the Cadbury. However, both codes do not mention the participation of the employees to the management and merely mention the employees of the companies. Although the both codes consider the democratically management by using non-executive directors and independent member, they do not give attention to the employees of the company that much. Horizontal management will be beneficial for the companies because employees should not feel that they are working on behalf of the owners or shareholders, they should feel as an owner while they are working. Except for the situation about the employees both Codes of Conduct include the principles of corporate governance.

Within the considerations above, Codes of Conduct play a fundamental role while achieving corporate governance. Especially in the UK, Codes of Conduct have become harder than hard law. Even it is based on voluntarily compliance, both Cadbury Report and UK Corporate Governance Code 2014 force corporate entities to implement the codes by the principle of 'Comply or Explain'. With the implementation of this principle each listed companies, should comply with the Code of Best Practise and UK Corporate Governance Code otherwise they have to explain why they could not comply with the codes. By this way, the percentage of the applicability of the code has been increased and it has become effective as much as the hard law in the UK. Moreover, this implementation has increased the investing in UK companies because foreign investors look for the stable economy and reliable companies to invest in, thus the principles of the Codes of Conduct in UK provide these essentials and attract investors all around the world which enliven the economy in the UK.

In conclusion, this article has critically examined the effectiveness of Codes of Conduct by referring to Cadbury Report (1992) and UK Corporate Governance Code (2014) while achieving corporate governance. As it is mentioned above, corporate governance is a mechanism direction or controlling of companies but in order to achieve it companies should consider the fundamental principles of the corporate governance which are democracy, accountability, fairness and transparency. Both Codes shows similarities, even the Cadbury Report was published in 1992. The role of the non-executive directors is a significant fact in the Cadbury Report and UK Corporate Governance Code, the main aim is to bring an independent judgment to the relating issues of the board. Furthermore, Accountability is also a significant issue for the companies because companies should remain standing while they are achieving corporate governance and accountability is the life-blood of the companies that express reliability. Differently from the Cadbury Report, UK Corporate Governance Code also considers the Leadership as a main principle. The responsibilities of the chairman are clearly defined and it also lays the emphasis on the board for the success of the company. The role of the Codes of Conduct could not be underestimated; it definitely contributes the success of the company. Because element of the good governance is included. However, it should not be limited just in the UK, Codes of Conduct should have become widespread all around the world.

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