

# WHY DO WE NEED CORPORATE GOVERNANCE CODE IN UK

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## ABSTRACT

The Corporate Governance is the system by which companies are directed and controlled. The issues regarding the corporate governance was the black letter in the field of the company law in United Kingdom until the huge scandals that took place in the late 1980's and early 1990's which led to the reform of UK listed companies. The scandals made the public question about the corporate governance code and ultimately led to the fall of trust of public in the company's accountability and also the scandals led to the massive downfall of the country's economy and as it is the known fact that the economy of any country depends upon the drive and efficiency of their companies. It was after the collapse of 3 major companies that led to the formation of these committees, the London stock exchange required all the listed companies in United Kingdom to comply with the corporate governance code and to give the reasons for non-compliance, it was soon after the Cadbury committee was set. Cadbury committee was the first to deliver their response over the growing concern after the collapse of these major companies, it was followed by the Greenbury committee who also shared their response on issue with the directors pay and remuneration. Other committees like Hample, Turnbull and HIGGS also laid their suggestions which finally led to the formation of Combined Code later on, which will be discussed in the later part of the paper. The paper also discusses the struggle of UK towards achieving a good and most effective corporate governance code for its existing companies.

## KEY WORDS

Corporate governance UK, Hample Committee, Turnbull, Higgs, Cadbury Committee, Greenbury Committee, Combined Code.

## INTRODUCTION

“The Corporate Governance is the system by which companies are directed and controlled “. The issues regarding the corporate governance was the black letter in the field of the company law in United Kingdom until the huge scandals that took place in the late 1980’s and early 1990’s which led to the reform of UK listed companies.<sup>i</sup> The scandals made the public question about the corporate governance code and ultimately led to the fall of trust of public in the company’s accountability and also the scandals led to the massive downfall of the country’s economy and as it is the known fact that the economy of any country depends upon the drive and efficiency of their companies.

It was after the collapse of three companies that was BCCI, POLLY PECK and ROBERT MAXWELL GROUP that the attention was drawn towards having the strict corporate governance code for the UK companies.<sup>ii</sup> It was then when committees like Cadbury, Greenbury, Hampel, Turnbull etc. were formed and delivered their recommendations towards forming the good corporate governance and gave rise to early UK corporate governance codes. Further in the paper we will notice that the accountability, integrity and transparency plays a great role in achieving the good corporate governance and these were the main essence that was absent from the companies that led to the downfall of the three major companies in the UK.

It was after this collapse and the formation of these committees the London stock exchange required all the listed companies in United Kingdom to comply with the corporate governance code and to give the reasons for non-compliance, it was soon after the Cadbury committee was set. Cadbury committee was the first to deliver their response over the growing concern after the collapse of these major companies, it was followed by the Greenbury committee who also shared their response on issue with the directors pay and remuneration. Other committees like Hample, Turnbull and HIGGS also laid their suggestions which finally led to the formation of Combined Code later on, which will be discussed in the later part of the paper. The paper also discusses the struggle of UK towards achieving a good and most effective corporate governance code for its existing companies.

Further the paper will critically analyze the question why do we need a UK corporate governance code and what led to the formation of the Combined code which is the final

corporate governance code for UK. Some recent cases will be used as an illustration to support the need of corporate governance in UK, some drawbacks of the combined code will also be discussed and that the constant revision of the code is required to avoid or to minimize the scams and scandals that take place due to lack of good corporate governance. And finally the conclusions will be drawn along with some suggestions as to how the Combined code further be revised to keep up with the good corporate governance that might help in avoiding the future business scandals.

## **COLLAPSE OF BCCI, POLLY PECK AND ROBERT MAXWELL GROUP**

### **POLLY PECK**

Polly Peck in order to expand the funds took a massive amount of debt from the market and to gain its investors and creditors trust and confidence presented the false profits and losses in its books and exaggerated the same, then after that, from 1988 the money gradually started to vanish from the company in the form of loans and highly doubtful transactions also the assets were found to be registered in the name of the CEO Mr. Nadir by the Serious Fraud Office (SFO). After the company was raided by the SFO the share prices of the company collapsed. The collapse of the Polly Peck was a huge loss for investors and city funds and its collapse also came as the shock as it was considered the safest bets on the LSE (London Stock Exchange) and now that was imploded. <sup>iii</sup> When Polly Peck was raided and the shares of the company were suspended at that time the shares of UK'S more indebted companies nose-dived as well as shaking up the economy. It is said that one of the major reasons that the collapse of the Polly Peck took place was due to the concentration of power in the hands of one single person which might have not led to the discussions of the decisions among the board of directors.

### **BCCI**

BCCI is still considered to be the biggest banking crime of all time. Massive amount of depositors were brutally affected by the collapse of BCCI which was dealing with the accusations of money laundering and fraud. The BCCI was also alleged for hiding the huge amount of losses it was suffering and that it was on the verge of collapsing. From the case it

was concluded that an approach was needed where trust and frankness or in other words transparency was required which was obviously missing in this case.<sup>iv</sup>

### **MAXWELL GROUP**

Maxwell group was accused of shunting money between his companies to portray their profits and that the company was flourishing in terms of profits and also the company owed large amount of debts. The company kept changing its dates on which they reported earnings to deceive the auditors. And to bolster its share price the company looted money from the pension fund of the Mirror Group. In the consequence to this the shareholders of the Mirror Group was totally wiped out. The people who were affected the most were the pensioners as 460 million pounds were looted from their pension funds and it is said that all this would have still been avoided if they had carried out the proper stewardship.<sup>v</sup>

As we can see from the above examples which were the biggest collapses of all time and affected the shareholders, stakeholders etc. badly was all because they lacked trust there was no proper stewardship that was carried on and also there was too much power in the hands of the individual. Had it been that there was a proper and good corporate governance the chances for these collapses to happen might have gone down to minimal. Until these cases there was as such no concern regarding the proper corporate governance it was mainly after these three major collapses when attention was drawn towards having the proper and a good corporate governance and also there was an urgent need because public at large was losing their faith and trust from the UK companies investors were paranoid about making any investments and risking their money. It was after these collapses when the Cadbury committee followed by few more committees came out with certain recommendations that was needed to control the situation and to avoid any such scandals in the near future.

### **CADBURY COMMITTEE**

The committee was set up in 1992 by the Financial Reporting Council. The main reason behind setting up this committee was obviously the collapse of the Polly Peck, BCCI and Maxwell Group and also to improve the system of financial reporting and the accountability as these were the main reasons behind these collapses. And it is due to these collapses that the public has now started raising questions regarding corporate governance. The focus of this committee

was on the functioning of the board and on the role of auditors. In attempt to gain back the confidence of the public, the London Stock Exchange required all the listed companies of the UK to comply with the code and to give reasons in case of non-compliance. The maximum of the Cadbury committee recommendations were implemented by the London Stock Exchange.<sup>vi</sup> But there was no strictness if compliance wasn't made by the companies as there was no external source monitoring the functioning of the board. The main aim of the Cadbury committee was to strengthen the unitary board system and not to replace it. Cadbury in its draft also mentioned that if there was any such draft before the scams then the chances of avoiding such scams would have been high. The committee was confident about its draft that the approach based on the compliance with the voluntary code coupled with the disclosure will prove to be more effective than a statutory code.<sup>vii</sup>

The reasons behind setting up this committee was very simple the less confidence on the financial reporting and on the ability of the auditors to provide safeguards which the user of the company sought and expected. The loss of accounting factor, there was no framework to ensure that directors reviewed the controls in their business and the pressure of competition was too hard to handle by the company as well as the auditors which made it even more difficult for the auditors to stand up to the demanding board of directors.

Another reason behind the committee to setup was the working of the corporate system and this accelerated due to the major collapses that happened, so the need was felt to clarify the responsibilities and to raise the bars came from the number of reports on different aspects of the corporate governance which was published or were in preparation at that time.<sup>viii</sup>

The committee believed that there should be openness between the company and the public within the limits set by their competitive position and there should be confidence build between the company and all its stakeholders. So with this the disclosure of information by the companies will contribute to the effective working of the market economy and this will give the chance to the shareholders and investors to carefully scrutinize the company before buying the shares or investing in the company. The committee also came up with the concept of non-executive directors and that they should be independent.<sup>ix</sup>

As we have seen the Cadbury committee was the first to lay out the structure regarding the good corporate governance and some of its recommendations are still useful today but it left

some of the key areas which needed the attention too. It failed to define independence so the companies continued to appoint the relative friends etc. to board as non-executive directors which made it difficult for non-executive director's concept to operate and be effective. Also they did not deal with a specific issue regarding the director's pay and remuneration in much of a detail. The committee suggested that the remuneration committee should contain mainly of non-executive directors but the details of the policy was not examined.

## **GREENBURY COMMITTEE**

The committee was established in 1994 by the Confederation of British Industry which was successor to the Cadbury committee called Greenbury committee that contributed in establishing some guidelines towards achieving a good corporate governance for the UK based companies. It kept its focus very narrow though, the focus was mainly dealing with the directors pay and remuneration which the Cadbury Committee failed to focus on. The recommendations which it placed was adopted by the London stock exchange along with the Cadbury committee recommendations. Though the committee was successful in pointing out the problem with the directors pay and remuneration but the idea of disclosing the salaries of the directors was highly criticized. As knowing the salary information will not solve the problem but will accelerate the salaries paid to the directors because directors might ask for higher salaries if they will know that directors of the equivalent company is paying more to their directors. <sup>x</sup>

## **HAMPLE COMMITTEE**

As per the recommendations of the Cadbury Committee there should be another committee to review the effect of its recommendations and update the same. And to do so a committee was set by Ronald Hample in 1998 to report the findings which mostly consisted of a review of Cadbury and Greenbury. The committee also suggested the effective communication throughout the company in order to make best decision possible for the company and as suggested by its predecessor committees it also suggested the good accountability, performance and transparency. The London Stock Exchange also showed its support towards the recommendations that Hample committee laid by implementing it. But the committee received its share of criticism when it was said that the committee was rather principal based than rule based.<sup>xi</sup> The committee also received the criticism by the Turnbull committee which recommended that directors have duty towards the internal control dealing with both financial

and non-financial risks. However along with the Cadbury and Greenbury committees Hample committee formed the part of the UK corporate governance code.

## **TURNBULL COMMITTEE**

The committee was established in 1999 to provide direction on the internal control. The main focus of this committee towards achieving the good corporate governance was by focusing on the risk management and by concentrating on the profit maximization of the shareholders. The committee suggested that there should be a reliability upon the internal and external reporting and compliance and also to focus on the operational efficiency and effectiveness. They paid heavy emphasis on the financial risk management. They said that the zero risk is not the aim but the main attention should be towards the controlled risk as risk form the part of a company's environment hence the opportunities threats and risk should be calculated by the company. A revised version of the report came out in 2005 although there were not any important changes that were made the amendment was only done to motivate more informational disclosure including the board to give report on significant actions they have taken as a remedy in case of any weakness or fallings that were identified from the annual review.<sup>xii</sup> The recommendations laid down by the Turnbull committee was taken up the London Stock Exchange just as the previous Committees. Later on along with the Cadbury, Greenbury, Hample Turnbull formed the part of the UK Corporate Governance Code.

## **HIGGS REVIEW**

Higgs review came out in 2002 commissioned by the government which was based on the role and effectiveness of non-executive directors. The review was made for the appraisal of the UK corporate governance in light of the major collapses especially after the collapse of another major company Enron in the United States. The review offered significant changes to the Combined Code and also gave some non-code recommendations. Some of his principal recommendations revolved around the board, role of the non-executive directors, senior independent directors, recruitment and appointment, induction and professional development, chairman and remuneration. Although the report did not pay much attention to the remuneration part. The report did not get much affection from the major companies who were likely getting affected from the proposal. As the proposal expected the companies to have thousand new non-executive directors which was considered difficult to comply with. Also the

chairman was disappointed with the enhanced role of the independent director in relation to dealings with the major shareholders.<sup>xiii</sup> Nevertheless apart from all the frowning it received, Higgs Review filled the gaps that was left by its predecessor that is Cadbury report. The draft provided the role and functioning of the NEDs in detail. In summary the HIGGS Review made a major contribution in strengthening and improving the existence of the combined code.

From the above mentioned collapses we can easily draw the conclusion that how the absence of good corporate governance has caused problems in the UK and how the market economy was badly affected and how it led to the formation of the committees and finally the Combined Code of UK corporate governance was formed. The above mentioned Committees can be stated as the good example as to why UK needs a good corporate governance. And as earlier stated Cadbury Committee in its draft reported that if these recommendations were laid down earlier then the chances of these scams to happen would have reduced, along with the recommendations of the other committees giving their contribution, striving to make and to delivering the importance of the corporate governance code. Which again makes the argument strong about as to why UK needs a corporate governance code.

## **COMBINED CODE**

The Cadbury, Greenbury, Turnbull, Hample, Smith committee and Higgs review together form the part of the combined code. The combined code got published in 2006 but the journey towards the better corporate governance did not stop for UK, there were series of events that took place before, finally in 2018 the UK Corporate Governance Code came into picture. Before 2018 code there were series of revised version of the combine code that was published, in 2008 a revised version of the combined code got published again and there were few changes made regarding the EU requirements relating to audit committees and corporate governance statements. Again in 2010 a revised form of combine code came out which included a revised format to give clear advice on board composition and the risk management reporting provisions were improved. In 2011 there was an announcement made by the FRC about the launch of an enquiry which was led by Lord Sharman to identify lessons for companies and auditors addressing going concern and liquidity risk. Another revised form the code was published in 2012 which comprised of board giving confirmation regarding the annual report and that the accounts that were taken as whole are fair, that they are balanced and easy to understand and



not complex, and that the company will keep updating about the policies on boardroom diversity and finally better reporting by the audit committee was required. In 2014 another revised version of the UK corporate governance code was published which enhanced the quality of information that should be received by the investors about the company they are planning to invest, other than this, the remuneration part was also enhanced to ensure that the executive remuneration is designed to promote the long term success of the company, and to demonstrate the same to the shareholders how this will be achieved. In 2016 the code was again revised to show the changes that were needed to implement the EU Audit Regulation and Directive. Before further discussing the final 2018 code there were some drawbacks of the combined code, the markets and shareholders are not able to assess companies' compliance with this principle.<sup>xiv</sup> There were significant problem of quality of the explanations given by the companies.

Finally in 2018 a new UK corporate governance code which was set up and aimed at setting up higher standards of corporate governance in UK. The aim is to maintain the transparency, integrity in the business world along with taking care of the investors' interest, economy and the society as a whole. 2018 code gave significance to the relationship that lies between the company, shareholders and stakeholders. So basic idea was to balance the remuneration in such a way that it promotes long term success, with this keeping the corporate environment healthy and a good quality board composition and a focus on diversity.

2018 code acts as the guide as to how the principles have been applied, and those principles that have been applied will help the investors to keep a track of the practices that a company has been following. There is a new requirement that has been laid down by the new code that, wherever the companies are allocated if it is a parent company with a premium listing they should make sure that there is enough corporation between the groups so that the board of the parent company can discharge its governance responsibilities under the new code properly which would obviously include the communication of the purpose, strategies and values of the parent company.<sup>xv</sup>

2018 code has five sections to it dealing with the significant issues, absent of which has caused corporate governance disaster in the past. Section 1 of the code deals with the *leadership and purposes* so in summary section one deals with the cultural environment of the company and their connection with the shareholders and the stakeholders. Now section 2 deals with the

*division of responsibilities* as the head suggests this section deals with the division of duties within the board and determines the role of the non-executive director and also acts as a guide in terms of determining the independence of the directors. Section 3 of the code deals with the *composition, succession, and evaluation* this section basically emphasis on the diversity and ethnicity of the companies in their workforce along with this the section requires the boards and their committees to have a fair combination of the skill, experience and knowledge. Now coming to section 4 of the code which deals with the *audit, risk and internal control*, also it is duplicating the requirements in section C of the 2016 code. Lastly section 5 of the code deals with *remuneration*, the section contains the structure of the remuneration schemes.<sup>xvi</sup>

On the basis of the feedbacks some further changes were done to 2018 code. More emphasis was made on the language to sound less perspective. Some changes were introduce in the introduction part of the code to show how important is the guidance to promote high standards and also to encourage the use of the changes so that it works side by side of the 2018 code. Also changes were made to section 1 of the code just to adjust its focus. And a new section was added to section 3 of the code on externally facilitated board evaluations.

The continues changes that has happened in the code since 1992-2018 gives us the clear picture about the fact that how important it is for the companies to have a proper corporate governance code and how difficult it would be to survive without one as the previously discussed scams speak for themselves. The hard efforts that has been put in by the committees, striving to achieve the code that is best as far as possible for the companies in itself speaks the importance of the corporate governance in the business world.

## **RECENT CORPORATE SCAMS IN UK**

Despite of the continues changes and efforts to improve the corporate governance in UK, there are number of cases reported recently to prove the fact that the Combined Code for UK corporate governance needs a constant attention and also throws the light on the question which we are dealing with in this paper that why UK need a corporate governance code? Even though there is a good corporate governance code set for the UK still there are major scandals reported till very recently i.e. in 2018. We will be dealing with the Carillion, British House Stores (BHS) and Patisserie Valerie collapses to support our further writing as to Why UK need a corporate governance code?.

## **CARILLION**

Carillion was the British multinational facilities management and the construction giant and the UK's second largest building and outsourcing provider before its downfall. Carillion was forced down to go for liquidation because of its profit warnings, 39% wiped shares and the CEO left the company. It was reported out of many reasons behind the collapse of the Carillion one of the reasons was the inefficiency of the board in its performance. As the board did not succeed in managing the risks that was involved in the company that is they allowed the company to take high debts while trading in the low margins. Not only the board was incapable to handle the risks but they were unsuccessful in handling the annual reports and accounts. The lack of internal auditing led to the failure of the company as it didn't include modelling in relation to capital and liquidity risk, which could have been the early alarm.<sup>xvii</sup>

## **BRITISH HOMES STORES (BHS)**

BHS was an iconic department store chain before it faced its demise. Until it was purchased and taken private the company enjoyed its success in the streets of the UK. According to the findings the reasons behind the downfall of the company was that the board allowed abnormally high dividends to be taken out of the company. It was pointed out that the dividends were twice the proportion of the net profits attributable paid out by the competitors like Primark and M&S. Also the company was pension scheme deficit. The company was passed down to several owners before it finally faced its demise causing the workers and pensioners to suffer. Yet again BHS is a good example of inefficiency on the part of the board and the auditors.<sup>xviii</sup>

## **PATISSERIE VALERIE**

Patisserie Valerie has shown a tremendous success by holding 192 bakeries chain in UK before it finally went down to vain. Patisserie was suspended because of the material misstatements that it presented in the company's accounts. The gap was found to be massive between the financial status that it was portraying and the financial status it held in the reality. There was a report that was made that showed the evidences of the fraud the company was conducting. The 10 million pounds worth overdrafts were unreported. Again another case showing the inefficiency of the board, audit and accounting system.<sup>xix</sup>

There is no correlation between the recent three scandals that has happened in UK that is the BHS, Carillion and Patisserie Valerie yet we can draw out some similarities between these three cases if we go deeply into these cases we would find out that firstly, there was inefficiency reported in the auditing both internally and externally. In case of Carillion and BHS auditors were highly negligent about the red flags because of their limited remit. Had they been more careful they would have noticed the red flags that was there throughout and would not have faced their downfall which ultimately led to the demise of their respective companies.

Second of all the work carried out by the Patisserie Valerie forensic accountants evidently lacked the internal control in terms of the quality assurance. In the case of BHS and Carillion case the Board of directors were very inactive, their management was not sufficient enough to draw a link between the financial outcomes and the very competitive environments. The board should have been very careful while dealing with the finances as the margin for error was too small.<sup>xx</sup>

The unfortunate demise of these companies have chances to draw the attention towards raising awareness regarding the directors duties and liabilities and further throwing light upon the mishaps that could be faced by the companies in case they do not have a proper corporate governance.

## **HYPOTHESIS**

In my opinion, keeping all the scams including the latest one's there will always be a space that will left that will require constant attention of the law makers. If we take the latest scandals that has happened, if there was more effective corporate governance paired with more independent directors' chances for these scandal to occur would have been very less. Also lack of skills among the board could possibly the reason for these companies to go down in vain. And with globalization and development of the new companies the corporate governance failures will be far more reaching. There is a requirement of strong and more informed leadership to keep the company ongoing. Also the companies have to be more careful with the time passing by, the shareholders and investors are becoming more informative about their rights, similarly it is time for the board to be more informative and skilled and should perform their duty with due diligence. And as we have already seen that without a proper corporate governance it would be very hard for the company to survive in such competitive environment. The insufficiency has

always been caused because of the misleading audits they have been the heart of corporate failures so more attention should be paid towards audit and accountancy reports. Although 2018 code has come up with improved guidelines to deliver a good corporate governance but it will be too soon to comment on that as the first reporting against the 2018 code will be made in 2020. Although lot of changes have been made in the recent code to make it as effective as possible but all we can do is hope for the best.

But nevertheless UK has been very remarkable in case of its corporate governance and has always delivered an effective guidelines but there always a room for misfortunes and mishaps that should be taken into consideration while drafting a code so in my suggestion how good may be the drafting there always be a loophole, gaps and space for scams to take place so a lesson can be learned from such downfalls and effective measure can been taken to avoid a similar fate in the future.

## **CONCLUSION**

As noted corporate governance has received increasingly high profile in the last few decades and the recent scams have accelerated its importance and has given the strong support to its existence. It gives the structure to the companies through which they further develop their objectives. A bad corporate governance not only brings down the company but also the entire economy gets shaken up. Corporate governance provides the investors with the reason to trust and show their faith in a company and not only the investors but the stakeholders as well. It gives recognition to the shareholders which in turn secures the future value of any company. It can be said that it is the key through which the companies secure their leading position in the financial market and to stand out in the global competition. The concept not only includes institutional but also includes the social aspects. So to keep the company going it is very essential to focus on the good corporate governance. With the above discussed scams that has happened in past that is the collapsing of the three major companies in UK which has brought UK a bad fate was only due to the lack of good corporate governance and not forgetting the significant fall of some recent UK companies like Carillion, British Homes Stores (BHS) and Patisserie Valerie is the very clear answer to the question as to why UK needs a corporate governance code. To sum up I would like to add that we have already learnt that how important it is to have a corporate governance code and similarly how difficult it is to reach a perfect one

as there will always be a gap left for a scandal. Also, it is very hard to stick with one code, constant attention and changes will be demanded to avoid any future scams. But UK despite of all, can be posted as a good example in achieving a good corporate governance as it is striving each time to get a better one next time.

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