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BUT WHERE WAS THE BOARD?

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Is Corporate Governance Still Credible?

'Corporate governance' has become a highly fashionable phrase in the past decade and is seen by many to be the solution to many of our current economic and organisational issues. It is not. But it may become so – if it can be seen as a learning system. This paper explores ways of linking the four major players in such a system: boards of directors, owners, legislators and regulators.

Corporate Governance stands at a turning point as a credible international concept and as a discipline. From its classic Greek roots of *kubernetes* its original meaning has survived some three millennia but its current public credibility is low. The fundamental notion that a group of competent people is needed both to steer an organisation forward and to keep it under prudent control has stood the test of time. However, and especially since the start of the Western Financial Crisis in 2007, the present competence of those chosen to direct our current organisations, private, public and not-for-profit is under increasing and continuing public criticism.

Organisations are the cement and stabilisers of our civil society. But the public has fast lost trust in their over-comfy assumption that those who lead our national and business institutions must know what they are doing. This is not proven. Indeed, a quick glance at their c.vs shows that few have had induction

and training, let alone assessment, for their crucial directing role. They may have been competent executives, professionals or activists but none of these roles demand the subtlety and complexity of exercising directoral competence.

If we take the United Kingdom as an example, the credibility of the leadership of the banks, insurance companies, financial services practices, MPs, the NHS, the BBC, the police, the media, even football clubs, and many others is daily under great public criticism. It may be that the public's assumption of trust and competence was never wise but at least it was there. Their expectations of the competence and integrity of those who govern us have now been eroded, lost even, and so the frequent question of *where was the board?* is heard most days in the land. Ironically, this is now asked less of business (financial services aside) than of our major national institutions. This public perception helps destabilise the previous fuzzy national consent on the assumed skills of those in positions to lead us. This unsatisfactory situation leads to ill-informed but understandable public gossip about the effectiveness and efficiency of our organisations further eroding confidence.

The challenge for this conference is, therefore, to create *informed* public debate and consequent learning about, and acceptance of, the critical role that effective corporate governance plays in civil society. We need to be much more outward-looking to explain our expertise and good news in helping our society's concerns and much less concerned with such 'angels on the head of a pin' arguments as to how many years a director should serve, or how many directors should sit on a board.

Figure 1: The Learning Organisation.

This means debunking the two most common myths about 'corporate governance'. First, that it is the silver bullet to cure all of our organisational and financial troubles. Second, that it is all about compliance to codes with little concern about the future success of the organisation. So our task is in developing and publicising those key questions that need be asked frequently by any informed member of the public about the quality of the leadership and prudent control of our organisations. Both of these latter need to become integrated learning systems before a board can become effective. So what are the agreed criteria by which we judge that our leaders are competent in the ensuring the effectiveness and efficiency of our organisations? Where is the learning focus, and dissemination, of such public scrutiny? And who are the major players, thought leaders and implementers in this national debate?

And Now the Good News

Continuing with the UK as an example, the good news is that we have already in place the legislation and codification framework that we need. Yet our problem is threefold. First, the primary legislation is not rigorously implemented and so lacks public credibility. The 2006 Companies Act is comprehensive and lists the Seven Non-Exhaustive Duties of a Director. Each is important. But most directors do not know them and so cannot apply them. Second, our definition of 'corporate governance' is too narrowly focused on Listed Companies. This has allowed Codes to grow that do not apply to the vast majority of organisations in our business society, let alone our civil society. Whilst this asymmetry is understandable historically, it is now skewing our corporate governance mind-sets to the detriment of our society. The South African example of a national law that ensures that corporate governance applies to *all* registered organisations in that country is a better way forward. Third, there is no concept of a national *system* of corporate governance. Therefore, no learning between the four interested parties is expected or encouraged. All of these myths need to be debunked. It is our job to do so.

Towards a Learning System of Corporate Governance

The four main national players in any system of effective corporate governance are:

- The Boards of Directors
- The Owners
- The Regulators
- The Legislators

The Purpose of corporate governance is simple – to ensure the success of the organisation. Let us look at the roles of each of the four main players. First, the role of the board of directors is simple – to drive the enterprise forward whilst keeping it under prudent control. Or at least it is simple to state, but much more complicated to deliver successfully. Second, the role of the Owners is now becoming increasingly messy, indeed it is increasingly hard to find out who is an 'owner'. Third, the role of the regulator is to balance the learning system so that good conduct and fair play are observed by all parties; and fourth, the role of the legislators is to set the national context in which organisations may work freely, to review this periodically and otherwise to keep out of the way. The issue for us is to create a national system where each player can learn their role more effectively, can learn how better to respond and debate with the other three players, and how the whole can be brought together into a national process

of learning so that corporate governance can respond continually to the changing demands of our civil society.

If the roles of each player are so clear and all we need is to integrate them into a learning system, why are many of the current corporate governance practitioners so frustrated and the public so disillusioned? Surely it is not beyond the wit of any reasonable participant to play their role appropriately? Seemingly so. So let us aim to do two things here. First, review some of the major pressures for change which are already beginning to redefine the role of effective corporate governance. Then to look at each of the four players in turn and comment on the changes demanded.

My frequent travels outside the Western Economy allow greater diversity and challenge to my thinking. For example, in Africa and Asia I find the whole push against domination by western multinationals enlightening. Many countries are arguing that for their own healthy development they need to assert that their laws, especially company laws, take precedence over the home-based laws of international corporate headquarters. The tension between international corporates seeing national units as mere wholly-owned subsidiaries and, therefore, subject to their higher legal power, is growing. The nations' reactions against such 'extraterritoriality' (an iniquitous foreign policy of the US for many years) is seen as more countries insist that companies working in their country need a 'licence to operate' which is reviewed regularly. If they do not obey the local rules, then they are fined. or out. These local rules increasingly use a 'triple bottom line' approach and are often underpinned by references to the UN's Global Compact. Indeed we see a growing split between the US-focused view of corporate governance 'CRG' (reporting dominated by Compliance, Risk and Governance) and the EU-Commonwealth 'ESG' approach (reporting dominated by reporting on Environmental, Societal and Governance issues). Do we need to adopt more clearly the concept of a licence to operate?

It is now becoming possible to see enough converging trends to be able to integrate a number of previously seemingly random demands and innovations into an outline of a future international version of 'Stakeholder Capitalism' within which effective corporate governance will play a central and sustaining role. In its simplest form this is manifest not just in continuing public criticism but in the fact that as so much of global wealth is now the consequence of the accumulation of , for example, employee's pension funds. So the say of these employees as to where and how their wealth is invested must become much greater. Trustees and fund managers beware! Karl Marx may have got it right albeit for all the wrong reasons.

One can argue also that many seemingly random advances being debated now will reinforce the move to Shareholder Capitalism. For example, the breadth, depth and outputs of the legal reporting systems are under great scrutiny as the public's lack of trust in politics and business is made more articulate. Annual reporting is moving much more in the ESG direction. Shell has had its 'triple bottom line' for 15 years and even a previous recalcitrant like BAe has become a models of more open and future-orientated reporting. See Novo Nordisk as a model of how this can be presented well. In Auditing we see two trends. First, in the externally-led audit there is pressure even in the City of London, led by Mike Mainelli, for the growth of 'Long Finance' moving away from the deployment of masses of auditors who finally give a 'true and fair' statement towards a more focused, critical review of the extant business model, then the selection of key areas of concern for deeper analysis, combined with the random selection of 'normal' areas for deeper analysis. This culminates in a more client and user-friendly output highlighting areas of concern, and ranges of probability, in which current and future risks lurk. Internal audit is moving also, with Risk Management, towards a more rigorous role in helping the board with more informed prudent control of the business. Indeed, there are trends towards creating a Chairman's Office group, virtual or physical, where the Chairman and Company Secretary oversee the direction and compliance of the company, and use the latest information and communications technology to monitor the Board's Dashboard to ensure that they are fulfilling their fiduciary duty to ensure that the company has a future and is under prudent control.

These and other trends are pushing our approach to corporate governance away from the current compliance-fixation. The growing power of stakeholders cannot be disregarded, especially their legal sanctions. Employees, suppliers, local communities, environmental and social change groups, have increasing legal powers to block or change a business' strategic or operational plans. When these are strengthened through instant communication media, the old model of the company as a lone gun-slinger able to live or die alone looks as outdated as a stagecoach.

As the final part of this address let me give a few immediate thoughts about the four key players mentioned previously.

Boards of Directors

Forget the Codes for a moment and concentrate on the basics – the primary law as seen in the 2006 Companies Act. In the UK, the Seven Non-Exhaustive Duties of a director usually have insincere words muttered about them during a

director's induction and then are forgotten. But if we are to build public trust in the *competence* of our directors then being seen to observe all seven duties is critical. The development of two stand out to me as fundamental in building trust and an informed public. First, *to promote the success of the company.* Following the crass examples of HBOS, Royal Bank of Scotland, the NHS, the BBC etc. there is a glaring need to make this the central demand for the performance of boards of directors, and to assess it regularly. The moves to ESG reporting and Long Finance make this increasingly likely because the optimisation of profit, rather than its maximisation, becomes the norm. Surprisingly there is little research on Business Models or Board Dashboards in this context. Something must be done – a challenge for this conference.

The second Duty in the 2006 Act on which I concentrate is *to exercise reasonable care. skill and diligence*. These are not considered particularly important by the Compliance industry mainly because they are not measured. Previously the interested public would be appalled to hear that this was so. Today they would not be at all surprised. What this suggests to me is that directing needs become a full profession, with rigorous examinations of knowledge, skills and attitude, an enforceable code of conduct, regular reviews of competence and, especially, a focus on the customer or client. Directing can no longer be a comfy add-on to a busy executive life. Statutory Directing is already a 24/7 unlimited personal liability and the public must demand that it is now treated as such. The development of over 1,000 Chartered Directors in the UK, and the start of such professionalisation in South Africa and Australia shows a way ahead. If these are combined with the professionalisation of the Company Secretaries, through for example the ICSA's international Chartered Secretary award scheme, and the creation of the Chairman's Office, then we may see true progress on care, skill and diligence.

Figure 2: The Learning Board taken from 'The Fish Rots From The Head'. Bob Garratt. Profile Books. 2010.

Owners

This is by far the messiest and unresolved area of corporate governance. It is confused by the overlapping terminology used – 'owners', 'stewardship', 'shareholders'. 'stakeholders' etc. In the public sector it is even worse as politicians and civil servants often seek power without consequent responsibility in public entities, as we have seen in NHSFT Mid-Staffs by creating false 'boards' who are left to deal with the often dire results whilst the creators can play an eternal game of buck passing. In business even the lawyers cannot now agree whether the concept of a 'share' means a property right or an portion of control over a company. The 'beneficial owner' was thought to be a

clear definition but even this is under strain. To complicate matters Pension Fund Trustees are seen often as weak, lacking in professionalism, and only too willing to delegate totally their fiduciary duties to fund managers. In turn, fund managers are often seen as not focused on their client needs but more interested in the over-long chain of intermediaries between beneficial owner and ultimate performance. As each link in this chain takes its cut it is little wonder that investors often find remarkably low returns on their investment. With the current debate ranging from whether longer-term shareholders should have a premium dividend to how to handle high-frequency trading where 'ownership' can be four nano-seconds this area needs immediate and major reconsideration.

Regulators

The notion of a regulator is to maintain balance and fairness in a system. The great advance of a spinning regulator of a clockwork mechanism was a driving concept in the design of the American Constitution where the Legislature, Executive and Judiciary needed to be in constant balance. But where are the balancing regulators in the corporate governance world? There does not seem to be a balance between the primary law, secondary law (the Codes), and stakeholder wealth generation for the public good. In the UK the regulators have been subject to 'accountant capture' since the very term *corporate governance* came onto the modern scene. This is hardly surprising as the seminal *Cadbury Report on The* Financial *Aspects of Corporate Governance* set the scene so powerfully that it was copied globally. Luckily Sir Adrian exceeded his brief and suggested that the issue was much deeper than finance alone. But the pervasive finance, even accountancy and compliance, mind-set has had a corrosive influence on the development of effective corporate governance. However, as the ESG, stakeholder power, professionalisation and even, ironically, Long Finance, concepts take hold the annual reporting round will have to break out of an accountancy fixation. I argue that to speed these trends we need to break the present national corporate governance regulators out of their subordinate position in the *Financial* Reporting Council and have them stand alone as independent guardians of national corporate governance. A new national institution is needed that covers all registered bodies – private, public and not-for-profit.

Legislators

Under-performing corporate governance is now such a major national issue for legislators that they tend to avoid or delegate it to the outer reaches of the Civil Service or committees and reviews in the hope that they will bury it. In my dealings with legislators I have found a dangerous mixture of arrogance and ignorance of the topic. The arrogance comes from the assumption that, by definition, they must 'know' about corporate governance because they are those

elected nationally or locally as our governors; they are governance. This is unproven . There is no certified training for politicians or civil servants in corporate governance. Their ignorance comes from a fundamental lack of knowledge and, sometimes, interest in how our organisations are measured in effectiveness and efficiency terms.. It is common for politicians to comment publicly on 'dysfunctional organisations' without having any notion of what role they as legislators can do about it. Their knee-jerk reaction is to pass more laws and then not enforce them rigorously, which rarely helps matters.

The worst example I have seen involves the development of the NHS Foundation Trusts. These hospital trusts have a 'board of directors' and even a Code of Corporate Governance modelled on the FRC one. Boards are expected to accept their full duties as if they were a statutory board. However, there are two problems with this. First, an NHS Foundation Trust is not a legal entity despite the passing of two recent Health Acts. This is denied by previous health ministers but agreed by a previous Attorney General and by Monitor, the NHSFT regulator. So no-one knows when push comes to shove what the board's ultimate powers, responsibilities and liabilities are. The board may be frustrated by this but ministers and civil servants can continue to exercise power without responsibility, and pass bucks. To the best of my knowledge only a handful of the corporate governance world have expressed any concern about this. Second, the politicians and civil servants in their ignorance of effective corporate governance practice later went further and redesigned NHSFTs so that they now have *two* boards running in parallel! You now have a Board of Directors and a Board of Governors. The latter are self-selected as representatives of the community and are then elected to the Board of Governors. Their duties are fuzzy apart from one – the ability to choose and sack the Chairman. Guess where they put their main attention? The political notion was to involve more public interest in such important community organisations but the consequence, despite now renaming the second board as the 'Council of Governors' has been to set up opposition rather than co-operation. And such ignorance is shown in the development of 'public interest corporations' with more false 'boards' such as Network Rail. I suggest that the legislators do two simple things rather than interfere in areas of which they know little but where they can do great harm. First, to extend the Seven Director's Duties to *all* registered organisation in the country – private, public and not-for-profit. South Africa has done this so why can't we? Second, to strengthen an independent national corporate governance regulator with the power to appraise, encourage training and ultimately to prosecute infringements of the primary law.

Conclusion

This is a very sketchy map of the domain of corporate governance – more Ptolomeic than Mercator and certainly not Google Earth. I hope it has set some hares running and that these are reflected in the working sessions and plenaries of this conference. Effective Corporate Governance is such a fundamental cement for any society that we are all charged to develop it well. Who knows that we may even be able to convince governments to agree a Business Covenant as some now have with a Military Covenant?