The Future of Governance

During 2016, SAMI published a series of blogs under this theme and explored this together with other aspects of governance.

The Growing Pains of Corporate Governance

What will corporate governance look like in 2040? Corporate governance, as most people know it, is just a generation old. Although the term existed it was rarely used until The Report of the Committee on the Financial Aspects of Corporate Governance. It was the response to the collapses of Coloroll and BCCI in 1990. Coloroll was a company that grew rapidly as an acquirer of other companies and using creating accounting to give the impression of healthy profit. BCCI (Bank of Credit and Commerce International) revealed massive losses following financial crimes. While the Committee was working, The Daily Mirror boss Robert Maxwell was found to have stolen from the pension fund and fruit trader turned conglomerate Polly Peck also collapsed in 1990 with debts of £1.3bn. These scandals caused considerable concern about the state of UK plc so the Cadbury Report in 1992 attracted much interest.

The Committee that gave birth to modern corporate governance was a voluntary initiative of great and good. Chaired by Sir Adrian Cadbury, then Chairman of Cadbury Schweppes, its members included representatives from the CBI, accounting firms, Bank of England, Hundred Group of Finance Directors, Financial Reporting Council, academia, ICAEW, Institutional Shareholders' Committee, Law Society, London Stock Exchange and Institute of Directors. The most influential part of the report is the two page Code of Best Practice. The rest of it though is well worth reading and is as applicable today as it was in 1992.

Corporate Governance in the UK grew up influenced by further corporate problems and scandals. While still a toddler there were widespread concerns about executive pay, particularly in newly privatised companies such as British Gas. Another committee was formed chaired by Sir Richard Greenbury followed by another code of practice. The collapse of Barings Bank in 1995 renewed interest in a forgotten suggestion of the Cadbury report - that boards should review and report on the effectiveness of internal control. The result was the Turnbull Report containing guidance for directors on internal control and risk management. Corporate Governance was 9 years old when Enron failed. Enron was swiftly followed by a plethora of accounting and financial scandals in the USA, many of which were audited by Arthur Andersen. On mainland Europe there was an Italian accounting scandal involving Parmalat and a Dutch one with Ahold termed Europe's Enron by the Economist. Had the UK approach to governance protected us from such scandals? Perhaps, but it did not protect us from a much bigger problem to come.

Corporate Governance was a teenager in 2007 when we first became aware of a Credit Crunch and achieved adulthood while we were still in the Global Financial Crisis. UK banks were very much involved and UK Corporate Governance was little help. Early reports into what went wrong did not see much problem with governance although that view subsequently changed as the nature of what was happening became clear. Even in 2008 though analysis of what happened at Enron and in banks such as Northern Rock and Bear Sterns showed many similarities. I wrote an article then about these similarities but, in 2008 and 2009, banks were very sensitive and vigorously defending their reputation; the magazine I wrote for would not publish it as lawyers advised it would be actionable to mention Enron and banks in the same article. The similarities I described included high gearing, a reliance on credit ratings, complex structures few understood, business models not understood by board members, off balance sheet entities, ultra high executive remuneration, conflicts of interest as well as accounting and auditing issues.

Now in its twenties, Corporate Governance has evolved and has enjoyed reviews and new editions of codes every two years or so over the last 10 years. But it still presides over an almost regular revelation of continuing problems of ethics, risk management and accounting.

So has Corporate Governance done any good? The answer must be 'yes' but surely we must be disappointed that Corporate Governance did not protected us better from scandal and economic failure. There are other problems which should be addressed. When failure happens our governance system seems to mean that no one is ever accountable. The chairman, CEO and all the other directors can claim either that they were ignorant of what was going on in their organisation or shelter under a collective protective board umbrella and say they did nothing wrong.

Short termism, despite much thought, is as intractable an issue as ever. The economy is driven increasingly by gyrating markets and attempts to control them by central banks. There is a marked reluctance by companies to invest in long term projects, except where backed in some way by government. This may be in large part the reason why the UK economy has gone ex growth and why there are few jobs for young people. Capitalism now seems driven by financial engineering rather than sound business principles.

Our accounting system does little to help. It gives little insight of the future value creating potential of companies and does a poor job in saying if value was created in the past. Profit is not the same as value and accounting profits can be made while destroying the potential to create value in the longer term. Accounting profits fail to distinguish between profits which contribute something useful to the world or profit derived from economic rent which merely appropriates value created others. Our accounting system also has a problem with accuracy. Company financial statements show figures to four significant figures yet some of these figures may be little better than guesses and are known with a confidence of + or - 10%. Company reports convey very little about the inherent uncertainty in many of the figures reported. I helped Z/Yen write a proposal on Confidence Accounting to address this problem.

How then might governance evolve? To date Corporate Governance seems to have taken something of a scientific management or machine view of people that expects them to behave rationally. If something goes wrong, the response is to tweak a code and introduce new requirements or piece of regulation.

It has been over simplistic. People are complex and work in complex systems. Corporate Governance should acknowledge this. All the scandals that influenced Corporate Governance as it grew up involved people. People who should have known better, better either as in better informed or better as in more moral. Sometimes people did know better but did not act on what they knew. They felt inhibited for some reason from acting or were motivated not to act. As governance evolves it should take this complexity, and human nature, into account.

There are some promising signs. There is much greater interest now in corporate culture, in business models and in reporting on value creation. Let's hope that these initiatives will bring about real improvement in how organisations are directed and controlled. But perhaps the biggest change needed would be to recognise what Corporate Governance is for. It should not be to comply with a code, or provide a means of defence when things go wrong. Its purpose should be to help ensure that companies crate sustainable value. It should be judged on the extent to which it is doing that.

Written by Paul Moxey, published 11 February 2016

Systematically Designing The Future Of Governance

T.S. Eliot[1] suggests that we are all trying to escape the darkness within and without by "dreaming of systems so perfect that no one will need to be good". I plead guilty.

Of course I know that systems are dependent on those who operate them. Good systems cannot ultimately work without people who are willing and able to operate them as they were designed to be operated.

However, I also believe that, although systems can never eliminate the need for people "to be good", they can encourage people to be good or not. For, at the very least, systems can make it easier, or harder, for people to be good or not.

We think about governance (the work of directing and controlling organizations) as being about ensuring the good (successful, ethical) operation of organizations. I want to suggest that what we are not thinking about enough is how we can best ensure the good (successful, ethical) operation of boards. Today we have systems for all sorts of things but where are the systems for governance?

Systems are designed to accomplish particular things. I believe that one of the main reasons we don't have a range of good systems of governance to choose from is because we are largely pretty unclear about the unique things that we expect governance to accomplish.

Of course, governance is still a relatively new concept. When Dr. John Carver, the creator of the only really comprehensive system of governance I know (Policy Governance®[2]), first started studying the subject in the 1970's he could carry all the then available materials in his arms. Yes that would be impossible today; but compared with disciplines such as management and accounting, governance is still in its infancy. In spite of all the increased heat and light on the subject, it all remains a bit of a mush.

People still use the term "governance" interchangeably with the term "management". The role of the board is in there somewhere but whether and how it differs from the role of others in the organizational set up is not at all clear.

Speaking about Policy Governance, Sir Adrian Cadbury, who is widely credited with leading the creation of the world's first and most influential corporate governance code[3], said:

"What I value about John Carver's thinking is that it provides a logical and coherent base, a unifying theory of governance that covers both the corporate and voluntary sectors, a universal definition of the difference between governance and management rather than the more usual approach of attempting to allocate functions between them.[3]"

Talking about the journey that led him to Policy Governance, John Carver said "Finally I grasped the problem. In the scientific sense there was *no model for governance*; ideas about the topic were strikingly devoid of conceptual coherence". He went on to make it clear that by "a model" he meant something that "is internally consistent and has external utility".[4] In this article I am using the word "system" to denote the same characteristics.

Crucially, what these quotes highlight is that having a good governance system depends on having a good governance theory. For, as Kurt Lewin the founding father of social psychology, famously said, "There is nothing so practical as a good theory". To me it seems clear that governance can never truly be a discipline in its own right until and unless we have a good theory as to its unique purpose.

I would be delighted to engage further with readers of this blog to discuss that purpose but for now I will leave you with another quote from John Carver; one that highlights a keystone of Policy Governance theory about governance as the unique purpose of the board:

"If I had to isolate one critical perspective it would be this: governance is a "downward" extension of ownership, not an "upward" extension of management."[5.]

[1]T. S. Eliot, Choruses from "The Rock", VI.

[2]Policy Governance® is an internationally registered service mark of John Carver. Registration is only to ensure accurate description of the model rather than for financial gain. The model is available free to all with no royalties or license fees for its use. The authoritative website for Policy Governance is www.carvergovernance.com.

[3]Sir Adrian Cadbury, Chairman of the UK Committee on Financial Aspects of Corporate Governance (source of the Cadbury Report) in an editorial review of Reinventing Your Board by John and Miriam Carver (Jossey Bass: 2006)

[4]John Carver in the Foreword to The Policy Governance Fieldbook by Caroline Oliver and others (Jossey Bass: 1999)

[5]Kurt Lewin in Problems of research in social psychology. In D. Cartwright (Ed.), Field theory in social science: Selected theoretical papers (pp. 155-169). (New York: Harper & Row. 1951)

Written by Caroline Oliver, published 13 April 2016

What now for governance?

Theresa May's pronouncements on reforming the governance of big business, controversy over the failure of BHS, continuing revelations from the Panama papers and the publication of the Financial Reporting Council's deliberations on corporate culture and the role of boards mean interesting times for corporate boards. The confluence of these events along with Brexit and the implications of a Trump presidency will challenge the best of them.

May is responding to a perceived public demand to address what some see as an unacceptable face of business. There is nothing new in the extraction of wealth from an established business by its directors nor in efforts to hide money or avoid taxes. The BHS story and the Panama papers simply remind us it is still happening. Nor is there anything new in attempts to prevent such things and unfortunately it seems unlikely that the latest ideas by our new prime minister and the FRC will be any more successful than previous efforts. Her words may remain just words, they might not become policy and if they do policy might not be implemented. She may think that talking tough is sufficient: perhaps, in political terms, it will.

May's proposals at first sight seem like a breath of fresh air to those frustrated or angry with how big business seems, in their eyes, to benefit a few people at the expense of many so her intention to give more power to shareholders and employees will be appealing. Giving shareholders a binding vote on executive pay looks like a way to empower shareholders but would be difficult to introduce as it could require other legal changes and it could have unintended consequences in the relationships between boards and shareholders. Similarly the idea of having employees represented on boards would increase board diversity but would employees want to take on the potential legal liability that goes with board membership? And would it mean boards run companies better? Volkswagens employee representatives on its board did not stop the emissions scandal. The effectiveness of non-executive directors can be limited by a lack of detailed knowledge of the business. Employee will have a very detailed knowledge of their work area but could be equally ignorant about other parts of a company unless there is a process for other employees to inform them. It would be naive to think that employee representation would make boards better. But it could help if board Chairmen use the change constructively - particularly in helping boards to be more aware what is going on with their companies.

What is needed is for reforms to change behaviour for the better. The FRC report on culture, in trying to turn culture into a process or set of tasks, fails to help people in understanding human behaviour – why people do what they do and when and in what circumstances. This is a pity as that surely is why any board should want to learn about culture. The FRC talks about the importance of values and ethics but does not seek to understand why employees might not heed values statements or ethical codes and, by extension, why attempts to establish a culture may not work or have unintended serious consequences.

For work on culture to have any value for companies it must address why people do things and when and that requires understanding what motivates and incentivises people. It is necessary to understand the business model and consider what its continuing success depends on and, within this, how people are motivated and incentivised. Most boards want to do the right thing for their companies, their shareholders and their employees. More instructions to be ethical will be less helpful than changes which remove incentives to cheat and improve incentives to do the right thing.

Some foresight would be also helpful including in making sense of the politics. Scenario planning brings rewards. It sensitises people to what might happen, and gets them thinking creatively in how to address issues. It also gets them doing systems thinking, understanding cause and effect better rather than incrementally simply reacting to one event after another. This prepares people for uncertainty so they can embrace it rather than recoil from it.

Doing these things - thinking about incentives, thinking about scenarios then acting appropriately-should make boards and their companies more resilient and better able to thrive in a post Brexit and possibly Trump environment.

Written by Paul Moxey, published 14 September 2016