ACG Analysis

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Don't Rely on Compliance

Corporate scandals, the role of regulation and Holistic Corporate Governance

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1 Introduction

The UK has recently suffered the collapse and liquidation of its second biggest construction company and one of its biggest providers of construction and services to the state through the Private Finance Initiative (PFI). Up till this point, Carillion passed all the formal tests: unqualified audit reports from KPMG, compliance with the Corporate Governance Code and cooperation with the Stewardship Code. However, analysts have been predicting problems for some time, having analysed its accounts and spoken to its suppliers and customers, and its shares were shorted by hedge funds for several years before its demise.

So what price compliance? This disaster prompted us to look back at the corporate scandals which have led to regulatory responses and to consider, yet again, why these successive regulations have consistently failed to prevent subsequent scandals.

2 UK scandals in Corporate Governance leading to the Cadbury Report

In the years prior to the setting up of the Cadbury Committee, a succession of scandals created tensions in which investment managers in the City of London felt they were being misled and ripped off by directors and managers of listed companies.

Some examples were:

Guinness

In the late 1980s, Guinness was attempting to take over the larger Distillers competing with a rival bidder. Its chief executive organised a covert share buying scheme to keep up the Guinness share price and win the takeover. The share support scheme was deemed illegal and the participants sent to jail. The CEO was found to have illegally benefited personally and similarly jailed. The competing bidder was agreed to have been disadvantaged by the scheme.

Polly Peck

Through the 1980s, Asil Nadir built Polly Peck to become a big player in a range of businesses including textiles, electronics and fruit and vegetables. By 1990 the company had joined the FTSE 100 and had a global footprint, albeit with an important base in Northern Cyprus. At this point Asil Nadir decided he wanted to take the company private, and though he didn't pursue this, it transpired that he had been transferring assets to his Cyprus companies. The situation progressively unravelled as the company was found to have major debt exposures, Nadir was asked to return the funds from Cyprus, but refused, and within a couple of years the company fell into liquidation. Nadir was charged with false accounting and theft, but fled to Cyprus.

Maxwell Communications

Robert Maxwell was a Czech émigré who had fled the Nazis, had a distinguished war record, built a publishing empire and served as a Member of Parliament. By the end of the 1980s he was a very wealthy man and amongst other acquisitions, his Maxwell Communications Corporation (MCC) owned the Mirror Newspaper Group. However, the indebtedness incurred by his buying spree and insufficient cash generation was causing (as yet unseen) problems for MCC and he was having to resort to improper solutions. As an aggressive, litigious and overbearing personality, he kept doubters at bay until the point when he died, drowned overboard from his yacht off the Canary Islands. This triggered an unravelling of his empire and revealed that to keep MCC afloat, he had raided the Mirror Group Pension Fund which was owed over £200m.

BCCI

This was an international bank set up by a Pakistani financier Agha Abedi in 1971, with headquarters in London and Karachi. The initial shareholders were Bank of America and Abu Dhabi, and the bank grew over the next twenty years into a huge operation, initially focusing on the West, but latterly extending its reach into Africa and Asia. It was subject to suspicion and controversy from the early days, partly because its structure was designed to make it difficult for regulators in any particular country to control it, hence it was perceived as being poorly regulated. Nonetheless, through the drive and charm of Mr Abedi, by the late 1980s it had grown into a global business. The beginning of the end came through heavyweight regulatory challenge in the USA over its suspected illegal ownership of an American bank. There followed accusations of money laundering, dealing with terrorist organisations and blatant breaches of sound lending practice, and eventually an investigation produced such a damning report that in 1991 the authorities forcibly liquidated the bank.

UK Regulatory responses:

Cadbury Report: The Financial Aspects of Corporate Governance 1992
The suspicion between the City of London investing institutions and the management of these large companies led to a determination to level the playing field and make managements more transparent and accountable. So a Committee was set up between the London Stock Exchange and the Institute of Chartered Accountants to set out some new rules about the Financial Aspects of Corporate Governance. This committee, chaired by Sir Adrian Cadbury, scion of the eponymous chocolate company family, reported in 1992, and the title illustrates the restricted approach to corporate governance.

It was a concise document, whose Code consisted of a mere 19 recommendations occupying 2 pages of A5 sized paper. These recommendations were grouped under the four headings of The Board of Directors, Non-executive Directors, Executive Directors and Reporting and Controls, and the Code was famously framed as principles-based, "Comply or Explain".
Essentially it restricted itself to the behaviour of the Board and the publishing of the financial results, though the sting in the tail was a requirement to report on how effective were the internal controls and whether the Board believed that the company was genuinely a going concern. These last two caused consternation in the auditing profession, but ultimately provided a rich source of income for them.

Sir Richard Greenbury: Report on Directors' Remuneration 1995
Following the implementation in listed companies of the Cadbury Committee's recommendations, with the establishment of an Audit Committee, the focus shifted to directors' pay packages. Public pressure led the regulators to determine that something must be done to stop greedy directors from paying themselves disproportionate salaries and bonuses. Sir Richard Greenbury was then a highly successful chairman and CEO of Marks & Spencers, the clothing retailer, and his committee essentially aimed to put remuneration packages through a formal procedure, creating Remuneration Committees, and publishing the full details in the Annual Reports. Cynics said at the time that this would simply lead to an escalation in pay since all companies would want to show that their packages fell into the top quartile, and recruitment consultants (paid proportionately to the size of the pay packages) would encourage this.

Hampel Combined Code

Following the Greenbury Report, a committee was set up to review progress in implementing the Cadbury Code, chaired by Sir Ronnie Hampel, chairman of ICI. His committee reported in 1998, concluding that all that was needed was to combine the work done up to that point, and no fresh regulation was needed. In due course, a Combined Code was then released.

Turnbull Report

After Hampel, the accountancy profession demanded clarity on the issue of Internal Control, so another committee was set up under Nigel Turnbull which reported in 1999 on Internal Control: Guidance for Directors on the Combined Code.

Myners Report

After Turnbull came a Government initiated investigation into institutional investment by Paul Myners, reporting in 2001, to examine how well investment managers and pension trustees were looking after the interests of their clients, foreshadowing the later Stewardship Code

Higgs Review

Then another Government sponsored study, this time into the role of non-executive directors, which Derek Higgs chaired. He reported in 2003, recommending more stringent selection of directors and initiating the role of Senior Independent Director, who would represent the views of the NEDs to the chairman. This was felt by some to undermine the role of the chairman, but it persists to this day.

Smith Report

The same year, 2003, produced another report, this time by Robert Smith, in the aftermath of the collapse of Arthur Andersen, into the independence of auditors in relation to a company's corporate governance framework.

Corporate Governance Code

In 2010, the Financial Reporting Council issued a new version combining and updating the Combined Code and related reports and issued it as the UK Corporate Governance Code. This has been periodically updated in the subsequent years.

Stewardship Code

At the same time, the FRC issued a code for investing institutions which it called the Stewardship Code, and which it hoped would cause investment managers to take more interest in the governance of the companies in which they had invested.

Sharman Inquiry

Following the financial crash of 2008, the FRC asked Lord Sharman to consider risk management and going concern, the issue touched on by the original Cadbury report, and in 2012 he submitted his recommendations which strongly emphasised the importance of long term viability in board deliberations.

So here we have 20 years of regulatory response to corporate governance scandals and there are common threads throughout. First is that they all essentially address the board and the way the directors organise and conduct themselves. Second is that they all have a financial origin or orientation.

And how successful have they been in preventing the sorts of corporate governance scandals that kicked the whole process off with the Cadbury Report in 1992?

3 Scandals in the UK over the last 25 years

It is, of course, counterfactual to speculate how many more corporate disasters there would have been if the launch of the Corporate Governance Code had not happened. However, let's look at a few of the major collapses which did happen.

Barings

In 1995, Barings, a 233 year old merchant bank, collapsed with debts of nearly £1bn after a young trader in its Singapore office broke all the rules and after producing huge profits, managed to hide his subsequent larger losses right up till he couldn't conceal them any longer. The board in London clearly allowed him to operate with insufficient supervision, applauding his performance without understanding (or worrying about) how he did it.

Equitable Life

Probably the oldest mutual insurer in the world, dating back to the mid 1700s, Equitable Life had a reputation as one of the soundest and safest companies in its industry. Until, in the euphoria of a rising stock market in the mid-1990s, it introduced a savings product which made guarantees regarding terminal bonuses on savings policies. When the market collapsed a few years later all those clever actuaries realised that they had already paid out too much and wouldn't be able to meet future commitments, and attempted to wriggle out of the contracts. When the House of Lords rejected their case, Equitable Life had to close to new business and cut promised payouts.

MG Rover

MG Rover was the final gasp of a company which originated in the 1960s as the British Motor Corporation, became British Leyland through a state driven merger with a truck company in the 1970s, was sold to British Aerospace in the 1980s and after continuing decline sold to Ford in the early 1990s. Ford abandoned it after some 10 years, selling it to BMW, who bought it for its LandRover 4 wheel drive capability. Failing to make money, but producing their own 4 x 4, they kept the Mini (which they relaunched to great success) and sold the LandRover element to Ford. Ford later sold it to India's Tata and the residual MG Rover volume car element was spun off in 2000 to a consortium led by four businessmen, described as the "Phoenix Consortium". After abortive attempts to make a success and failure to do a deal with a Chinese manufacturer, MG Rover was put into administration in 2005 with debts of over £1bn. The MG part was then acquired by another Chinese company and became very successful, as did the LandRover element under Tata. However, on the way through, the "Phoenix Four" were discovered to have drawn £42m in fees as the company collapsed. Deloittes were fined for conflict of interest, having advised the Phoenix Consortium while acting as auditors of MG Rover.

Royal Bank of Scotland

The recent history of this 300 year old bank is well-known. Its rapid expansion in the 1990s and early 2000s under a hard driving CEO made it briefly the biggest bank in the world by assets. The expansion came to an abrupt end after it won a contested takeover for Dutch bank ABN AMRO in 2007, in a consortium with Santander and Fortis. Its overstretched balance sheet was wrecked by the subsequent global financial crisis in which its exposure to US sub-prime caused it to run out of funding, and it was nationalised by the UK government. The general view was that its board, consisting of leading lights of industry, had virtually no banking experience and gave the CEO so much rope that he hanged them all. Subsequently RBS has been fined for a succession of illegal and immoral actions before and after the crash.

HBOS

HBOS began in 2001 as a union of Bank of Scotland, the oldest bank in Scotland, with Halifax, which had been the premier building society in England. In sidelining the old leaders, the aggressive new management and board set out on an expansion plan targeting commercial lending. It was warned by a whistleblower in 2004 about excessive risk taking. He was fired and in 2008 the bank was hit by the fallout from the financial crash. Ultra staid Lloyds Bank was persuaded by the UK Chancellor of the Exchequer to save it by a takeover, on the understanding that competition concerns would be waived. The result was to wreck Lloyds' finances and Lloyds itself had to be bailed out by the government. Criticism of both HBOS directors and the Lloyds' board was severe and heads rolled.

Carillion

Very recently, the second biggest construction company in the UK was put into liquidation after a standoff between bankers and the government over government refusal to provide guarantees for further support. The proximate cause of Carillion's failure was that they ran out of funds, with some £25m in cash at the end, against nearly £1bn in debts. The longer term reason appears to have been a combination of bidding too low to win large contracts, with insufficient margin for over-runs, and deploying more and more extreme forms of finance to make up for slow payment by debtors. The work in progress also seems to have risen sharply, calling into question whether it could ever ultimately be invoiced, with the implication for further large losses. The backdrop was that the auditors signed off the accounts each year and the government continued to give it huge contracts. Investigations are now commencing into the performance of the auditors.

4 Effectiveness of regulation

So how effective was this deluge of regulation in improving corporate governance in this selection of disasters?

Barings:

Cadbury Rule 1.1 of the Cadbury Code reads: “The board should … retain full and effective control over the company and monitor the executive management”.
Clearly the board didn’t do this.

Equitable Life:

Cadbury Rule 2.2 reads: “Non-executive directors should bring an independent judgement to bear on issues of strategy, performance, resources….”
Cadbury Rule 4.6 reads: “The directors should report that the business is a going concern, with supporting assumptions or qualifications as necessary”.
The non-execs clearly didn’t challenge the actuaries’ wildly optimistic assumptions about the future liabilities. Later they were sued for their negligence – a very worrying period for them till the suit was dropped.

MG Rover:

Cadbury Rule 3.2 reads: “There should be full and clear disclosure of directors’ total emoluments…”
Cadbury Rule 3.3 reads: “Executive directors’ pay should be subject to the recommendations of a remuneration committee made up wholly or mainly of non-executive directors”.
The fees extracted by the Phoenix Four were out of all proportion to their personal performance and the board should not have permitted them.

RBS

Cadbury Rule 1.1 reads: “The board should …retain full and effective control over the company and monitor the executive management”
Cadbury Rule 1.2 reads: “There should be a clearly accepted division of responsibilities at the head of a company, which will ensure a balance of power and authority such that no one individual has unfettered powers of decision…”
Cadbury Rule 2.2 reads: “Non-executive directors should bring an independent judgement to bear on issues of strategy, performance, resources….”
Fred Goodwin, the CEO, was effectively completely out of control and though the board comprised respected businessmen, they were not bankers and allowed the CEO to bet (and lose) the farm.

HBOS

Cadbury Rule 4.5 reads: "The directors should report on the effectiveness of the company's system of internal control"
Cadbury Rule 4.6 reads: "The directors should report that the business is a going concern, with supporting assumptions or qualifications as necessary".
The board was warned about the riskiness of the business they were building and ignored the warning, firing the whistleblower.

Carillion

Cadbury Rule 4.1 reads: "It is the board's duty to present a balanced and understandable assessment of the company's position
Cadbury Rule 4.6 reads: "The directors should report that the business is a going concern, with supporting assumptions or qualifications as necessary".
Such warnings as the company disclosed were buried deep in the report to the accounts, and the financing device used to pay pressing creditors had the effect of masking the growing short term liquidity crisis.

Here, for simplicity, we are just applying the original Cadbury principles. What these examples illustrate is not that there is anything wrong with the principles, but that they didn't prevent ambitious CEOs or lazy boards from allowing bad things to happen. These happened despite a succession of regulatory augmentations which, in twenty years, transformed Cadbury's nineteen rules into whole manuals of detailed regulation and guidance.

And where were the auditors during all this? Completing their audits according to the standards of the day, is their answer.

5 The USA and Corporate Governance regulation

In this article, we will dwell only briefly on the American scandals and the regulatory response, simply to illustrate a similar scenario of compliance followed by disaster. In the very early 2000s, three huge scandals rocked Wall Street, all happening within a short while of each other.

Enron

This was a giant energy trading company which collapsed spectacularly when its profits shown by fraudulent accounting were overwhelmed when its even more fraudulent financing schemes were unable to fund its mounting debts. Profit recognition was at the heart of its misleading accounting, and off-balance sheet special purpose vehicles secured against its own shares hid its funding problems until they grew so large that they couldn’t be concealed any longer. A share price collapse produced a liquidity crisis and the end happened quickly in 2002. The CEO and former CFO went to jail. Auditors, Arthur Andersen, were destroyed by their behaviour.

Worldcom

This communications company was brought low by a simple accounting fraud – capitalising billions of pounds of expenses that should have been written off. When this was uncovered the company quickly ran out of cash and shareholders who had owned a business worth $100bn were wiped out. Auditors were Arthur Andersen. The CEO and former CFO went to jail.

Tyco

This global security systems, engineering and electronics group expanded rapidly through the late 1990s and the losses it started to generate were concealed by false accounting, while its debts mounted unsustainably. A major restructuring was needed, but meanwhile its CEO and CFO were accused of a huge theft from the company. Auditors, Price Waterhouse, were fined hundreds of millions of dollars. The CEO and former CFO went to jail.

6 US Regulatory response: Sarbanes Oxley

In the USA, the collapse and revealing of the associated scandals of Enron, WorldCom and Tyco led to the Sarbanes-Oxley Act in 2002. this was a major Act, attempting to tackle the fraudulent accounting which had misled shareholders, the inadequate auditing which had failed to uncover it, the poor boardroom performance which had permitted it to happen, and the bank lending which had continued to fund uncreditworthy businesses.
At the time, and to this day, Wall Street criticised the Act as excessive regulatory interference in business, but the politicians weren’t finished, regardless of the criticisms, and repeated the regulatory attack a few years later.

7 Subsequent scandals in the USA

As we asked in relation to the deluge of corporate governance regulation in the UK, how effective was the SarBox Act? Sadly, it failed completely to avert the behaviour in the financial services field over the next few years which registered on a spectrum from incompetent through sailing close to the wind to downright crooked. The result was the Crash of 2008.

We don’t need to go into the details here, during which such leading companies as Lehman Brothers, Washington Mutual and insurer AIG featured in a financial collapse which led to a global financial crisis.

However, the politicians had their revenge on Wall Street and the result was another raft of regulation in 2010.

8 The regulatory response: Dodd Frank Wall Street Reform and Consumer Protection Act.

Dodd Frank imposed a huge raft of new regulation on the financial services industry, with the intention of ensuring that banks never again would have to look to public bailouts following excessively risky lending or trading. Similar capital adequacy and risk management rules have been rolled out round the world subsequently, for similar reasons.

So far, the global debt recession following the crash has ensured that these capital buffers haven't been tested, but ethical behaviour doesn't seem to have been guaranteed by the raft of regulation, and where unethical management leads, financial disaster sooner or later follows.

A fairly recent example is Wells Fargo Bank, for some years a renowned exponent of the art of cross-selling, with its CEO famed for taking the bank into the leading ranks through his skill in this area. Right up until it was discovered that sales targets were being met by unauthorised setting up of customers' accounts and related transactions. The CEO eventually resigned, but what was the board doing all that time?

9 South Africa and King I – IV

South Africa led the emerging markets in introducing corporate governance regulations in the late 1990s, along the lines of Cadbury, but broadened, almost philosophically, to apply to the particular situation in South Africa. Subsequently there have been further updates, and we are now looking at King IV.

However, the scandals following the election of President Zuma and the acknowledged failure of big Four auditors KPMG with the Gupta firms, Deloittes most recently with Steinhoff, and the disaster that is Eskom, all point to a Code that is well-meaning but ineffectual.

10 Some significant corporate governance disasters and their cost

To illustrate the huge financial impact of corporate governance gone bad, here is a short list of some of the disasters of the past few years and the impact they had on the company's value after the disclosures:

Company	Problem	Cost $bn
AIG	bad strategy and underwriting risk assessment	239
WorldCom	fraudulent accounting	186
Volkswagen	corrupt operational practices	99
RBS	bad strategy and corrupt practices	92
Enron	misguided strategy and fraudulent accounting	66
BP Deepwater Horizon	failure of control at operational level	65
Lehman	excessive leverage and risk exposure	60
Samsung	cultural issues and corruption	45
Wells Fargo	bad culture and corrupt operations	28
Tesco	fraudulent accounting	18
HP/ Autonomy	board flipflopping over strategy	10
Steinhoff	fraudulent practices	10
Toshiba	bad strategy and financial engineering	9
Thyssen Krupp	bad strategy and senior level corruption	6
Total		**$933 bn**

11 What price regulation and how these could have been anticipated by ACG?

This staggering total of nearly a trillion dollars is just a sample from round the world. And it all happened post Cadbury and the majority post SarBox. So clearly regulation isn’t effectively eliminating bad governance. Provided, that is, you define corporate governance holistically, as we do, since all these companies passed the regulatory tests right up till the time they were found to have failed them.

Our theme is that good Corporate Governance is about an holistic approach and compliance with regulations merely permits a company to enter the market, whereas holistic corporate governance provides the critical core competence which provides competitive advantage and builds brand value. All the companies mentioned above acquired the “enabling competence” of compliance which allowed them to compete in their various markets. They all failed, in their similar and different ways, to exercise and exhibit holistic good corporate governance.

The essence of our approach is that there are some core principles of good corporate governance which need to be recognised, and that a system must be set up to monitor performance in regard to some key metrics if good governance is to be established and maintained. As the saying goes: what you can't measure, you can't manage, which is why a long time ago we devised a measurement and management approach which is designed to address the shortcomings of the strict compliance and box-ticking approach to corporate governance.

12 Holistic corporate governance and Value

Finally, the occasionally vexed question about whether this focus on corporate governance results in a higher share price (a more valuable company). Three points should be made:

- the first and obvious one, looking at the examples above, is that bad governance leads to bad results, and the defensive dimension for investors is increasingly mentioned by the biggest global investing institutions
- the second is that the performance of companies should be measured by the benefit they generate for a broader group of stakeholders than just the owners, and this is increasingly expected by societies round the world and even incorporated into companies legislation in some countries
- finally, from the point of view of the stakeholders directly affected, good corporate governance, measured more holistically, for instance by the ESG rating, is recognised by customers and leads to increased brand appreciation. This in turn is recognised by investors and brand appreciation leads to brand value.

And, after some years of inconclusive discussion about whether compliance with corporate governance regulations, ie compliance with a limited set of objectives, and the suspicion that there isn't much effect, the evidence is now clear that there is a significant, measureable effect.

However, this increased valuation comes from companies that are implementing a broader interpretation of corporate governance - ESG. This is a step along the road to ACG's holistic CG, and it is accepted by all the big global investing institutions to improve shareholder returns over an extended period.

The days of rule-based, financially-oriented, box-ticking compliance are numbered.

13 About Applied Corporate Governance

Applied Corporate Governance was founded to provide corporate governance training, advice and consultancy for organisations around the world and in both private and public sectors. Our website, www.applied-corporate-governance.com was originally set up to reproduce and update our work in this field developed over more than two decades. It is now recognised as a leading global resource in its sector, with readers and subscribers from almost every country on the planet. From this base we continue to expand the range of content, including analysis and comment on current issues, as well as more substantial articles and analyses such as this with greater longevity, which address the challenges of designing and implementing corporate governance programmes. The Leadership Zone on the site aims to foster strong, ethical leadership through dedicated content and training.

We are primarily a father and son team, based in the UK and Spain, who share a commitment to improving standards of governance and a passionate belief that our approach has the potential to prevent massive corporate failure and improve the lives of millions through transforming transparency, accountability and responsibility of companies and countries alike. We believe our family connection and age difference, combined with a long history of working together, give us a unique set of strengths in helping people and organisations, from providing different perspectives to allowing for robust debate on the best course of action. We also have a wide network of friends, colleagues and contacts on all five continents to aid us in our pursuit of good corporate governance. In particular, we are now working with a local consultancy is South Africa, Trueline Leadership Consulting, to deliver localised training in governance and entrepreneurship.

Below are links to a few of the web pages most relevant to the subject of holistic corporate governance:

What is ESG? Can it really unlock Brand Value?
http://blog.applied-corporate-governance.com/holistic-corporate-governance/what-is-esg-can-it-unlock-brand-value/

Corporate Governance and Islamic Principles
http://blog.applied-corporate-governance.com/holistic-corporate-governance/corporate-governance-and-islamic-principles/

Innovation: Corporate Governance's hidden but vital contribution
http://blog.applied-corporate-governance.com/news-updates/innovation-corporate-governances-hidden-but-vital-contribution/

Best Corporate Governance Practice - the Five Golden Rules
http://www.applied-corporate-governance.com/best-corporate-governance-practice/