Applied Corporate Governance

People Planet Profit

BEYOND COMPLIANCE series

The Holistic Way to Good Corporate Governance

Booklet 1

What is Corporate Governance?

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www.applied-corporate-governance.com

Applied Corporate Governance™ is a trading name of Tangley International Ltd (registered in the UK). We are dedicated to helping organisations and indeed nations achieve long-term sustainability and growth through training, research, entrepreneurship and implementation of good corporate governance.

The Applied Corporate Governance brand has two arms:

- the ACG website, dedicated to informing, campaigning and improving culture across all sectors and regions. It is a recognised thought leader in its field.
- Corporate Governance Training: a private organisation offering a range of standard and tailored training programmes and online learning, often in partnership with local organisations.

For more information please visit the website or contact us at info@applied-corporate-governance.com.

Note: while our methodology was originally designed for commercial organisations, the principles apply equally to not-for-profits and non-governmental organisations (NGOs). This is because of the holistic nature of the methodology and view that all organisations, commercial or otherwise, should be guided by the same principles. If you are a non-commercial organisation, contact us for ***special terms****.*

Preface

This series of booklets is the latest in almost 30 years of corporate governance publications by Nigel Kendall, starting in 1992, at the very beginning of mainstream debate on the subject. His second book on the subject set out a series of “Golden Rules”, which became the basis of ACG, a brand established to build on successful corporate governance training and expand its reach though digital publishing (the ACG website, downloadable ebooks and courses).

As we say throughout the site, the first and most critical rule is an ethical approach, and this should permeate an organisation from top to bottom. The way this creates the culture determines the performance in relation to the other four Rules.

Culture is, ultimately, determined by leadership. A strong board committed to the principles of corporate governance will encourage a healthy, ethical culture. The directors, and no-one else, have the ultimate responsibility for the Company to its stakeholders. Their role is to:

- define the Company’s business and long-term objectives and identify strategic opportunities
- make sure the Company has access to the right quality of people, technology and organisation
- set the cultural and moral tone of the Company
- evaluate and monitor the chairman and the chief executive and if necessary replace them
- evaluate the internal controls to ensure the protection of the stakeholders and to evaluate the financial statements issued by the Company
- take care that the Company has effective management processes for making sure that its resources are applied to the profitable exploitation of business opportunities
- oversee the process of management development to provide an adequate succession

There are two critical factors in carrying out these roles. The first is a creative and stimulating chairman who carries weight and respect throughout the Company, not just at board level. His or her role is key – to build a team and to weld it together. To do that, the chairman also needs a second factor, namely the vision and independent perspective of directors who are not part of the operating management of the business.

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"No one pretends that democracy is perfect or all-wise. Indeed it has been said that democracy is the worst form of government except all those other forms that have been tried from time to time."

Winston Churchill

CHAPTER 1: INTRODUCTION

1.1 Purpose of this Booklet

This Booklet is designed to take readers through the background to the Corporate Governance story and explain why it is regarded as important by both the public and politicians. In this, the first of a set of Booklets on Corporate Governance, we set out the rules and regulations which have been introduced to formalise codes of corporate governance. And we show how successive attempts to improve corporate behaviour by introducing new regulations have consistently failed to prevent the next scandals, and are always playing catch-up.

In the second Booklet, we specifically address the Board of Directors and consider the responsibilities of the Chair. We examine the issues they currently are facing and the information they need to fulfil their statutory and regulatory duties. The Board of Directors is responsible for the proper running of the company, commencing with ensuring an ethical culture, and, by extension, all the directors must be familiar with the most important techniques of management, including setting strategy, structuring and resourcing the organisation, risk management and accountability.

In subsequent modules we address the issues faced by auditors and regulators and the fact that Boards of Directors, auditors and regulators are not receiving information to the degree required to spot problems early on and take preventive action. Hence they are all coming under increasing criticism from a general public astonished that companies are still caught behaving badly but regulators and auditors don’t catch them until it’s too late.

Over the past thirty years, we have developed our own approach to Corporate Governance, which we call Applied Corporate Governance (ACG), and which defines governance holistically and establishes a reliable means of assessing corporate performance. We draw attention to the fact that compliance with current law and regulation, while clearly beyond challenge, simply qualifies a company to trade legitimately, but does not, of itself, produce good corporate governance.

We also make the point that there are several key groups of participants beyond shareholders, and the company itself and its management are accountable to the various stakeholder groups, of which the most important are clearly the customers, the employees and the owners. And the regulators and auditors are responsible for monitoring and checking that the company is being run properly. Increasingly, the regulatory framework and auditing responsibilities are being interpreted and extended to address the wider issues associated with stakeholders generally and sustainability, as investing institutions concern themselves with companies' ESG (Environment, Social & Governance) performance.

In the third Booklet, therefore, we describe a holistic approach to Corporate Governance, measured by seriously effective board information systems, and supplemented and fed by interactive stakeholder engagement, as the answer. This set of modules is our contribution to the improvement of corporate governance generally and board performance by directors and oversight by auditors and regulators in particular.

For aspiring or current board members, the intention is to inform or remind directors of their fiduciary duties in regard to corporate governance and give them the means of developing and implementing a system of good corporate governance based on the holistic approach which is at the heart of these Booklets. The aim is to equip board members with the skills and tools to build an open, ethical business in touch with the needs of all its stakeholders, and to remind non-executive directors (NEDs), of the very wide range of experience that they need to bring to their task.

1.2 Issues it addresses

One of the key messages we want to make at the very beginning of this Booklet is that the company is an independent entity, and the role of the Board of Directors is to look after the health of that independent entity. The Board's role is NOT to run the company, which is the job of the management team appointed to fulfil that role. The tendency for the two roles to overlap is to be guarded against, hence, for example, the insistence on splitting the roles of Chair of the Board and CEO of the company. When a senior executive sits in the boardroom as a director, he or she performs a different role and has different responsibilities from those of their executive role.

The public understanding about Corporate Governance is that it indicates whether a company is being run properly and doesn't have scandals or go bust. The regulatory approach, focusing on board behaviour and compliance with board rules isn't enough in today's world. It sounds too obvious to say, but if board members don't understand how a business really works, compliance with board behaviour rules won't prevent bad results. So boards need to understand business holistically, not just how to behave in board meetings. Obvious it may sound, but in the examples in this and subsequent Booklets, the reader will find that, time and time again, the boards of these large companies clearly are not paying attention to how their companies are being run.

Though shareholders have certain rights, company law and practice is increasingly acknowledging that there is a much wider group of stakeholders to which the company owes obligations, and whose interests the directors must take into account. Corporate Governance specialist, Professor Bob Garrett devotes a significant part of his latest book, Stop the Rot, to this issue, and to the fiduciary duties of directors under the UK Companies Act 2006, which require the directors to bring appropriate experience to their job and to apply reasonable skills.

Again, it may seem obvious that directors should bring reasonable skills to board meetings and to take proper account of the long-term future of the businesses for which they are responsible, but experience shows that even in the biggest companies, this cannot be taken for granted.

So our holistic approach goes to the heart of what running a business is all about, and compliance with regulations, while obligatory, is not enough.

1.3 Why we take this approach

One of the best-selling management books of the 1980s was In Search of Excellence, by Tom Peters and Bob Waterman. It is interesting to revisit their conclusions and look at what subsequently happened to the companies they studied.

Their eight guidelines for assessing whether a company was being well run were:

- a bias for action
- close to the customer
- autonomy and entrepreneurship
- hands on value driven
- stick to the knitting
- simple form, lean staff
- simultaneous loose-tight properties

These are generally uncontentious, but arguably are broadly operational guidelines and useful as a check on whether a business is being run sensibly. However, they cannot be described as holistic, and in today's world they don't address some of the most pressing current issues such as culture, strategy and stakeholder obligations.

If we take a quick look at the companies they studied, we find fourteen they describe as “exemplars”, and of these all but one are still thriving independent companies today.

However, of the next category, twenty-two companies designated as “excellent” examples, there are a mere thirteen, or 59% still independent. And, interestingly, of the remaining twenty-six, just fourteen, or 54% survive as independent companies which haven’t been taken over or gone through bankruptcy proceedings. So “excellent” management according to Peters’ and Waterman’s eight guidelines was not sufficient to prevent long-established companies such as K-Mart and Eastman Kodak or more recent businesses Wang and Amdahl from going to the wall.

So this booklet starts by discussing what is generally meant by Corporate Governance and outlining the various Codes which have been put in place over the last three decades. And it ends by outlining how our holistic approach departs from the traditional approach, but that regulation and investor trends are moving in this direction.

CHAPTER 2: HISTORY OF CORPORATE GOVERNANCE

2.1 What is Corporate Governance?

Since the production of Sir Adrian Cadbury's seminal Report in 1992, most people turn to the definition by his Committee, which was:

"Corporate Governance is the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the board include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The board's actions are subject to laws, regulations and the shareholders in general meeting."

Just over a decade later, in 2004, the OECD defined corporate governance as:

"Procedures and processes according to which an organisation is directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among the different participants in the organisation – such as the board, managers, shareholders and other stakeholders – and lays down the rules and procedures for decision making."

In that period, we can see the emphasis broadening from the company-to-shareholder relationship of Cadbury to the more inclusive OECD definition which mentioned other stakeholders. Two years later, the UK Companies Act of 2006 addressed the general duties of directors in broader terms still, talking about promoting the success of the company for the benefit of a wide range of stakeholders.

Since then, the trend worldwide (with the possible exception of the USA until recently) has been in the direction of stakeholder inclusivity, and it is starting to be taken for granted that companies which demonstrate good corporate governance, defined broadly, perform better and demonstrate stronger value creation.

We at ACG applaud this trend, having preached the gospel of holistic governance for the past twenty five years, but we are also concerned that corporate governance is managed in a way that is compatible with business objectives, and managed through systems and metrics which deliver improved performance. Despite progress in the past twenty years towards broadening the interpretation of corporate governance, we believe little progress has been made in creating systems which help companies deliver the desired improvement in corporate governance performance.

These Booklets set out to show the deficiencies in the conventional approach and to provide a practical way to unify the key elements of a holistic system of good corporate governance.

2.2 UK History of Corporate Governance

While corporate governance is a fairly recent issue, the concept has been in existence as long as the corporation itself - really as long as there has been large-scale trade, reflecting the need for responsibility in the conduct of commercial activities. A merchant of old necessarily had to ensure that any venture, for which he (and it was usually, though not always he) provided capital, was being planned and executed responsibly, and that he was kept informed.

The basis for British company law, which grew up in the nineteenth century, was to offer business the protection of limited liability by separating personal liability from that of corporate organisations. Personal liability could therefore be limited to the amount of the shareholding in an incorporated company, limited by shares. This worked well when the shareholders were truly proprietors, and it still obtains today, of course, in medium and small businesses. Major companies, on the other hand, do not usually function like that any more.

The size of companies began to change as a result of the new technologies of the Industrial Revolution, which required much larger firms to create economies of scale. Shareholders ceased to manage them directly and hired professional managers - below board level - to run them instead. As time went on the managers began to graduate to board level, and gradually came to form the majority of board members. The process of completely separating ownership and control was accelerated after the Second World War when the financial institutions started to build up their industrial investment portfolios. The fund managers who handled these investments had no interest in individual shares as such. Their job was to balance their portfolios, which they did by diversifying them. They left the management of the companies to the professional managers.

The formal division between boards of directors and the business management continued into the second half of the 20th Century in many of the old industries like banking, insurance, shipping, brewing, construction, textiles and the larger manufacturing firms, where it was for a long time customary to separate the board from the executive management. The chief general manager was often the only member of management to attend board meetings, and even then not necessarily as a director. By the last quarter of the last century all these companies had changed their structures following takeovers, amalgamations and changes in social attitudes. In the smaller organisations, of course, the executives, who may often be the owners, will usually constitute the majority of the board, and the issue of fiduciary duty to the owners doesn't apply in the same way.

Corporate governance developed as a subject for academic research probably mainly in the United States in the years after the Second World War, but it came to prominence in the UK with the publication of the Cadbury Report on the Financial Aspects of Corporate Governance in 1992. The title indicates the limited focus, which reflects the origins of the exercise which, prompted by recent corporate scandals, were all about protecting City investors from being exploited by rapacious managements who, hence, needed to be brought under a measure of control.

The Cadbury Code of Best Practice had four sections with 19 subsections and covered a mere two pages, but its principles, with the related mandate to "comply or explain" reasons for non-compliance, have since been largely adopted all around the world, with the exception of the United States. The simplicity of Cadbury has been lost to some extent in subsequent elaborations and the UK Corporate Governance Code as it is now known (most recently updated in 2018 following a comprehensive review), is a more substantial document, but the pragmatic approach of comply or explain is retained.

A survey of Codes of Corporate Governance round the world suggests that the UK's approach is broadly the one that has been followed, even in the non-Anglophone countries which adhere to the two-tier board, compared with the UK's preference for unitary boards.

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 much 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 competing bidder was agreed to have been disadvantaged by the scheme, which was deemed illegal. The participants were sent to jail, including the CEO of Guinness, who was found to have illegally benefited personally.

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, returning to the UK only in 2010, to be charged with theft and sentenced to ten years in prison.

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.

Bank of Credit & Commerce International (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 nineteen recommendations occupying two 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 among those 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 & Spencer, 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 (FRC) 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.

Subsequently, we have further disasters, such as the major collapse of Carillion, an outsourcing giant, which managed to hide its liquidity problems arising from its unprofitable contracting, until suddenly it couldn’t any longer. And Patisserie Valerie, an admired and expanding chain of cake shops, which suddenly discovered a huge hole in its accounts, pushing it into administration. Then Tesco, which had to take a £250 million hit to its profits through “accelerated recognition of income “ and “delayed accrual of costs”.

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. But still the corporate governance scandals happen.

2.3 UK Corporate Governance Code July 2018

The most recent release of the Corporate Governance Code by the Financial Reporting Council was in July 2018. Regularly since 2010 the FRC has issued an update, but the essential principles have remained unchanged.

The Code applies to all listed companies, and the description of its role and its own definitions are summarised in the following paragraphs. The full Code can be seen via the link in the Appendix.

Introduction

The purpose of corporate governance is to facilitate effective, entrepreneurial and prudent management that can deliver the long-term success of the company.

Corporate governance is the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. However, the environment in which companies, their shareholders and wider stakeholders operate continues to develop rapidly. Long term success will depend on building and maintaining good relationships and mutual respect with these stakeholders through a culture of integrity and openness.

The responsibilities of the board include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The board's actions are subject to laws, regulations and the shareholders in general meeting.

Corporate governance is therefore about what the board of a company does and how it sets the values of the company, and is to be distinguished from the day to day operational management of the company by full-time executives.

The Code is a guide to a number of key components of effective board practice. It is based on the underlying principles of all good governance: accountability, transparency, probity and focus on the sustainable success of an entity over the longer term.

The 2018 version of the Corporate Governance Code has an updated set of Principles that emphasise long-term sustainable success. It supports these Principles with more detailed Provisions so that, by applying the Principles with the Provisions and associated Guidance to Board Effectiveness, companies can demonstrate through their reporting how their governance contributes to the companies' long-term success.

It emphasises the flexibility in the Code and relies on companies to adhere to the spirit of the Code, through the "comply or explain" philosophy.

Reporting on the Code

The 2018 Code relies on companies conveying to shareholders and stakeholders generally through their reporting, how they have applied the Principles set out in the Code, and hence the quality of their governance. Thus "boilerplate" is frowned upon, and high-quality reporting is regarded as evidence of good governance. And non-compliance with the Code is expected to be explained and justified.

It stresses that reporting must make it clear to readers how the directors have complied with their statutory duties under the Companies Act 2006, which takes precedence over any possible alternative interpretation of the Code.

Similar expectations apply to investing institutions and their responsibilities under the Stewardship Code.

The Main Principles of the Code

Section 1: Board Leadership and Company Purpose

A A successful company is led by an effective and entrepreneurial board, whose role is to promote the long-term sustainable success of the company, generating value for shareholders and contributing to wider society.

B The board should establish the company's purpose, values and strategy, and satisfy itself that these and its culture are aligned. All directors must act with integrity, lead by example and promote the desired culture.

C The board should ensure that the necessary resources are in place for the company to meet its objectives and measure performance against them. The board should also establish a framework of prudent and effective controls, which enable risk to be assessed and managed.

D In order for the company to meet its responsibilities to shareholders and stakeholders, the board should ensure effective engagement with, and encourage participation from, these parties.

E The board should ensure that workforce policies and practice are consistent with the company's values and support its long-term sustainable success. The workforce should be able to raise any matters of concern.

Provisions

Provisions 1 – 8 provide detailed guidance on implementing these Principles.

Section 2: Division of Responsibilities

F The chair leads the board and is responsible for its overall effectiveness in directing the company. They should demonstrate objective judgement throughout their tenure and promote a culture of openness and debate. In addition, the chair facilitates constructive board relations and the effective contribution of all non-executive directors, and ensures that directors receive accurate, timely and clear information.

G The board should include an appropriate combination of executive and non-executive (and, in particular, independent non-executive) directors, such that no one individual or small group of individuals dominates that board's decision-making. There should be a clear division between the leadership of the board and the executive leadership of the company's business.

H Non-executive directors should have sufficient time to meet their board responsibilities. They should provide constructive challenge, strategic guidance, offer specialist advice and hold management to account.

I The board, supported by the company secretary, should ensure that it has the policies, processes, information, time and resources it needs in order to function effectively and efficiently.

Provisions

Provisions 9 – 16 provide detailed guidance on implementing these Principles.

Section 3: Composition, Succession and Evaluation

J Appointments to the board should be subject to a formal, rigorous and transparent procedure, and an effective succession plan should be maintained for board and senior management. Both appointments and succession plans should be based on merit and objective criteria and, within this context, should promote diversity of gender, social and ethnic backgrounds, cognitive and personal strengths.

K The board and its committees should have a combination of skills, experience and knowledge. Consideration should be given to the length of service of the board as a whole and membership regularly refreshed.

L Annual evaluation of the board should consider its composition, diversity and how effectively members work together to achieve objectives. Individual evaluation should demonstrate whether each director continues to contribute effectively.

Provisions

Provisions 17 - 23 provide detailed guidance on implementing these Principles.

Section 4: Audit, Risk and Internal Control

M The board should establish formal and transparent policies and procedures to ensure the independence and effectiveness of internal and external audit functions and satisfy itself on the integrity of financial and narrative statements.

N The board should present a fair, balanced and understandable assessment of the company's position and prospects.

O The board should establish procedures to manage risk, oversee the internal control framework, and determine the nature and extent of the principal risks the company is willing to take in order to achieve its long-term strategic objectives.

Provisions
Provisions 24 - 31 provide detailed guidance on implementing these Principles.

Section 5: Remuneration

P Remuneration policies and practices should be designed to support strategy and promote long-term sustainable success. Executive remuneration should be aligned to company purpose and value, and be clearly linked to the successful delivery of the company's long-term strategy.

Q A formal and transparent procedure for developing policy on executive remuneration and determining director and senior management remuneration should be established. No director should be involved in deciding their own remuneration outcome.

R Directors should exercise independent judgement and discretion when authorising remuneration outcomes, taking account of company and individual performance, and wider circumstances.

Provisions
Provisions 32 - 41 provide detailed guidance on implementing these Principles.

2.4 The UK Stewardship Code September 2020

The latest update of the Stewardship Code was released in late 2019 after a period of consultation. The Code's description of its role and its own definitions are summarised in the following paragraphs.

Introduction

Stewardship is the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society…………

…………Environmental, particularly climate change, and social factors, in addition to governance, have become material issues for investors to consider when making investment decisions and undertaking stewardship. The Code also recognises that asset owners and asset managers play an important role as guardians of market integrity and in working to minimise systemic risks as well as being stewards of the investments in their portfolios.

How to report

All Principles are supported by reporting expectations. These indicate the information that organisations should include in their Stewardship Report and will form the basis of assessment of reporting quality.

When applying the Principles, signatories should consider the following, among other issues:

- the effective application of the UK Corporate Governance Code and other governance codes;
- directors' duties, particularly those matters to which they should have regard under section 172 of the Companies Act 2006;
- capital structure, risk, strategy and performance;
- diversity, remuneration and workforce interests;
- audit quality;
- environmental and social issues, including climate change; and
- compliance with covenants and contracts.

Principles for asset owners and asset managers

Purpose & governance

Principle 1
Signatories' purpose, investment beliefs, strategy, and culture enable stewardship that creates long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society.

Reporting expectations

Context

- the purpose of the organisation and an outline of its culture, values, business model and strategy; and
- their investment beliefs, i.e. what factors they consider important for desired investment outcomes and why

Activity………

Outcome………

Principle 2

Signatories' governance, resources and incentives support stewardship.

Reporting expectations

Context………

Activity

Signatories should explain how:

- their governance structures and processes have enabled oversight and accountability for effective stewardship within their organisation and the rationale for their chosen approach;
- they have appropriately resourced stewardship activities, including:
  - their chosen organisational and workforce structures;
  - their seniority, experience, qualifications, training and diversity;
  - their investment in systems, processes, research and analysis;
  - the extent to which service providers were used and the services they provided; and
- performance management or reward programmes have incentivised the workforce to integrate stewardship and investment decision-making

Outcome………

Principle 3

Signatories manage conflicts of interest to put the best interests of clients and beneficiaries first.

Reporting expectations

Context

Signatories should disclose their conflicts policy and how this has been applied to stewardship.

Activity………

Outcome………

Principle 4
Signatories identify and respond to market-wide and systemic risks to promote a well-functioning financial system.

Reporting expectations
Context………

Activity
Signatories should explain
- how they have identified and responded to market-wide and systemic risk(s), as appropriate;
- how they have worked with other stakeholders to promote continued improvement of the functioning of financial markets;
- the role they played in any relevant industry initiatives in which they have participated, the extent of their contribution and an assessment of their effectiveness, with examples; and
- how they have aligned their investments accordingly

Outcome………

Principle 5
Signatories review their policies, assure their processes and assess the effectiveness of their activities.

Reporting expectations
Context………

Activity
Signatories should explain
- how they have reviewed their policies to ensure they enable effective stewardship;
- what internal or external assurance they have received in relation to stewardship (undertaken directly or on their behalf) and the rationale for their chosen approach; and
- how they have ensured their stewardship reporting is fair, balanced and understandable.

Outcome………

Investment approach

Principle 6
Signatories take account of client and beneficiary needs and communicate the activities and outcomes of their stewardship and investment to them.

Reporting expectations
Context
Signatories should disclose:
- the approximate breakdown of:
  - the scheme(s) structure, for example, whether the scheme is a master trust, occupational pension fund, defined benefit or defined contribution, etc;
  - the size and profile of their membership, including number of members in the scheme and the average age of members;

  OR

  - their client base, for example, institutional versus retail, and geographic distribution;
  - assets under management across asset classes and geographies;
- the length of the investment time horizon they have considered appropriate to deliver to the needs of clients and/or beneficiaries and why

Activity………

Outcome………

Principle 7
Signatories systematically integrate stewardship and investment, including material environmental, social and governance issues, and climate change, to fulfil their responsibilities.

Reporting expectations
Context………

Activity
Signatories should explain:

- how integration of stewardship and investment has differed for funds, asset classes and geographies;
- how they have ensured:
  - tenders have included a requirement to integrate stewardship and investment, including material ESG issues; and
  - the design and award of mandates include requirements to integrate stewardship and investment to align with the investment time horizons of clients and beneficiaries

OR

- the processes they have used to:
  - integrate stewardship and investment, including material ESG issues, to align with the investment time horizons of clients and/or beneficiaries; and
  - ensure service providers have received clear and actionable criteria to support integration of stewardship and investment, including material ESG issues

Outcome………

Principle 8
Signatories monitor and hold to account managers and/or service providers.

Reporting expectations
Context………

Activity
Signatories should explain how they have monitored service providers to ensure services have been delivered to meet their needs.

Outcome………

Engagement

Principle 9
Signatories engage with issuers to maintain or enhance the value of assets.

Reporting expectations
Context………

Activity
Signatories should explain:

- the expectations they have set for others that engage on their behalf and how;

OR

- how they have selected and prioritised engagement (for example, key issues and/or size of holding);
- how they have developed well-informed and precise objectives for engagement with examples;
- what methods of engagement and the extent to which they have been used;
- the reasons for their chosen approach, with reference to their disclosure under Context for Principle 1 and 6; and
- how engagement has differed for funds, assets or geographies

Outcome………

Principle 10
Signatories, where necessary, participate in collaborative engagement to influence issuers.

Reporting expectations
Context………

Activity
Signatories should disclose what collaborative engagement they have participated in and why, including those undertaken directly or by others on their behalf.

Outcome………

Principle 11
Signatories, where necessary, escalate stewardship activities to influence issuers.

Reporting expectations
Context………

Activity
Signatories should explain:

- the expectations they have set for asset managers that escalate stewardship activities on their behalf;

OR

- how they have selected and prioritised issues, and developed well-informed objectives for escalation;

- when they have chosen to escalate their engagement, including the issue(s) and the reasons for their chosen approach, using examples; and
- how escalation has differed for funds, assets or geographies

Outcome………

Exercising rights & responsibilities

Principle 12
Signatories actively exercise their rights and responsibilities.

Reporting expectations
Reporting expectations for listed equity and fixed income investments are below. In addition, signatories should report on how they have exercised their rights and responsibilities across other asset classes they are invested in, where they have the ability to do so, as disclosed in their reporting against Principle 6.

Context
Signatories should:

- state the expectations they have set for asset managers that exercise rights and responsibilities on their behalf;

OR

- explain how they exercise their rights and responsibilities, and how their approach has differed for funds, assets or geographies.

In addition, for listed equity assets, signatories should:

- disclose their voting policy, including any house policies and the extent to which funds set their own policies;
- state the extent to which they use default recommendations of proxy advisors
- report the extent to which clients may override a house policy;
- disclose their policy on allowing clients to direct voting in segregated and pooled accounts; and
- state what approach they have taken to stock lending, recalling lent stock for voting and how they seek to mitigate ‘empty voting’.

Activity………

Outcome………

Principles for service providers

1 Purpose, strategy & culture
2 Governance, resources & incentives
3 Conflicts of interest
4 Promoting well-functioning markets
5 Supporting client's stewardship
6 Review & assurance

2.5 The USA and corporate governance regulation

The USA has a rather different approach to company law which may be summed up as follows. In the UK, company law has evolved over the past 150 years to protect the company as a separate legal entity in such a way that the directors are expected to act in the best interests of the company itself, albeit with due regard for the interests of the owners and other major stakeholders.

In the USA, company law at state level has always existed separately from company law at federal level, and the rights of states are protected vigorously. Unfortunately, rights of owners are not well protected in state law, and reporting of company activities to shareholders has, in the past, often not even been legally required. Consequently, when attempts were made after the Crash of 1929 to put more protection in place for shareholders, and the recently introduced UK Companies Act 1929 was used as a template, only parts of the UK's comprehensive act could be adopted. Thus the 1933 Securities Act introduced regulation aimed at protecting those intending to trade in shares by mandating the reported information they were entitled to receive to help them judge whether they were paying a fair price, but not addressing the disclosure of detailed information to the actual owners of the shares regarding the operations of the company they owned. That would have impinged on the state laws governing companies incorporated in the individual states – Delaware being one of the most popular, and one with relatively weak protection for owners – and hence addressing the rights of owners, as opposed to purchasers, was out of bounds.

Because of the limitations of the resulting legislation, the Securities and Exchange Commission (SEC) had to be set up in the 1934 Securities Act to oversee the new regulations, and address the problems with an Act that was aiming to regulate trading while simultaneously indirectly trying to influence corporate governance.

The result of the two Acts was, in effect, to place a higher duty of care on the directors to comply with the SEC's reporting requirements than they bore for looking after the company and the interests of its shareholders. Very different from the position in the UK and, indeed, in Europe.

Moreover, in line, perhaps, with its more litigious culture, the USA has taken a much more legalistic approach to corporate governance, most recently with Sarbanes-Oxley following the Enron and WorldCom scandals and with Dodd-Frank after the 2008 financial collapse. It can be said that the UK has adopted a more shareholder/business-led approach to corporate governance whereas the USA has taken a more regulator-led approach. Here, we will dwell only briefly on the American scandals and the subsequent regulatory response, simply to illustrate a similar scenario to the UK of new compliance requirements failing to prevent later disasters.

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, as its even more fraudulent financing schemes were progressively unable to fund its mounting debts. Profit recognition was at the heart of its misleading accounting, and off-balance sheet special purpose vehicles, whose financing was secured against Enron's own shares, hid its funding problems until they grew so large that they couldn't be concealed any longer. A collapse in Enron's share price 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 again 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.

US Regulatory response: Sarbanes Oxley

Following the accounting-driven scandals at Enron, WorldCom and Tyco, there was huge pressure to protect investors from illegal and irresponsible accounting practices and from boards which permitted or even encouraged such practices. So, in 2002, Congress passed the Sarbanes-Oxley Act, also known as the Corporate Responsibility Act, to improve regulation in four areas:

- enhancing corporate responsibility
- increasing criminal punishment
- tightening accounting regulation
- introducing new protections

Addressing the accounting practices, the Act laid out demanding new rules for auditors and management regarding internal controls and checks on their adequacy. And addressing the superficiality or carelessness of board responsibility for the financial reports that companies issue, it mandated that senior management should certify the accuracy of the published information.

In response to such actions as Arthur Andersen's deleting and shredding of records in connection with the Enron audit, it laid down rules covering what records should be stored and dealing with falsification and destruction of records.

Subsequent scandals in the USA

In section 2.2, we asked, in relation to the deluge of corporate governance regulation in the UK, how effective was the regulatory response. Here, we ask the same question about the Sarbanes-Oxley Act. The answer, briefly, is that, 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.

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

The Dodd Frank Wall Street Reform and Consumer Protection Act was the regulatory response to the crash of 2008, and introduced several new government agencies which were tasked with making the financial services industry safer. Specifying a new category of banks which were deemed to be so big that they presented a threat to the country's financial stability if anything went wrong with them – nick-named "too big to fail"- it aimed at making them provide such large reserves that they could sustain very significant financial stresses. Also, it put in train a process for what it called "orderly liquidation" if a major financial institution had to be wound up. The aim was to prevent the kind of panic that followed the demise of Lehman Brothers.

Additionally, it set out a programme to include the largest insurance companies in its overview, on the basis that these too could constitute a threat to the nation's financial stability. And it addressed consumer protection by setting up a Consumer Financial Protection Bureau to try to prevent a recurrence of the sub-prime lending disaster which was the proximate cause of the financial crash.

A further move to make banks safer was introducing the so-called Volcker Rule which barred banks from proprietary trading underpinned by clients' funds. This was seen as a step back towards the earlier Glass Steagall Act which separated commercial banking and investment banking, and prevented banks from offering both types of services.

Finally, an interesting move was the introduction for whistle-blowers of a share in any fine that was levied as a result of their whistleblowing. This was to recognise the usually catastrophic effect that invariably befalls whistle-blowers, regardless of whether their actions prove justified.

2.6 The European Union and Corporate Governance

Developments in corporate governance in the Commission

In 2005 the European Commission set about, in its own words, "*modernising company law and enhancing corporate governance in the European Union*" to improve the rights of shareholders of companies across the Member States. In June 2007 it adopted a Directive on Shareholders' Rights which had to be implemented in member states by summer 2009, whose purpose was to "*ensure in particular that shareholders have timely access to the complete information relevant to general meetings and facilitate(s) the exercise of voting rights by proxy*". Additionally, it attempted to tackle the issue of share blocking and related practices. Amongst other objectives, it was aiming to help shareholders in publicly traded companies to hold those companies to account.

In 2008 the global financial roof fell in and there was a subsequent search for scapegoats to blame. This caused much popular challenging of the way very large financial corporations, in particular, had been managed and much discussion and argument about how to prevent such perceived bad behaviour causing a similar future disaster. So, as part of its own contribution to the debate, in April 2014 the European Commission presented a proposal for the revision of the Directive on Shareholder Rights. It identified "*certain corporate governance shortcomings in European listed companies. These shortcomings relate to different actors: companies and their boards, shareholders (institutional investors and asset managers) and proxy advisors. Identified shortcomings related mainly to two problems: insufficient engagement of shareholders and lack of adequate transparency.*"

What was the Commission's rationale for its proposal to improve Corporate Governance in the member states of the European Union, and what was it proposing?

It concluded that its direction of travel was driven by the "*two objectives of enhancing transparency and engaging shareholders*". Certainly, no objective observer would quarrel with this. It went on to say that "*the overarching objective of the current proposal to revise the Shareholder Rights Directive is to contribute to the long-term sustainability of EU companies, to create an attractive environment for shareholders and to enhance cross-border voting by improving the efficiency of the equity investment chain in order to contribute to growth, jobs creation and EU competitiveness*".

Additionally, "*it contributes to a more long-term perspective of shareholders which ensures better operating conditions for listed companies*".

So far, so good, but then it got more specific. In an Impact Assessment, it identified five main issues:"

1) Insufficient engagement of institutional investors and asset managers;
2) Insufficient link between pay and performance of directors;
3) Lack of shareholder oversight on related party transactions and

4) Inadequate transparency of proxy advisors
5) Difficult and costly exercise of rights flowing from securities for investors."

It sensibly picked up the (UK driven) comply or explain approach on the basis that this gives member states the flexibility to interpret the Directive in ways compatible with their local culture. But it then went on to say that certain elements of corporate governance should be dealt with in a "more binding form", particularly shareholder identification, the transparency and engagement of institutional investors and board remuneration. It then spelled out its preferred options:

"1) Mandatory transparency of institutional investors and asset managers on their voting and engagement and certain aspects of asset management arrangements;
2) Disclosure of the remuneration policy and individual remunerations, combined with a shareholder vote;
3) Additional transparency and an independent opinion on more important related party transactions and submission of the most substantial transactions to shareholder approval;
4) Binding disclosure requirements on the methodology and conflicts of interests of proxy advisors;
5) Creating a framework to allow listed companies to identify their shareholders and requiring intermediaries to rapidly transmit information related to shareholders and to facilitate the exercise of shareholder rights."

Naive or being pulled in different directions?

It seems that there were multiple motivations influencing the people charged by the Commission with improving corporate governance in the European Union. These include:

- improving the working of the internal market by harmonising rules and regulations
- making the EU capital market work more effectively
- sorting out perceived deficiencies in corporate behaviour
- improving the competitiveness of EU corporations
- improving the behaviour of investing institutions and their advisers

This can result in drafters being pulled in several different directions. But the motivations also include:

- doing social good and supporting Corporate Social Responsibility
- promoting equality in the workplace and moderating pay differentials

The proponents look to underpin their objectives by:

- extending regulations, expanding official reporting and increasing compliance staffing
- enforcing compliance by introducing harsher sanctions for those judged to have broken the rules.

Some might say that here is a bureaucracy looking after itself. It considers that the requirements listed above in its preferred options "*would best fulfil the objectives without imposing disproportionate burdens*".

However, this proposal was not only internally inconsistent – preaching minimum impact on business while mandating a raft of new requirements, but it shows a lack of understanding (or a wilful neglect) of the way corporate governance works. It attempts to impose on shareholders duties which they have, for very good reasons, delegated to the board. Anyone who has given more than passing consideration to the issue of stewardship in corporate governance knows the difficulty of getting shareholders in public companies to engage more closely with their investee companies.

The European Confederation of Directors' Associations, ecoDa, which represents national institutes of directors throughout Europe (around 50,000 individual directors) wrote a paper setting out its reaction to the proposal for a Shareholder Directive, making the point that this attempts to place on shareholders important areas of decision making which more properly belong in the boardroom. Boards of directors are charged by shareholders with the fiduciary duty of supervising the corporate management on their behalf. ecoDa is too polite to say that the Commission simply doesn't understand the way business works, but the message is there.

This is a worrying development in the approach of the Commission to what should be the encouragement of good corporate governance in the EU.

Subsequent developments

Compounding these worries was the reshuffle of the duties of the Commission among the various Directorates. Following Jean-Claude Juncker's appointment as President-elect of the EU, he announced various changes to the allocation of duties in the various directorates of the Commission. In the context of this focus on corporate governance, the most worrying was the planned transfer of the Directorate F (Capital and Companies) away from the Directorate General for Internal Markets. Directorate F at that point embraced four departments - F1 Free movement of Capital, F2 Corporate Governance and Social Responsibility, F3

Accounting and Financial reporting, F4 Audit and Credit Rating Agencies. All of the Directorate F was to be transferred to the DG for Financial Stability, Financial Services and Capital Markets Union with the exception of Directorate F2 which was being transferred to the DG for Justice.

Looking back at the Shareholder Rights amendment proposal, which was all about corporate governance, it described itself as "*consistent with the existing regulatory framework. In particular, the new Capital Requirements Directive and Regulation*". This would surely suggest that, if it was going to leave the DG for Internal Markets, F2 might belong in the DG for Financial Stability, Financial Services and Capital Markets Union. Sending it to the DG for Justice would send a very different signal.

The message it seemed to send was that the Commission planned (indeed, preferred) to take a legalistic approach to regulation covering corporate governance. Moreover, the areas covered by the Justice Directorate - Justice, Consumers and Gender Equality - embraced such contentious areas as fundamental Human Rights, gender equality and consumer affairs, consumer health and food. All this suggests not only a more legalistic direction but one highly influenced by social affairs and staffed by people whose beliefs and personal agenda might be potentially inimical to the corporate world.

ecoDa, referred to above, had written to the Commission and to the members of the European Parliament drawing their attention to the illogicality of placing corporate governance into the Justice Directorate. It made the case for it to remain in the planned Internal Market, Industry, Entrepreneurship and SMEs directorate. Six years later, it remains in the DG for Justice.

Ignoring recent experience?

The UK implemented its Cadbury rules on corporate governance over twenty-five years ago, based on principles rather than detailed rules and an approach to enforcement based on comply or explain. Subsequently, a version of this has been adopted round the world, except in the US, which has its own approach to corporate law and governance. The experience thus far is that most countries are happy to adopt a set of rules which are recognisably similar to those initiated in the UK Corporate Governance Code. This has unquestionably improved governance to a degree, and such organisations as the World Bank routinely insist on such a framework being in place before they commit to investing in such countries.

However, the degree to which the rules are implemented in spirit as well as letter is much less certain, though there is little chance of the right boxes not being ticked. So the proposed introduction by the Commission of detailed and legally binding rules on the behaviour of investors covering nearly thirty nations comprising the EU, with widely differing cultures and traditions was, probably, simply going to lead to bureaucracy, wasted resource and box-ticking. Moreover, this would become a classical example of good intentions leading (inevitably) to unintended and adverse consequences.

Scandals in the EU (apart from the UK)

Here are a few examples over the past twenty years, and we can consider whether the EU Commission's current efforts are likely to prevent future scandals of an equivalent nature.

Parmalat
This was an Italian dairy food company which blew up in 2003 having discovered a €14bn hole in its accounts. This was a forty-year-old family business which the owners had grown into an international firm with declared revenues of nearly €8bn. After a series of acquisitions, funded by bond issues underwritten by big international banks, it had built up an opaque structure of international companies which enabled it to hide growing losses. Eventually, the false accounting and fictitious and fraudulent documents couldn't hide the cover-up any longer and the company collapsed into administration. The CEO and several executives were convicted for their roles in the fraud, which was very clearly a dreadful example of bad corporate governance at board level.

Ahold
In the same year. 2003, one of the European leaders in food retail, Dutch giant, Ahold, was hit by an accounting scandal. This was preceded by an acquisition spree in which Ahold bought fifty companies in the US, building its US business to be the biggest part of the group. Sadly, the pressures of expectation resulted in accounting misbehaviour which involved declaring nearly $1bn of fictitious revenue in its US subsidiary, Foodservice, arising from incorrect treatment of vendor rebates. Additionally, trading was wrongly consolidated from a number of subsidiaries where Ahold didn't, in fact, hold control. The governance was not helped by a management board with an over-powerful CEO and a weak supervisory board with insufficient independence. In the end, it agreed to pay out $1bn to head off a shareholder class action.

Volkswagen

This motor giant has survived the exhaust emissions scandal, where exhaust mechanisms were designed to meet the demands of American regulations in preparation for a big sales drive in the US. These mechanisms were built to pass the specific conditions of US emissions tests, but, to protect cars from the resulting adverse effects on fuel consumption, the design also produced an actual on-the-road performance which would have failed the test by a significant margin. This wasn't an accounting fraud, but the corporate governance issues are still being addressed several years later, and VW's failings have led to huge fines. There are still suggestions that the actions of middle-ranking staff in relation to policies with such significant implications must have had implicit endorsement from top management and the board. Alternatively, if they weren't aware of what was going on, they certainly should have been. Heads have indeed subsequently rolled at the highest levels.

BT Italia

In 2017, UK telecoms giant, BT was hit by the revelation that for some years its Italian subsidiary had been subject to what it called improper accounting practices. The result was that it had been overstating its earnings in recent periods, and the result was a charge to profits for the year of £225m to head off legal action from Deutsche Telecom and Orange. Additionally, it wrote down the value of its Italian company by £530m, causing much criticism of the board and a hit to its share price.

2.7 Japan

In 2014, a Stewardship Code was published, with seven principles for institutional investors:

- policies regarding stewardship
- handling conflicts of interest
- monitoring investees to help promote growth policies
- solving problems through constructive engagement
- policies on voting
- reporting on their stewardship
- having an in-depth knowledge of investees and their markets

The Stewardship Code is currently being reviewed and revised, and at the time of writing (January 2020) a revised Code is being drafted.

In 2015, Japan introduced a new Corporate Governance Code. Its general principles comprised:

- rights and equal treatment of shareholders

- co-operation with other stakeholders
- information disclosure and transparency
- responsibilities of the board (the biggest section)
- dialogue with shareholders.

The Code is similarly being reviewed and revised.

The effectiveness of these new codes is still being debated, as is the role of active investors, in changing a business culture which has grown up since the end of World War 2.

Scandals in Japan

Kobe

Kobe Steel is an iconic Japanese company with a history going back to its foundation in 1905. In 1995, its head office was destroyed and other facilities disrupted by the Kobe earthquake, but it recovered and continued to grow. So how did this company, one of the top ten steel producers in the world, suddenly hit the news with such an impact that its global website simply featured a succession of apologies for its "Improper Conduct"? The proud culture at Kobe masked fear of missing expectations at an operational level, which eventually produced disaster.

In October 2017, it was obliged to issue a series of apologies to its customers, primarily, for the recently published fact that for many years it had falsified its quality control certificates. These events, which resulted in an almost daily series of apologies, were reported to have arisen from new quality processes that were put in place earlier and had resulted in the exposure of a widespread breakdown in quality assurance.

In summary, hundreds of customers were affected, ranging from aircraft and automobile makers to high speed train manufacturers, and tens of thousands of tons of steel and other products had been incorrectly certified. The US authorities commenced an investigation, as did the Japanese. This was a company which was highly respected and apparently complied with all the required regulations. Except that it didn't, because staff under pressure ignored or bent the rules.

Other examples

In the motor industry, Nissan disclosed that final inspections on cars were conducted by technical people who apparently had been assisted with their exams to achieve the necessary qualifications. In other words, they were probably not properly qualified to carry out the inspections with which they were later entrusted. When this came into the public eye it resulted in a huge recall of Nissan vehicles.

Subaru was later caught by a similar process of cheating, which again caused a big recall.

In different fields, Mitsubishi Materials admitted to falsifying quality data for products delivered to customers, and Toray Industries similarly owned up to dishonesty in regard to quality standards on its carbon fibre products going into the tyre industry.

2.8 South Africa

Following the end of Apartheid, South Africa opened up to the world again and an initiative was taken to bring its corporate governance into line with best practice in the developed world. A respected Supreme Court judge, Mervyn King, was appointed in 1992 to chair a committee to produce guidelines on corporate governance. Over the next twenty-four years, he issued King Reports I to IV, compliance with which came to be a requirement for companies listed on the Johannesburg Stock Exchange.

Scandals in South Africa

Some scandals driving changes promoted by the King Reports included the following:

Pretoria Bank
The chairman's report, 31 October 1990, contained the following statement:
"*The past 12 months … strong performance by Pretoria Bank with strong growth in both assets and income. ….net income after tax increased by 192% from R292,439 to R861,381 …wish to thank my co-directors for the…diligent and competent way in which they fulfilled their duties.*"

The reality was that Pretoria Bank was insolvent, the managing director had been dismissed as a result of fraud, the general manager had also been dismissed, and during the financial year, approximately R700,000, more than 15% of the capital of the bank, had been stolen (c. R407m in today's money).

Cape Investment Bank
The chairman's review, 31 October 1990, said:

"This is the third annual review of the Group. It was a difficult but gratifying year characterised by achieving forecasted results, rapid expansion both in terms of organic and acquired growth, uncertain environments and the resultant strain on people and the organisation."

The reality was that the bank was insolvent, numerous offences had been committed by directors, and but for handouts of approximately R50 million, the auditors would not have signed unqualified reports on the annual financial statements.

Masterbond
The press announcement on 3 September 1991, signed by directors Jonker and Brits, said:
"*Prospects: The Masterbond Trust Group has achieved excellent profits during the year under review. Despite the expected downturn in the economy we believe the Group will maintain its profit growth.*"

The reality was that the probability of liquidation was being foreseen and actually happened within thirty days. Jonker and Brits were later jailed for fraud.

The King Reports

As a result of scandals such as the above, retired judge, Mervyn King, was asked to chair a committee to put forward proposals on corporate governance, and the resultant King Report was published in 1994. The eight principles addressed boards and directors, reporting, auditing and ethics.

Subsequently, there were several reports expressing criticism of a lack of attention to the qualitative aspects of corporate governance and what was seen as a narrow focus on internal financial and accounting controls and a lack of attention to affirmative action. Experience of issues arising from implementation of the King Report, together with a new constitution, new JSE Listing requirements and the report of the Nel Commission into the Masterbond scandal therefore led to another review by King and his colleagues, whose revision was led by corporate governance specialist, Philip Armstrong. King II, as it became known, was published in 2002, with 24 recommendations, mostly centring around boards and compliance, but also addressing risk management and audit and sustainability.

In 2009, a further revision was issued as King III, taking effect in 2010, which had nine main principles and 75 sub-principles. It primarily addressed the role and operation of the board, the audit committee, risk management, IT management, and integrating sustainability reporting.

Finally, in 2016, King IV was published, effective in 2017. As Mervyn King says in the Foreword, the foundation stones are: ethical leadership, organisation in society, corporate citizenship, sustainable development, stakeholder inclusivity, integrated thinking, and integrated reporting. It reduced the number of principles from 75 to 17, and moved from "comply or explain" to "comply AND explain", which Mervyn King says will help organisations understand that they have to approach governance mindfully, not just as a matter of compliance. The four major focuses are:

- leadership, ethics and corporate citizenship
- strategy, performance and reporting
- governing structures and delegation
- governance functional areas.

So South Africa led the emerging markets in introducing corporate governance regulations in the early 1990s, along the lines of Cadbury, but broadened, almost philosophically, to apply to the particular situation in South Africa. Subsequently the further updates led to 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. Will King IV have more impact?

2.9 Australia

The Australian Stock Exchange issued its Principles and Recommendations for good corporate governance in 2003, updated it in 2007, modified it in 2010 by addressing diversity and the composition of the remuneration committee, issuing the third edition in 2014, and the latest, Fourth Edition in February 2019.

It adopts the comply or explain approach, which it titles "if not, why not". And all listed companies are required to adopt these guidelines or explain why they have chosen not to. There are eight broad principles and 29 recommendations to underpin these principles. The principles are:

1. Lay solid foundations for management and oversight:
A listed entity should clearly delineate the respective roles and responsibilities of its board and management and regularly review their performance.

2. Structure the board to be effective and add value:

The board of a listed entity should be of an appropriate size and collectively have the skills, commitment and knowledge of the entity and the industry in which it operates, to enable it to discharge its duties effectively and to add value

3. Instil a culture of acting lawfully, ethically and responsibly:
A listed entity should instil and continually reinforce a culture across the organisation of acting lawfully, ethically and responsibly

4. Safeguard the integrity of corporate reports:
A listed entity should have appropriate processes to verify the integrity of its corporate reports.

5. Make timely and balanced disclosure:
A listed entity should make timely and balanced disclosure of all matters concerning it that a reasonable person would expect to have a material effect on the price or value of its securities

6. Respect the rights of security holders:
A listed entity should provide its security holders with appropriate information and facilities to allow them to exercise their rights as security holders effectively

7. Recognise and manage risk:
A listed entity should establish a sound risk management framework and periodically review the effectiveness of that framework.

8. Remunerate fairly and responsibly:
A listed entity should pay director remuneration sufficient to attract and retain high quality directors and design its executive remuneration to attract, retain and motivate high quality senior executives and to align their interests with the creation of value for security holders and with the entity's values and risk appetite

Scandals in Australia

The oligopoly of the four big Australian banks, Commonwealth Bank, ANZ, NAB and Westpac, had come through the 2008 financial crash apparently relatively unscathed. However, for the customers and the regulators, things were not as benign as they appeared. In recent years there has been a succession of complaints building up and pressure for a Royal Commission to examine the financial sector.

Eventually, near the end of 2017, the government bowed to the inevitable, and agreed to set up the Royal Commission. From that point on, the scandals drip-fed into the public domain, and none of the banks was spared, but also the financial planning industry came into the spotlight as the iconic AMP was pilloried. A short list gives the flavour:

NAB

- 15% of mortgages had a policy waiver so didn't fulfil the full criteria for lending
- a whistle-blower revealed a cash for loans bribery scheme in 5 branches: fraud, fake payslips etc
- an expensive car loan and credit card were issued to a 22-year-old just starting a job ($35K loan would cost $60K to pay back over 7 years)

Westpac

- loans were made by Westpac and others, up to $3m, to a 71-year-old nurse to finance property investments; they went wrong and cost her all her savings; Westpac lent $360K to her at age 67 when she already owed nearly $1m
- the head of financial advice told the banking royal commission it would be difficult to unwind the inherent conflict between sales and advice because the first bank to do it would be at significant disadvantage

CBA

- it was aggressively selling credit card insurance to unemployed people who probably wouldn't be able to claim
- it was raising the credit card limit for a self-confessed gambler
- a customer was still being charged 10 years after his death, for planning advice

ANZ

- it was breaking responsible lending laws by not checking borrowers' expenses
- it had granted a 30-year house loan to a 71 year old pensioner
- it was charging excessive late payment fees
- it was overcharging borrowers on their home loans

AMP

- fees were charged to thousands of people who didn't receive promised advice
- it had misled ASIC countless times over the fee charging complaints

So it looks as if the advocates for a public enquiry were justified in pressing the government to change its mind and set one up.

2.10 KSA – example of an Emerging Market

The Saudi Arabia Stock Exchange, the Tadawul, is the latest Stock Market of global significance to be listed on the MSCI Emerging Markets Index. That event, provisionally announced in June 2018, and confirmed in 2019, can be expected to progressively generate interest in the KSA from International Investors driven by the fact that “index neutral” funds will have to consider allocating at least 1.5% of their investments to this “new” element of the Index. As an indication, the Annual Statistical report as at the end of 2019 showed a total market capitalisation of $2.4bn, up by 385% on the previous year.

It has been understood for some time that a prerequisite of such international investment is that companies listed on the Tadawul must produce IFRS- compliant financial statements. Less well understood is that International Investors are equally, if not more, focused on the quality of Corporate Governance demonstrated by Companies in which they consider investing.

In February 2017, the Capital Markets Authority (CMA) introduced new Corporate Governance Regulations in preparation for the inclusion of the Tadawul on MSCI in 2018. The 2017 CMA Corporate Governance code, effective since April 2017, is a clear recognition of the importance of corporate governance to international investors, and represents a very substantial overhaul of, and improvement on, its predecessor. The challenge now is for Tadawul companies, which seek to attract fresh international investment, to demonstrate compliance with, and application of, this new Code. This is a very significant task which should not be underestimated.

Inclusion on the MSCI Index is a singular event for a country and its stock market; it never happens twice. The consequences are:

- fund/portfolio managers globally tend to allocate assets in line with the MSCI
- therefore, to remain "neutral" to the index, around 1.5% of globally investable funds would be allocated to the KSA (in excess of $100bn)
- fund managers prefer to be neutral unless they have good reason to be "overweight" or "underweight"
- investment decisions are influenced by the degree of confidence in:
  - financial results and prospects
  - perception of standards of Corporate Governance
- so companies which inspire confidence in their corporate governance will attract greater and more immediate investment flows and companies attracting inward investment will see their shares rise in value.

The demands of the new Regulations required all Tadawul companies to report on their specific progress corporate governance policies, and their implementation of them by 31 December 2017.

Numerous academic studies have proven that investors conducting due diligence prior to investment decisions give equal weight to a company's demonstration of applied Corporate Governance as they do to their audited Financial Statements. Thus, investors will value evidence of the "application" of Corporate Governance principles more highly than "legal compliance".

The objective for transforming corporate governance in Tadawul companies is to enable them to be comfortable in the new, international-facing environment that MSCI inclusion will bring. And the biggest issue facing these companies is that the governance decisions are currently made by the boards, on which the executives are not usually present in this still family-controlled economy. And transforming the behaviour of the boards requires sign-in by those self-same family-controlled boards.

Scandals in the KSA

In 2008, interestingly, two years after the new Corporate Governance Code was first introduced by the CMA, construction company, MMG became a publicly listed company on the Tadawul. The founder, Mohammad Al-Mojil, sold a 30% stake.

Just four years later, however, after the firm had made heavy losses, its shares were suspended and an investigation was made into its financial reporting and its operations for the previous seven years. The result was that charges were made that Mohammad Al-Mojil and others had made misleading representations about the company's value and prison sentences followed.

Furthermore, the auditor, Deloittes, was banned from audit work in the Kingdom for the next two years.

2.11 Influences on the Development of Governance

The main current influencers of the evolution of corporate governance practice include the following:

- long term investors
- asset managers
- sovereign wealth funds
- activist investors

- private equity
- proxy advisers
- regulators and lawmakers
- populists
- educators and academics.

Let us look at each of these in turn:

Long term investors

These are those relatively rare organisations like Warren Buffett's Berkshire Hathaway, whose aim is to select carefully a company which they believe has a strong market position, is well-run and has a long-term future. Berkshire Hathaway's philosophy is to give management a free hand and to stay invested and supportive unless and until some aspect changes irrevocably. Hence they have been a shareholder in Coca Cola for decades, but came out of Tesco after a number of years following evidence of questionable management practices and indications that Tesco had lost its way both internationally and domestically.

In our view, though they would be unlikely to express it in these terms, Berkshire Hathaway almost certainly would subscribe to our Five Golden Rules of good corporate governance when assessing whether to make a long-term investment and also in their regular reviews of performance by their investee companies.

It is interesting that Warren Buffett recently convened a group, with Jamie Dimon of J P Morgan, to put together a new set of principles for corporate governance in public companies. This group includes Capital Group, Berkshire Hathaway, J P Morgan Chase, J P Morgan Asset Management, Black Rock, GE, CPP Investment Board, Verizon, Vanguard, State Street Global Advisers, T Rowe Price, and Value Act Capital. This broad group includes a bank, investment companies, industrialists and an activist investor, and the purpose is to encourage longer term investment and reduce friction between investors and shareholders. We have to hope that, encouraged by Warren Buffett, they take a holistic approach rather than simply go for better communication between the owner stakeholder group and management.

Asset managers

The term asset manager covers a wide spectrum with an equally wide approach to investing clients' funds. To the extent that these fund managers take a long view, we can probably regard them as being interested in all five of our golden rules of good governance. However, stewardship is increasingly featuring in critical discussions about the poor contribution of these investment organisations to corporate governance. This indicates that the majority of them don't get very involved, or indeed wish to get involved, with the organisations in which they are invested.

There are good reasons why this is so, including a sheer lack of resource to participate to any degree in discussions with the boards of the large number of companies comprising their portfolios. Couple this with an unwillingness to cross swords on strategy with in-house specialists and a wariness of finding themselves privy to inside information and laying themselves open to regulatory criticism. Notwithstanding, in the UK at least, there has been a specific effort to improve things in the shape of Sir David Walker's report which led to the Stewardship Code, introduced in 2010. However, in its review of progress in 2015, the Financial Reporting Council said "Our chief aim is to foster a better quality of engagement between companies and investors ….", while expressing concern at a lack of real progress.

One way or another, the current position is a generally limited engagement between the group of owners represented by institutional investment and the companies they (part-) own. This is compounded in the UK, at least, by a steadily reducing proportion of investment in equities by the more stable, longer term investors represented by the pension funds and insurance companies, who have been turning more and more into bonds, infrastructure and overseas shareholdings, where there is even less chance of meaningful engagement.

A further trend is the growing predominance of passive funds, which may be thought to have even less interest than active funds in the governance of the companies in which they are invested. This trend is partially offset by the increasing interest in ESG performance, as reported by organisations like MSCI. But these trends overall suggest that it's unlikely that asset managers as a class will create any meaningful influence on corporate governance, whatever the well-meaning intentions of the Stewardship Code.

Sovereign wealth funds

In recent years, the funds built up by certain countries have begun to make an impact on the global investment scene. One of the most notable is that of Norway, which is acknowledged to be the world's largest, with a fund of c$1trillion. It has also taken one of the most outspoken positions on corporate governance.

The Norwegian fund said in its second report on responsible investing that it had sold out of a record number of companies, including many which were involved in the coal industry. The chief executive of its fund manager told the Financial Times that the aim of its votes against resolutions at AGMs in companies including such global leaders as Exxon, ABInBev and Toyota was to “raise the stakes a bit”. The fund has also attacked the corporate governance of VW, describing it as “complex and problematic”.

The reputation, and clout, of this huge fund clearly makes its view influential, and it appears to have achieved some changes in policy through making its views public. But we see no public expression of a comprehensive, holistic set of principles, such as those comprising our Applied Corporate Governance approach, supported by independent surveys. As such, we see limited impact on governance from the big sovereign wealth funds.

Activist investors

In the 1980s, the likes of Carl Icahn and T Boone Pickens were known as corporate raiders, whose purpose in acquiring a big enough stake in a company to be able to exercise influence, was to force changes which increased the value of their stockholding. Often the route they took would disadvantage other shareholders as the boards bought them off to get rid of them. And the employees’ interests wouldn’t generally have figured highly in their priorities.

More recently hedge funds such as Bill Ackman’s Pershing Square have become serious players in the game of engineering corporate change. But the aim has always been to ramp up shareholder value. This could be by direct investment or by backing groups whose policy is to consolidate in an industry. Hence Bill Ackman’s backing for Valeant Pharmaceuticals, the Canadian company whose business model has been described as a “platform company”. This model involves a string of acquisitions funded by debt, with the aim of driving rapid growth. Sadly for Mr Ackman, platform companies haven’t worked very well recently and he lost a lot of money on Valeant. But the policy of backing this type of company relies on a constant flow of acquisitions which cannot be sustained indefinitely. Holistic corporate governance it is not.

A more measured approach was taken by ValueAct in persuading the board of RollsRoyce to consider its ideas and even to accept the appointment of a director to its board. It remains to be seen whether the input from ValueAct will turn out to have provided a holistically beneficial impact on Rolls Royce. If their aim was to be a long-term investor supporting not only improved profitability but helping to secure the long-term future of Rolls Royce and its employees through appropriate and well-directed investment, this seems to have been abandoned. At the time of writing they have resigned their directorship and have been selling down their stake after Rolls's problems with its Trent 1000 engine.

Private equity

Longstanding private equity firms such as KKR, Carlyle, Blackstone and Apollo have grown huge in the past thirty years, but their aim has remained the same, to take large public companies private and restructure them to increase their value, out of the public eye and free from the constraints attached to public companies. The formula for generating and extracting shareholder value, broadly speaking, relied on improving the business performance, then gearing the company to the maximum extent feasible to take out as much cash as possible before floating it with a good, but short, track record and optimistic forecasts. The result, too often, was the crippling of the company with an unsustainable level of debt when market conditions changed. However, over the years it is probably fair to say that the time horizons of the big private equity firms have grown rather longer, and the quick turn-round followed by trade sale or IPO is less time-driven than earlier. Though difficult market conditions in recent years have been a factor, this is probably also due to the combination of the size and maturity of these firms enabling them to take a more measured view, and the influence of global thinking on responsible investing and good corporate governance, coupled with regulatory changes.

Collectively, though, the fact that the owner (the private equity firm) is directly in charge and in a near all-powerful position, instead of being a remote investor, should make it easier for the exercise of good corporate governance. The current reputation of these big firms as owner/investors is generally quite high and must reflect governance which genuinely balances the interests of the key stakeholder groups: themselves as owners, together with the customers and the employees. They are not a group naturally given to grandstanding, and have historically preferred to keep a low profile, but it would be good to see them come out with a set of holistic corporate governance principles.

Proxy advisers

Leading international firms such as ISS and Glass Lewis have built their reputation on assessing companies' corporate governance performance, and research by

Corporate Secretary showed that nearly half of the companies surveyed had communicated with either ISS or Glass Lewis to correct a mistake or get a voting recommendation changed.

But how do these firms define corporate governance? We would say essentially by reference to the regulatory requirements, and to us, their approach is very much focused on the way the board reacts with shareholders.

To the extent that their scrutiny makes it difficult for large (and smaller) companies to skimp on regulatory reporting compliance or to disadvantage groups of shareholders, they perform a valuable role. But in essence they are doing the regulator's job for them and as such their contribution is subject to all the limitations associated with regulatory regimes. Moreover, they are unlikely ever to extend this approach to include the other stakeholder groups, as in our holistic definition, unless they change their business model. Consequently, they are hardly more likely than the regulator to prevent another Enron or Lehman type of catastrophe.

Regulators and lawmakers

Compliance with company constitutions, company law, industry regulations and corporate governance codes, while all very desirable, does not amount to corporate governance and does not necessarily even lead to good corporate governance.

Anyone doubting this need only look to the major corporate disasters of the current century. To quote just a few examples:

- WorldCom and Enron, respectively the first and second biggest bankruptcies in US history at the time, led to Sarbanes-Oxley.
- in 2008, Lehman Bros and Washington Mutual collapsed, creating two even bigger bankruptcies and leading in turn to the later Dodds-Frank regulations
- also in 2008, RBS had to be rescued by the UK Government following its disastrous joint takeover of Dutch bank ABN Amro.

All five companies complied with all the necessary regulations for years until everything blew up – in two cases due to fraudulent accounting, in two cases due to being dangerously over-exposed in their business models and in the final case due to a “bet the farm” decision which lost the farm.

In the UK, the Corporate Governance Code is seen as having improved corporate behaviour and the Stewardship Code is seen as well-intentioned though probably not very effective. But neither, in our view, approaches corporate governance holistically. In the US, SarBox was widely criticised as being over-bureaucratic and clearly failed to prevent the unacceptable practices in banking which led to the financial crisis of 2008. In turn, Dodds-Frank is criticised for being even more bureaucratic and is already in the process of being emasculated on the basis that it is restricting the ability of financial services to support vital business growth and that it probably won't prevent the next breakdown anyway.

The general criticism of regulation is threefold:

- it is invariably backward-looking, trying to fight the last war, and will always miss the next major problem
- it very often has unexpected consequences, which may create huge and unanticipated new problems
- bureaucrats administering these regulations have a vested interest in extending their remit, regardless of whether this is in the best public interest.

So, in our view, the regulatory authorities and lawmakers aren't ever going to contribute to holistic corporate governance.

Populists

There has been a significant increase in populism since the 2008 crash and the resulting austerity, initially in developed nations and now in emerging markets. Business, particularly financial services, has taken a beating in the media and populist leaders such as Marine Le Pen in France, Podemos in Spain, Five Star in Italy, Boris Johnson in the UK and Donald Trump in the US, have been the beneficiaries.

In its 2016 Edelman Trust Barometer, international communications firm, Edelman, published its global survey of peoples' trust in four groupings to do the right thing in their behaviour: government, business, NGOs and media. The result as far as business is concerned was both concerning and a source of opportunity. The survey showed a big gap between the views of the better educated and wealthy citizens and their poorer, less well-educated fellow citizens. Basically, the elite trusted the leadership of business much more than did the rest of societies. But Edelman's reading of the situation is that the non-elite are much better connected and informed than ever before and are no longer willing to take a lead from the elite. The 2017 Trust Barometer showed that trust in all four groups had gone down. Therefore, the elite can't any longer expect their more knowledgeable and better-informed views to carry the day and populist, anti-business views may increasingly prevail.

The opportunity lies in the finding that business as a whole is more trusted than government and seen as more likely to be able to solve the problems of the future. Moreover, well-respected business leaders of firms which address social issues, like Unilever recently, command respect with the public. So the lesson is that companies which embrace good corporate governance in the wider sense (as we would advocate) are likely to command the support of the general public and be in a better position to protect themselves from populist attacks.

Educators and academics

While recognising the key role of Sir Adrian Cadbury and his committee in getting the concept of corporate governance introduced to, and accepted, by boards of large companies, we would argue that the Corporate Governance Code is at best a subset of holistic corporate governance. Real advances in thinking about corporate governance have been driven by academics and taught by educators.

We don’t need to go into the history of research into corporate governance in the US after the last War, but arguably the introduction in the UK of the Corporate Governance Code gave weight and legitimacy to the work done by academics over the years.

Chapter 3: The ACG Holistic Approach

In the UK and US, the debate over the past few decades has focused on the separation of ownership and control and consequently, particularly, the relationship between shareholders and management. In the USA, as we have said, the concern is more to do with prospective buyers and sellers than owners per se.

3.1 Corporate Governance Relationships

Our holistic approach puts the issue in the wider context of responsibility towards all parties with a significant interest in the business. We illustrate the relationships in Figure 3.1.

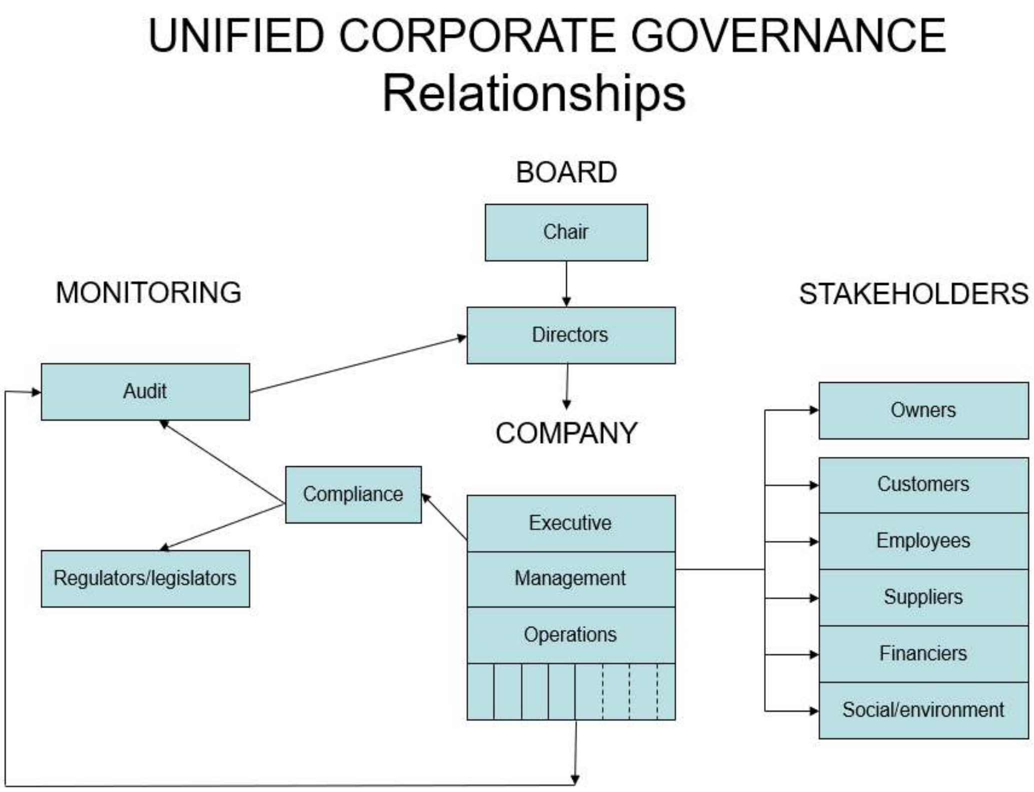

Figure 3.1 Corporate Governance Model - Relationships

What we see here are four groups:

- the board of directors exercising supervision and accountability to the stakeholders for what the company is doing
- the owners, customers and other stakeholders, all with an interest in what the company is doing

- the company itself, which is supposed to deliver what its stakeholders want from it
- the monitoring bodies:
  - the auditors, who are essentially checking on the performance of the board through what the company has been delivering, and primarily reporting to the owners
  - the regulators, who check whether the company has been acting within the laws and regulations that apply to it.

Overall success comes when each of the four components achieves success. And successful corporate governance in the eyes of the general public means overall success for the business. Hence, we describe corporate governance more broadly than simply compliance with laws and regulations. Successful corporate governance requires a holistic system which recognises the interests of the five groups comprising the corporate governance relationships.

Such a holistic system demands structuring, operating and controlling an organisation to achieve the following:
- a fundamental ethical basis to the operation
- fulfilling the long-term strategic goal of the owners while balancing the interests of the other important stakeholders
- considering and caring for employees past, present and future
- maintaining excellent relationships with customers and suppliers and local communities
- taking account of sustainability and the needs of the environment
- complying with legal and regulatory requirements

Moreover, this has to be taken in the context not of a separate discipline, but of improving the management and the health of the business, using, but adapting, existing systems, which is the rationale behind the holistic approach, and why we call it Applied Corporate Governance.

This holistic approach embraces naturally the fiduciary duties of board members, and their requirement to exercise due skill and care in performing these duties, while placing them in the broader context of understanding and overseeing good management practices.

It also places obligations on owners to keep themselves properly informed about what the company they own is doing, and how well the board which is supposed to be looking after their interests is doing its job.

Finally, it requires an audit process which is effective in meeting the expectations of the stakeholders with an interest in the business, which, of course, include the regulators and the state.

So we have structured this approach to reflect the four elements in this model:
- the board, who cause the company to operate in the way that it does and seek to deliver the outcomes from its corporate vision
- the stakeholders, who all have an interest in the company
- the company itself, which actually delivers on the ground
- the auditors and regulators, who check the accuracy of the reporting and the legality of the performance of the company.

3.2 A practical approach

In developing the principles which we espouse, we were insistent that these should lead to a practical structure which could stand independent of in-house systems. Moreover, this structure should link to existing feed-back processes which reinforce good management practices while providing the basis of a system for continuous improvement in performance in corporate governance. This would entail defining measurable metrics which provide the basis for management of the key factors and using external independent surveys to avoid organisational capture. Hence our naming it Applied Corporate Governance. In our view, this holistic approach to corporate governance is progressively being adopted by investors (note the current interest in ESG and companies' Culture and Purpose), and the regulators will follow behind.

From the history of corporate governance and related regulation outlined in Chapter 2, we can draw some conclusions and, on the basis of the way successful companies conduct themselves, we can formulate a short set of rules regarding the practice of genuine good corporate governance. When we look at the record of successful organisations, we find they have to a great degree abided by these rules, and failed ones have to a large extent ignored them. Hence we have christened the practical application of these rules Applied Corporate Governance.

3.3 Principles of applied corporate governance

Specifically, our holistic definition comprises five elements by which the performance of the company in terms of good corporate governance can be judged - what we call our Five Golden Rules:
- an ethical approach which is in tune with the societies and cultures in which a company operates

- balanced objectives which fulfil the goals of all the key stakeholders
- strategic management rather than opportunism or clientelism driving the policy and decision-making process approach
- an organisation structured and resourced to deliver the strategic plan
- a culture of accountability and transparency to all stakeholders.

This approach recognises that the interests of different stakeholders carry different weight, but also that all stakeholders should be treated with respect. This isn't as simple as it might be wished, as we can see by looking at the potentially conflicting aims of the main stakeholder groups:

- *owners:*
  - long-term investors, some of whom may be looking for a steady income with maybe the need to finance dividends out of borrowing, others at long-term capital growth and minimal distributions
  - short term shareholders who are most likely to be looking at rapid capital gains, but who may also include short-sellers
- *customers:* who will be looking at the company's ability to survive and grow and to supply consistent quality without making excessive profits at their expense; possibly with the more demanding requirement for regular innovation in the products and services they supply and hence investment
- *employees:* who will expect security of employment, which in turn requires financial soundness, but not at the expense of restricting levels of remuneration
- *suppliers:* who will look to financial soundness and the ability to pay their bills on time
- *bankers:* who will be expecting financial soundness and security against loans, coupled with an adequate level of cover on interest payments
- *general public:* whose interest is likely to be in maintaining existing levels of employment in local communities or even in expanding them, which may conflict with the company's need to restructure to preserve its future
- *government and regulatory authorities:* who will be relying on compliance with rules and the payment of as much tax as possible.

3.4 Managing by these Principles

To achieve consistent and improving corporate governance, the board must have in place a monitoring and reporting mechanism which permits accurate observation of corporate governance performance and encourages continual improvement. This monitoring mechanism must be based on measuring the company's performance in regard to the five principles above, and compliance with rules and regulations is simply one small part of this.

The principles behind the monitoring mechanism are:

- the company's performance in regard to the five Golden Rules must be measured regularly – we would say preferably continuously by an on-going process of stakeholder engagement, but in any case at least once a year - and which process we will describe in a later Booklet.
- performance is determined by taking the views of the key stakeholders
- these views must be gathered by independent survey, thereby avoiding "capture" by the company's internal systems and vested interests
- the results of the survey should be reported to the office of the chairman for consideration by the board and communicated with the key stakeholders in an open and transparent way
- finally, the directors in preparing for their board meetings must properly brief themselves in order to carry out their legal and fiduciary duties and the company must have systems in place to facilitate this.

In summary, the vital starting point is an ethical culture, as most serious problems with corporate governance start with failings here. Then, with this in mind, running the business successfully cannot be simply about a focus on market domination or shareholder value. And good corporate governance is not simply about the relationship between directors and owners, but about the ethos of an organization and fulfilling its clearly agreed goals. Moreover, to arrive at universally acceptable goals, there has to be a process of identifying the different needs of key stakeholders, and, as much as possible, harmonizing them. This is the starting point for the smooth running of the business – keeping all parties in tune with the goals of the business and thus with each other.

The function of the Board, and the relationship with the Owners are two key determinants of whether the principles constituting good corporate governance are likely to be followed, and we address these in the next Booklet.

A further important consideration is the framework of law and regulation under which a company operates, in various jurisdictions around the world for larger businesses, and the practicality of the regulation and zeal with which regulators monitor the companies under their supervision. Similarly, the role of the auditors in supposedly keeping the company on the straight and narrow has come under serious question in the past few years.

And in the third Booklet, we set out in detail the way forward to address the current problems of governance and create the systems to achieve the standards of corporate governance that tomorrow's public expect.

APPENDIX: USEFUL LINKS

Full UK Corporate Governance Code
The full Code can be seen on the FRC website
https://www.frc.org.uk/directors/corporate-governance-and-stewardship/uk-corporate-governance-code

Full UK Stewardship Code
See link to the full Code on the FRC website
https://www.frc.org.uk/investors/uk-stewardship-code

Sarbanes-Oxley
https://www.sarbanes-oxley-101.com/

Dodds/Frank
https://www.thebalance.com/dodd-frank-wall-street-reform-act-3305688

Corporate Governance policy in the European Union
See link to CFA Institute Report
ec.europa.eu/newsroom/document.cfm?doc_id=45773

Japan Corporate Governance Code
https://www.jpx.co.jp/english/news/1020/b5b4pj000000jvxr-att/20180602_en.pdf

South Africa King IV
https://www.pwc.co.za/en/publications/king4.html

Kingdom of Saudi Arabia Corporate Governance Code
https://cma.org.sa/en/RulesRegulations/Regulations/Documents/CGRegulations_en.pdf

ISO 26000: Guidance on Social Responsibility
https://www.iso.org/obp/ui/#iso:std:iso:26000:ed-1:v1:en

OECD Principles of Corporate Governance
http://www.oecd.org/corporate/principles-corporate-governance/

