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PART 1

THE DISCIPLINE OF GOVERNANCE

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CHAPTER 1

The landscape and definitions of governance: the major actors

This chapter:

- establishes the area for review;
- examines existing theories of governance and indicates where and how they do not describe the real world accurately;
- introduces the concepts of procedural, behavioural, structural and systemic governance;
- suggests alternative definitions for governance.

Introduction

Corporate governance has been the single most significant issue on the business agenda nationally, internationally and globally for the past thirty or more years. Although it may not have always appeared under the same title, its successes – and more particularly its failings – will have affected every working individual in every economy across the world during that time. Most importantly, the financial cost of recent failures of corporate governance (since the turn of this century) and the worldwide governmental response to them, will affect at least two generations of workers yet to enter the workforce worldwide, with incalculable political and social consequences.

Given this level of importance and impact, it seems important that we get the study of corporate governance issues right. This might reasonably be expected to include not simply a tour of what exists now but also an examination of how we got here – since to mix up a couple of aphorisms, those who do not understand the lessons of history are condemned to repeat them: the first time as tragedy, the second time as farce.

Not everyone is convinced of the need to undertake this examination. In 2002, ten years after the publication of the Cadbury Report – which in definitional terms, provided the benchmark for most future examinations of the subject, the Economist Intelligence Unit (EIU) produced a survey entitled 'Corporate Governance – the New Strategic Imperative'.[1] In the terms of the argument of the introduction it

[1] EIU/KPMG, *Corporate Governance: The New Strategic Imperative* (London: EIU/KPMG, 2002).

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reviewed the landscape of corporate governance and decided to stick with the basic Cadbury definition as being the platform from which to consider the issue of how businesses are run and for whom. The use of the Cadbury Report's conclusions was grudging: the EIU suggested at one point in the review that the pendulum may have swung too far and that business was being actively inhibited by regulation. Seeing no reason to recommend change it only nodded towards a further (evolutionary) definition prepared by the Organisation for Economic Co-operation and Development (OECD) three years earlier.

Five years after the EIU's report came the events of 2007–8 and the financial paralysis which followed – these events can quite correctly be ascribed to failures of governance. Ten years on from the EIU's report, and twenty years after its initial publication, the definition used in the Cadbury Report is still the standard starting point for most examinations of corporate governance. The longevity of the definition and the endorsement of it as recently as 2009 in the UK's Walker Review,[2] might suggest that the problems of corporate governance had been cracked. Yet, since 1992, the private sector has suffered the collapse of Barings Bank (1995); the extinction of GEC plc through governance failures (1996); the double-dip collapse of Railtrack (1997 and 1999); the dot.com bust of 2000–01; the Equitable Life Scandal (2000); the scandal over the false oilfield reserves claimed by Royal Dutch Shell (2004); the blast at BP's Texas City Oil refinery which cost the lives of 15 workers and injured 170 others (2005) and resulted in record fines on the company; the purchase of Amro Bank by RBS (2007) which is widely attributed as the factor that toppled the bank into public ownership eighteen months later; the BAE Al-Yamani scandal (2008) which again resulted in record fines; political scandal and legislative changes; the 'Phoenix 4' affair at British Leyland (more political noise); the Sirbir, Keydata and Farepak scandals, together with directorial misbehaviour at JJB and Carphone Warehouse – all in 2009; and the loss of at least £250 million of shareholder value at Mitchells and Butlers because of poor governance. Obviously there was something in the water in 2009, since it was such a bad year for ethical behaviour.

The behaviour of companies overseas was no better in the same period: among the more notable instances are the collapse of HIH Insurance in Australia; the carbon trading scandals of 2009/10, again in Australia; corruption problems at Siemens which led to record fines for that company in 2006 and appear to have arisen again in 2011; the Satyam affair in India, uncovered in 2009 but running for at least six years previously; governance problems at Societe Generale in 2009/10; the overambitious expansion and then collapse of the Icelandic banks; and, repeating the mistakes of five

[2] Sir D. Walker, *A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations* (London: HM Treasury, 2009).

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years earlier, the governance failures at BP which brought about the Mexican Gulf disaster in 2010, costing yet more lives as well as stupendous amounts of treasure; and continuing corporate scandals in the telecoms and extractive industries in India. During this time Goldman Sachs was also doing 'God's Work' on the sovereign debt burdens of Greece, Portugal and municipal bonds in Germany, while losing $1.3 billion of Libya's investment fund. And of course the collapse of the Western financial sector in September 2008 – the biggest failure of corporate governance ever – the cost of which is mind-bendingly high.

It doesn't seem as though the problem has been cracked since, from the time of the publication of the Cadbury Report's definition, trillions of pounds have been wiped off the value of businesses worldwide; thousands of jobs lost; personal savings and pensions have been reduced or eliminated; economic prospects have been retarded and governments have been tainted by their contact with bribery, incompetence, peculation and fraud – all through failures of governance of one sort or another. And, if this were not enough, the number and value of private sector scandals (this recital takes no account of public sector problems) has accelerated since the 1990s in comparison with previous decades as the list below shows:

The 1960s

Rolls Razor (1964)
Emil Savundra and Fire Auto and Marine (1966)

The 1970s

Secondary Banks Crisis (1973–75)
Lloyd's: the Sasse syndicate collapse (1974)

The 1980s

de Lorean (1982)
Lloyd's: Christopher Moran (1982)
The Guinness Affair: Ernest Saunders and Gerald Ronson (1986)
Blue Arrow 1/Manpower (1987)
The Herald of Free Enterprise (1987)
The Kings Cross fire (1987)
The Barlow Clowes affair (1980–)
The Piper Alpha disaster (1988)
Lloyd's Insurance collapse (1988)
The Marchioness disaster (1989)

The 1990s

BCCI (1990)
Polly Peck (1991)
Maxwell and Mirror Group Pensions (1991)
British Gas and the 'fat cats' row (1994)

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Barings Bank – Nick Leeson (1995)
The GEC collapse (1996)
Railtrack (1997 and 1999)

The 2000s

Equitable Life (2000)
Administration of Turner and Newall (2001)
Collapse of HIH Insurance (2001)
RDS reserves restatement (2004)
Langbar International (2005)
BP Texas City blast (2005)
BAE ethics report (Woolf Report – 2008)
RBS/ABN Amro (2007)
Northern Rock failure (2008)
Sirbir (2009)
Carphone Warehouse (2009)
JJB Loans scandal (2009)
Keydata (2009)
Farepak (2009)
The Phoenix 4 – Leyland (2009)
Arch Cru failure (2009)
Qinetiq privatisation (2002)
CDC and Aventis (2004)
The Australian carbon trading scandals (2009/10)
Satyam (2009)
Mitchells and Butler (2009–)

The 2010s

BP/Florida Gulf (2010)
The Cadbury takeover (2010)
Marks and Spencer's succession problems (2009–10)
Southern Cross Scandal (2011)
ENRC (2011)
William Hill pay controversy (2011)
Thomas Cook pay controversy (2011)
William Morrison pay controversy (2011)
Prudential Chairmanship controversy (2011)

The increase in the number of scandals and uncovering of misbehaviour could be due simply to increased public awareness of the incompetence or greed of some directors of public companies, more eagerly investigated by a Press alerted to the prevalence of corporate scandal. But with a record as extensive as this, it is

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appropriate to ask if there is something more significantly wrong: are the measures by which we gauge corporate good behaviour and the standards to which we hold company managers insufficiently rigorous?

Some experts tend to favour a positive attitude towards the evidence. The most recent examination of the structures of UK governance – the Review prepared by Sir David Walker in 2009 into the UK's Banks and other Financial Institutions (BoFIs) concluded that, as far as the banks were concerned, the existing corporate governance code needed only minor tweaking. In sum, the review concluded, corporate governance in the financial sector was working pretty much as it should. Others might say that such a conclusion is absurd after the record of the last three decades and that we really should look again at the definitions of corporate governance that we work with to see if they are still fit for the uses to which we put them.

The Cadbury Committee definition and others

The Cadbury Committee was set up jointly by the City of London and the accounting profession in the summer of 1991[3] to look at what actions might be taken to soothe public disquiet about how major companies were being run, especially in light of the BCCI and Maxwell/Mirror Group scandals of the immediately preceding years.

The Committee's purpose was to review those aspects of corporate governance that related to financial reporting and accountability. The formal set of instructions (included as Appendix 1 to the Report) was as follows:

> To consider the following issues in relation to financial reporting and accountability and to make recommendations on good practice:
> a) the responsibilities of executive and non-executive directors for reviewing and reporting on performance to shareholders and other financially interested parties;
> b) and the frequency, clarity and form in which information should be provided;
> c) the case for audit committees of the board, including their composition and role;
> d) the principal responsibilities of auditors and the extent and value of the audit;
> e) the links between shareholders, boards, and auditors;
> f) any other relevant matters.

Despite the final clause of the remit, the Committee was not expected (either implicitly or explicitly) to undertake a root-and-branch review of what was happening in the City; nor to concern itself with the specific details of individual cases; not even to look outside the City or to speculate or recommend on anything beyond what the current

[3] Sir A. Cadbury, *Report of the Committee on the Financial Aspects of Corporate Governance* (London: Gee, 1992).

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best practice was. Since the definition was supposed to act as the benchmark for examination of the processes by which commercial organisations were run and managed, this was equivalent to freezing the current set of practices. The remit pretty much established the conclusions.

Following on from its deliberations, which lasted a little over eighteen months and involved taking over 200 pieces of individual evidence, it produced a report which contained the following definition:

> Corporate governance is the system by which business corporations 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.[4]

It is this definition which forms the starting point for most other reviews of governance – despite its obvious shortcomings over the passage of time. There are four obvious limitations of the Cadbury definition – first, that the definition of corporate governance is highly limited in identifying the actors who are involved in the determination of policy. Only three groups of individuals are identified in the Cadbury definition – directors, shareholders and auditors. Governance, in the Committee's view, is limited to the interplay between these parties. One of those parties (the shareholder) is almost immediately out of the action as soon as the company has been established, receiving only backward-looking information and only able to intervene on retrospective intelligence – which is all the company is legally obliged to reveal. The definition almost appears to suggest that the shareholders' job is done when the structures have been set up: there is no reference to continuing oversight.

Second, the formulation lacks any dynamic aspect in that the definition can be interpreted to suggest that structures of governance appear to need setting once and then be left alone ('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').

Third, it is a 'blunt instrument' offering only the barest of elaborations about the context or form of governance, with no attempt to go beyond a shallow description. While this is probably a deliberate choice, it renders the description unfit for any form

[4] Cadbury, *Report of the Committee on the Financial Aspects of Corporate Governance*, para. 2.5

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of prescription about how governance should be developed: some members of the committee were unconvinced from the outset that anything needed to be done.[5]

Finally, the definition appears to apply only to business corporations acting for profit.

In short, the definition begs further questions:

- Against what ethical framework or context does the control and direction of businesses take place?
- How do the shareholders exercise a continuing oversight to ensure that the appropriate governance structures are maintained in place? (Assuming of course that they were able to do so in the first place.)
- Are the only constraints on manager/directors the law, informal rules and initial shareholder involvement possibly with a highly ritualised subsequent involvement?
- What mechanisms exist to develop the organisation in line with the changing dynamics of the business world, to protect good governance?
- Do similar strictures apply only to commercial organisations or more widely to, for instance, public sector organisations?

If the public sector collectively stated that the principles of good corporate governance did not apply to the management of public resources, there would be a justifiable outcry. A definition of the proper governance of corporate bodies in the public sector is required, not least given the political trend to attempt to re-balance economies worldwide by encouraging public sector service providers to both include and ape the techniques and practices of the commercial sector.

Recognition that Cadbury left some areas unresolved came in the form of reports by subsequently-convened committees – the Greenbury,[6] Hampel,[7] Higgs,[8] Myners,[9] and Smith[10] Reports. Some issues still remain unresolved, as will be shown in Chapter 6.

The most glaring omission from the Cadbury Report, the refusal to include any participants other than shareholders, directors and auditors, was partially rectified by the next report from a committee of experts tasked with reviewing the issue. The OECD produced an 'official' definition, which arrived seven years later in 1999.[11] By that time most of the developed economies had begun to review the problem, anyway,

[5] Correspondence with Mike Sandland in CAD-0121, Cadbury Archives, Judge Business School, University of Cambridge.

[6] R. Greenbury, *Directors' Remuneration: Report of a Study Group Chaired by Sir Richard Greenbury* (London: CBI, 1995).

[7] R. Hampel, *Report of The Committee on Corporate Governance* (London: Gee, 1998).

[8] D. Higgs, *Review of the Role and Effectiveness of Non-Executive Directors* (London: DTI, 2003).

[9] P. Myners, *Institutional Investment in the UK: A Review* (London: HM Treasury, 2001).

[10] FRC, *Audit Committees Combined Code Guidance* (London: FRC, 2003).

[11] OECD, *Principles of Corporate Governance* (Paris: OECD, 1999).

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from their own perspectives but still mostly working on the basis of the Cadbury Committee's definition. As a consequence, the OECD's formulation was unlikely to depart far from what had become received wisdom. The definition from the OECD 'Ad Hoc Task Force on Corporate Governance' is as follows:

> Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance.

This definition suffers from the same problems as the Cadbury definition – hardly surprising given its obvious parentage.

Other definitions

In the years that followed, economists and auditors also had a stab at defining governance, with even greater brevity than Cadbury:

> Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment.[12.]

> Governance is the combination of processes and structures implemented by the board in order to inform, direct, manage and monitor the activities of the organisation toward the achievement of its objectives.[13]

These definitions extend the scope of the description very little: in the seven years that elapsed after the initial publication by Cadbury – and all that had transpired in that time – all that the OECD managed to develop out of the Cadbury definition was a nod to the inclusion of stakeholder involvement and a wink to subsequent monitoring by shareholders.

Yet, in the UK alone, there had been further developments which had impacted on the basic Cadbury definition. The Nolan Committee[14] had reported on ethical standards in public life in 1995, setting out the qualities required of those involved in public

[12] A. Shleifer and R. W. Vishny, *A Survey of Corporate Governance*, NBER Working Paper 5554 (Cambridge, MA: NBER, 1996).
[13] Chartered Institute of Internal Auditors (UK), www.iia.org.uk/en/Knowledge_Centre/Resource_Library/corporate-governance.cfm.
[14] Lord R. Nolan, *First Report of The Committee on Standards in Public Life* (London: Committee on Standards in Public Life, 1995).

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