Theory and Practice of Corporate Governance

Theory and Practice of Corporate Governance explains how the real world of corporate governance works. It offers new definitions of governance and new conceptual models for investigating governance and corporate behaviour, based on both practical experience and academic investigation. In examining the historical development of corporate governance, it integrates issues of company law, regulatory practice and company administration with contemporary corporate governance policies and structures. An extensive range of international examples, both recent and historical, is used to compare theoretical explanations of governance behaviour with practical outcomes. The book will be particularly suitable for students taking an ICSA-accredited course – giving a necessary critical view on governance, law and regulation – and through utilising new conceptual models, it will stimulate debate among both theorists and practitioners.

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An Integrated Approach

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Introduction

It is the central contention of this book that much of what currently passes for the theory of corporate governance and which forms the foundation of regulatory policy is based on a description of forces, relationships and actors that holds very little similarity to the way that the real world operates. Sometimes, the suggestions of the theory will turn out to be supported by the reality of practice; at other times the two will be in disagreement. But because the current explanations of corporate governance used by policy-makers do not correctly explain the real world, much of the practical superstructure of governance is directed towards the wrong purpose or works only partially. There are examples throughout the text of good (and bad) governance practice to support this view.

The traditional/conventional view

In discussing the existing dominant descriptions of the way that corporate governance is supposed to work, the terms traditionalist or conventional approaches to (or sometimes theories of) governance will be used.

The conventional view typically emphasises the primacy of the shareholder; concentrates on the ownership rights of shareholders; and dwells on the consequences of the relationship between shareholders and managers through the legal and economic prism of the principal-and-agent relationship. Occasionally the traditionalist view may admit additional players (stakeholders) to the governance game but usually only grudgingly or by allocating walk-on parts.

This view is also based largely on the economic characteristics of the period which, in British history, starts with the Victorian era and ends about a century and a half later, towards the end of the twentieth century. That was a very different world from that which now exists; what held true then may not hold true now in terms of the relative significance of the components that go to make up the commercial world.

One of the arguments that will be developed in this book is that, ironically, just as the paradigm of governance for this period was being articulated by the report of the Cadbury Committee of 1992, so the characteristics of the commercial world were changing radically. The resulting changes were beyond the scope of description that the Cadbury Committee arrived at. The shape of the economy to which the Cadbury definition would have applied (at least in Britain) was receding into the distance of history: the Cadbury Committee's world view was focused on an economy which was on the cusp of changing into something that the Committee had not recognised.

Reviewing the existing accepted and conventional definitions and formulations of corporate governance to see if they do reflect reality helps to explain one of the puzzles of the impact of governance, which is why – if all this activity in developing policies, proposals and principles has taken place in the past twenty years – governance lapses seems to have become more frequent and their consequences more damaging. In the argument advanced in this book Cadbury's definitions and prescriptions become a bit like the Anglo-Saxon legend of King Canute in reverse – with the King not commanding the waves to stop but with them leaving him watching the tides race away, while he gesticulates futilely from what was once the shoreline, admonishing them to come back to what he understood.

The investigation in the book of what corporate governance is – and by implication what constitutes good corporate governance – extends, then, beyond the repetition of the paradigms of the Cadbury model, to highlight the disparities between the theory and the way that governance operates (or not) in practice.

The gap between theory and practice

The disparity between theory and practice is particularly striking when comparisons are made between the mechanisms and effects of corporate governance in listed public limited companies and unlisted private companies. The unlisted companies – especially smaller ones – appear to follow the broad projections of the conventional definitions (although this has now been changed slightly by the effects of the Companies Act 2006). But in large companies it is very difficult to see how corporate governance conforms to the conventional descriptions: the existence of shareholder primacy can be questioned on a number of fronts; the characteristics of shareholder ownership are not met in practice; stakeholders occupy a much more significant role than the traditionalist view accords them.

In practice, the effective regulation of large companies is hamstrung by regulators, stakeholders and shareholders pulling on policy levers, which the theory holds should work but where, in fact, no linkage exists to real world environments or the behaviour of those involved in managing those organisations, either practically or legally. This then means that if changes in governance practice are sought they do not work in the way intended or perhaps not at all. The impact and significance of Einstein's dictum – 'In theory practice and theory are the same; in practice they are not' – is sorely neglected in developing and improving corporate governance structures.

In considering what constitutes good corporate governance the main focus in this book is therefore on large companies – usually, but not exclusively, those with some form of stock market listing or those with large numbers of shareholders who are distant from day-to-day contact with the company but where there may not be a public market in the shares.

These two sets of companies are where ownership and control are starkly contrasted. Concentration on them effectively excludes the vast majority of small limited liability businesses – which while numerically superior, tend to be less significant economically because of being small in turnover and capitalisation and often with very few shareholders. But if bigger companies are run properly on the vaunted characteristic of principle-based governance that 'a rising tide lifts all boats', the rising tide effect will presumably eventually improve standards in all, by example and gradual cultural change.

Failures of governance in large stock market-listed companies have far greater and more widespread economic impact than those of a plethora of small ones. The failure of a Barings, a Parmalat or even a Farepak is of far greater economic consequence than that of several modestly-capitalised local engineering companies or building firms, however important they may be locally to stakeholders.

The necessity of context

One strand of the argument throughout this book is that to effectively understand the processes of corporate governance it cannot be removed from the contextual issues that have shaped it.

So a significant part of this book is devoted to analysis of the underlying factors concerned with corporate governance as it now stands. These are the factors that have brought about the current processes of governance of the major commercial organisations and public bodies so important to our collective economic well-being.

The global financial crisis that erupted in 2008 brought the issues of corporate governance into sharp relief. But much of the substantial body of commentary that the crisis generated is still little more than description of events and so lacks any prescriptive value. This is largely because the basic terms on which debate about governance rests are poorly formulated; the contributing factors which bring about effective corporate governance are poorly described. Debate often lacks any appreciation of context so progress in corporate governance flounders because the origins of the issues are inadequately understood and there is little common ground from which to develop proposals for change.

To take an example from geography: a simple description of the landscape – rolling hills, sharp valleys, flat plains – does not really help to understand its development. For that an understanding of geology is needed – an account of how the effect of glaciers, the winds and the rivers interacted to produce the shape of the landscape. To relate this analogy to corporate governance, most existing accounts and theories are mere description of the governance landscape when what is really needed is an attempt at a better understanding of the geological processes – the linkages between procedure, behaviour and systems – which produced it. Throughout the book attempts will be made to consider why corporate governance structures are the way they are or why they do not appear to work, rather than just describing how they appear to be.

Appropriate historical examples which illustrate why procedures, behaviour and systems were changed are the most useful tools for illuminating change. So this book – and the accompanying website – contains many examples of governance failures (and some examples of good governance) to assist an understanding of context. Given the propensity of organisational managers to flout the rules of governance, there is no lack of examples.

An effort has been made to extend the range of examples used in the book beyond the normal Anglo-American boundary found in the majority of textbooks on corporate governance. The Anglo-Americans have no exclusivity on good governance and little cause for congratulation on the sturdiness of their governance structures (despite official pronouncements and political complacency) but they are not alone in recording examples of poor governance. In fact the examples that are reported nearly every week in the financial press which, during the course of writing this book, included (in no particular order) the Southern Cross Scandal; the HSBC pay regime and chairmanship controversy; the Galleon Fund insider dealing trial; the ENRC directorships; failures of ethics and good governance at News International; remuneration arguments at Thomas Cook, William Morrisons, Tesco and William Hill indicate that poor governance is alive and flourishing. A companion website to this book – www.stephenbloomfield.co.uk – gives details of many instances of governance breakdown (both contemporary and historical) and is constantly updated with new examples.

One of the weaknesses of much of the teaching of corporate governance is that it usually considers each discipline separately – administration and secretaryship; law; and accounting. But in governance terms they are different lenses through which the same subject is viewed. It is impossible when discussing corporate governance effectively to separate the individual components of the practical operation and hold them sterile and apart. To do so is like describing a fruit cake only in terms of its ingredients: technically accurate but it does not convey the texture or flavour of the finished article.

This does give rise to some boundary problems however. The strength of the 'single ingredient' approach is that it allows a clear distinction between all the sub-disciplines which facilitates description of each area without elaborate cross-referencing. But its weakness is that it does not convey the complex inter-related nature of the subject matter of governance – a complicated blend of law, finance, administrative practice and ethics. By avoiding the monocular approach in favour of trying to identify the way that governance works in the real world, this book will sometimes touch on subjects more than once in different places, occasionally a partial but relevant explanation of an event may be provided initially which is then elaborated more fully elsewhere.

Consideration of how the conventional description of governance might be improved uses a classification of dimensions of governance – described more fully in the first chapter – which breaks the blunt instrument approach of the conventional description into a more subtle set of distinctions.

The book is laid out in a series of sections. The first section, Chapters 1, 2 and 3, deals with the governance landscape (rather than the geology). Here governance is divided into two specific types, which are considered separately: the inward-facing aspect of governance – that which concerns principally shareholder relationship – and the outward aspect – the relationship of the company with its stakeholders. This first part establishes the broad boundaries of the subject area and the bones of the argument that the traditionalist/legalist theories of governance which form the basis for the regulatory structures of governance are inadequate to describe what really happens. The concepts of 'procedural', 'behavioural', 'structural' and 'systemic' governance are also introduced: these operate at different levels within companies and throughout the economy to reinforce individual governance practices and activities.

The second part (Chapters 4 and 5) then looks at the legal framework within which companies operate – paying particular attention to developments from the 1970s and 1980s to the passage of the latest Companies Act in 2006. The chapters examine the relationship between law and governance both at the theoretical level and again how things work out in practice – in particular taking into account the rule of unintended consequences and extending the argument about existing descriptions not working well and developing the 'geological' approach.

The third part (Chapters 6, 7 and 8) looks at the overlap between law, regulation and governance; and contends that the abiding characteristic of regulatory activity – in particular that of auditing activity – is that it fails. The basis for this claim is that even with the thicket of regulation that surrounds financial activity, governance failures are very prevalent. Regulators and legislators have been facing a losing battle that has accelerated over the past thirty years, as they seek perpetually to catch up with a market place where 'innovation' has often been allowed to dominate at the expense of suitability for purpose, and the interests of a small minority have been allowed to outweigh the well-being of the many. The situation has been made worse since this innovation was subject only to the lightest of regulatory touches in the first decade of the new millenium, and regulation that was implemented appears to have been unable to check in a timely way activity that has proved subsequently to be inimical to the interests of stakeholders in general. A good and effective corporate governance system would surely act as a prophylactic, not a sticking plaster.

Chapters 9, 10 and 11 (Part 4) look at what might be called the secretarial or administrative aspects of governance, including a more detailed revisiting of the prickly issue of remuneration that was briefly introduced in Part 1. Again, the traditionalist/legalist theories are drawn upon to explain the operation of governance where unintended consequences are once more apparent in regulatory practices based on these precepts.

Part 4 also looks, in Chapters 12, 13 and 14, at the environment in which the listed company operates and reviews in particular the development of the separate reports and recommendations that constitute the UK Corporate Governance Code. The UK reports are found mostly to lack impact, because their underlying assumptions about the operation of governance arrangements are faulty. If anything this tendency seems to have accelerated as the reports have been produced – with the notable exception of the 1999 Turnbull Report. It also describes the anticipated framework of the regulatory environment following the forthcoming break-up of the Financial Services Authority (FSA) into the Prudential Regulation Authority and the Financial Conduct Authority, and the regulatory implications of new and fragmented markets for shares and financial instruments.

Part 5 of the book draws together the aspects of failure of governance in its various components of procedural, behavioural and systemic dimensions. Taken together these may be considered to be *counter-governance* when they are pursued as matters of policy or *contra-governance* when policies are occasionally instituted which are intended to by-pass laws or regulations through criminality, recklessness and market abuse. Needless to say there are subjects and instances which re-appear here having made their first appearance in other chapters, but this section is intended to deal with the issues in a coherent way, placing them against the background of the extended definitions of governance developed earlier in the book.

The final chapter makes some observations about the development of governance policies and in particular the fashionable – but no less valuable for that – concept of stewardship and its relationship to the areas covered in the argument.

Stephen Bloomfield