

Cambridge University Press

978-1-107-01224-0 - Theory and Practice of Corporate Governance: An Integrated Approach

Stephen Bloomfield

Frontmatter

[More information](#)

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.

STEPHEN BLOOMFIELD leads the Corporate Governance Unit at Anglia Ruskin University. He was a visiting fellow in Corporate Governance at Kingston University and London South Bank University and, prior to his academic career, he was a stockbroking analyst and then a director of a major venture capital fund. He has been a director of numerous venture capital funded companies and is a fellow of the Institute of Chartered Secretaries and Administrators.

Cambridge University Press

978-1-107-01224-0 - Theory and Practice of Corporate Governance: An Integrated Approach

Stephen Bloomfield

Frontmatter

[More information](#)

Cambridge University Press

978-1-107-01224-0 - Theory and Practice of Corporate Governance: An Integrated Approach

Stephen Bloomfield

Frontmatter

[More information](#)

Theory and Practice of Corporate Governance

An Integrated Approach

STEPHEN BLOOMFIELD



CAMBRIDGE
UNIVERSITY PRESS

Cambridge University Press
978-1-107-01224-0 - Theory and Practice of Corporate Governance: An Integrated Approach
Stephen Bloomfield
Frontmatter
[More information](#)

CAMBRIDGE UNIVERSITY PRESS

University Printing House, Cambridge CB2 8BS, United Kingdom

Published in the United States of America by Cambridge University Press, New York

Cambridge University Press is part of the University of Cambridge.

It furthers the University's mission by disseminating knowledge in the pursuit of education, learning and research at the highest international levels of excellence.

www.cambridge.org

Information on this title: www.cambridge.org/9781107012240

© Stephen Bloomfield 2013

This publication is in copyright. Subject to statutory exception and to the provisions of relevant collective licensing agreements, no reproduction of any part may take place without the written permission of Cambridge University Press.

First published 2011, 2013

Second Edition 2012

Reprinted 2013

A catalogue record for this publication is available from the British Library

Library of Congress Cataloguing in Publication data

Bloomfield, Stephen.

Theory and practice of corporate governance : an integrated approach / Stephen Bloomfield.

p. cm.

ISBN 978-1-107-01224-0 – ISBN 978-1-107-61224-2 (Paperback)

1. Corporate governance. I. Title.

HD2741.B575 2013

658.4'2-dc23 2012029372

ISBN 978-1-107-01224-0 Hardback

ISBN 978-1-107-61224-2 Paperback

Cambridge University Press has no responsibility for the persistence or accuracy of URLs for external or third-party internet websites referred to in this publication, and does not guarantee that any content on such websites is, or will remain, accurate or appropriate.

Contents

<i>List of Figures and Tables</i>	<i>page</i> xii
<i>Introduction</i>	xiii

PART 1 THE DISCIPLINE OF GOVERNANCE

1 The landscape and definitions of governance: the major actors	3
Introduction	3
The Cadbury Committee definition and others	7
Other definitions	10
The weakness of principle-based structures	12
Additional considerations	16
Governance as risk management	16
Governance and management: the dimensions of governance	17
Two suggested definitions: private sector and public sector	19
The main actors in governance: shareholders and stakeholders	20
The actors and ownership and control: distinguishing theories	21
The company as an actor	24
2 Inward-facing governance	26
The company	26
Common structural factors of companies	27
Shareholders	29
The shareholders' advantage: limited liability	30
Directors	33
The contract between the parties: the Articles of Association	36
Challenges to the traditionalist interpretation	37
Shareholder ownership	38
Shareholder control of companies	41
... in smaller companies	43
... in larger companies	45
Summary	53

3 Outward-facing governance	55
Longitudinal and operational dimensions of governance	57
Stakeholder theory	59
Measurement of performance	60
Other stakeholders' interest in the company	64
Stakeholder theory and corporate social responsibility	66
CR and civil society	75
Summary and conclusion	76
PART 2 THE RELATIONSHIP BETWEEN LAW AND GOVERNANCE	
4 The protection of the laws	81
Introduction	81
Additional dimensions of governance	82
The Companies Act 2006	83
The ways that the law impacts on governance	85
Shares as evidence of ownership	87
Shareholders collectively (1)	89
Disguised returns of capital	90
Shareholders collectively (2): protecting value and power	95
Shareholders collectively (3): shareholder meetings and votes	96
Shareholders collectively (4): shareholders' remedies	97
Redress via the Articles	98
Court resolution	98
Removal of directors	98
Derivative actions	98
Oppression of minorities	99
Winding up	99
The company and the law	99
Summary and conclusion	101
5 Critical governance law	102
Introduction	102
Market regulation	102
Directors' responsibilities: the Companies Act 2006	103
Derivative actions	106
Other actions	108

The Companies Act 2006	108
The Corporate Manslaughter and Corporate Homicide Act 2007	109
Governance effect	111
The Bribery Act 2010	112
The corporate offence: ‘failure to prevent’	114
Summary and conclusion	117
PART 3 GOVERNANCE AND THE LISTED COMPANY	
6 The development of governance – the Governance Codes	123
Introduction	123
Ideal listed company governance structure in the UK	124
The development of the Corporate Governance Codes in the UK	127
‘The Mayfair Set’	133
Public disquiet and change	137
The Cadbury Committee Report (1992)	137
The Greenbury Committee Report (1995)	138
The Hampel Committee Report (1998)	144
The Turnbull Committee Report (1999)	147
The Higgs Report (2003)	148
The Myners Report (2001)	150
Conclusion	151
7 The 2007–8 financial crisis: the failure of systemic governance	153
Introduction	153
Near misses	155
The use of unregulated debt as a cause of the collapse	168
Summary	171
8 Systemic governance: the Turner Review, the Walker Review and the Vickers Commission	172
The Turner Review (2009)	174
The Walker Review (2009)	174
The Vickers Commission Report (2011)	176
The ‘bonus culture’	178
The impact on traditionalist views of governance	179

viii CONTENTS

The systemic governance issues – the subordinate cause	181
Not too big to fail ... too big to audit – the contributory cause	182
Inadequate regulation – the visible cause	183
The other guilty parties	188
Conclusions	195
PART 4 GOVERNANCE AND REGULATION	
9 The company and the stock market	201
Introduction	201
The purposes of stock markets	203
The first issue – mobilising capital	207
The second issue – treating shareholders equally	212
The final issue – effective allocation of resources	220
Conclusion	228
10 Non-shareholder regulation of companies	230
Introduction	230
The links between governance and regulation	232
The consequences of regulatory increase on shareholders	235
Regulation of the market by the market	236
‘Passporting’ and the international regulation of markets	242
Unregulated markets	245
Regulation of short-selling	247
Disproportionate activity	251
Inappropriate activity	252
Insider dealing and market abuse	252
The private shareholder	258
Regulation of takeovers	259
Conclusion	261
11 Changes in regulatory structures – the PRA, the FCA and the ICB recommendations	263
The Bank of England	267
The Financial Policy Committee	267
The Prudential Regulation Authority	268

The Financial Conduct Authority	268
Shortcomings of the new structure	269
12 Failure – the abiding characteristic of regulation	277
Introduction	277
Audit and its failings	278
Audit failure	281
‘Good audits’	283
Accountants’ and auditors’ judgement	285
The application of accounting standards	285
Auditor defensiveness	286
International developments	287
Limitation of auditor liability – shareholder issues	288
Audit firm governance	290
Concluding remarks	298
13 Accounting for profits: the root of information asymmetry	300
Introduction	300
Accounting and governance	301
The information made available	302
Specific problems in the account process	305
Problems arising for the shareholder	308
Accounts and the stakeholder	309
Accounts and the marketplace	312
The problem of intangible assets	313
Goodwill and its forms	314
Narrative reporting	318
Intangibles and CR	320
Summary	321
14 Reward and performance	322
Introduction	322
The problem of managerial performance – balancing managerial reward and shareholder interests	323
The divisive issue of directors’ pay	325
The policy origins of the bonus culture	328

x CONTENTS

Bonus and option implementation	329
Institutional influences	330
Psychological influences	331
The fundamental flaws in the bases of remuneration structures	332
The pernicious effects of management share options and the operation of 'moral hazard'	339
Moral hazard	339
Irrational allocation	339
Summary	340
PART 5 COUNTER-GOVERNANCE: FAILURES OF GOVERNANCE AND CORPORATE FAILURE	
15 Counter-governance (1): theory	345
Introduction	345
The failure of structural governance and corporate failure	347
'Innocent' failure	351
The legal view of corporate failure	352
Ethics and governance	356
Summary and conclusion	363
16 Counter-governance (2): abuse of stakeholders	364
Introduction	364
Other forms of governance abuse: cartels	365
Other forms of governance abuse: concealment of information	370
Other forms of abuse: environmental crime	371
Other forms of abuse: pension funds	372
Other forms of abuse: the utilisation of trans-national loopholes, tax avoidance and evasion	377
Summary and conclusion	380
17 Concluding remarks	382
Policy failure	382
Inadequate and outdated definitions	382
Dimensions of governance	383
Stakeholders' importance – and problems	384
The force of law	385
Failure of the codes	385

CONTENTS xi

Intermediaries and their failings	386
Market imperfections	388
Accounting and audit	390
Reward issues	391
Counter-governance	391
Recognitions of inadequacies	392
<i>Bibliography</i>	396
<i>Index</i>	409

List of Figures and Tables

Table 5.1	Fatal injuries in the Waste Disposal industry in the UK 2009/10–2010/11 Source: HSE website, www.hse.gov.uk/waste/statistics.htm	<i>page</i> 112
Table 9.1	Numbers of companies on the Alternative Investment Market 1995–2011 Source: London Stock Exchange website, www.londonstock exchange.com/statistics/markets/markets.htm	210
Figure 11.1	UK banks' leverage Source: Published accounts and Bank calculations	264

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 millennium, 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