Best Practice in Corporate Governance

Building Reputation and Sustainable Success

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CHAPTER 1

What is Corporate Governance? Why is it Important?

An early definition of corporate governance may be found in the Cadbury Committee Report of December 1992: '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 the appropriate governance structure is in place.' Ten years later the Higgs Report had a different focus: 'Corporate governance provides an architecture of accountability – the structures and processes to ensure companies are managed in the interests of their owners.' An international view of corporate governance is provided by the OECD Report 'Corporate Governance' of April 1998: 'Corporate governance comprehends that structure of relationships and corresponding responsibilities among a core group consisting of shareholders, board members and managers designed to best foster the competitive performance required to achieve the corporation's primary objective.'

Corporate governance is a development of the concept of government, which has existed from the earliest days of social organisation and has evolved into the elaborate constitutions of many of today's nations. Governance principles and structures apply to organisations with varying degrees of complexity ranging from international bodies, such as the United Nations, through national, regional and local levels, down to small clubs and special interest groups. Most of these groups have rules which regulate their conduct of affairs and facilitate the settlement of disputes between members.

The governance of corporations began with the charters for early commercial voyages and enterprises, for example, the East India Company, and business partnerships followed by joint stock companies, limited liability companies and consortia, for example, between airlines. Over time the constitution of corporations became more detailed and complex, incorporating customs and practices which had grown up round the early basic charters. These customs and practices were also codified into company law (statutes and case law) so that corporate governance became multi-layered.

The early days of corporations were characterised by frequent frauds and scams, for example, the South Sea Bubble, and Victorian novels are full of corporate misdemeanours and lawsuits. The introduction of the limited liability company in 1856 led to a rapid increase in incorporation. The ability to trade shares on a stock exchange helped to boost the value of successful companies and to weed out failures.

Initially most limited liability companies had close links between their shareholders and their directors, many of whom were also shareholders. This link facilitated communication and the rights issues of shares needed to fund expansion. As companies grew they required

more professional full-time management, initially appointed below board level (as in many US companies today) but later some professionals became executive directors. This was necessary to provide depth and continuity in directing the company, most of whose directors were part-time non-executives with a portfolio of other directorships and interests. A typical company in the early twentieth century would have a part-time chairman, often a nobleman or a person with City connections, and a managing director who was answerable to the board for controlling the company's business. Later it became usual to have a finance director, particularly when the company had a large number of institutional investors who required briefing on the company's financial performance in detail. A few other executive directors were appointed to reflect activities of prime importance such as sales, research, and manufacturing.

This model remained in balance for many years but came under pressure after World War II. The end of Empire (and Imperial Preference), the growing economic might of the USA and the resurgence of Germany and Japan, in particular, created competitive pressures to which British companies were not accustomed. Their shareholder profile had changed; there were proportionately fewer individual shareholders and the weight of institutional investors increased as pension funds were channelled into equities rather than bonds. Two groups of shareholder emerged, individual and institutional, and their power and influence diverged. Individual shareholders had become numerous but most had small stakes in the company and few had links to individual directors. Their contact with the company was limited to receiving an annual report, a dividend cheque and an invitation to the annual general meeting. Institutional shareholders were able to demand more regular and detailed briefing on the company's progress and prospects, and were in a position to time the sale of their stake in whole or in part, if they were not satisfied. Institutional shareholders are key players in the City and have close links to the investment banks, lawyers and accountants whose activities drive the City machine. Another group whose influence was becoming increasingly felt by companies was the news media; their agenda was to exploit weaknesses in company performance and to find negative stories about individual directors.

Why corporate governance became important

Corporate governance became important partly because the classic model of meeting shareholder expectations delivered declining relative results and also because the primacy of shareholders began to be challenged. Between 1900 and 2000 Britain's share of world GDP declined from some 25 per cent to 5.6 per cent. British companies were driven out of major markets, such as shipbuilding, vehicle manufacture, computers, investment banking, and so on, despite sustained efforts to concentrate in order to build critical mass. Britain saw its lead in innovating key new products lost to American and other competitors (in jet propulsion, body imaging, genetically modified crops, for instance). These setbacks were reinforced by a number of company disasters from the 1970s onwards, forcing the rescue of Rolls Royce, Jaguar and others, and latterly by several major scandals (BCCI, Maxwell, Polly Peck, Guinness, and so on). It seemed that British business was not only failing to compete globally but was also at risk of internal decay. Such a situation was not only damaging to the British economy; it represented a direct threat to the credibility of the City of London as a market for investors. As a result the Stock Exchange launched the Cadbury Inquiry into the financial aspects of corporate governance in 1990.

Developing the codes and revising company law

The Cadbury Inquiry began soon after the Companies Act of 1985. This was a major piece of legislation which consolidated all previous Companies Acts. For this reason, and to effect change in the practice of corporate governance by persuasion rather than force of law, the output of the Inquiry was a set of codes of behaviour, against which companies were expected to report annually to their shareholders. This procedure was followed for the output of all subsequent inquiries – the Greenbury Committee Report on directors' remuneration, the Hampel Report, which consolidated and replaced both the Cadbury and Greenbury Reports, the Turnbull Report on managing risk, the Smith Report on audit and the Higgs Report on non-executive directors.

Following the Hampel Report, directors are expected to 'comply or explain' rather than tick boxes. This has made reporting against the Combined Code (Hampel) and subsequent codes more flexible and specific to company circumstances. It also opens the door to 'spin and window-dressing' to present company practice in the most favourable light.

In parallel with the development of codes of behaviour, the movement for improving corporate governance has helped to drive a revision of company law, to be integrated into a new Companies Act. Consultations on the proposed Companies Bill began in March 1998 with a major consultation exercise, around 'The Strategic Framework' starting in February 1999. The purpose of the consultation was to modernise core company law (excluding the Insolvency Act and the regulation of financial services), recognising the European dimension, with 11 directives to date, the EC Treaty and the European Convention of Human Rights (now incorporated in UK law). This process has now completed its consultations and the Final Report of the Company Law Review Steering Group was submitted to the Secretary of State for Trade and Industry in June 2001. One of the key innovations will be the need to publish an Operations and Finance Report, 'to provide a discussion and analysis of the performance of the business and the main trends and factors underlying the results and financial position and likely to affect performance in the future, so as to enable users to assess the strategies adopted by the business and the potential for successfully achieving them' (Company Law Review). Work on drafting the new Companies Bill continues and it is now well past the original deadline for legislation for reasons which are not revealed.

Beyond the codes – alternative models

We have seen that the Cadbury Report was commissioned to explore the financial aspects of corporate governance, since the impact of failure and scandal on the City had been financial, primarily through loss in the value of shares. The Cadbury Code and its successors to date have continued to focus on financial outcomes, though Hampel and Higgs touch on some wider issues, for example, the need to involve stakeholders other than shareholders and the need to create more dynamic company boards.

One month after the issue of the Cadbury Report in January 1993, the RSA (The Royal Society for the encouragement of Arts, Manufactures and Commerce) began an inquiry into the form 'Tomorrow's Company' would take. The inquiry was sponsored by a wide range of British businesses, under the leadership of Sir Anthony Cleaver, Chairman of IBM UK. It involved a significant number of interviews with chairmen and chief executives, together with the development of selected case studies into the sources of business success, supported

targetted research on competitiveness and board-room values from a wide range of sources. The inquiry was concluded in June 1995 and reported as follows:

- British companies would need to change radically to cope with global competition.
- The fundamental change needed was to identify and work with stakeholders in order to maintain a 'licence to operate' from society as a whole.
- Directors' duties needed to be redefined to support this 'inclusive approach'.
- People involved with companies would need to be included in this 'inclusive approach' in order to motivate them and maximise their contribution to the enterprise.
- The financial community would also need to be included in this process in order to maximise their support.
- Companies would need to build relationships with communities and government to underpin their 'licence to operate'.

These findings represent a much wider view of corporate governance than that taken in the Codes. No longer is the company responsible solely to shareholders but it now has to seek and maintain a 'licence to operate' from society as a whole. All stakeholders need to be identified and included in the considerations of the company, more as if they were family members rather than through arms-length legal contracts. The range of stakeholders was seen to be very wide, and such stakeholders were expected to contribute to the success of the enterprise, rather than exploit it.

It is perhaps significant that the new Companies Bill adopts the concept of responsibility to stakeholders, and the 'inclusion' approach needed to meet it. Legislation usually lags original thinking and best practice, it consolidates them and generalises them by which time most of the competitive advantage of distinctiveness has been lost. This book aims to focus on the areas of corporate governance which legislation has not reached or which may not be appropriate for legislation.

The stakeholders in corporate governance

Corporate governance is a system for optimising the contribution of a number of disparate parties to a purpose which they are persuaded to share. These disparate parties are often referred to as the 'stakeholders' in the enterprise, and their potential for support or damage to the enterprise may vary depending on circumstances. The interplay of these stakeholders is the theme of this book, but it is useful at this stage to introduce them and explore their potential roles. This list does not include uninvited stakeholders, such as the media or special interest groups.

SHAREHOLDERS

Shareholders have traditionally been the key stakeholder in companies. In earlier organisations they would have been partners, and the partnership model survives into modern times, largely in small businesses and the professions. The function shareholders and partners have in common is ownership of their organisation. In English law the rights of property have traditionally had precedence over most other rights, so that ownership of a company gives its shareholders pole position in the ranking of stakeholders.

For smaller companies share ownership may still be a matter of pride and involvement, but the owners of larger companies have changed since the early days of limited liability. The growing involvement and power of executives has tended to make owners into spectators rather than participants; this tendency has been compounded by the increasing involvement of institutions as shareholders. Institutions do not think or act as involved owners – they hold shares as an investment and buy and sell purely for financial gain. Shareholders in most large companies are less likely today to think as owners, most will be using the company as a stake in their own financial game – some will be using their shareholding to advance other causes, for example, NGOs seeking to subvert company policy through pressure.

Lack of involvement by shareholders has been a major contribution to problems of corporate governance. The activities of corporate raiders in the 1960s, especially in the USA, were facilitated by shareholders who had no sense of ownership and were eager to sell their shares, irrespective of any consequences for the company or other stakeholders, such as employees. Executive directors became too powerful in recent years and have been allowed to indulge in take-overs, most of which have destroyed shareholder value. Concern about excesses in rewards for poor performance have only recently led to any action by shareholders. It remains to be seen whether shareholders will become more active stakeholders in their companies.

THE BOARD OF DIRECTORS

Historically the board of directors has been the agent of shareholders to direct their company. In the past many directors were shareholders or representatives of shareholders, creating conflicts of interest with their prime duty of care to the company as a whole. Even today it is not unusual for directors to be appointed by major individual shareholders, so that this conflict remains a governance issue.

Earlier boards comprised solely non-executive directors, with company management delegated to a general manager and a small team of specialists. As business became more complex and decisions needed to be made more rapidly, some of the managers were appointed to the board, initially the managing director, then the finance director and sometimes a few specialists. UK boards tended to have more executive directors than those in the USA, where often the only executive director was the CEO, supported off-line by a full management team. In Germany, Holland and Austria a two-tier board structure was favoured, with a supervisory board of non-executive directors (with representatives of labour, banks, and so on) and an executive board of managers. In the USA company boards were for many years virtually ‘out of the loop’ in terms of controlling their company, so that real decisions were taken by managers. Recently a spate of scandals (Enron, World.Com, and so on) has drawn attention to the weakness of company boards and the need to increase their ability to exercise control.

One of the key issues in corporate governance is the working of the ‘agency principle’. This is the doctrine that shareholders are the owners of their company and that company directors are solely agents to exercise the will of shareholders. Company law enshrines this doctrine, so that shareholders have limited liability but directors unlimited liability in respect of third parties if the company goes into liquidation. In recent years many company directors have been tempted to behave as if they were owners of the company, following a pattern of ‘heroic leadership’ established by iconic CEOs in the USA, for example, Jack Welch of GE. An extreme example of this behaviour is Jean-Marie Messier, formerly CEO of Vivendi

Universal, who expanded his company to the brink of disaster. In recent times directors' rewards have matched the over-vaulting ambition of the role models among their peers. Restraining abusive levels of remuneration is now a major issue; the Association of British Insurers reports that most of their challenges at AGMs (in 2004) have been related to directors' remuneration.

One of the key challenges for corporate governance is to rebalance the distribution of power between shareholders and company directors, so that the balance of power between all stakeholders can be calibrated to meet the needs of the company in the context of society as a whole.

CUSTOMERS

According to Peter Drucker, the sole purpose of business is to find a customer. Without a customer there can be no business, since there is no cash-flow to sustain it. It might be thought, therefore, that customers are the prime stakeholders in any enterprise, with shareholders providing capital to serve them. The capitalist system does not, however, exist to favour customers but to create wealth for all participants. As with all stakeholder issues, balance is the secret of sustainable success.

Company law considers customers solely in contractual terms, largely as potential debtors in a winding up, and other legal relationships are contractual. In a wider context, however, customers need to be considered as major stakeholders and their interests need to be a key focus of management attention. Most progressive companies seek to build sustainable relationships with customers ('customer relationship programmes') which underpin future sales. Once again a balance needs to be struck between the company's interests and that of customers. Where customers have the economic power to subordinate the interests of their suppliers, the relationship between them is difficult to sustain. Major supermarkets have now the economic power to drive supplier prices down to unrealistic levels – such customers can be the stakeholder from hell!

Customer relations can involve issues other than price. Many enlightened customers involve their suppliers in their planning processes, even in the design of future products. With increasingly complicated supply chains, this relationship needs to be linked through different stages to achieve customer satisfaction. This requires a higher level of trust than has traditionally existed between customers and suppliers, and greater mutual commitment.

EMPLOYEES

Before the marketing revolution which put customers in the forefront of managerial concern, employees were a prime focus for management. Organisations which are 'supply-side' focused, rather than demand-led, are concerned to emphasise the provision of goods and services rather than respond to customer needs. Today this orientation is typical of public bodies and it is no coincidence that employees are a major stakeholder in such organisations and that trades unions remain strong in the public sector. Outside the public sector, the growth of global competition has made the ideal of life-time employment unsustainable and companies in the private sector have repeatedly needed to 'downsize' their employment to meet cyclical and competitive shocks.

Employees remain stakeholders in their company, however, since the company needs their skills and experience and employees can use the company to develop and enrich their

curriculum vitae. Companies are increasingly developing a core of key employees whom they aim to retain and to offer advancement, supported by part-time and temporary employees and a number of out-sourced operations at the periphery. It is likely that companies will have relatively fewer employees in the future, and rely on contractors for services which are not distinctive or at the core of their business.

SUPPLIERS

Some companies did not identify suppliers as stakeholders until recently. I advised a major corporation a few years ago and had difficulty in persuading them that suppliers needed to be included in their stakeholders' programme. Traditionally suppliers have been treated with some disdain – told what to do and bullied into lower prices and faster service. When companies realised that it was expensive to have a multiple supplier policy and that picking champions for each speciality and working with them led to better service and reducing prices, partnership became the new policy. This has brought suppliers into closer relationship with their customers and is of greater importance at times of rapid change and of increasingly extended supply chains.

As companies become leaner in order to compete against low-cost competition from China, India and other emergent countries, it is likely that they will increasingly rely on external contractors. When IBM downsized in the 1990s it spun off whole operations to trade with them at arms length. Employees became suppliers. In the increasingly complex and competitive world we face, relationships will change, yet those involved are still stakeholders. It is increasingly common for companies who are usually competitors to be partners in a specific project. Stakeholder relationships make tactical changes possible.

COMMUNITY

Apart from 'virtual' companies, all businesses exist in one or more communities, from which they draw employees and suppliers and in which their customers may operate. Even 'virtual' companies have 'communities of interest', which may be the core stakeholders but which may involve their families in a wider audience. Internet companies do not have local physical communities but they have a wide audience of website visitors and potential users.

Companies have become aware of the communities in which they are located only in recent years. Earlier, some companies built their own communities (Cadbury, Lever Bros, and so on) in order to ensure a contented and dedicated workforce, but the majority were content to minimise their relationship with communities and recruit individuals. The activity of businesses can have a large impact on communities – the contraction of the coal, steel and ship-building businesses has devastated many communities where they were the sole or main employer. Government assistance relieved many of the worst cases but companies were often seen as unsympathetic. Sometimes communities are damaged by disasters, such as oil spillages, and the response of companies is not always adequate in such cases. Even after 13 years there is no settlement of claims from local communities in Alaska arising from the Exxon Valdez disaster.

In recent years companies have begun to recognise that the support of local communities is essential for their ongoing success. Concern to help build stronger communities is manifest in Business in the Community (see Chapter 7) and The Prince's Trust. Major corporations have established programmes for 'corporate social responsibility' in which they provide

financial and staff support for community projects. These programmes are often supplemented by activity to protect the environment. Major corporations, such as Shell, BP, BAE SYSTEMS, and so on, publish annual reports on their work on social and environmental issues, which are monitored by relevant special interest groups.

Companies need to relate to communities in all parts of the world in which they trade. This involves different cultures, languages and religions; it also involves them in issues such as corruption, child labour and exploitation which may affect their reputation, even through third parties, such as suppliers, unless they are constantly vigilant.

GOVERNMENT

The last of the stakeholder groups identified by 'Tomorrow's Company' is government. This includes government at all levels and in all countries in which the company operates. It may be argued that government is a regulator not a stakeholder. This approach ignores the opportunities for dialogue which can be found through a constructive approach to government and the need for government to consult companies about ways to develop their business (and thus employment and taxable profits). No business, even Microsoft, can afford to ignore government and it is government which provides much of the infrastructure and services needed to facilitate the growth of business.

Many companies have tended to deal with government through trade associations and key contacts, such as local MPs. Larger companies have recognised the need to be pro-active in their dealings with government and public bodies. To do so, most appoint a Director of Government Relations, or equivalent, who can identify the key contacts needed in the public services. Companies increasingly use lobbyists to press issues with government which are of importance to them. Lobbying through trade associations produces no competitive advantage!

Government is not an easy stakeholder to manage. It is larger than any company and has the full panoply of authority under the law to protect it. Government can pass laws which are damaging to groups of companies, for example, changing tax regulations, and can require companies to undertake tasks for it, such as collecting taxes. Government intrusion in companies' affairs seems likely to increase, as governments reach the limits of taxation and borrowing. Government is a very real stakeholder – it has the power to destroy your company.

The dimensions of corporate governance

There are a number of models of corporate governance, some of which are based on structures and processes (such as the codes developed out of the Cadbury Report and its successors) and others which are not rules based but relate to an interacting set of principles. The advantages and disadvantages of each approach will be discussed in Chapter 2. At this stage it may be useful to draw out the dimensions of the structure known as corporate governance.

We have seen that governance is a system by which organisations are governed. For complex organisations, such as national governments, the system is intricate in its detail but should be clear in its principles. Lord Nolan, who was commissioned by John Major in 1994 to examine the governance of all public bodies, instituted a progressive review of 'Standards in Public Life' which has examined government and public bodies from top to bottom and is

now addressing related issues, such as election expenses. The Nolan Committee established at the onset of its work a set of 'Seven Principles of Public Life' to act as touchstones for its inquiry. These are:

- Selflessness – acting solely in the public interest.
- Integrity – avoiding obligations to third parties.
- Objectivity – making judgements solely on merit.
- Openness – explaining actions fully; restricting information only to protect the public interest.
- Honesty – declaring any private interests which may conflict with the public interest.
- Accountability – being open to any scrutiny appropriate to the office held.
- Leadership – setting an example in observing these Principles punctiliously.

Another set of principles established by the OECD in 1998 included:

- Fairness – protecting shareholder rights and ensuring contracts with resource providers are enforceable.
- Transparency – requiring timely disclosure of adequate information on corporate financial performance.
- Accountability – ensuring that management and shareholder interests are kept in alignment.
- Responsibility – ensuring corporate compliance with laws, regulations and society norms.

(The OECD Report stresses that regulations, however well enforced, are not sufficient to promote best practices. The search for best practice is the theme of this book.)

These sets of principles (and others which are mainly similar) do not themselves provide codes of practice, much less rules, for running organisations. Their main purpose is to influence personal conduct, hence group behaviours, in order to build trust. Trust is the basic currency of human intercourse; trust enables people to transact with each other at all levels, and allows transactions 'on credit' which facilitate new initiatives and future paybacks rather than deals settled 'on the nail'. Where trust is sufficiently strong there is less need for contracts and regulations – 'my handshake is my bond' becomes reality and transactions are accelerated.

How do these sets of principles relate to the codes? The codes occasionally refer to principles, but it is possible to descry principles within their wording. Relating these perceptions to the Nolan principles there is congruence with the exception of 'selflessness' and 'objectivity'. These exceptions illuminate in a flash the basic cultural differences between the public and private sectors! Whether these differences will be sustainable in an increasingly assertive society to which both are answerable must be open to conjecture.

The concept of 'fairness' in the OECD principles seems to be different from Nolan at first sight. In fact it parallels the 'selflessness' of Nolan, except that it protects the interest of shareholders rather than the public.

The eight key dimensions of corporate governance

It is useful at this stage to take a fresh look at the purpose of corporate governance and how that purpose can be achieved. The primary purpose of corporate governance is to ensure the

survival and sustainable success of the organisation to be governed. This is also the primary duty of company directors in company law. In order to survive and prosper, any organisation needs to define its objectives and identify the groups and/or individuals who have a stake in achieving those objectives. This process begins to raise the issues which the regime of governance will need to address and control:

- What are the purposes of each of the stakeholders and how may they be reconciled with each other and those of the organisation?
- What are the roles and relative importance of different stakeholders within the organisation?
- How can the energies of all stakeholders be harnessed to the purpose of the organisation with minimal conflict and dissipation?
- How can the long-term purpose of the organisation be protected from short-term pressures? And so on.

These questions (and others) highlight the eight core dimensions of corporate governance:

- The identity of the organisation
- The purpose of the organisation
- Leadership
- The distribution of power within the organisation
- Inclusiveness and communication
- The pattern of accountability required
- The maximisation of effectiveness
- Ensuring sustainability.

1 *Identity* We all need to know who we are. Organisations also need a defined and clear identity, partly to distinguish them from other organisations and partly to rally support (saluting the flag). Who we are is partly the image we project but essentially the set of values which defines us. The image will be the symbol of the organisation's personality – like Johnnie Walker for whisky or the Legal and General umbrella; this personality needs to develop character by being identified with, and consciously living, a defined set of values. Developing character is reflected in the building of a corporate brand which attracts loyalty and custom and becomes the reputation which has value as an intangible asset on the balance sheet.

2 *Purpose* Having clarified 'who we are', the next question is 'what shall we do?'. Defining the purpose of an organisation is part of the process of developing character, by adding depth to personality. Purpose gives the sense of direction to an organisation which galvanises action. It also acts as the catalyst for co-operation – individuals sharing a purpose and working together – which can be very motivating. The early Crusaders were an example of such motivation (until failure and disillusionment occurred). War and crisis are catalysts for motivated co-operation; survival concentrates all minds on an immediate purpose. Without the stimulus of fear, corporate governance needs to build and sustain consensus round a shared purpose and persuade those involved to leave their personal objectives 'outside the door'.

3 *Leadership* Leadership is the driving force behind corporate governance. It maintains a firm focus on purpose and enables those involved to set each other an example in working to achieve it. Leadership is not the sole prerogative of one person, or a self-selecting group; leadership may change depending on circumstances, for example, a technical specialist may lead in a situation where patents are crucial. In a crisis companies often bring in 'company doctors' to administer harsh medicine; after the crisis a different form of leadership is needed. Leadership depends fundamentally on trust. The followers have to trust the motives, skill and judgement of the leader and the leader has to trust his or her followers to deliver their support. In Chapter 3, the issue of leadership is addressed in considerable detail.

4 *Distributing power* In a dictatorship all power is concentrated at the centre. Dictators do not trust anyone else to exercise power and their followers are obliged to pretend to trust them. Even today some organisations concentrate power at the centre, often because of family control or because of autocratic leadership. The concentration of power rarely succeeds beyond the medium term – even 'Napoleonic' leaders make mistakes, for example, Jean-Marie Messier, and all are mortal. In a complex modern business no single person can be all-knowing and omnipresent so that distributing power to allow results to be achieved is the only workable model.

The process of distributing power, accounting for its use and avoiding abuse, and surrendering it when appropriate, is at the heart of corporate governance. Power is not owned by any single individual (even a sole shareholder is beholden to other stakeholders) and its use needs to be carefully scrutinised. Power is of value only to advance interests; to be effective it usually requires co-operation. A recent book by Paul Seabright, *The Company of Strangers* (Princeton, 2004), shows the inner workings of co-operation, and the process of balancing calculation and reciprocity between parties in order to achieve it.

5 *Inclusiveness and communication* 'Openness' or 'transparency' is a principle shared by all governance codes and its effect on corporate performance can be very significant. Openness is the basis for building trust which is at the heart of any meaningful relationship. In the framework of corporate governance openness is expected in all relationships so that information is communicated freely unless there is a corporate (not personal) reason not to do so. This is the inverse of the working of the Official Secrets Act 1911 which has been abused by governments and civil servants for too long.

Openness is also reflected in the principle of 'inclusiveness' which was established by the Tomorrow's Company Report in 1995. This requires companies to identify all stakeholders in their affairs and to involve them in their working relationships. Inclusiveness widens the boundaries of any organisation, both improving its intelligence and understanding of the wider world, and making it more accountable to society.

6 *The pattern of accountability required* All governance codes require accountability and the grant of any authority needs to be balanced by accountability for its use. Accountability is more embedded in public life than in the private sector but repeated corporate scandals constantly remind the public of the failures in accountability which damage their pension plans. Shareholders have often been weak in holding company directors to account and auditors have not operated objectively. The new Companies Bill, the impact of the Higgs Report on the use of non-executive directors and the recommendations of the Smith

Report should all begin to improve accountability but only if there is a will to hold directors (and others in the governance system) to account and to be more rigorous in how they are rewarded.

7 *Maximising effectiveness* Corporate governance is directed at the achievement of an agreed purpose. Part of its role is to ensure that corporate activities are focused on ‘fitness for purpose’, both to enhance outcomes and to avoid waste. Maximising the effectiveness of corporate activities is a key dimension of corporate governance, involving action to ensure customer quality, minimising waste and building a sustainable reputation. Action to improve efficiency by increasing productivity and ensuring value for money supports this work. One growing criticism of the expansion of corporate governance is that it is ‘driving out enterprise’ and forcing companies to delist from the Stock Exchange. This concern is expressed in an article in the *Financial Times* by Richard Lapthorne, Chairman of Cable and Wireless plc (24 November 2004).

8 *Ensuring sustainability* Failures in corporate governance are often caused by actions to maximise short-term results. Enron’s collapse was partly caused by the need to report ever increasing quarterly profits. Corporate governance needs to focus on achieving results which will be sustainable into the future. To do so means that the pace of growth can be maintained and that resources match the company’s needs. The governance system needs also to ensure that incentives for performance support a sustainable pattern of growth, so that personal rewards do not mortgage the company’s future.

The governance system needs to optimise all eight dimensions consistently and needs to be proof against external and internal shocks. The management of risk is crucial in this regard, and is addressed in Chapter 3.

Governance and ethics

Ethics are often confused with morals but a clear distinction may be drawn between them. Morals are guidelines for distinguishing between conduct which is right or wrong. Conduct which is wrong is not moral. Ethics help to distinguish between actions which are not immoral, and both of which are ‘right’, but each of which may have different outcomes. Ethics enable us to deal with dilemmas where choices have to be made which have different repercussions for the parties involved. Avoiding and resolving dilemmas is a key function of corporate governance, not least in balancing the demands for short-term action against the protection of longer-term interests.

Interest in ethics has grown considerably in recent years, due in large measure to the practical issues faced by individuals and particularly by businesses, in an increasingly complex world. Issues such as corruption, child labour, global warming, and environmental sustainability are faced by many businesses; other businesses, for example, tobacco and alcohol, have issues around the danger of using their products. This growing interest in ethical issues led to the foundation of the Institute of Business Ethics (IBE) in 1986 in order ‘to emphasise the essentially ethical nature of wealth creation, to encourage the highest standards of behaviour by companies, to publicise the best ethical practices and to demonstrate that business ethics involve positive initiatives, as well as constraints’. The institute is a multi-faith

organisation with charitable status and wide support from major British companies. A key tenet of the IBE is that 'goodness advances with a mixture of altruism and self-interest'.

The link between corporate governance and ethics is also important as a means of broadening corporate governance from a focus on processes to concern about individual and group behaviours. Behaviours are the means of demonstrating values, which are part of a company's identity (see 1 above). Many companies have espoused a set of values for some years, yet few have learned how to embed those values in their culture. The mismatch between values and behaviours is a basic issue for corporate governance, and will be addressed in further detail in Chapter 4.

For many years the role of ethics in business has not been seen as productive of economic gain. 'Good' companies have been admired but there has been no proof that they are more sustainably profitable than average businesses. A systematic approach to this issue is provided by Good Corporation (see Chapter 8). Some fund managers, for example, Friends Provident, have established 'stewardship' funds to encourage investment in environmentally friendly businesses. Others avoid investment in arms manufactures, tobacco companies, alcoholic drinks businesses, and so on. Recent research by IBE and Gerard International, an ethics consultancy, has shown that there is a demonstrable link between the results of companies and their ethical behaviour (www.ibe.org.uk). Another initiative has been the establishment by the *Financial Times* of the FTSE 4 Good Index, which tracks the performance of selected 'ethical' companies and that of its general indices. A new FTSE/ISS Index was launched in December 2004 which will attempt global coverage of companies in respect of their corporate governance rating and their operating performance. No clear pattern has yet emerged but this new index may begin to draw one out.

Balance of power

In reviewing the outlines of corporate governance and seeking to demonstrate its importance, it will have been seen how crucial is the balance of power, both within and outside an organisation, to its governance. Power is essential to achieve results yet, like electricity and other forms of physical power, it is dangerous unless properly controlled. The dictum of Lord Acton – 'Power tends to corrupt and absolute power corrupts absolutely' – is as applicable to business as to politics. The harnessing of power to an agreed purpose is the key process in corporate governance which drives the achievement of results. The exercise of power needs to be controlled, both to avoid excesses and to ensure it drives only the achievement of the agreed purpose.

The balance of power in any multilateral relationship depends, basically, on the relative strength of the parties involved. Large companies have greater economic strength than the smaller companies with which they deal. Where this economic strength is so great that it threatens the balance of society, governments intervene to restrain it, using, for example, competition legislation. In the early twentieth century American governments acted to break up monopolistic power exerted by the major 'trusts' in steel, oil and transport. More recently American and EU administrations have been struggling to restrain the monopolistic activities of Microsoft. At the level of a corporation the balance of power requires to be controlled both between different stakeholders and between different functions and their leaders. Often the balancing act needs to work across both dimensions simultaneously and may involve external agents, for example regulators.

The balance of power between stakeholders is conditioned both by economic strength and by law. Economic strength is most evident in the supplier to customer relationship, but may be seen in employee relations where trade unions are strong or very weak. At the margin, even economic strength may be constrained by the law. Legal considerations influence the balance of power mainly through contract, for example, for supply, of employment, and so on, or through statute, for example, the protection of employees under the Safety, Health and Welfare Act 1989. Power is also balanced through internal regulations, for example, only non-executive directors may sit on the Audit Committee, cheques require two signatures, and so on. This network of controls is designed to limit the discretion of any one person, or of any specific group of people, who may wish to exploit the rest of the stakeholders. In Chapter 2 we shall see how corporate governance works internally to diffuse power; in Chapter 4 we shall see its wider application.

Regulation

There are cycles in corporate governance as in many aspects of society. In an ideal world people trust each other and work to maintain trust. This process requires a balance of 'give and take' so that relationships are strong and people can find their natural role in society. If individuals are too subordinated to society it is possible for that society to be harnessed to the ambitions of manipulative leaders – leading to dictatorship and disaster. If individualism becomes too strong society breaks down and the resulting situation resembles the anarchy of the Wild West. In order to avoid extremes and allow the daily pattern of transactions needed to sustain society, a third party is needed. This is analogous to the referee in a football match and requires the same independence and knowledge of human nature. This third party is a regulator.

In the past, regulation was exercised by the dominant party in society, usually a monarch supported by a priestly clan. The vertical structure of society has now largely disappeared in modern democracies and different groups manoeuvre to secure and sustain advantage, usually by negotiation, sometimes by force as with strikes. As society has become more complex it has become more difficult to maintain the working harmony necessary to sustain it. Law has fulfilled that role, both by statute and common law. The speed of change in society has made it increasingly difficult for statute to match reality, and common law, being based on precedent, is increasingly struggling to provide up-to-date judgements. As a result there is increasing use of non-judicial processes, for example, arbitration and regulation in a number of forms.

Many forms of regulation have legal backing, either because they were created by statute, for example, regulators for privatised utilities, or because they are subject to a royal charter. In general the UK has fewer statutory regulators than most European countries and a preference for self-regulation persists. The Take-over Code and the Code of Advertising Practice have established a British model of regulation by code which has proved to be fairly resilient. Sir Adrian Cadbury sees the balance of advantage between statutory and non-statutory regulation as follows:

The advantages of non-statutory systems … are normally their speed of judgement, their relatively low cost and their ability to deal with new issues as they arise, none of which are attributes of statutory systems. A further benefit of the voluntary approach is that it can promote compliance,

not just with the letter of the law, but with the intention behind it, thus setting a higher standard. Statutory systems, on the other hand, have the advantages of relative certainty, enforceability and therefore of fairness, since their rules apply equally to all.

(*Corporate Governance and Chairmanship*, Oxford University Press, 2002)

During the 'Thatcher years' there was a clear move towards deregulation, with many old statutes and regulations repealed or set aside. The increase of terrorist activity and recent corporate scandals in the USA have started a move back towards greater regulation, with a diminution of trust and greater reliance on clear rules. Where governance is weak or unreliable, trust is diminished and regulation becomes more powerful.