

Creating value through governance –  
towards a new accountability:  
a consultation

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ACCA (the Association of Chartered Certified Accountants) is the global body for professional accountants. We aim to offer business-relevant, first-choice qualifications to people of application, ability and ambition around the world who seek a rewarding career in accountancy, finance and management.

Founded in 1904, ACCA has consistently held unique core values: opportunity, diversity, innovation, integrity and accountability. We believe that accountants bring value to economies in all stages of development. We aim to develop capacity in the profession and encourage the adoption of consistent global standards. Our values are aligned to the needs of employers in all sectors and we ensure that, through our qualifications, we prepare accountants for business. We work to open up the profession to people of all backgrounds and remove artificial barriers to entry, ensuring that our qualifications and their delivery meet the diverse needs of trainee professionals and their employers.

We support our 162,000 members and 428,000 students in 173 countries, helping them to develop successful careers in accounting and business, with the skills needed by employers. We work through a network of over 89 offices and centres and more than 8,500 Approved Employers worldwide, who provide high standards of employee learning and development.

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The Forum investigates the drivers of business and financial behaviour, exploring ways that risk can be managed to ensure that sustainable and long-term business objectives are not sacrificed for short-term financial performance. The Forum focuses, in particular, on the 'for-profit' private sector and those larger corporations and financial services institutions that have a significant impact on wider society, whether individually or collectively. The Forum's goal is to influence policymakers and regulators to create an appropriate environment for responsible and profitable business.

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This consultation paper forms part of ACCA's investigation to examine whether existing governance and risk management frameworks are 'fit for purpose'. It asks whether corporate governance in practice, is helping business to create value or whether something has gone wrong.

### How to respond

Please email your responses to [paul.moxey@accaglobal.com](mailto:paul.moxey@accaglobal.com) with 'Creating value through governance' in the subject line, by 31 August 2014.

## Foreword

Corporate governance is vital to societies that depend on business to create economic wellbeing. Achieving good corporate governance is complex: it involves economics, politics and fundamental aspects of human nature as well as business and markets. Partly for the sake of brevity and because the term corporate governance is not just relevant to companies, the word governance is generally used in this paper. Ultimately, governance is about how to make good decisions. As providers of financial information to support better decision making, accountants play a key role in governance.

Capital markets, and attitudes to them, have changed radically in the 20 years since the present direction of governance was set. ACCA is now questioning whether existing corporate governance and risk-management frameworks remain fit for purpose in light of current financial and economic conditions and our experience of how the frameworks have operated in practice over the past two decades.

Although corporate governance has grown from sound roots, it has become burdened with excessive rules and too much complexity.

Events since 2007 have demonstrated that certain banks and other major corporations which were thought to have excellent standards of governance and risk management turned out to have neither. Present approaches have not ensured that companies focus on, and succeed in, creating long term sustainable value.

Governance and risk management are complex matters that go to the heart of thinking about business, finance and economics. The consultation paper now being published by ACCA does not claim to include all the right questions, let alone all the right answers. The hope is rather that this inquiry will lead to a better understanding of the problems and also to some solutions.

ACCA welcomes responses to these questions, general comments about the issues raised in the paper, as well as responses to the other specific questions asked.

Following the consultation period ACCA intends to publish an updated paper on the subject of governance and value creation, reflecting the responses received and discussions held.



# Creating value through governance – towards a new accountability: a consultation

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The word governance comes from the ancient Greek verb *kyberan* meaning to pilot or to steer.

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'We are shocked and surprised that, even after the ship has run aground, so many of those who were on the bridge still seem so keen to congratulate themselves on their collective navigational skills.'

UK PARLIAMENTARY COMMISSION ON BANKING STANDARDS 2013

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'Any measure used as an instrument of policy will lose its efficacy as a measure because it will be gamed.'

RESTATEMENT OF GOODHART'S LAW

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'Whether we live in a poor or an adequately financed society depends on the effectiveness of our system of governance.'

ROBERT MONKS

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## Executive summary

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This paper argues that corporate governance is about creating value and that governance codes should be evaluated on how well they facilitate the creation of value. It sets out how a framework of 'performing, informing and holding to account' can work.

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The paper presents the issues in detail, offers suggestions for change and asks many questions. For accessibility this summary outlines the main arguments together with eight questions put forward that are considered fundamental to the resolution of the problems identified.

Chapter 1 examines the conflicting interests of the company and its shareholders and other stakeholders, concluding that such conflicts are inherent in the system. The chapter advances seven hypotheses.

1. There is confusion as to what governance is for and what can be expected from good governance.
2. Regulation of governance and risk management has not helped to create a healthy corporate culture or effective boards.
3. Governments, companies and shareholders have used unreliable measures to manage performance.
4. Boards often have less control over companies than is generally recognised.
5. Many people mistakenly view governance as merely structure and process, whereas it should be seen as a complete system with purpose, inputs and outputs and one that involves people.
6. Boards and executives of many large listed companies have become unaccountable.
7. Governments and regulators have pursued a simplistic incremental approach to reform and have failed to consider the broader context of the whole system. Attempts to deal with symptoms have had unintended consequences; root causes of problems remain unaddressed.

### THE PURPOSE OF GOVERNANCE

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Chapter 2 discusses the recent financial crisis and the lessons we need to learn from it. The chapter finds many problems. Fault lines in the relationships between executives, independent directors and shareholders were exposed. People were not held accountable. And arguably some of the systems we now have make it easier to avoid accountability. The paper suggests a simplified approach to governance that applies the original concept to today's world in order to improve decisions and behaviours, to raise performance and to bring greater and sustainable prosperity.

**Has corporate governance become too focussed on form and compliance at the expense of the quality and integrity of decision making? (Q1.4)**

**Should creating sustainable value be the overarching purpose of governance? If not can you suggest a better purpose? (Q3.1)**

## ENSURING ACCOUNTABILITY

Companies and those in them need to perform in the interests of shareholders and wider society, they need to inform these stakeholders about how they are performing, and shareholders and others need to be able to hold the performers to account. The paper proposes, in Chapter 3, a new accountability framework to help firms to perform by informing, and being held to account by, their stakeholders. Each of the three framework elements is discussed in Chapters 4, 5 and 6. Chapter 7 considers if all is well within the context of the framework.

**Do you find the framework likely to help to improve corporate governance and help focus companies on creating sustainable value? What could make it better? (Q3.4)**

**Which of the three areas, performing, informing and holding to account, is most problematic? Are there any simple fixes? (Q7.4)**

The paper suggests that accountability should be extended to the relationship between professional fund managers and the people who place their money with them. As these providers of capital are often also employees in companies there could be a virtuous circle of accountability linking employees and savers to professional fund managers to boards, to executives and back to employees and savers.

**Which of these relationships is most problematic?**

**Between:**

**(a) executive management and boards**

**(b) boards and institutional shareholders**

**(c) institutional shareholders and savers.**

**Are there any simple fixes? (Q7.7)**

## GROWTH, VALUE AND PROFIT

Chapter 8 discusses the causes and measures of economic growth and the nature of value, profit and income. It suggests the need to distinguish between profit that contributes to growing economic and societal wealth and the income which essentially transfers or captures value that has already been created. Some companies and sectors contribute more to value creation than others but few are at the extremes of only creating or only capturing value. Understanding this distinction could enable policy makers, investors and employees to encourage companies to do more creating (and less capturing) value, which should benefit everyone.

**Should economic and other policies to promote growth attempt to encourage companies to create value rather than capture value that others have created? How could regulators, investors and employees do this? (Q8.3)**

Figure 1: The aim of governance is to create value sustainably

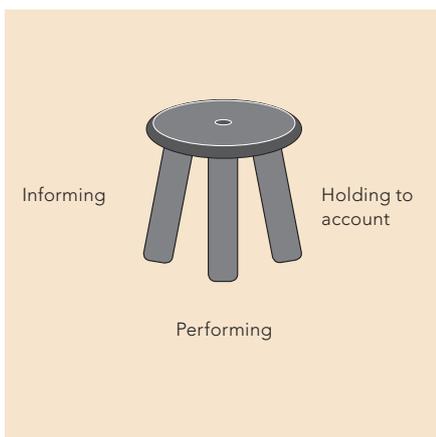
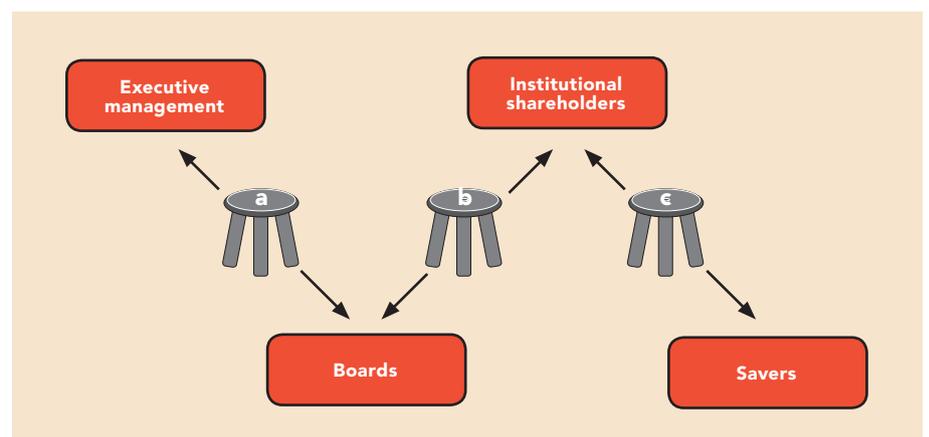


Figure 2: The three interfaces of the framework



## RESTORING TRUST

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Trust is important to any company and any market economy. The industrial and commercial expansion over the last 300 years could not have happened in the absence of trust. Yet trust in big business, particularly in banks, has suffered profound shocks recently. Chapter 9 considers the importance of companies doing 'the right thing' and suggests that companies have a responsibility to society as well as to shareholders. It discusses the importance of values and suggests that boards should ensure they understand that their companies have the right culture.

**Is lack of trust a problem? What should policy makers, businesses, and investors do to restore trust? (Q9.1)**

## REGULATION AND ITS CONSEQUENCES

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Chapter 10 recognises that regulation and compliance play important roles but that regulation often has unintended consequences. The paper finds that in financial services, a focus on compliance with the letter rather than spirit of rules has allowed people to avoid personal responsibility or fail to apply moral judgement.

**Is it a major problem that much regulation, particularly in financial services, has allowed people to avoid personal responsibility or to fail to apply moral judgement? What can be done? (Q10.2)**

## RECOMMENDATIONS

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The following five provisional recommendations are proposed as a means of introducing the new framework and making it effective through a voluntary approach.

1. There should be general acceptance that the purpose of governance is to create value sustainably.
2. Governance codes and policies should be assessed against the accountability framework at each of the interfaces between management, boards, institutional shareholders and providers of funds.
3. Companies and investors should develop and report using more suitable measures of performance and value creation.
  - A) Performance should be considered in terms of both value created by the company and the contribution of boards, management and staff.
  - B) Corporate reporting should additionally include:
    - i. probabilistic information on confidence and uncertainty
    - ii. information on the ethical health and values of the organisation, including the assessment and assurance system
    - iii. information to convey how, and by how much, companies create sustainable value and contribute to public good
    - iv. governance reports should be based on the principle of 'apply and explain' rather than 'comply or explain'
4. Policymakers and institutional shareholders should:
  - address the asymmetry in the risk : reward ratio between management, shareholders and other stakeholders. Ways should be found to enfranchise savers in order that they can hold institutional investors to account.
  - examine ways to give investors incentives to favour companies that create long-term value for themselves and for society against those that rely on short-term economic rent for their profits.

## 1. Introduction

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This paper sets out how sound corporate governance, and within it risk management, can contribute to creating value for society and considers why reform is needed.

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It is written for those with an interest in the financial system, in the contribution of enterprise to economies and in what leads to market dysfunction – all of us. It is intended to generate debate among those who make or influence the rules on corporate governance, accountants, senior managers, board members, investors, academics, regulators and supervisors, risk and control specialists, company secretaries, and those in the media and politicians.

The *Cadbury Report* (1992) defines corporate governance as ‘the system by which companies are directed and controlled’. Modern corporate governance is often considered to have originated with the innovative, voluntary approach outlined in the code of best practice that formed part of the report and that is still commonly called the Cadbury Code.

Subsequently copied around the world, the code has also been extended, but many enhancements have often had the effect of reducing governance to a box-ticking compliance exercise.

Achieving good corporate governance is not just about business or financial markets. It involves economics, politics and fundamental aspects of human nature and decision-making. Gaining a better understanding of the issues should lead to improved behaviour and decisions and, thereby, to better performance and greater prosperity. Accountants play a key role in corporate governance and decision-making as providers of sound information to business and to society, particularly on financial matters.

The ACCA paper *Corporate Governance and Wealth Creation* (Moxey 2004) asserts that getting governance right is important to

prosperity, but finds little academic evidence that good governance either (a) prevents corporate failure or (b) contributes to improved organisational effectiveness. At the time the research was carried out (post Enron, WorldCom and Parmalat), there was no convincing evidence to support the major reforms in the area of corporate governance, particularly regarding the role of independent non-executive directors.

This paper reveals a lack of consensus over what comprises good governance and what it is for. At the time it was written, there was conflicting evidence about the link between governance and performance.

A decade of further research provides equally convincing cases which can be used to suggest that good governance (a) improves and (b) harms corporate performance. As well as a lack of measures of good governance there is also a dearth of reliable measures of value creation.

Further corporate failures have led to reviews by governments and regulators and to a flurry of regulatory activity. Much has changed. Have things improved?

Twenty-one years after the *Cadbury Report*, governance should have come of age. It should have thrown off its growing pains of babyhood and childhood and ceased to be the awkward teenager. What sort of adult has it become? Has it helped companies to create value sustainably? In the UK, the early signs were promising. The Cadbury Code was introduced after a number of scandals and corporate failures: Robert Maxwell's thefts from the Mirror Group pension fund, and the collapses of Barings, BCCI and Polly Peck. The

### BOX 1.1: THE CONTINUING CRISIS

The credit crunch developed into a financial and economic crisis afflicting much of the developed world. As governments stepped in to save what would otherwise have been bust banks, the economies of Iceland, Greece and Cyprus needed external financial support. Today, Spain, Portugal and Italy still look vulnerable. There is little room for complacency in the UK, France, Japan and even the US, where some cities, states and counties are bankrupt and the national debt now exceeds \$17 trillion. Many banks remain constrained by balance sheet size and by a lack of capital, affecting their ability to increase lending. Rumours continue to circulate of banks needing further financial support to stay in business, yet few governments can afford to repeat the bailouts of 2008 and 2009.

demise of Marconi in 2001 was another governance failure, a result of a failed strategy that was clearly risky and driven by what the board perceived as an imperative from shareholders to 'be decisive and do something' with the cash pile built up by previous managers.

While the collapses in the US of Enron in 2001 and WorldCom in 2002 were followed by accounting scandals at the Dutch company Ahold in 2003 and the Italian Parmalat in 2004, many governance specialists believed that the Combined Code on Corporate Governance had immunised UK-listed companies from such problems.

By 2005 the US, the UK, the European Union (EU) and other countries had adopted governance reforms and many thought the problems thrown up by such corporate failures were solved.

Then came what started out as a credit crunch and became a worldwide financial and economic crisis. Several once-great banks failed and others became 'zombie' banks, on life-support from taxpayers. Although the massive governance and risk-management failures are now clear, these banks were considered at the time to be well governed and to have good risk management. While each failed for different reasons, a common factor was the inability of those charged with running them to consider the possibility of what followed. The problems continue to surface: weak internal controls; risky trading; money laundering; interest-rate rigging; mis-selling; cover-ups; and rogue trading.

The incremental approach to governance has suffered from path dependence. In 1992 in the UK, insurance companies and pension funds held 53% of UK shares and could exert considerable influence on boards. The approach to governance should have changed when the nature of ownership changed. Insurance company and pension fund ownership in the UK had fallen to 13.7% by 2010. In the same period shareholdings of individuals declined further, with the slack being taken up by non-UK investors and what the Office for National Statistics (ONS) calls 'other financial institutions' (ONS 2012). While the ability of UK shareholders to hold UK companies to account was declining, listed companies and boards changed, becoming more global and driven by financialisation and short-term targets (Kay 2012).

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**To date, governance reforms have focused on structures and processes. They have not addressed culture or the incentives that drive behaviour.**

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It is now clear that having the right culture<sup>1</sup> is essential for corporate success. Governance codes, risk-management procedures and regulation have proved ineffective in promoting the right behaviour or in creating value. Even if the woeful performance of UK and US shares so far this century cannot be blamed on governance and risk management, it is difficult to say how these factors have contributed to a spirit of entrepreneurialism or business dynamism. The result seems to be regulatory environments in which individuals often are not held to account, either individually or collectively, when a company fails. Some consider that the present approach to governance and to shareholder value has brought about corporate structures that pay no real regard to standards of business ethics and morality.

It is appropriate to take stock.

1. What has been learned from what went and continues to go wrong?
2. Have the causes been addressed, or are only the symptoms being worked on?
3. Have the right lessons been learned, or are these yet to be learned?

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1. ACCA is researching corporate culture and its impact on behaviour and performance with backing from the Economic and Social Research Council (ESRC). The report is due in June 2014.

**BOX 1.2: THE DIFFERING INTERESTS OF SHAREHOLDERS, THE COMPANY AND OTHER STAKEHOLDERS**

Section 172 of the UK Companies Act 2006 clarifies the obligations of directors:

‘A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (among other matters) to:

- a. the likely consequences of any decision in the long term
- b. the interests of the company’s employees
- c. the need to foster the company’s business relationships with suppliers, customers and others
- d. the impact of the company’s operations on the community and the environment
- e. the desirability of the company maintaining a reputation for high standards of business conduct, and
- f. the need to act fairly as between members of the company.’

It was believed at the time that the Act would ensure ‘enlightened’ shareholder value and value would be maximised where boards had regard to the ethical and societal factors above. The Act has not had the intended effect. While the matters that a director should consider are clear, the Act does not help in situations where the interests of shareholders are not aligned with those of the company itself or its other stakeholders.

The distinction between shareholder and company interest is fundamental to how boards act. The interests of shareholders trump those of the company and of other stakeholders. Board directors of many publicly listed companies equate their role of maximising shareholder value with raising the short-term share price. The interests of employees and creditors, of the community and the environment, and the desirability of high standards of conduct risk being ignored if they do not raise the short-term share price. Does this encourage companies and their directors to be sociopathic?

The example below develops the reference by Colin Mayer (2013) to the differing interests of shareholders and others. Suppose Adriana and Paul are directors of AP PLC. The company has 1,000 shareholders, each owning a £1 share; £1,000 of credit taken from suppliers; and total assets of £2,000. The company is trading successfully and has a good product. A strategic opportunity requiring relocation arises where there is a 50% chance of doubling assets and a 50% chance of losing everything. What would Adrian and Paul do? Table 1.1 illustrates the situation.

Table 1.1: AP PLC

	Before	After	
		Failure	Success
Assets	£2,000	£0	£4,000
Borrowings	£1,000	£0	£1,000
Shareholder value	£1,000	£0	£3,000

As a legally separate person, the company is unlikely to think the risk worth taking. Why risk doubling in size if there is an equal chance of being killed?

- The employees see little point in taking the risk. They risk relocation or losing their jobs and have little to gain. There may be more work and more pay but also change, which can be uncomfortable.
- Customers have little to gain but would have to find another reliable supplier if the gamble fails.
- Suppliers also have nothing to gain and could lose all they are owed.
- The local community loses either way – relocation if the opportunity succeeds, unemployment if it fails.

The individual financial positions of Adriana and Paul may determine their incentive to risk failure, particularly if there is the possibility of a large bonus if the opportunity succeeds. Their duty is clear, though ... to act in the interests of shareholders.

What are shareholder interests? If the opportunity succeeds, the company assets are doubled but the creditors will stay the same, so each share is worth £3. They have a 50/50 chance of turning £1 into £3 and a 50/50 chance of losing everything. The expected outcome is £1.50, so shareholders will vote to take the risk even if it is against other stakeholders’ interests.

This hypothetical, but plausible example illustrates the inherent conflicts. No obvious solution exists if the law puts the interests of shareholders above all others.

In exploring corporate governance and managing risk in a wide context, there is much cause for concern. The following hypotheses are advanced.

**1. There is confusion as to what governance is for and what can be expected from good governance.**

**2. Regulation of governance and risk management has not helped to create a healthy corporate culture or effective boards.**

As regulation of governance and risk management has increased, corporate 'cultural failures' do not appear to have diminished and may have increased. An unhealthy culture was at the heart of much of what went wrong. A change in corporate and political values and culture, with priority given to ethics, culture and leadership, is necessary to recreate genuine prosperity.

**3. Governments, companies and shareholders have used unreliable measures to manage performance.**

In short, no one knows what 'good' performance is.

- Economists and politicians disagree on the simple yet fundamental question of how to create economic wealth and prosperity; and whether or not governments or their citizens should borrow their way out of a debt crisis.<sup>2</sup>

- Financial statements do not convey whether a company is in a better position to create future value at one balance sheet date than at an earlier date. 'Profit' is an inadequate, easily gamed, measure and investors lack suitable alternative metrics for determining the true value of companies.

The size and complexity of financial statements is undeniably a major issue; arguably the financial statements of banks need to be large because banks are complex institutions. Kevin Mellyn explains in his book *Broken Markets* (2012) that banks have two essential functions: to transmit money; and to bring together savers and borrowers. Reporting on these should take about 50 pages to explain. What takes up the other 450 is the complexity introduced by the introduction of 'silos' and of 'products'. If banks ARE that complex, are they manageable? Should they be broken up into units that can be more easily managed and, thereby, explained?

**4. Boards have less control over companies than is generally recognised.**

One of the more surprising findings from the crisis is the ineffectiveness of the boards of failed banks in ensuring that their executives steered a safer course. It is still not clear whether those boards and their executives allowed staff to take excessive risks knowingly or unknowingly. A probable explanation is that human beings suffer from various cognitive biases that limit their decision-making ability. An overestimated ability to predict the future and to influence events leads to a mistaken confidence in the ability to identify and manage risk; to a blind faith that strategies will succeed; and to a reluctance to consider contrary viewpoints.

**5. Many people mistakenly view governance as merely structure and process, whereas it should be seen as a complete system with purpose, inputs and outputs and one that involves people.**

The complex system is not operated by machines but by people – managers, executives, non-executive directors, investors and shareholders, regulators and professional advisers. Ultimately, it is the incentives and interests of the different groups that drive behaviour more than procedures or rules.

**6. Boards and executives of large listed companies have become unaccountable.**

Shareholders of large companies are often widely dispersed. While, as a group, they have an incentive to hold companies and their boards to account, single shareholders see little benefit in doing so. In a *Financial Times* report (Whitehead 2013a), Robert Hodgkinson, an executive director at the Institute of Chartered Accountants in England and Wales, is quoted as saying that too much onus is placed on shareholders to act as a 'safety valve for society's concerns', for example over remuneration. He said 'they can't be the primary means of making sure things work'. The presumption that shareholder engagement will necessarily improve standards of governance should be challenged. Ferreira et al. (2013) find that banks in which managers were more insulated from shareholders in 2003 were less likely to be bailed out in 2008/9.

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2. As is explained in Chapter 8, real economic growth can only come from three sources: (1) the use of new resources, particularly energy and raw materials; (2) more efficient use of those resources; and (3) growth in population (which arguably is a subset of source 1 and does not contribute to per capita growth. Other activity may increase measured GDP, but is not real growth.

**7. Governments and regulators have pursued a simplistic incremental approach to reform and have failed to consider the broader context of the whole system.**

Attempts to deal with symptoms have had unintended consequences; root causes of problems remain unaddressed. The Basel regulations on capital adequacy have been widely criticised as encouraging banks to create and hold risks in the shadow banking sector in order to avoid holding further capital. Bank balance sheets were allowed to balloon and mis-state risks. For example, loans to Organisation for Economic Cooperation and Development (OECD) countries, including Greece, were treated as having the same risk characteristics as cash, a matter of some significance to the people of Cyprus. Regulation and

standard-setting suffer from a lack of joined-up thinking. International Financial Reporting Standards, which might make sense in isolation, are blamed for encouraging pro-cyclicality when combined with bank regulation.

There is an important connection between governance and economics which is generally overlooked. Politicians argue about how to get economies growing again and banks are under fire for not lending. It is surprising that the debate about growth rarely touches governance.

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**Governance is about creating value, sustainably, over time, and delivering growth through less dramatic economic cycles – softer booms and slowdowns that do not always result in busts.**

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A fundamental rethink is required about how corporate governance and risk management contribute to creating value. In losing its real purpose, governance has too often become about no more than compliance with structures and practices. Although this keeps people busy, it is of little use if business is to resume its trusted place as the engine of economic prosperity.

This paper suggests a new approach to corporate governance, based on three complementary components: performing, informing and holding to account.

## CONSULTATION QUESTIONS

- Q1.1 Do you agree with the seven hypotheses? If not, in what way(s) do you disagree?
- Q1.2 Should there be more research into links between governance practice and organisational performance?
- Q1.3 Are you aware of convincing evidence about whether there is, or is NOT, a causal link between good governance and better performance?
- Q1.4 Has corporate governance become too focussed on form and compliance at the expense of the quality and integrity of decision making?**
- Q1.5 Is there a 'right' amount of gearing or leverage and a 'right' speed of money, and debt, creation?
- Q1.6 Is the UK an appropriate case study? Do other, better governance examples exist elsewhere in the world? Does the primacy of the shareholder in UK company law make it uniquely difficult to include proper consideration of other stakeholders in the UK, compared with other countries?
- Q1.7 How can the conflict of interest between shareholders and the company and other stakeholders best be addressed?
- Q1.8 Is risk management part of corporate governance or is it separate?

## 2. Lessons from the recent financial crisis

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### Company failure must point to governance failure.

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In 2008 ACCA published *Corporate Governance and the Credit Crunch* (Moxey and Berendt 2008). Using the evidence available at the time, it concluded that the credit crunch then taking place, while having many causes, was mainly a failure of governance facilitated by failures in regulation and supervision. Although they had been ticking all the right boxes, failed banks had ineffective governance and risk management. That paper was the first to take a holistic systems view of events and to explain things in layman's terms. At the time, many institutions were slow to recognise that poor governance was at the heart of the problem.

That paper, and the follow-up paper, *Risk and Reward: Tempering the Pursuit of Profit* (Davies et al. 2010), discussed the problems caused by remuneration systems. There is no need to repeat this here and it is clear that lessons are being learned and remuneration systems are undergoing change. The key lesson about remuneration is the need to avoid giving people the opportunity to become rich at great risk to others but no risk to themselves.

There are other lessons to learn that are less obvious and they concern the ability of boards.

In December 2010 the FSA concluded its first inquiry into the failure of the Royal Bank of Scotland (RBS),<sup>3</sup> saying it found no evidence of governance failure on the part of the board. This surprised many. Company failure must point to governance failure unless it was clearly not to do with the board.

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3. The 298-page report is no longer available on the FSA website but its conclusion, that no enforcement action was warranted, became the subject of a House of Commons Treasury Committee Report (2012).

There are few, if any, examples of company failure for which the board was not at least partly responsible. It is hard to believe that the board members were mere victims of circumstance in the RBS failure.

In the summer of 2012, the UK Parliamentary Treasury Committee reported on its inquiry into LIBOR rigging.<sup>4</sup> During its evidence gathering, the Committee heard that the official conducting an FSA review had assessed the governance of Barclays Bank as 'best in class'. It also heard that, during the same period, others at the FSA were concerned about the culture, including the tone at the top, of Barclays. The report stated that Lord Turner, the FSA chairman, wrote to the then Barclays chairman about what the FSA saw as behaviour at 'the aggressive end of interpretation of the relevant rules and regulations' and about the bank's 'tendency to seek advantage from complex structures or favourable regulatory interpretations.'

This illustrates that there is more to governance than merely complying with the provisions of corporate governance codes. Whereas most large listed companies fully comply with the letter of the relevant Code, it is harder to tell if they follow the spirit. While culture at the top of an organisation and the tone set by the board are crucial to whether or not there is good governance, it is hard for outsiders to judge and there is little evidence of thorough assessments of the quality of governance. Few company governance reports convey much about reality and have little

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4. See Parliament.uk (2012). LIBOR is the London Interbank Borrowing Rate, a benchmark for short-term interest rates. LIBOR is set by the British Bankers' Association, following input by some 20 international banks.

beyond the well-crafted text assuring us that everything is just fine.

The LIBOR inquiry also illustrates another problem with accountability. Our present governance system, with separate chairman and chief executive and numerous independent non-executive directors, is a logical response to addressing the problem of too much power in the hands of one individual. There is, however, an unintended consequence: it seems to make it difficult to hold anyone responsible when things do go wrong. Certainly no one has been held properly to account in any of the failing organisations.

Neither is regulation merely about compliance. The UK Regulator is changing its approach to allow supervisors to exercise judgement in deciding when the spirit of a code or regulation is being followed. It may be harder to get a board to respond appropriately, the Treasury Select Committee chair interpreted Lord Turner's letter to Barclays as a reading of the Riot Act.<sup>5</sup>

Nonetheless, the Committee's report makes it clear that neither the CEO nor the chairman of Barclays seemed to get the message, despite the fact that the Barclays Board Minutes recorded the seriousness of the matter thus: 'Resolving this was critical to the future of the Group.' The Committee report says that judgement-led regulation will 'require the regulator to be resolutely clear about its concerns to senior figures in systemically important firms'.

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5. The Riot Act was introduced in Great Britain in 1714 following a period of civil disturbances. The Act created a mechanism for a proclamation, following precise wording, to be read out to a gathering. If the group of people failed to disperse within one hour of the proclamation, the Act provided that the authorities could use force to disperse them.

Governance tick boxes, regulation and risk-management systems all took no account of human behaviour – people would risk bankrupting their institutions to earn a bonus – or of the effect of cognitive biases on individuals' decision-making ability.

Regulators and supervisors ended up in impossible positions – caught between governments that wanted a light touch and those they were trying to supervise who could run rings around them. These issues are discussed in detail in *Risk and Reward: Tempering the Pursuit of Profit* (Davies et al. 2010).

Since then more information has come to light that reveals the extent of cultural problems in a number of institutions. The public's capacity to be shocked has become dulled by news of widespread interest-rate fixing, money-laundering, mis-selling of payment protection policies and interest rate hedging products, and rogue trading. Bank supervisors misunderstood what governance was about. They raised issues, which were then largely ignored by boards, but supervisors failed to realise that problems of culture were part of good governance.

The board of at least one institution also seemed unaware of the role of a board in ensuring a good culture in the business. Sir Ronald Garrick was a non-executive director of Bank of Scotland from March 2000, who joined the board of the UK bank HBOS when it was formed and served as a deputy chairman and a senior independent

director. In written evidence to the UK Parliamentary Commission on Banking Standards, he stated: 'I have no doubt that the HBOS Board was by far and away the best board I ever sat on. My recollection of the culture and characteristics of the board was one of openness, transparency, high intellect, integrity, good working relationships between the chairman and chief executive, and a suitable diversity of backgrounds, mix of experience and expertise to maximise effectiveness.'

'The papers which came to board meetings were consistently of high quality. If with the benefit of hindsight I was asked if I wanted to sit on this board again I would be saying yes.'

'Non-executives had excellent opportunities to challenge executives at the full-day sessions to discuss budgets and strategy...the diversity of backgrounds and the mix of experience was extensive.' 'Non-executives had access to the company secretary and group counsel for his advice. In addition, in the furtherance of their duties, non-executives were entitled to seek independent professional advice at the company's expense'.

On budget reviews he said: 'Liquidity was always on the agenda at annual budget reviews and at the Treasury Risk and Capital Committee (RCC) meetings, and I know asset quality and risk-management processes were discussed at the Corporate RCC on a regular basis as part of a review of stressed or impaired assets'; and 'The best opportunity for challenging divisions would be at the budget review sessions and at RCC meetings'.

His positive opinion was shared by other board members, including Sir James Crosby, former CEO of HBOS, and former deputy chair of the FSA, who claimed that the board possessed adequate experience among its executives and non-executives to challenge the Group's corporate banking activities. Andy Hornby, who succeeded Sir James as CEO, never considered that the non-executive directors 'felt restrained from challenging the executive team in whatever way was most appropriate'.

The Commission report concluded that:

**'Judging by the comments of some former Board members, membership of the Board of HBOS appears to have been a positive experience for many participants. We are shocked and surprised that, even after the ship has run aground, so many of those who were on the bridge still seem so keen to congratulate themselves on their collective navigational skills'.**

Was this board unique in believing it was doing a good job and was in control even before events proved it wrong? It seems unlikely. Just as most drivers believe their skills behind the wheel are better than average, most managers estimate their management abilities too highly. This natural human bias combines with a tendency to ignore evidence that does not accord with existing views. While many boards do a good job, directors should be more aware of and open about their limitations.

The Commission's report shows a need to take another look at what was thought to be good governance and risk management. The proposed Performance and Accountability Framework, set out in Chapter 3, will enable people to assess the efficacy of their governance practices.

### **BOX 2.1: THE PURPOSE OF A CORPORATION**

It is implicit in this paper that the purpose of corporate governance is to ensure the company achieves its purpose. Normally this purpose can be summarised as to create long term sustainable value. This purpose seems appropriate for most corporations. It should also be appropriate for many public sector organisations, the difference, of course, is that values will be measured differently.

## **CONSULTATION QUESTIONS**

- Q2.1 Have current governance systems made it harder to hold people to account for company failure?
- Q2.2 Are there any examples of corporate failure where the board was not in any way responsible for the failure?
- Q2.3 Have the problems of remuneration that encouraged people to take excessive risk been properly addressed?
- Q2.4 Is it a governance failure if a board makes a bad business decision that severely damages the company but complies with governance requirements such as having a separate CEO/chair and sufficient independent NEDS?

### 3. A new accountability framework for governance

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This paper proposes a new, overarching purpose for corporate governance – to create value sustainably.

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#### THE REAL PURPOSE OF CORPORATE GOVERNANCE

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In 2008, ACCA published its *Corporate Governance and Risk Management Agenda* (Chambers and Aitken-Davies 2008), containing 10 principles for governance and managing risk applicable to any organisation, large or small, in any sector. ACCA's paper *Corporate Governance and the Credit Crunch* (Moxey and Berendt 2008) is structured around a discussion of these principles in the context of what caused the 2008 credit crunch. It was always intended that these principles be reviewed and revised if circumstances changed. Circumstances have changed.

The first principle of ACCA's 2008 *Agenda* is that 'boards, shareholders and stakeholders should share a common understanding of the purpose and scope of corporate governance and how performance is measured.'

The *Agenda* says that corporate governance has three complementary purposes.

- **Performing**  
The board ensures that a company creates value: as representatives of the enterprise's owners, board members protect resources, allocating and directing them to make sustained and sustainable progress towards the enterprise's defined purpose.

- **Accounting**  
Those governing and managing an enterprise must account appropriately to its stakeholders for their performance in relation to the defined purpose.
- **Holding to account**  
Shareholders and, where appropriate, other stakeholders, can and do hold boards to account in relation to that performance.

The debate on governance has concentrated on structure at the expense of value creation. This is unfortunate and a new approach is required which puts creating value at the centre of governance. IFAC recognised this in its 2009 *Key Principles of Evaluating and Improving Governance in Organisations* (IFAC 2009). Its first principle is 'the creation and optimisation of sustainable stakeholder value should be the objective of governance'.

The South African King III Code, issued in 2009 and updated in 2012, says that 'good governance is essentially about effective leadership. Such leadership is characterised by the ethical value of responsibility, accountability, fairness and transparency. Responsible leaders direct the company strategies and operations with a view to achieving sustainable economic, social and environmental performance'. Governance must be ensuring that this is done.

This paper supports the IFAC view of governance, and restates it slightly, to assert that the overarching purpose for corporate governance is to create value sustainably. The need to measure value in social and environmental, as well as financial, terms needs to be accepted by everyone with an interest in good governance: boards and their advisers,

shareholders, policymakers, regulators and other stakeholders.

Free enterprise without regulation may or may not be the best way to create lasting value in today's world. Although Adam Smith wrote of an invisible guiding hand that would enable trade to flourish and create wealth, the risk that market forces left alone will allow some to get rich while others starve is no longer regarded as acceptable in most societies. Taxation provides a fairly effective means of redistributing wealth according to prevailing societal expectations. A problem that is harder to address – commonly known as the 'tragedy of the commons' (Hardin 1968)<sup>6</sup> – was a significant feature of the 2008 financial crisis. Then, individuals or corporations, acting according to their self-interest, destroyed their own institutions, risked the financial system as people then knew it, and triggered a major global recession. Arguably, increasing regulation has made matters worse and the solution to the tragedy of the commons must be found in a more enlightened approach to governance.

Policymakers and regulators, in particular, should seek to ensure that the governance of an enterprise reflects its wider role in economies and society. Policies on corporate governance should promote creation of sustainable value throughout the economic system. They must aim to support Smith's invisible hand with a benign guiding hand (see Haldane 2012) to prevent tragedies of the commons and ensure that wealth is distributed in accordance with the prevailing current wisdom of society as it evolves over time.

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6. Garrett Hardin developed his ideas from an article of 1833 by William Forster.

## A NEW ACCOUNTABILITY FRAMEWORK FOR GOVERNANCE

The three purposes set out in ACCA's *Agenda* have been adapted into a new framework based on three components or legs:

- performing
- informing, and
- holding to account.

The need for companies to perform requires boards, management and staff to perform. It is necessary to be clear about what is meant by performing and to choose the right metrics. Those responsible for performing then need

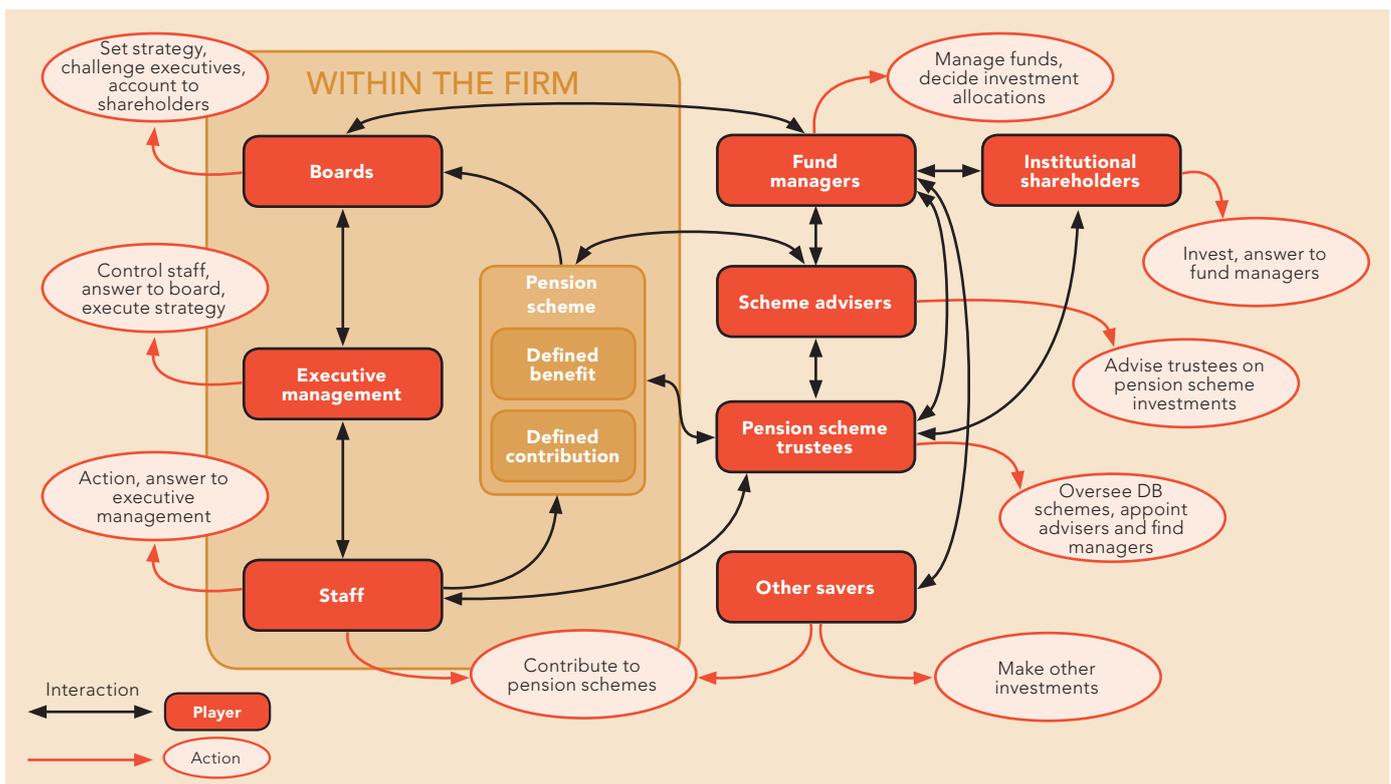
to inform those to whom they are, or should be, accountable and to be held accountable in return. In a similar way, professional investment managers need to perform and be accountable to those who entrust their money to them.

All three components are essential if a company is to create value sustainably for its shareholders and other stakeholders. They can be thought of as the three legs of a stool (Figure 3.1). All are needed and each leg must be sound. In an ideal world, the first component, 'performing', ought to be sufficient, but such a world does not exist. Left to their own devices, people may perform in a way that is optimal for

Figure 3.1: The aim of governance is to create value sustainably



Figure 3.2: Companies and their owners



themselves rather than the company's shareholders or other stakeholders. For hundreds of years boards and, before them, stewards, were required to account for their stewardship. The second component, informing or accounting for stewardship, is also vital, but not sufficient. Stakeholders, typically shareholders, need to be able to hold a board to account. These three components, when they work properly, make a sound system for corporate governance and for creating sustainable value.

The ownership of listed companies, represented in Figure 3.2, is complicated. Each company has a board, directors, executive management and staff.

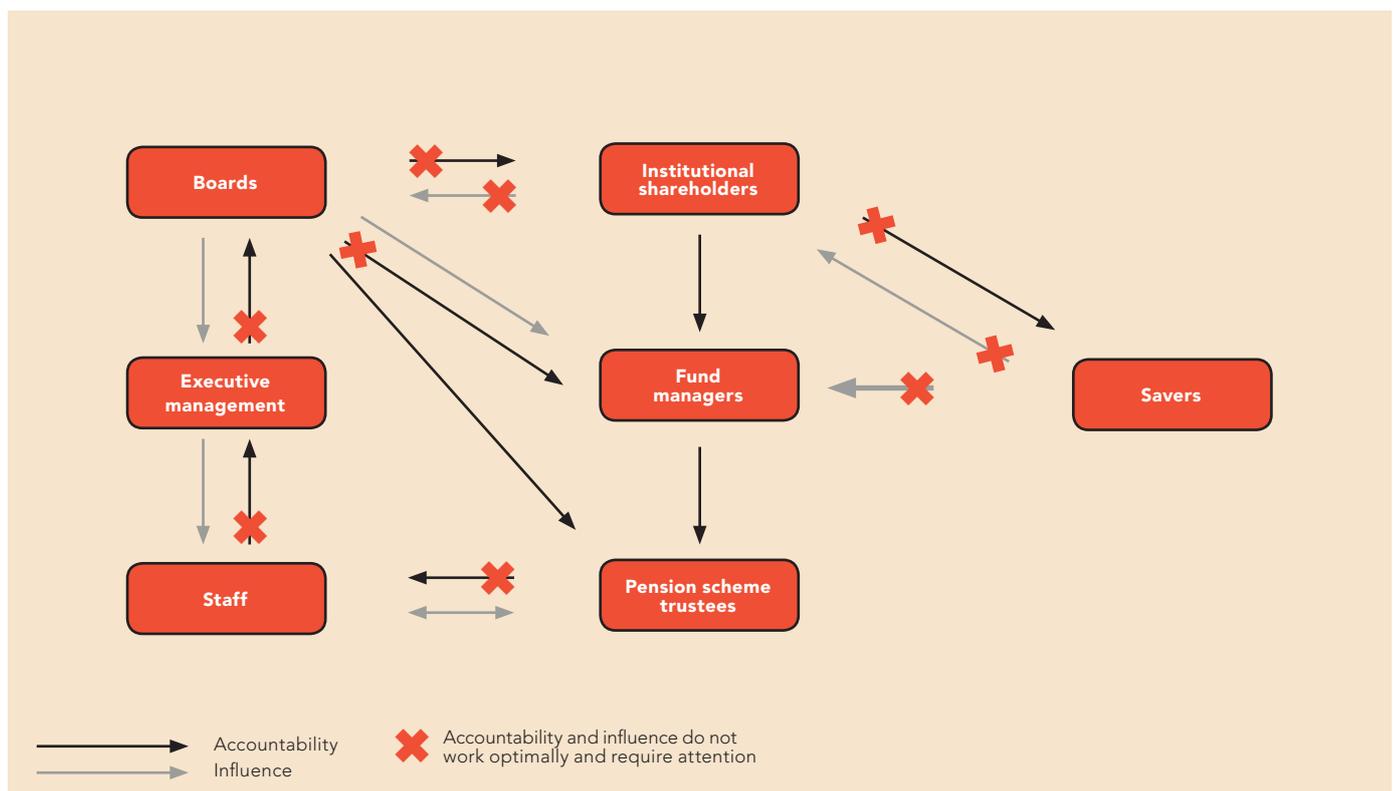
Company shares are owned by institutional investors or by fund managers selected by the institutional investors. The money used to buy shares is provided by savers, either saving directly with an institution or through an employee pension scheme administered by trustees. This is slightly simplified in Figure 3.3. The dark arrows show lines of accountability, the lighter arrows show lines of influence. The crosses show where accountability and influence do not work optimally and require attention.

Figure 3.3 shows savers as being somewhat out on a limb, which in many respects they are. Across the corporate

landscape as a whole, however, the savers and the staff are essentially the same people.

As is demonstrated in Chapter 7, 'How well are the three components of the framework working', there are serious problems with accountability between management and boards and between boards and shareholders. The most intractable problems are in the investment management chain, where retail savers have no influence over institutional investors and fund managers, institutional investors have insufficient influence over boards, and boards have insufficient control over management.

Figure 3.3: Companies and their owners (simplified)

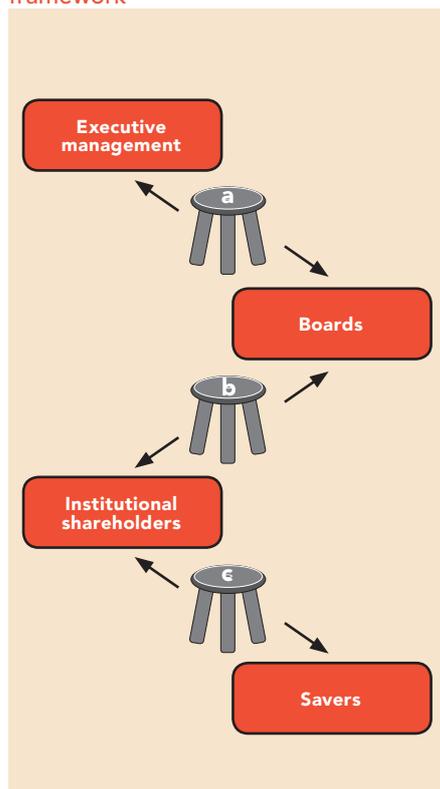


The governance system is failing at each level. The accountability framework presented in this paper addresses the three interfaces between:

- (a) executive management and boards
- (b) boards and institutional shareholders
- (c) institutional shareholders and savers.

For governance to be effective all three components must work at each interface, as shown in Figure 3.4).

Figure 3.4: The three interfaces of the framework



### a. Executive management and boards

- i. Performing – management makes good progress towards the company’s defined purpose, which normally is creating long-term sustainable value.
- ii. Informing – management informs the board on progress.
- iii. Holding to account – boards support management in creating value, monitoring performance and holding management to account if it fails to create value or to give proper account.

### b. Boards and institutional shareholders

- i. Performing – the board directs the company in pursuit of its purpose and achieves that purpose.
- ii. Informing – the board gives account to shareholders and other stakeholders on progress.
- iii. Holding to account – shareholders and other stakeholders, hold the board to account if it fails to create value or to inform them properly.

The purpose should include shareholder value in the longer term; achieving this will normally necessitate serving and balancing the interests of other stakeholders. The Johnson and Johnson Credo (see Johnson and Johnson n. d.) and the Panasonic Code (both mentioned in Chapter 9 under ‘The value of values’) are relevant.

### c. Professional managers and providers of capital (savers)

- i. Performing – professional managers select investments that create sustainable value and engage appropriately with boards to ensure they do.
- ii. Informing – professional managers inform providers of capital on real investment performance.

- iii. Holding to account – providers of capital hold professional managers to account if they fail to create value or to give proper information.

In the long chain of intermediation between providers of capital and professional managers, many conflicts of interest exist. The third component – holding to account – works particularly poorly. It completely fails as far as retail savers are concerned.

The framework could be used to assess the widely accepted ‘comply or explain’ approach which, as discussed in Chapter 7, is not working well.

Most corporate governance attention has focused on the relationships between shareholders, boards and management and most debate has rarely touched the interface between savers and fund managers. Therefore, the circle of accountability between providers of capital and those who create value is incomplete. Since staff in many large organisations also save in a pension scheme or other fund, staff and savers are often the same people with common interests.

The framework identifies the three distinct interfaces. What is needed is a feedback loop for the whole governance system. The failure of accountability between beneficiaries and fund managers fundamentally undermines the efficacy of attempts to have good governance over companies with a diversified shareholder base (Figure 3.5).

Other problems exist where there is a concentrated shareholder base (Figure 3.6): the dominant shareholder can short-circuit the circle and influence boards or management directly and ignore the interests of staff, beneficiaries and fund managers.

Figure 3.5: The governance chain (diversified shareholder base)

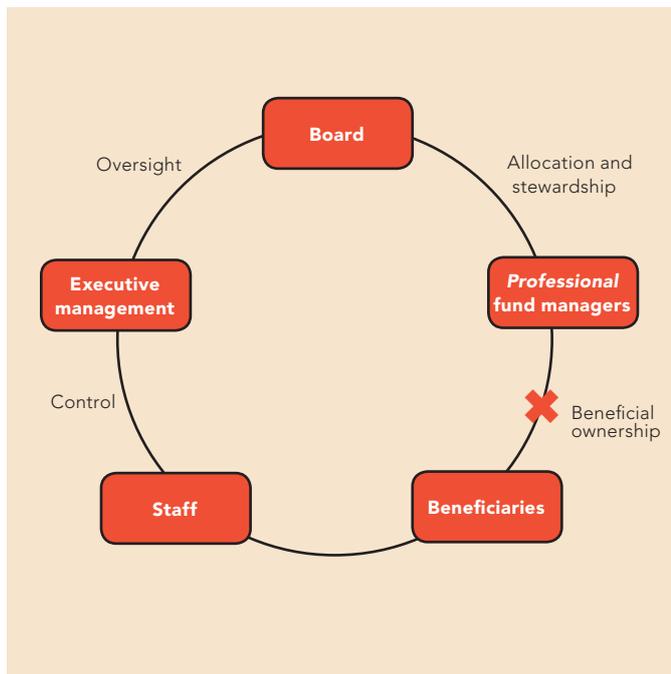
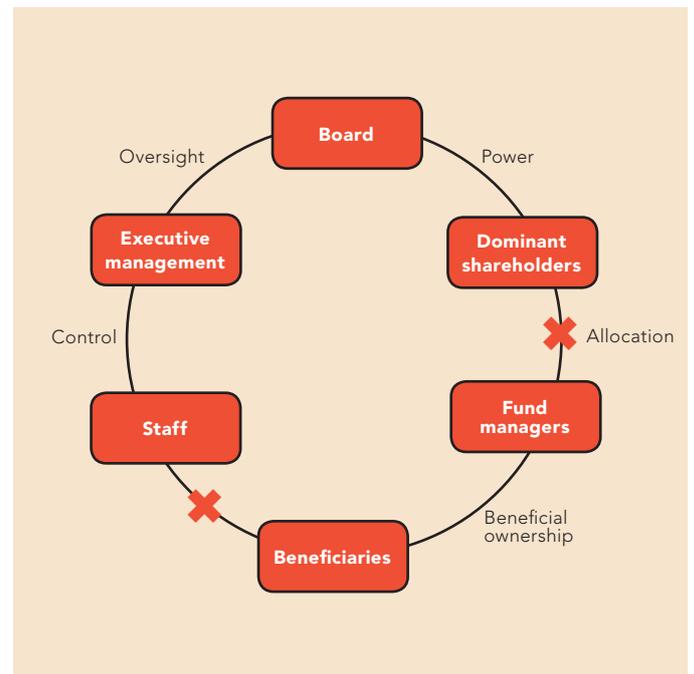


Figure 3.6: The governance chain (concentrated shareholder base)



The three components, performing, informing and holding to account, cannot work well if there are conflicts of interest. Key to implementing this framework, or any other improvements to governance, is ensuring the right incentives. Conflicts of interest, particularly concerning remuneration, should no longer be tolerated; policymakers, boards and shareholders need to review conflicts and how incentives work, and make changes as necessary.

Chapters 4, 5 and 6 look at each component of the framework and how they apply at each of the three interfaces.

### CONSULTATION QUESTIONS

- Q3.1 Should creating sustainable value be the overarching purpose of governance? If not, can you suggest a better purpose?**
- Q3.2 Do you agree with the three complementary purposes: performing, informing and holding to account? If not, why not?
- Q3.3 How important is it to have a complete circle of accountability linking staff, management, boards, professional fund managers and savers to ensure the governance system works as a whole?
- Q3.4 Do you find the framework likely to help to improve corporate governance and help focus companies on creating sustainable value? What could make it better??**
- Q3.5 Of the three interfaces shown in Figure 3.4, a, b and c: (i) at which one is accountability most problematic? (ii) which should be addressed first by policy makers?

## 4. Performing – value creation

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Performance can be considered both as an output and as a process. It is important to know how both can best be measured and know about the limitations of measurement.

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This chapter considers how organisations perform, what contributes to performance, and how performance can be measured.

Performance depends on many factors but effective leadership and good decision making are clearly important, as is having a good business model.

Creating value is primarily the responsibility of the board, but company shareholders must also:

- (a) support the board in discharging its responsibility, and
- (b) hold the board to account when necessary.

For companies, their boards and, indeed, for investors, sustained performance over time depends on having a clear purpose and the commitment and resource to achieve

that purpose. The firm's leaders must continually monitor the external environment, learn from the results of their actions and make appropriate adjustments, thereby creating a complete system with its own feedback loop.

This approach to performance is readily comprehensible and is as relevant to the individuals and teams working within an organisation as it is to the leadership. It is based on the CoCo (Criteria of Control) Framework developed by the Canadian Institute of Chartered Accountants in 1995.

CoCo was introduced with the objective of improving organisational performance and decision making through better control, risk management, and corporate governance. The framework includes 20 criteria for effective control in the areas of purpose, commitment, capability, and monitoring and learning. The importance of ethics, values and integrity feature throughout the guidance; for example, the commitment part of the framework (see Box 4.1) includes the following elements:

B1. Shared ethical values, including integrity, should be established and practised throughout the organisation

B4. An atmosphere of mutual trust should be fostered to support the flow of information between people and their effective performance toward achieving the organisation's objectives. (Canadian Institute of Chartered Accountants 1995).

### BOARD EFFECTIVENESS

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While the need for an effective board is undoubted, what constitutes such a board is difficult to determine. Spotting ineffective boards is much easier with 20–20 hindsight, but recognising an effective one is much harder: before, during or afterwards.

The word 'governance' comes from the Greek *kyberan*, 'to steer'. The suggestion here is that the most important functions of a board are to steer management in the right direction, set the right moral tone, to monitor management's progress and to make changes where appropriate.

Conclusions from the inquiries into the recent bank failures might lead commentators to ask whether the currently typical board system, comprising a small number of full-time executives and a larger number of independent non-executive or outside directors, is actually the best model for running a large enterprise.

These and other inquiries, such as that into the failure of Enron, also suggest that boards had less control over a company and a weaker understanding of the risks being taken than had been thought. It would seem that what is currently widely regarded as a model board structure actually discourages effective decision making and creates a risk-averse board culture which is, nevertheless, still risk-prone. This is a bigger matter than can be discussed here, but it seems wise to keep an open mind on whether there are better structures for running large companies.

### BOX 4.1: THE COCO GUIDANCE ON CONTROL

CoCo's internal control integrated framework includes 20 criteria for effective control in the four areas of purpose, commitment, capability, and monitoring and learning.

#### Purpose

- A1 Objectives should be established and communicated.
- A2 The significant internal and external risks faced by an organisation in the achievement of its objectives should be identified and assessed.
- A3 Policies designed to support the achievement of an organisation's objectives and the management of its risks should be established, communicated, and practiced so that people understand what is expected of them and the scope of their freedom to act.
- A4 Plans to guide efforts in achieving the organisation's objectives should be established and communicated.
- A5 Objectives and related plans should include (suitable) measurable performance targets and indicators (that are aligned with objectives).

#### Commitment

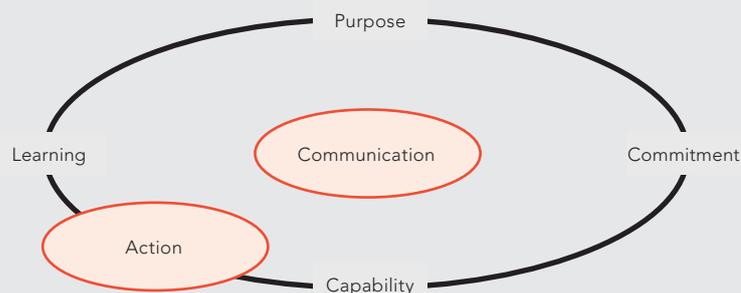
- B1 Shared ethical values, including integrity, should be established, communicated and practised throughout the organisation.
- B2 Human Resource Policies and practices should be consistent with an organisation's ethical values and with the achievement of its objectives.
- B3 Authority, responsibility, and accountability should be clearly defined and consistent with an organisation's objectives so that the appropriate people make decisions and take actions.
- B4 An atmosphere of mutual trust should be fostered to support the flow of information between people and their effective performance toward achieving the organisation's objectives.

#### Capability

- C1 People [working within the organisation] should have the necessary knowledge, skills, and tools to support the achievement of the organisation's objectives.
- C2 Communication Process should support the organisation's values and the achievement of its objectives.
- C3 Sufficient and relevant information should be identified and communicated in a timely manner to enable people to perform their assigned responsibilities.
- C4 The decisions and actions of different parts of an organisation should be coordinated.
- C5 Control Activities should be designed as an integral part of the organisation, taking into consideration its objectives, the risks to their achievement, and the interrelatedness of control elements.

#### Monitoring and Learning

- D1 External and internal environments should be monitored to obtain information that may signal a need to re-evaluate the organisation's objectives or control.
- D2 Performance should be monitored against the targets and indicators identified in the organisation's objectives and plans.
- D3 The assumptions behind an organisation's objectives should be periodically challenged.
- D4 Information needs and related information systems should be reassessed as objectives change or as reporting deficiencies are identified.
- D5 Follow-up procedures should be established and performed to ensure appropriate change or actions occur.
- D6 Management should periodically assess the effectiveness of control and communicate the results to those to whom it is accountable.



It is suggested that boards should apply the following four principles.

1. Boards should lead by example and promote the right culture.
2. Boards should be responsible for the management of risk and ensure that their strategy actively considers both risk and reward over time.
3. Boards should encourage diversity of thinking when making decisions.
4. Board and executive remuneration should promote enterprise and good performance and be transparent.

These principles are discussed below.

### **1. Boards should lead by example and promote the right culture**

The board is responsible for the direction and control of an enterprise. The board should recognise that control depends to a great extent on culture and make sure that the corporate culture supports the achievement of the enterprise's purpose and is not adversely affected by perverse incentives. The board should review its own effectiveness from time to time (a) as a team and (b) in achieving the enterprise's purpose.

Boards should set the right tone and behave accordingly. They should pay particular attention to ensuring the continuing ethical health of their enterprises. Directors should regard one of their responsibilities to be the guardianship of the corporate conscience; non-executive directors should have a particular responsibility for guarding the corporate conscience. Boards should ensure that they have appropriate procedures for monitoring their enterprise's 'ethical health'. This will involve their gaining a good understanding of how incentive

structures work within the company.

Boards should report publicly to key stakeholders on the results of their effectiveness reviews and on their satisfaction with the enterprise's ethical culture.

### **2. Boards should be responsible for managing risk and uncertainty and ensuring their strategy actively considers both risk and reward over time**

All enterprises face risk and uncertainty: success in achieving strategic objectives will usually require understanding, accepting, managing, and taking risks. In a competitive economy reward without risk is usually only available to monopolies, companies enjoying external protection (eg the banking sector) or where risks can be externalised (the banking sector or where costs such as pollution are not borne by producers).

Consideration of risk and uncertainty should, therefore, be a key part of strategy formulation. Risk management should be embedded within an enterprise so that risk is considered part of decision making at all levels. To avoid creating a risk-averse culture, risk management should be about understanding and dealing with uncertainty, including both threats and opportunities. Boards should understand the risks faced by the enterprise, satisfy themselves that the level of risk is acceptable, and challenge executive management when appropriate.

Boards should be responsible for risks being managed even if they do not actively manage risk themselves. Boards should recognise that it is never possible to assess every risk accurately and that it is unwise to think that all risks can be identified, let alone managed. Even if a risk has been identified, the

impact of an event may be more severe than anticipated, or may coincide with other events or combine with them in unexpected ways. Boards should therefore 'expect the unexpected' and ensure that the enterprise has more resilience than might otherwise be thought necessary. Scenario-planning, particularly using reverse stress-testing is an excellent way to bring the unexpected into focus and help plan required resilience.

Boards should report to key stakeholders on how they discharge their responsibility for risk management.

The effectiveness of board processes, particularly in relation to risk, is a difficult area to study. McNulty et al. (2012), in a multidisciplinary study for ACCA, found that financial risk taking (as indicated by liquidity and financial slack) was lower in companies with boards of fewer than eight members, where the board tenure of executive directors was significantly greater than that of non-executive directors and where the non-executive directors seemed more engaged. Curiously, in contrast to measures of financial risk, the researchers found no significant relationship between any of the above variables and measures of business risk (investments and acquisitions).

### **3. Boards should encourage diversity of thinking when making decisions**

People, both individually and in groups, can be affected by various forms of cognitive bias that can adversely affect their effectiveness when they make decisions. Boards are vulnerable to groupthink. Boards that allow a balance of viewpoints when making decisions, and that welcome constructive challenge and a degree of dissent, are less likely to be affected by groupthink or individual bias. They will make better decisions.

The conventional view is that, in large enterprises, diversity of thinking is usually best enabled by boards having both external non-executive and internal executive members and a non-executive chairman. The chairman has a crucial role in encouraging open debate and allowing diversity of views to be aired, and should do so. Non-executive directors ideally would come from a range of backgrounds.

Unanimity of thinking, however, is not necessarily a goal to aspire to. Healthy decision making benefits from constructive counter argument or scepticism within a shared value system.

Non-executive directors should challenge executives in a constructive way. No single individual should be able to dominate decision making. It follows that the board should work as a team with external members contributing to and challenging strategy rather than simply having a monitoring or policing role. Boards should comprise members who possess skills and experience appropriate for the enterprise. All board members should endeavour to acquire a level of understanding of financial matters that will enable them to participate in decisions about the financial direction and control of the enterprise.

The board, or its chairman, should report publicly to key stakeholders on how they ensure diversity of thinking. As implied earlier, various enquiries into corporate failures suggest a case could be made that the type of board prevalent today in large enterprises discourages good decision making. The conventional view of the role of independent non-executive directors should perhaps also be questioned (see Box 4.2).

#### **BOX 4.2: NON-EXECUTIVE SYSTEM CALLED 'NAIVE'**

Peter Whitehead, reporting in the *Financial Times* on a debate organised by Board Intelligence in July 2013, wrote 'the idea of appointing non-executive, independent directors to look after a business's best interests was dismissed as "nice, but naive" by the five company secretaries attending the think tank debate. Problems cited included:

- independent outsiders with no prior connection to a business not displaying the passion, courage and commitment needed to succeed as a non-executive.
- non-executives representing major shareholders on the board putting other NEDs to shame.
- expectations placed on non-executives were unrealistic and the brief should be reshaped.
- non-executives have great power and carry the burden of considerable responsibility, but there is a mismatch with the tools that they have.
- heavy reliance on non-executive directors can breed a false sense of security about the businesses.
- much could be learned from privately owned small and medium-sized businesses and other organisations not obliged to conform to corporate governance best practice. One said, "When common sense is allowed free rein, it's interesting how often management appoints 'advisers', as they see genuine merit in external challenge, but they don't saddle these advisers with responsibilities and liabilities." (Whitehead 2013b)

#### **4. Board and executive remuneration should promote good performance and be transparent**

Boards should understand how incentives work within their company and the role of remuneration in this. Inappropriate remuneration arrangements can promote perverse incentives that do not properly serve the enterprise's shareholders or other stakeholders. Remuneration should be aligned with individual performance in such a way as to promote sustainable enterprise performance in accordance with its stated purpose (see Figure 4.1).

The difference between pay levels of executives and non-executives should not be so great as to weaken the incentive for non-executive directors to engage fully in decision making.

Disclosures of director and senior executive pay should be sufficiently transparent to enable shareholders or other principal stakeholders to be assured that arrangements are appropriate. Boards should explain to key stakeholders how they ensure that remuneration promotes performance.

This is really just basic common sense and the three paragraphs above should be statements of the obvious. Regrettably, the post mortems of failed banks following the credit crunch revealed the extent to which poorly designed remuneration arrangements contributed to the crisis. Boards really should have known better. Shareholders should also know better but they need to be given information in a form which is more comprehensible than was the case five years ago.

## MANAGING UNCERTAINTY (INCLUDING RISK)

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ACCA's publication *Risk and Reward: Tempering the Pursuit of Profit* (Davies et al. 2010) discusses many of the shortcomings of present approaches to managing risk:

- a. risks considered in isolation rather than in relation to potential benefits
- b. scoring risks on a simple guess of impact and likelihood, ignoring the possibility that a single risk could have a high likelihood of a small impact and a lower likelihood of a high impact
- c. trying to treat the impact of rather than the cause of a risk
- d. populating risk registers on the basis of risks scored, as in b and c above
- e. ignoring the fact that risks may occur simultaneously and overwhelm the controls
- f. failure to appreciate human cognitive biases when assessing risk, including the belief that all significant risks have been identified, whereas there are always unknown risks
- g. a belief that a risk-management or internal-control system is formally designed and created by people and failure to appreciate the importance of controlling informal systems and networks of people

- h. failure to understand that the most important component of control is the corporate culture and such matters as teamwork, incentive systems, willingness to follow guidance or procedure and the existence of informal networks
- i. over-reliance on risk and other models
- j. fuzziness in understanding and use of terms such as risk appetite and tolerance.

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**The main failure of risk management is the underlying presupposition that risks can be identified and managed. This gives importance to the risk management function but at the expense of a misplaced sense of assurance that all will be well.**

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Even when most risks are identified, it is the unexpected large events that kill an organisation because they were not considered or were thought too improbable, either singly or simultaneously with other events.

Davies et al. (2010) suggests how such approaches could be improved. One of the suggestions is that scenario planning can be an efficacious tool, helping people to become more attuned to what could happen and how to respond.

It is better for boards and managers to focus on resilience so that the company and its people can respond better to unforeseen events as they arise. An organisation that is able to adapt, with empowered and motivated people and healthy informal networks, is more likely to survive an incident than one which thinks it has a control for every risk. This is akin to having a safety first rather than a risk first strategy. Such an organisation is more likely to thrive and to create value.

## MERGERS AND ACQUISITIONS

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Mergers and acquisitions require particular mention and surprisingly are not usually thought of as governance, or risk, matters. This is strange, as decisions about mergers and acquisitions are the most significant, from a strategic and financial point of view, that a board will take, and they often result in considerable destructions of value. Recent high-profile examples of value destruction include the RBS acquisition of ABN Amro, the Hewlett Packard acquisition of Autonomy and the merger of LloydsTSB with HBOS. Barclays acquisition of parts of Lehman, on the other hand, still looks like a good deal for Barclays shareholders.

Due diligence is essential but it is not possible to identify or assess all risks accurately. In 2008 J.P. Morgan bought Bear Sterns and acquired most of Washington Mutual, then in receivership, for \$1.8bn. At the time it seemed that the acquisition of Bear Sterns, in particular, in a share swap for \$240 million (ie \$2 per share) was a bargain. Perhaps it was and following general outcry the price was raised to \$10. J.P. Morgan probably did not anticipate having to pay \$13bn, agreed in October 2013, to settle investigations into business practices relating to mortgage-backed securities. Most of the settlement relates to the activities of Bear Sterns and WaIMu before they failed. In *Fool's Gold* (2010), Gillian Tett describes how J.P. Morgan's derivatives team created credit derivatives but the bank decided they were too risky to use for mortgages and so it was relatively unscathed by the credit crunch.

CASS Business School research in *CFO Magazine* (Sawers 2012) examined 3,000 acquisitions by UK-listed companies. The research showed that while most deals failed to add value to share price over three years, successful deals created more value than unsuccessful deals destroyed. The careful due diligence required to understand the risks and uncertainties associated with acquisitions and mergers should therefore include assessing the culture of the executives in the acquiring company as well as that of the company being purchased. Executives tend to be optimistic about acquisitions, do not consider the risks and uncertainties sufficiently and can get tempted to pay too much, particularly if a bidding war takes place. Steve Priddy (2013) rightly points out that the mergers and acquisitions (M&A) process, including due diligence, largely falls outside the commentary and scope of corporate governance and that this should be corrected.

## MEASURING VALUE

Businesses should create value – for their shareholders and for wider society. Governance must be about supporting and enabling business to do this sustainably, taking and managing risk and responding flexibly to uncertainty without suffocating entrepreneurial flair.

Knowing what success looks like should make it easier to achieve. Success means creating value, so it is important for boards, management and staff to share a common understanding of value and how to create it. As is explained in Chapter 3, value should be considered in social and environmental terms as well as in financial terms. Aligning individual performance with corporate performance can be particularly troubling. The recent history of corporate failure offers many unfortunate examples where incentives based on inappropriate measures created conflicts of interest and misalignment of objectives.

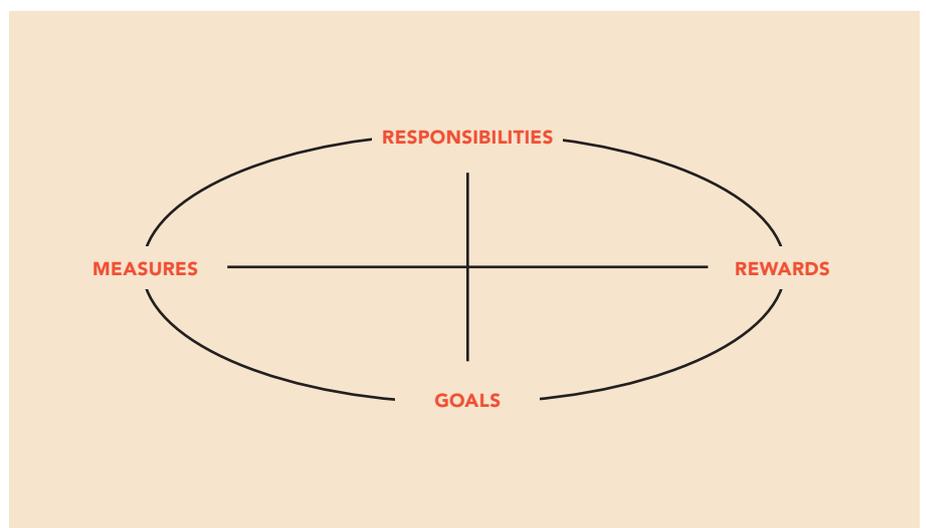
Organisational effectiveness requires alignment between people’s responsibilities, rewards, goals and the measures used and with the organisation’s goals and objectives (Figure 4.1).

Value should be considered in at least two respects: the ability of boards, management and staff to create value; and the actual value created; each needs a different type of measure:

- lead indicators for measures of ability, and
- lagging indicators for value created.

Particular care is needed in choosing a measure, since most are mere proxies for real performance and the very act of measurement can lead people to focus on the target itself rather than the underlying performance.

Figure 4.1: Organisational alignment



No single indicator, such as share price or profit, of performance or value creation will suffice. A broader and balanced set of financial and non-financial aims and measures is required. These should recognise that, as enterprises exist within a society, they also have a responsibility to society to act responsibly and contribute to it. Implicit in this is that enterprises should create value.

Managers, executives and shareholders will all be interested in the measures used and, of course, in how they are communicated. There is a clear need for research and discussion in how performance should best be measured and reported. A complex range of measures risks creating confusion when corporate reporting is already reckoned by many to require simplification. One approach to cutting through complexity would be for enterprises to set out how they contribute to or take from society. Stakeholders should be able to determine whether statements on contribution to society ring true or sound hollow and to reward or penalise boards as appropriate.

It is important to measure and report on the right things, know how accurate measures can be, know what the measures reveal and be able to spot when a short-term focus harms value creation over a longer term. Something that is hard to measure may be hard because it is intangible, such as customer satisfaction or team morale. Or it may be something fundamental such as corporate performance. Proxy measures such as scores on customer satisfaction or workplace questionnaires may be effective in measuring the

former; for the latter there are a variety of measures, such as units produced or sold, cash generated, profit and return on capital employed. None of these gives a reliable measure of satisfaction, team morale or corporate performance. It is important to understand the difference between proxy measures and what really needs to be measured. A measure is a bit like a map: it is a just representation of reality and should not be confused with reality itself.

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**Profit is a particularly inadequate measure of performance as it is too easily gamed.**

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Stopping advertising or asset maintenance brings an immediate short-term boost to profit and, quite probably, the company's share price, but damages the business and its stakeholders over the longer term.

It should now be clear that great care is needed when choosing and using measures. Introducing any measure as an instrument of management risks falling foul of the corollary of Goodhart's Law, which might read: 'any measure, as soon as it is used as an instrument of management, loses its managerial efficacy'. While the proposition will not always hold, it is worth considering in relation to measures used to manage and reward or punish behaviour.

This paper advocates the use of good measures to assess performance. The 'performance-target culture', however, which seems to have taken hold in much of the corporate world, can be seriously problematic thanks to Goodhart's Law.<sup>7</sup>

## CONFIDENCE IN MEASURES

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Accountants, in learning the fundamentals of their profession, use single point figures to report financial information. They are taught too little about the sensitivity of numbers to the underlying assumptions, or that the figure may be approximate, or that the real figure could be materially different.

A scientist or engineer, by contrast, is interested in the measurement error associated with any number. For example, it may be important to know whether, say, a 1,000mm long component in an assembly is exactly 1,000mm long or whether it is 997mm. A tolerance of 3mm might be just acceptable but a component that is 996.9mm might not be. Scientists and engineers are puzzled that accountants seem unconcerned about the accuracy of what they are measuring. Accountants assume that 1,000mm means exactly 1,000mm, rather than some number between 997mm and 1003mm.

In 2012, ACCA published a proposal on confidence accounting (Harris et al. 2012), which outlined how financial reports could show the levels of confidence for significant figures, particularly those that are hard to value accurately, such as oil reserves, land values and financial assets or liabilities calculated on the basis of financial models.

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**In measuring financial performance, it is as important to show the likely variance from a given result as it is to report the actual result. It is also helpful to form a picture of the confidence level behind the figures.**

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7. This subject is being studied by ACCA in its 2013-14 research project on corporate culture.

The chart shows how one could present the confidence associated with the calculation of net income for a hypothetical business. The figure reported in a set of accounts is £6,701,000 but the actual net income is most unlikely to be exactly this. On the basis of assumptions, which can be stated, about the known unknowns, there is only a 15% probability that net income is within the range £6 billion to £7.4 billion. Further, given the volatility of markets and risk factors that cannot be modelled, the real probability could be less than this. The implications of this should be considered when making decisions about bonuses.

This concept can usefully be extended from financial numbers in a set of accounts to other areas. It can be helpful to think of governance, risk and performance in terms of outcomes that can be measured. In Figure 4.2, the curve represents the range, or expected range, of possible outcomes for a particular measure. The measure could be financial: a firm's share price, profit, sales, costs or asset values; or non-financial: quality, oil reserves, emissions, ethical health or staff motivation.

For assets, incomes and things we want more of, performance is about shifting the curve in Figure 4.3 to the right, the large arrow at the top. The performance component of governance is about making sure the right outcomes are sought after, that the company has the capability to achieve them, and that management pursues and achieves the right objectives in the long-term interests of shareholders and other stakeholders. Another role for governance could be narrowing the range to reduce variability of outcome.

Figure 4.2: Measuring outcomes

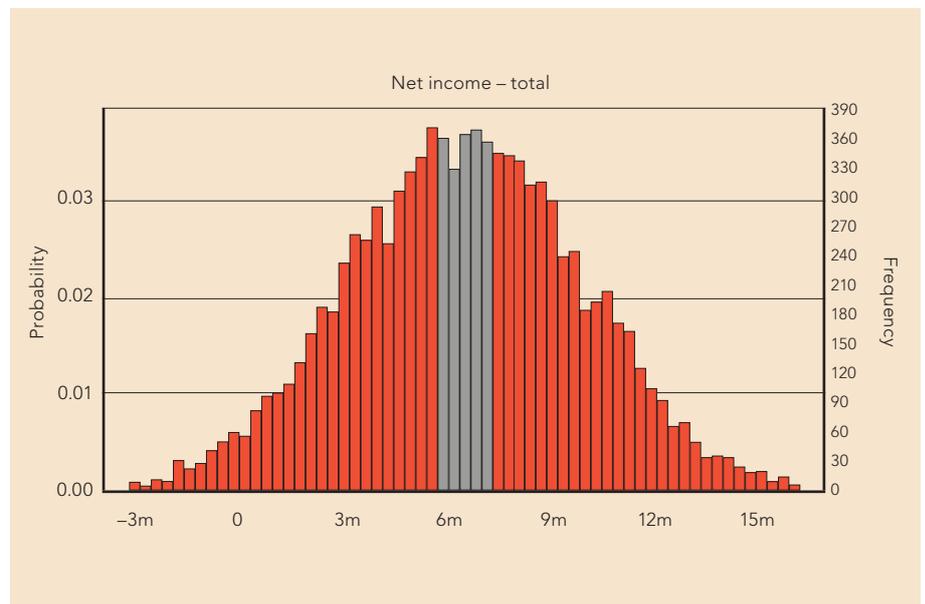


Figure 4.3: Seeking the right outcomes

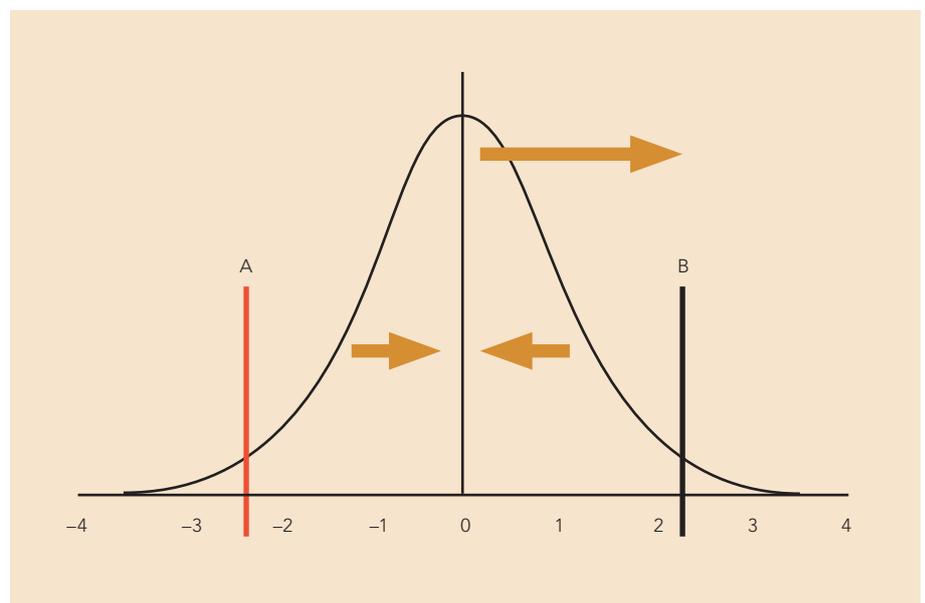
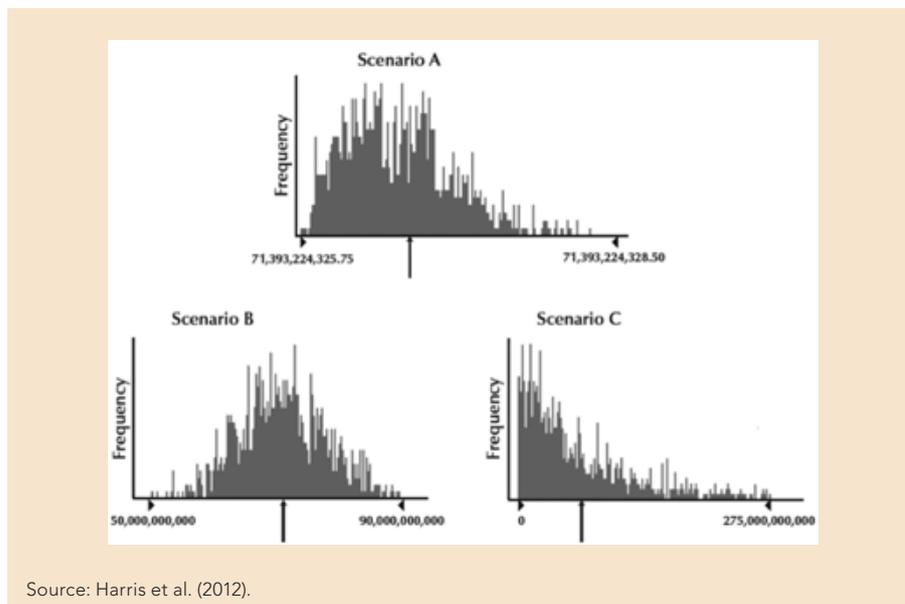


Figure 4.4: Different messages



Source: Harris et al. (2012).

Risk management is about limiting undesirable outcomes – removing the tail to the left of vertical line 'A'. The tail to right of vertical line 'B' represents the upside which may or may not be desirable. Removing the upside will narrow the range and improve predictability; whether such an outcome is required depends on the precise objective.

Should we manage a risk or take an opportunity? Managing uncertainty is a key management rather than a risk management role as it means managing opportunity – the upside as well as the downside. For many in large organisations this will require a change in mindset.

Not all outcomes form a classic bell curve. The three different distributions of possible outcomes illustrated in Figure 4.4 give different messages

about the levels of risk and uncertainty attached to the estimates. In some sectors, companies may have considerable opportunity to make profit over many years while pursuing a business model that practically ensures disaster.

Colin Mayer (2013) offers a simple prescription for making money – sell an option which pays on the occurrence of a rare event – say a 1 in 10-year chance. If, for each £10 of loss when the 'rare' event occurs, you earn more than £1 per year by selling the options, you make a profit over the long term. If you earn less than £1 per annum OR the event occurs before year 10, you risk losing your business. This is essentially what happened with vendors of credit default swaps. Managers, boards and shareholders need to understand the risk profile associated with a business model and the existence and possible impact of tail risk.

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Accepting and being comfortable with uncertainty will make us less susceptible to confidence bias. Organisations that manage uncertainty as they manage performance think differently from those that focus on managing or avoiding risk.

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As the culture of such an organisation becomes more comfortable with accepting future uncertainty, it is likely to react better to events as they happen, resulting in a more resilient business that is better able to balance risks against reward in assessing opportunities – in short, a more entrepreneurial firm.

A useful guide, particularly for accountants, on how good governance can be integrated into organisations to improve performance is the International Federation of Accountants paper, *Integrating Governance for Sustainable Success* (IFAC 2012). This guide explains how what it calls 'integrated governance' makes organisations successful. It identifies and discusses eight drivers for sustainable success and provides eight case studies from public and private sectors from across the world.

## CONSULTATION QUESTIONS

- Q4.1 Is the CoCo model useful for understanding performance? What alternative models could be used?
- Q4.2 Do you agree that boards (or chairs of boards) should assess and report publicly:
- on the results of their effectiveness reviews?
  - on their satisfaction with their enterprise's ethical culture? If not, why not?
  - how they apply the four principles set out above?
  - how they discharge their responsibility for managing risk?
  - how they ensure diversity of thinking?
- Q4.3 Should we question the assumption that at least half the members of boards should be independent non-executive directors? Could another structure be appropriate in some cases?
- Q4.4 Do you agree that performing, in terms of creating value, should be considered using both of measures of effectiveness (eg of boards) and measures of value actually created?

### Regarding outcome uncertainty

- Q4.5 Should performance measures include more information on uncertainty of outcome?
- Q4.6 If so, should the information be confined, in the first instance, to boards and their audit committees, or should it be part of public reporting?
- Q4.7 Would graphical representations be helpful in assessing performance of: (a) managers, (b) boards, and (c) professional investors?
- Q4.8 How much validity is there to the corollary to Goodhart's Law that any measure, as soon as it is used as an instrument of management, loses its managerial efficacy?

## 5. Informing on value creation

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The type of enterprise, its ownership structure and the culture within which it operates will determine how and what management should report to boards and how boards should account to their owners and/or significant stakeholders.

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No single model of accountability will be appropriate for all enterprises in all regions. A universal requirement, however, is to disclose sufficient, appropriate, clear, balanced, reliable and timely information to those to whom boards should be accountable. Such information should cover the enterprise's objectives, performance, prospects, risks, risk-management strategy, internal control and governance practices and contribution to society.

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**Management should report to boards and boards report to shareholders on progress in creating value, using a broad and balanced set of measures.**

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The 2008 financial crisis revealed weaknesses in reporting that are still to be resolved: financial institutions reported spectacular profits, sound governance, effective risk management and exemplary corporate responsibility. With hindsight, such reporting seems to have been wrong or misleading. It is now clear that boards can show increasing profits, yet at the same time be weakening an enterprise's ability to create profit over the longer term. Company financial reports should convey whether a company has created value over the reporting period and whether its ability to create value in future has improved.

The South African *King III* (IoDSA 2009) contained the first governance code to be based on a framework of integrated reporting. It requires boards to explain their performance in relation to a wide range of areas, including ethics, by explaining how they have applied the code's governance principles.

This concept led to the formation of the International Integrated Reporting Council (IIRC), a global coalition of regulators, investors, companies, standard setters, the accounting profession, including ACCA, and non-government organisations (NGOs). The Council shares the view that 'corporate reporting needs to evolve to provide a concise communication about how an organization's strategy, governance, performance and prospects, in the context of its external environment, lead to the creation of value over the short, medium and long term' (IIRC 2013a).

In December 2013, the IIRC published its *International <IR> Framework* (IIRC 2013b) following extensive consultation. Box 5.1 reproduces some of the key points of the framework on value creation, performance and reporting.

While it is early days for integrated reporting, if it leads to a more informed approach to value and how to measure its creation and its costs, companies should become better at creating value for shareholders and society.

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**Reporting on the various capitals should include an indication of the confidence or accuracy of measures and employ something like a 'confidence accounting' approach. Doing this will give a better idea of risk and uncertainty than the usual words in the 'risk' section of an annual report.**

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## BOX 5.1: INTEGRATED REPORTING

The sections below are extracts from *The International <IR> Framework* (IIRC 2013b), except for the section on 'The meaning of value' which is from *The Consultation Draft of the International <IR> Framework* (IIRC 2013a).

An integrated report should answer the question: How does the organization's governance structure support its ability to create value in the short, medium and long term? (IIRC 2013b, 4.8)

### The meaning of value

Traditionally, the meaning of value has been associated with the present value of expected future cash flows and value creation has been understood as the change in that measure of value due to an organization's financial performance. <IR> is based on the understanding that future cash flows and other conceptions of value are dependent on a wider range of capitals, interactions, activities, causes and effects, and relationships than those directly associated with changes in financial capital. (IIRC 2013a)

### Value creation

Value created by an organization over time manifests itself in increases, decreases or transformations of the capitals (see below) caused by the organization's business activities and outputs. That value has two interrelated aspects – value created for:

- the organization itself, which enables financial returns to the providers of financial capital
- others (i.e., stakeholders and society at large).

(IIRC 2013b, 2.4)

The ability of an organization to create value for itself is linked to the value it creates for others. (2.6)

Because value is created over different time horizons and for different stakeholders through different capitals, it is unlikely to be created through the maximization of one capital while disregarding the others. For example, the maximization of financial capital (e.g., profit) at the expense of human capital (e.g., through inappropriate human resource policies and practices) is unlikely to maximize value for the organization in the longer term. (IIRC 2013b, 2.9)

### The capitals

All organizations depend on various forms of capital for their success. In this Framework, the capitals comprise financial, manufactured, intellectual, human, social and relationship, and natural, although as discussed in paragraphs 2.17–2.19, organizations preparing an integrated report are not required to adopt this categorization. (IIRC 2013b, 2.10)

The capitals are stocks of value that are increased, decreased or transformed through the activities and outputs of the

organization. For example, an organization's financial capital is increased when it makes a profit, and the quality of its human capital is improved when employees become better trained. (IIRC 2013b, 2.11)

### The value creation process

The value creation process is depicted [in Figure 5.1]. (IIRC 2013b, 2.20)

At the core of the organization is its business model, which draws on various capitals as inputs and, through its business activities, converts them to outputs (products, services, by-products and waste). The organization's activities and its outputs lead to outcomes in terms of effects on the capitals. (IIRC 2013b, 2.23)

### Reporting on value creation

An integrated report explains how an organization creates value over time. Value is not created by or within an organization alone. It is:

- influenced by the external environment
- created through relationships with stakeholders
- dependent on various resources.

(IIRC 2013b, 2.2)

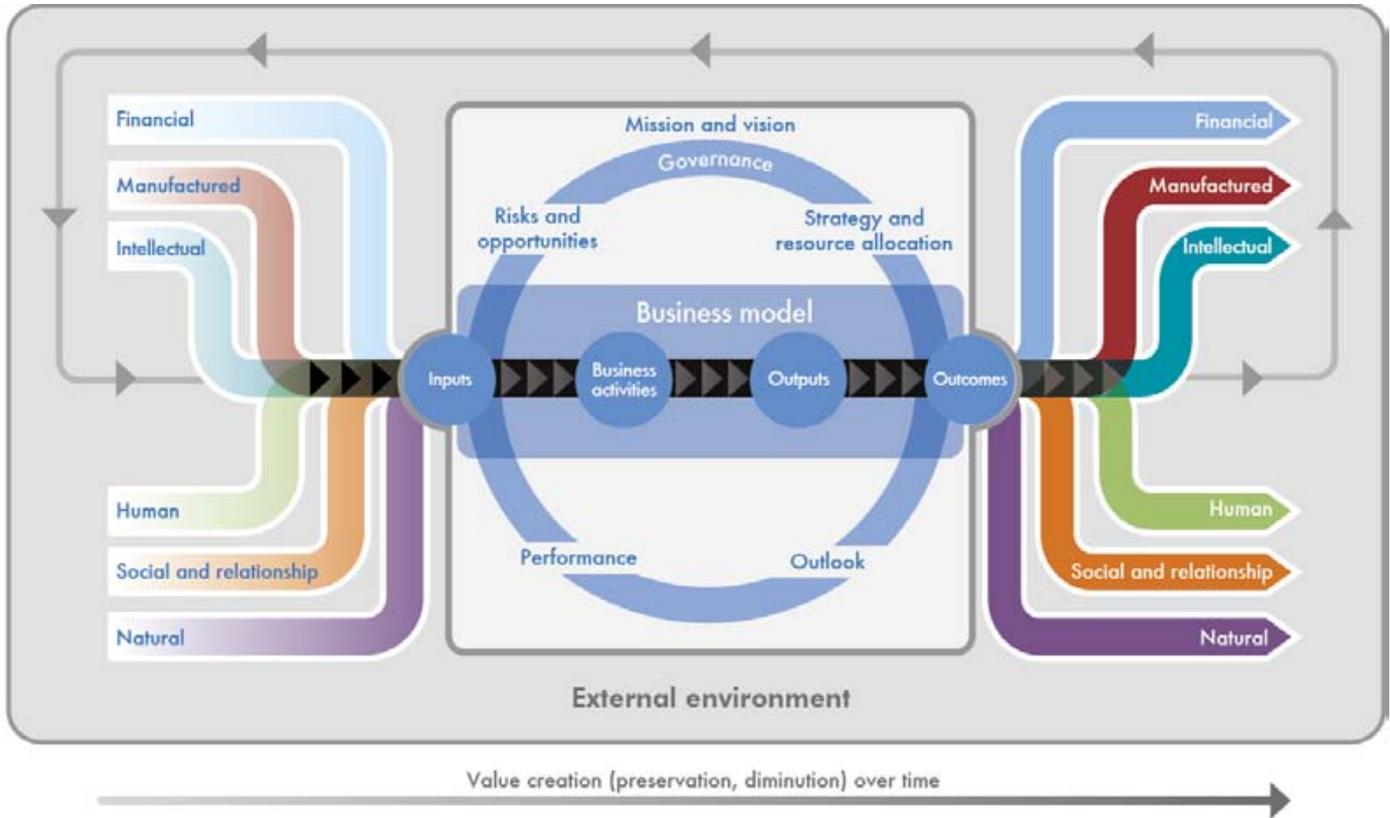
### Reporting on performance

An integrated report should answer the question: To what extent has the organization achieved its strategic objectives for the period and what are its outcomes in terms of effects on the capitals? (IIRC 2013b, 4.30)

An integrated report contains qualitative and quantitative information about performance that may include matters such as:

- quantitative indicators with respect to targets and risks and opportunities, explaining their significance, their implications, and the methods and assumptions used in compiling them
- the organization's effects (both positive and negative) on the capitals, including material effects on capitals up and down the value chain
- the state of key stakeholder relationships and how the organization has responded to key stakeholders' legitimate needs and interests
- the linkages between past and current performance, and between current performance and the organization's outlook. (IIRC 2013b, 4.31)

Figure 5.1: The value creation process



Source: IIRC 2013b

An integrated report should include disclosure on governance. Most governance reporting is made on the 'comply or explain' basis. Such reporting tends to focus on compliance with provisions and imparts little useful information on the quality of how companies have applied governance principles. ACCA has long argued that governance reporting should include information on how the board ensures that it has the right culture and values embedded in the organisation. To do this, boards must ensure that they understand their culture. This is not easy but *Risk and Reward: Tempering the Pursuit of Profit* (Davies et al. 2010) suggests how it can be done.

Choosing the right measures, understanding them and faithfully reporting on them is essential but not enough.

**Simply reporting on performance in relation to various capitals is rather like aiming darts at the red and green areas around the edge of a dartboard.**

Doing so may result in a high score against a set of reporting criteria. True integration means regularly hitting the bulls eye. In the case of reporting, the bullseye is when a reader of the report can readily determine whether and how much value a company has contributed to society – to a public good.<sup>8</sup>

8. This is discussed in more detail in 'Capitalism and the Concept of the Public Good', in ACCA 2011.

#### CONSULTATION QUESTIONS

- Q5.1 Should annual reports convey whether, and how much, value has been created over the reporting period?
- Q5.2 When reporting on the extent to which the various capitals have been added to or reduced, should reports convey information about the confidence or uncertainty of measures?
- Q5.3 Should annual reports set out how boards ensure that they understand their company's culture and that it is appropriate for the company's purpose?

## 6. Holding to account for value creation

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**Boards must be able to hold management to account, shareholders must be able to hold boards to account and providers of capital must be able to hold professional fund managers to account.**

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In some cases, other significant stakeholders should also hold the board to account for its performance, behaviour and financial results. ACCA recognises that in many societies, the owners of enterprises will have to take other stakeholder interests into account. As discussed in Chapter 5, the mechanisms required to enable this will depend upon the type of enterprise, ownership structure and culture.

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**Shareholders and other stakeholders with an ownership or quasi-ownership interest should engage with boards to ensure proper progress towards the enterprise's defined purpose.**

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Otherwise, boards will be unaccountable and enterprises effectively ownerless. Institutional investors and fund managers should put the long-term interest of their beneficiaries first. In doing so they will discharge their moral responsibility to ensure that the enterprises in which they invest operate in the long-term financial and other interests of beneficiaries.

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**As essential components of stakeholders' understanding of the enterprise, reliable corporate and financial reporting are vital to good governance.**

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Under the present system of boards with non-executive directors or supervisory members, a fully independent external audit of the financial statements, overseen by an effective audit committee, can provide assurance on the reporting. The membership of audit committees should have sufficient financial literacy and, in ACCA's view, at least one member should hold an appropriate accountancy qualification.

Holding boards and management to account is essential for good governance but it happens all too rarely. There have been too many examples of boards not holding executives to account and shareholders not holding boards to account. Chapter 6 of this discussion paper is necessarily short, as at present the structures, processes and incentives necessary to enable stakeholders, including shareholders, to hold people to account are not present. Chapter 7 sets out how well, or not, the three components of the accountability framework are working. This third component – holding to account – is the most problematic.

### CONSULTATION QUESTIONS

- Q6.1 Must boards be able to hold management to account?
- Q6.2 Must shareholders be able to hold boards to account?
- Q6.3 Must providers of capital be able to hold professional fund managers to account?
- Q6.4 How best can each of the above be carried out?
- Q6.5 Is one more important than the other two?
- Q6.6 What good examples are there of shareholders either (i) holding boards to account or (ii) engaging constructively with companies for their mutual long-term benefit?

## 7. How well are the three components of the framework working?

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They are not working well. Performance in value creation and in board and management effectiveness is sub-optimal partly because of a lack of measurement capability. If management does not know how to measure performance, it cannot expect to get the best performance.

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As a consequence, reporting fails to address the aspects of performance that matter most.

The failure of professional investors to hold boards to account is often characterised as a lack of shareholder engagement. The reality is more complex. The present presupposition that shareholder engagement is an unqualified good thing must be challenged. Investors do have an influence but it is not always helpful. In 2006 and 2007 institutional investors considered that banks such as Lloyds and even HSBC were not taking enough risk. Investors wanted these banks to get more exciting and sought to persuade them to take on more debt. This was widely reported at the time in the financial press and in *Changing Banking for Good*, a report of the UK Parliamentary Commission on Banking Standards (2013a)

Some banks told the Commission that shareholders had put pressure on management to increase leverage. RBS said that 'in some instances investors pressed for what were arguably unsustainable levels of return, creating pressure to increase leverage and take on additional risk'.

The Report also states that HSBC chairman Douglas Flint told the Treasury Committee that 'there was a great deal of pressure coming from shareholders who were looking for enhanced returns and were pointing to business models that have, with hindsight, been shown to be flawed and in particular very leveraged business models and saying, "You guys are inefficient. You have a lazy balance sheet. There are people out there that are doing much better than you are", and there was tremendous pressure during 2006/07'.

Meanwhile, non-executive directors, rather than offering the wise counsel and caution in the face of risky behaviour, may have encouraged more risky behaviour. Lee Jones reporting in *MoneyMarketing* in December 2008 said that Vince Cable, later business secretary in the UK government, told delegates at the Council of Mortgage Lenders' annual conference that one of the UK's top bank chiefs had admitted to him two years previously that his bank's lending practices were 'foolish and dangerous' (Jones 2008). Cable said the admission came from the chief executive of the bank: 'I had dinner with a chief executive of one of the now recently part-nationalised banks and we argued for an hour about his lending practices.' Finally he accepted that his bank's lending was foolish and dangerous, but said that he would have been sacked by his board if he had not lent these mortgages. Presumably the non-executives thought that shareholders would have been unhappy if lending practices had been reined in.

Corporate governance is meant to work on the basis that shareholders will provide the necessary pressure on boards to make it work. There is a perhaps unconscious presupposition that shareholders and non-executive directors know what is best. Clearly this is not always the case.

Examples of savers holding professional fund managers to account are difficult to find. And there is little prospect that this situation will change. The 'holding to account' component is working particularly poorly for providers of capital. The US governance expert Robert Monks gave a provocative keynote address at the International Corporate Governance Network (ICGN) annual conference in Paris in 2011. Addressing an audience comprising

mainly members of the institutional investor community, he said: 'This is a call to those responsible for the savings and dreams of hundreds of millions of trust beneficiaries.... Your beneficiaries suffered unacceptably large losses during the recent financial crisis attributable in substantial measure to your failure, as owners and as trustees, effectively to protect their interest' (Yemisi 2013).<sup>9</sup>

He quoted Princeton scholar Charles E. Lindbloom, who raised the importance of proper governance to wider society: 'Enormously large, rich in resources, the big corporations... command more resources than do most government units. They can also, over a broad range, insist that government meet their demands, even if these demands run counter to those of citizens.... And they exercise unusual veto powers.' To sum up, Lindbloom said: 'The large private corporation fits oddly into democratic theory and vision. Indeed, it does not fit.' Owners acting responsibly and effectively as stewards can answer this conundrum.

Monks went on: 'Hundreds of millions of persons have interests as shareholders in publicly traded corporations either directly, through mutual funds, insurance policies or employee benefit plans (including pensions). Because of the revolution in electronic communications shareholders can be informed, their opinion can be asked and their approvals solicited – all through the Internet, all for free, and all in very short time. The average member of the public thinks of "business" as an impersonal corporate entity, owned by the very rich and managed by overpaid executives. There is an almost total

failure to appreciate that "business" actually embraces in one way or another most citizens. But the hundreds of millions of shareholders – most of whom are of modest means – are the real owners, the real entrepreneurs, the real capitalists under our system.

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**'There can be no effective corporate governance, until, unless and to the extent that the major institutions become involved.'**

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This will not happen until and unless there is a formal legal policy that shareholder activism is in the public interest and is the national policy. Governmental response to the existing crisis does not give confidence that there will not continue to be major crises. Direct government involvement has had many unfortunate consequences with which we have not even begun to cope, not the least of which is the destruction of the legitimacy of corporate governance. The absence of corporate governance threatens the scenario of adequate resources to meet societies' needs.

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**'Whether we live in a poor or an adequately financed society depends on the effectiveness of our system of corporate governance. Institutions must take the initiative to protect their relevance as a wealth preserving energy in a free society. They cannot wait for others, nor can they decline to act. Institutions must take the lead, because all other courses have failed.'**

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The picture is not all gloomy. There is some encouraging activity by some shareholders. There are a few fund managers for whom engaging with companies to improve their ability to create value over the longer term is a key part of their investing strategy. Such funds are less concerned with diversification and they invest in far

fewer funds than would most fund managers. Their business model relies on research and choosing a few companies with which they can work.

### **COMPLY OR APPLY AND EXPLAIN?**

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Corporate governance in most countries is meant to be carried out on a 'comply or explain' basis, where companies report to shareholders on whether or not they have applied all the provisions of a code and, if they have not complied with all of them, must state which ones they have not complied with and explain why not. This is the 'inform' leg of the framework. If the 'inform' leg is not working well, the 'holding to account' leg is also unlikely to work. The European Commission Green Paper on company law and corporate governance (2011) identified a problem and a subsequent EU Action Plan (European Commission 2012) said 'there is a perceived lack of shareholder interest in holding management accountable for their decisions and actions, compounded by the fact that many shareholders appear to hold their shares for only a short period of time. There is also evidence of shortcomings in the application of the corporate governance codes when reporting on a comply or explain basis.'

The ecoDa report *Comply or Explain* says, rightly, 'people should not forget that governance is not an end in itself but a means to an end. Companies should develop a governance model that helps them to reach the corporate goal and allows them to make effective decisions in the long term interest of the company, shareholders and stakeholders. The board is a crucial factor to this end. But also shareholders have to play their role to foster growth, strategy, entrepreneurship and sustainability. These questions should be at the heart of board and

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9. The full text of the address is reproduced on the website of the Network for Sustainable Financial Markets (2011).

shareholder meetings and not the questions of compliance with a governance code. If too much attention is paid to overly formalistic questions in relation to governance compliance, **the final goal of governance might be lost: making it a more successful and sustainable enterprise for all and not only a better governance-compliant company.**' (ecoDa 2012)

For the comply or explain principle to work, three things must be in place:

1. sound and sensible principles or provisions, preferably principles, usually set out in semi voluntary codes
2. good information by boards on how the principles have been applied and provisions complied with, and
3. engaged and wise shareholders who apply the necessary and appropriate influence on boards.

## **THE ACCOUNTABILITY FRAMEWORK**

The accountability framework of performing, informing and holding to account framework can be adapted for considering the efficacy of 'comply or explain' in any particular setting. The performing leg is replaced by 'sound principles or provisions' which, if applied, contribute to or help facilitate the creation of value.

Although this paper has not examined whether the principles and provisions in the many codes around the world are sensible and sound, it seems clear that codes have become too detailed and prescriptive, with too much focus on the provision and not enough on the principle, encouraging a box-ticking approach to assessing governance.

In order to ensure that governance creates sustainable value, the codes

and the three framework components – performing, informing and holding to account – need to work at each of the three interfaces: between management and boards; boards and institutional shareholders; and institutional shareholders and those who entrust their money to them. At present they do not do this well enough.

If the principles and provisions do not create the framework for effective governance, the information supplied on their application and compliance has little value – even to engaged shareholders.

Following recent events where a number of financial institutions not only destroyed their own value but also imposed great costs on millions of people, and where a number were accused of criminal behaviour, few individuals have been singled out for culpability. This suggests that governance procedures have not prevented risks and not protected shareholders or other stakeholders. It may also suggest that far from helping create value, governance has been more efficacious in creating elaborate structures that shield people from blame when things go wrong.

For many, corporate governance has become an end in itself. It has ceased to help and, arguably, has made it harder for companies to create value. For now at least, what ecoDa called the final goal would seem to have been lost.

Equity markets suggest a gloomy picture of the effect of governance in developed markets. Over the longer term, enterprises that create value for themselves and the economy should also grow in value and equity prices ought to reflect this. The OECD *Pensions Outlook 2012* shows that the weighted average real return for pension funds across the 20 OECD countries was negative: 1.6% annually between 2007

and 2011 and 0.1% between 2001 and 2011(OECD 2012). The OECD also identified that equity withdrawal has shrunk equity markets, making it difficult to create value for savers.

Although pension funds do not invest solely in equities, they tend to rely on equities for growth, with other investments used as a less risky store of value for people nearing retirement. Since 2001, for most people, investing in equities has created little, if any, value. The attention given to governance and risk management over the last 10 years seems to have done little for investors, although returns might have been worse without the existing governance systems.

Arguably, in recent years too much confidence in the ability of markets to find correct prices has meant that price was believed by boards and investors to equal value. The recent rise in many equity markets has been caused not by economic fundamentals or by business growth but by savers' efforts to find stores of value in the face of government actions to increase the money supply by quantitative easing, currency deflation, and other attempts to stimulate growth and reduce the real value of government borrowing.

To return to the stool analogy, the 'inform' and 'holding to account' legs are not working. The 'perform' leg is not working either. Few codes articulate a purpose for corporate governance and fewer still articulate a purpose resembling creating value or successful sustainable enterprise. Without this clarity of purpose it would be a fluke if governance were to be widely seen as relevant to, let alone used for, creating value. This 'purpose' is completely missing in most countries. Corporate governance, as it exists now in much of the world, is like a three-legged stool with two wobbly legs and one completely

missing. People are not sure what it is for and such a stool has little practical use. Nonetheless, it could be fixed and so could corporate governance.

*King III* says: 'The "comply or explain" approach could denote a mindless response to the King Code and its recommendations whereas an 'apply or explain' regime would show an appreciation for the fact that it is often not a case of whether to comply or not, but rather to consider how the principles and recommendations can be applied'. *King III*, therefore, is based on 'apply or explain'.

*King III* also says 'It is the legal duty of directors to act in the best interests of the company. In following the 'apply or explain' approach, the board of directors, in its collective decision-

making, could conclude that to follow a recommendation would not, in the particular circumstances, be in the best interests of the company. The board could decide to apply the recommendation differently or apply another practice and still achieve the objective of the overarching corporate governance principles of fairness, accountability, responsibility and transparency. Explaining how the principles and recommendations were applied, or if not applied, the reasons, results in compliance. In reality, the ultimate compliance officer is not the company's compliance officer or a bureaucrat ensuring compliance with statutory provisions, but the stakeholders.'

It should be noted that *King III* says, 'All entities should, by way of explanation, make a positive statement about how

the principles have been applied or have not been applied. This level of disclosure will allow stakeholders to comment on and challenge the board on its quality of governance.' *King III* expects entities to say **how they apply the principles and explain if they have not applied a principle**. In other words, explain how you do and explain if you don't'. The phrase 'apply and explain' may be more appropriate.

An 'apply and explain' approach deserves to be encouraged. ACCA has often stated its preference for the application of principles over mere compliance with provisions. Although it is easier to apply a 'box-ticking' approach to provisions than to use principles, it is essential to look intelligently at how principles are being applied and to hold people to account where necessary.

## CONSULTATION QUESTIONS

Q7.1 Is the comply or explain approach working as it should?

Q7.2 Should 'apply and explain' replace 'comply or explain'?

Q7.3 Do you agree that the three components of governance are not working properly and that the overarching purpose of corporate governance is not being achieved?

**Q7.4 Which of the three areas, performing, informing and holding to account, is most problematic? Are there any simple fixes?**

Q7.5 What can be done to enfranchise savers who entrust money to institutional investors, so that the former can hold the latter to account for their performance?

Q7.6 Is there a need for representative bodies to look after the interests of savers?

**Q7.7 Which of these relationships is most problematic? Between: (a) executive management and boards, (b) boards and institutional shareholders, (c) institutional shareholders and savers. Are there any simple fixes?**

## 8. Value creation and national economic growth

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Adam Smith (1776) identified three types of income in a market economy: profit, rent and wages. 'Profit' creates real wealth, rent and wages merely (re) distribute wealth.

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An enterprise can generate profit in one of two ways:

- by providing goods or services that others are willing to buy; if both parties benefit, so does the economy
- by using regulation or some other mechanism to charge a higher price than would exist with proper competition. Termed 'economic rent', the value or excess price is transferred from one party to another and does not enlarge the overall economy.

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**Much of the profits reported by investment banks in recent decades were owed to value transfer rather than value creation. The consequent losses suffered by taxpayers, savers and investors have been reflected through tax subvention, lower returns on investments or deferment to future generations.**

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**Are we taking someone else's slice of the cake?**

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Policymakers and regulators should focus on measures that encourage businesses to enlarge the overall economic cake rather than profit from transferring value between individuals or firms.

It is necessary to distinguish real value creation from the illusory growth that contributed so much to the recorded 'growth' of the latter part of the 20th century and the early part of the 21st century. Asset values rose with no obvious losers, but as money does not grow on trees (see Box 8.1) much growth merely transferred value from providers of finance, such as retail savers and less sophisticated lenders. With governments struggling to remain solvent, a different value transfer is

taking place, from those with assets to those with borrowings. This has happened and is happening through inflation, through debt default (Greece) or state seizure of savings (Cyprus) and pensions (Argentina).

In addition to the definition of three types of income in a market economy, Adam Smith observed that economic rent could arise from rights and privilege, as well as a charge for using land, buildings or other tangible assets. This contribution of economic rent to the 'profits' of many businesses is particularly high in regulated sectors and those that enjoy state support – banking, house-building and various public services and utilities.

Profit, in the free enterprise, Adam Smith sense, will cause the economic cake to enlarge, while rent is about transferring a slice from one party to another.

In many sectors, and in many companies, it is difficult to distinguish between profit and economic rent. In reality, the profits of many large companies are a mixture of the two; but some companies and some sectors tend to have relatively more rent and others tend to have more profit. If one is interested in promoting genuine growth there is a need to distinguish profit that helps create wealth from 'profit' or rent that merely transfers wealth. Government policies and, arguably, investors should aim to promote businesses that profit from creating value in a competitive environment and refrain where possible from assisting businesses that depend significantly on economic rent.

Regrettably, institutional investors probably have more incentive to prefer businesses that extract rent to those that create economic value, as the

### BOX 8.1: QUANTITATIVE EASING OR 'MONEY DOES GROW ON TREES'

In his celebrated trilogy in five parts entitled, *The Hitch-Hikers Guide to the Galaxy*, Douglas Adams describes the events when Ford Prefect and a 'load of middle management men' from the planet Golgafrincham land on an uninhabited planet Earth, which they intend to occupy. After 572 meetings of the 'colonization committee' on the new planet, they have arrived at the topic of fiscal policy:

MANAGEMENT CONSULTANT: Um listen, if we could, er, for a moment move on to the subject of fiscal policy -

FORD: How can you have money if none of you actually produce anything? It doesn't grow on trees you know!

MANAGEMENT CONSULTANT: You know, if you would allow me to continue! Since we decided a few weeks ago to adopt leaves as legal tender, we have, of course all become immensely rich.

FORD: No really? Really?

MANAGEMENT CONSULTANT: But, we have also run into a small inflation problem on account of the high level of leaf availability. Which means that I gather the current going rate has something like three major deciduous forests buying one ship's peanut. So, um, in order to obviate this problem and effectively revalue the leaf, we are about to embark on an extensive defoliation campaign, and um, burn down all the forests. I think that's a sensible move don't you?

[Murmurs of agreement from crowd]

FORD: You're absolutely barmy! You've a bunch of raving nutters!

### BOX 8.2: A SOURCE OF ECONOMIC RENT TO BANKS

Banks benefit hugely from government guarantees and from access to very cheap money. Andrew Haldane, Bank of England executive director financial stability, calculated that the annual value of this subsidy to the five main UK banks between 2007 and 2009 was over £50 billion – roughly equal to banks' annual profits prior to the crisis. At the height of the crisis, the subsidy was larger still.

Haldane put the average annual subsidy for a sample of five top global banks as just under \$60 billion per year. He estimated that the loss of global economic output caused by the financial crisis could be \$200 trillion. If a levy were to be imposed on banks to recoup these costs it would have to be at least \$1.5 trillion annually – more than the total market capitalisation of the largest banks (around \$1.2 trillion) in 2010 (Haldane 2010).

former are generally less risky and their results are more predictable (until regulations change). Measures currently used for assessing corporate performance do not distinguish between these two types of income. Governments, companies and shareholders have been trying to manage performance using measures that have become problematic.

**Put simply, the problem is that it is difficult to know what 'good' is.**

Governments seem not to know where wealth comes from or how to create economic prosperity; and politicians disagree on simple yet fundamental questions such as whether a government should borrow its way out of a debt crisis.

- Published company accounts do not readily convey whether a company is in a better position to create future value at one balance sheet date than it was one year earlier. 'Profit' is easily gamed and is a particularly inadequate measure.
- Annual reports and accounts do not show whether profit comes from genuine value creation or from economic rent. The distinction may not be important for many investors individually, but for investors as a whole and for society it is crucial.
- Shareholders and investors therefore lack suitable metrics for determining the value of companies. The metrics they use are inadequate. This view may be controversial but the well-documented inability of actively managed funds to beat the market is powerful evidence.

There is a pressing need to find and use better measures of performance.

### BOX 8.3 BUSINESS, FINANCE AND MONEY CREATION THROUGH THE AGES

Looked at through the eyes of someone alive today, businesses might have appeared simpler during the industrial revolution than today and governance more straightforward. The reality is rather different. Then, as now, finance had to be raised, new technologies developed, distribution and transport systems revolutionised, people moved, housed, fed and trained. Ways had to be found to track cash, assets and liabilities. It has been suggested that the ability of companies to expand was, in the past, limited by the ability of their accounting and business systems to cope. The IT revolution has enabled large organisations to keep track of finances but has also contributed to a dramatic rise in the use of complex financial instruments (see Moxey and Berendt 2008) and hastened the financialisation of capital markets.

The *Kay Report* on UK equity markets identified the problem of financialisation (Kay 2012). As the nature of listed companies' business has changed over the last 20 years, boards have become less interested in developing businesses than in trading them through mergers, acquisitions and divestments (Moxey and Berendt 2008). The report observed that businesses invest less and find it more difficult to access finance than in the late 20th century. Trust is vital to business activity; anecdotal and survey evidence suggests that trust in business has declined (see, for example, Edelman Trust 2013). Without trust in the conduct of others and the enforceability of contracts, much of the growth of the past few hundred years would not have taken place. Finance would not have been forthcoming and long-distance commitments not made. As ownership increasingly became separated from management and disbursed across multiple parties, appropriate modes of governance developed to suit an increasingly industrial economy.

Trust in money is also vital. Money as a store of value and as a means of exchange plays a role that is essential but often misunderstood, as is the role of banking in enabling enterprise. It is well known that banks enable investment and growth by lending money. What is less known is the source of that money. People find it hard to believe that banks create new money from nowhere. Galbraith (1975) said that 'the process by which banks create money is so simple that the mind is repelled. Where something so important is involved, a deeper mystery seems only decent.'

How do banks create money? Before modern banking evolved, goldsmiths stored gold on behalf of others and issued receipts – an early form of paper money – to depositors. These receipts were more convenient to carry around and use than gold and they became widely accepted, allowing trade to flourish. People believed that each receipt was backed up by gold stored by the goldsmith. Goldsmiths realised that they could profit from their trusted status and lend money by issuing similar receipts that could also be used as a means of exchange. This encouraged expansion of trade and growth in economic activity. In creating money, the goldsmiths also created debt in equal amount. Everyone was happy until a few people suspected that a particular goldsmith did not have enough gold to back up the receipts he had issued, which triggered a run on the goldsmith.

Rulers decided that, as well as getting rich from their activity, goldsmiths were performing a function that could be useful to them – financing trade, overseas expansion and wars – and they allowed goldsmiths to become bankers. From the late 1600s, central banks became established and were authorised to limit the amount that other banks were allowed to lend as a multiple of the reserves they held, so the fractional reserve system was born. This allowed central banks to control the expansion of both money supply and debt. While an economy can benefit from a growing amount of money, too much growth can trigger major problems. During the 1990s and, particularly, the early 2000s the limits on the fractional reserve system effectively came to an end as banks used securitisation, derivatives and off balance sheet vehicles to increase leverage from a previously typical 10 times capital to 50 times or more. Collateralised debt obligations and credit default swaps allowed effective leverage of several thousand times (Tully and Moxey 2011). This turbocharged the creation of money and debt and the financial system became awash with liquidity, facilitating housing booms and stock market and other asset bubbles. The amount of money, debt and liquidity grew unsustainably and the bust inevitably followed the boom.

Meanwhile, growth in productivity and wages in the period immediately following the Second World War led to increasingly powerful pools of capital from savings accumulation through pension funds and asset managers. The model of ownership through beneficially held investment by remote managers, predominantly in listed businesses, funded tremendous corporate growth in the latter part of the 20th century. In 2008, liquidity collapsed, and growth now appears increasingly to be under threat, with investors chasing ever-riskier investments to earn the required yields. Prominent corporate failures and misdeeds suggest that the governance model that has emerged since the 1950s in response to diversified portfolio management by professional asset managers may no longer suit the conditions under which investment occurs.

Institutional shareholders face their own short-term performance pressures. With the growth in stock lending, some shareholders are able to profit from short-term trades and have become less interested in a firm's long-term growth prospects. The investment chain lengthened to include more intermediaries between companies and individuals. Conflicts of interest abound. The flood of liquidity in the late 20th and early 21st centuries meant that finance was easy to come by and shareholders became relatively less important as boards looked to private equity to finance de-listing their companies. That flood of equity has dried up and capital now is more concerned with looking for safe havens: seeking investment opportunities without downside risk.

The governance challenge for institutional investors is further complicated by the fact that as well as owning shares in companies they may also own their debt. A derivatives market in collateralised load obligations is developing with loan default swaps also being written. This mirrors the collateralised debt obligations and credit default swaps which featured in the sub prime crisis that led to the credit crunch and financial crisis.

## ECONOMIC GROWTH

Measures of the economy such as growth and GDP are particularly problematic. They are highly misleading.

There are many ways of recording growth artificially.

- Central banks and governments can intentionally cause inflation by debasing the value of their currency.
- Activity without any added value may be measured (I buy something from you; you buy it back from me... Voilà! Growth!). This would include much retail activity and many financial services transactions, including much of the securitisation of loans that led to the recent credit crunch.
- Borrow from someone else (our children are normally best) to fund spending by individuals or government.

The above methods will flow into GDP calculations (although the first will be excluded if adjustment is made for purchasing power parity (PPP)). They are favoured by governments and are easy to do, but none of them will produce genuine lasting growth. GDP is perhaps best thought of as a country's profit before interest and certain other costs. It is important to be very wary of actions that boost GDP but that also create liabilities and so boost financing costs.

There are only two ways that genuine per capita economic growth can occur:

1. by finding some more resources – done by miners, explorers, inventors and entrepreneurs

2. by innovation – making or doing something new, better, cheaper or more efficiently that people want with fewer resources – done by innovators, entrepreneurs, adapters and improvers.

A third way to create economic growth is to have more people, but this does not create growth per capita.

Governments' ability to affect any of the above positively is very limited and their attempts to do so can be clumsy and counterproductive. The easiest for them to influence is the third – having more people. They help this through encouraging immigration and tax or welfare benefits for parents with children, and subsidising child care. This will not make other individuals better off.

The only ways to create wealth per capita are through the first or second methods. Both primarily require a dynamic commercial and industrial economy prepared to innovate and take risks in the process, in the expectation of earning a reward. In mixed economies, this must be aided by state assistance in providing the requisite infrastructure, the rule of law and a business- and stakeholder-friendly legal framework that promotes trust, together with an educated and healthy workforce. Innovation in service industries, including financial services, will contribute to genuine economic growth if it means that ultimately fewer resources can be used for a given output.

The public sector, therefore, rather than being (as characterised by some) a drain on wealth, is an essential enabler of prosperity in any modern society.

To achieve growth using the first two methods requires good governance. This is what mainstream governance

and economic debate should be tackling. Instead, both governance and economic debate seem locked in endless rounds of futility. Steven Covey, the effectiveness guru, said 'begin with the aim in mind' (2004). This is good advice; governance can be an engine for economic growth if those responsible – management, board directors, shareholders and policymakers keep in mind that governance is about creating value.

Economic growth and commercial development are greatly assisted, but not caused, by access to finance and payment and money transmission systems. The economic expansion during the 18th, 19th and 20th centuries could not have happened without these. Financial services, therefore, are essential but must be made to work for society. As discussed above, not all business activity will lead to growth in value.

### CONSULTATION QUESTIONS

Q8.1 Is there a pressing need to find better measures for performance?

Q8.2 Is there a public interest purpose in distinguishing how companies create 'value' between competitive profit and economic rent?

**Q8.3 Should economic and other policies to promote growth attempt to encourage companies to create value rather than capture value that others have created? How could regulators, investors and employees do this?**

## 9. Doing the right thing

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In recent years, there have been numerous reports of organisations and their people having lost their moral compass.

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These include LIBOR and gas price-rigging, rogue-trading, money-laundering, mis-labelling of meat, mis-selling of payment protection, credit card and identity theft insurance, mis-selling of interest rate swaps, precipice bonds and domestic energy contracts, phone-hacking, annualised interest rates of over 4,000% charged on payday loans, bribery, ill-treatment of patients in hospital, cover-ups, manipulation of performance measures, a lack of sense of personal responsibility, and generally a reckless disregard for others. Many examples come from highly regulated sectors: finance, health, food and energy, and even from the police. There have been attempted cover-ups in banks, in Parliament, newspapers, the police and the NHS. These instances have become sufficiently numerous as to suggest a systemic problem.

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**It seems appropriate to consider the purpose of business and whom it serves.**

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In Adam Smith's world of business, an invisible hand guided businesses to create wealth for society. While the distribution of wealth in that society may not seem fair by today's standards, there is no denying that business created wealth for some and lifted many more out of poverty and subsistence living. It also fostered tremendous innovation. Such businesses contributed to a public good. Government's job at the time was to facilitate business and, gradually over time, society imposed its own standards about how wealth should be distributed and the environment in which people worked. There were some notable examples, such as Cadbury and Rowntree in the 19th century, of

company owners/directors who chose to support their staff by providing houses, education and pensions.

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**As enterprises exist within a society they have a responsibility to act responsibly and to contribute to society.**

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It is implicit that enterprises should create value and not simply engage in extracting value from others. Enterprises should contribute some public good and companies should say how they have done so.

The golden rule, found in most of the world's religions, 'do to others as you would have them do to you', does not give any particular direction or steer. Nor, in general, do most company and professional ethics frameworks and codes: they lack a moral compass. Even those that are expressed in terms of values rather than conduct contain much ambiguity.

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**While it may be too simple to say just 'do the right thing', this is the essence of what is needed.**

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A requirement to conduct enterprise for the public good should help. Everyone has a sense of what constitutes the public good. There may be occasions when one person's sense of public good may be another person's idea of public bad but, if the principle were enforced by the court of public opinion, it could be effective. Any bad should be outweighed by the good – at least as far as society at any time might judge what 'good' is.

Adam Smith, presumably, would have agreed. He said that 'by pursuing his own interest a person frequently

promotes the interest of society more effectually than when he really intends to promote it' (Smith 1776). He was cynical about the good done by people who affected to trade for the public good. It is clear, however, that we can not leave governance, policy or business entirely to pursuit of self interest. Hopefully, peer pressure will temper self interest.

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**We live in an age of transparency and openness. If, as a society, we expected companies to operate for the public good as they make profits, then companies would do so. There is no need to specify the extent of public good or how it is done.**

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Quality reporting should mean that companies will be rewarded if they are effective in both making profit and doing public good. Reporting must be true and fair, with the avoidance of glib, empty or misleading statements; and companies must not use such reporting as a public relations exercise. The internet age means that inappropriate reporting is likely to be spotted quickly.

It may be better not to define the public good but to leave it vague, because more definition could invoke Goodhart's Law, and encourage people to 'game' it. The public good is not, of course, about economic good alone. While economic well-being is nice, other things are equally, if not more, important. Bhutan has the concept of Gross National Happiness and, theoretically at least, is governed so as to raise happiness. Unlike GDP, this is not one target but a basket of targets across nine areas, so its susceptibility to Goodhart's Law should be limited.

Although securitisation of loans can serve a valuable public good in

enabling people with funds to provide them to people wanting them, and for risk to be taken on by people best placed to do so, the system went off the rails. Financial institutions were able to pass bundles of debt and related derivatives to individuals and other institutions that had little idea of what they were buying. Those involved had every incentive to 'game' the system and no incentive to do a public good. It is hard to envisage how the resulting bonanza for traders, then meltdown for their employers, could have been described by anyone as being a good thing; a requirement to work in the public good might have curbed animal spirits when there was no other restraint.

The concept of public good gives a clear moral steer or compass, and flexibility in how companies can contribute. The idea may sound radical, but the UK company law framework already went some way towards putting it into law when it adopted the 'enlightened shareholder' concept in the UK Companies Act 2006. The Act, in Section 172, confers a duty on directors to promote the success of the company and, in the course of making their decisions to that end, requires them to 'have regard' to a number of specific factors. As discussed in Box 1.2 of Chapter 1, Section 172 has not worked as many had intended.

It is implicit that, in having such regard, directors do not cause the company to harm the community or the environment. An amendment to include explicit reference to the public good would merely provide a subtle but vital direction.

## THE ROLE OF SHAREHOLDERS

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At present, Section 172 can be enforced only by shareholders and such enforcement has not happened yet. It is not clear how, if at all, boards pay attention to their responsibility under Section 172.

Given that a substantial proportion of the shares of large listed companies are owned by institutional shareholders investing on behalf of millions of people, it is reasonable to expect such companies to operate in ways that contribute to rather than harm society. Most smaller businesses do this already. To a great extent, to operate they rely on trust and common sense within the business, rather than on detailed internal controls. These firms are generally formed and evolve to meet a market need and in so doing contribute to the public good through Adam Smith's invisible hand; they are not usually able to exploit the benefits of oligopoly or to game regulation. A small business will not survive long if it treats its stakeholders – employees, suppliers, customers or local community – poorly.

Institutional shareholders should be encouraged to take an active interest in how their investee companies work in the public good. This could be the missing part of the Stewardship Code of the Financial Reporting Council (FRC). *The UK Corporate Governance Code* (FRC 2012), which currently makes no explicit reference to ethics, and which emphasises compliance with provisions at the expense of upholding principles, could also include a main principle that companies work in the public good and require companies to report truly and fairly how they do so.

## CONTRIBUTING TO THE PUBLIC GOOD

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There is an intrinsic satisfaction that most people derive from doing something good. The overall effect should be to promote trust, which in turn would promote enterprise and lead to a healthier, probably more prosperous and happier, society and reduce the regulatory burden.

Considering the public good would also provide a directional steer for regulation and supervision and could enable considerable reduction in regulatory complexity. Supervisory action taken transparently by reference to the public good should be simpler to enforce. A financial institution or company would have a clear test and would know it might have to explain its actions. This might be better than slavishly checking compliance with hundreds of regulations that may well, in any case, have unintended and unfortunate consequences.

## THE VALUE OF VALUES

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The authors' papers on the credit crunch (Moxey and Berendt 2008) and risk and reward (Davies et al. 2010) emphasise the importance of ethics and values. These should have a more prominent place in governance codes, most of which are silent on the subject or make only cursory reference to it. The South African King codes stand out in this respect and put ethics at the heart of governance.

Analysis of corporate failures reveals that many were the result of cultural problems, such as greed, dishonesty, falsification and occasional corruption and plain theft. There are plenty of examples of people doing the wrong

thing. Ethical codes can help curb the tendency to do the wrong thing, but doing the right thing is more about people having the right values.

If people have the right values they will do the right thing without needing to be told, or when no one is looking and even if others urge them to do the wrong thing.

The first principle of the UK Corporate Governance Code says 'Every company should be headed by an effective board which is collectively responsible for the long-term success of the company', and included in the supporting principle is the statement that 'The board should set the company's values and standards and ensure that its obligations to its shareholders and others are understood and met' (Financial Reporting Council 2012);

If the board does not set the right moral tone and values it is unlikely that a healthy culture will evolve by itself. Boards and shareholders alike should want to consider how well boards do this and satisfy themselves that the right values and standards are embedded throughout the organisation. There is no requirement in the UK or most governance codes to do this, but *King III* does require extensive disclosure on ethical matters, including the following stipulations.

'The board should:

1.1.7. set the values to which the company will adhere formulated in its code of conduct, [and]

1.1.8. ensure that its conduct and that of management aligns to the values and is adhered to in all aspects of its business.' (IoDSA 2009)

The chairman of UK defence company BAE offers a useful case study on the business benefits of doing this (Olver 2013). BAE came in for severe criticism over allegations of bribery in an arms deal (BBC News Channel 2010) and in 2010 paid £286m to settle US and UK probes into its conduct. The board of BAE resolved to change the culture: 'The culture we've tried to develop is one in which our people take the company's core ethical values into account in every decision they take. One where doing the right thing becomes an almost subconscious response' (Olver 2013).

ACCA has often advocated that companies should assess their ethical cultural health. *Risk and Reward: Tempering the Pursuit of Profit* (Davies et al. 2010) discusses this and offers an approach to how it can be done. Dick Olver highlighted five elements for creating a new 'culture that sticks, and is effective not just in its home market, but internationally' (Olver 2013).

He said it is necessary to:

1. ensure that the board structure is world class
2. have the right executive group
3. have an objective understanding of the organisation's culture today and where it should be changed
4. embed the new culture across the business and then sustain and develop it over time, and
5. apply the right values to forge new relationships with important external stakeholders.

### BOX 9.1: PANASONIC CODE OF CONDUCT\*

In 1929 the Panasonic Group wrote down a set of principles to guide its employees. The basic business philosophy (Panasonic Group 2013) sets forth the *raison d'être* of the group, describes the overall approach to corporate management, and explains what it expects from individual employees.

From the company's mission statement to the values that guide the basic attitude and behaviour of employees, the corporation lays great emphasis on the role it plays within society. A wider view is taken than just the financial bottom line; and considerable emphasis is placed on the role of the company in contributing to society through its business.

The attitudes and behaviour of its employees are embodied in the company creed and the basic business principles, of which there are seven:

- i. contribution to society
- ii. fairness and honesty
- iii. cooperation and team spirit
- iv. untiring effort for improvement
- v. courtesy and humility
- vi. adaptability
- vii. gratitude.

These principles aim to guide the employee in the direction of what the company sees as acceptable business behaviour.

They form part of the behavioural competencies that employees are assessed upon as they progress through their career and are embodied within the annual performance appraisal.

How do they operate on a day-to-day basis? Although they may appear to some as a detached creed which could not possibly work in a commercial world, my observations are that they work very well. Fairness and honesty do not hinder good business; indeed, they enhance it. External parties, once they get to know the company, appreciate that business will be conducted in a fair and open manner. This does not mean that hard business decisions are not made – they are – but as part of the consultation, all aspects of compliance are considered as well as the social impact.

Furthermore, senior managers throughout the group are made aware of their obligation to ensure that the company is steered along the correct path. Management is given a card to keep as a reminder, which says 'No matter how Panasonic's management transforms and how it is steered, it remains essential that all of us be committed to ensuring compliance based on our unchanging management philosophy. We must not underestimate the significance of this under any circumstances. It is important that not only the executives but also each one of the frontline staff always be aware of the importance of compliance. It is also important that we have a "transparent and self-correcting" environment in place where we can be sure that any such potential problems are found and resolved while they are still easy to address.'

The company's creed and pledges were put in place by the founder of the Panasonic Company, Konosuke Matsushita, in 1929. He founded Matsushita Electric, initially producing an electric light socket, in 1918 at the age of 24. This corporation grew to become the highly successful Panasonic Corporation. In 1962 *Time Magazine* ran a cover story on the management style of Konosuke Matsushita and from this grew wider interest in the company's ethics and principles.

Konosuke Matsushita was a rare individual, there are many books written about his life story. Born into a wealthy family, his father lost the family resources through speculation. He then suffered hardship as a young boy apprenticed at a very young age and working to support himself and his family. His redemption was that every part of that journey was used as a source of inspiration and learning. He never stopped in the pursuit of wisdom and this he maintained was the source of his youthful attitude.

How do employees view the principles today? By virtue of the way they are promoted, not as glitzy corporate culture but as a part of the company's history; and the fact that the founder was so humble does influence people. Generally, you will find a very high proportion of good calibre, ethical people within the company, who have a genuine concern for those around them.

\* Kindly contributed by Carol Jones, finance general manager and company secretary, Panasonic System Networks Company UK Ltd.

Some people might think that rigorous adherence to an ethical code could harm the business. Olver said: 'the received wisdom across the global defence and aerospace industry was that we'd seriously shot ourselves in the foot and that we would simply stop winning contracts in many countries. This view was reinforced by the fact that we now actively turn down projects if we think they might cause us to contravene our ethical code' (2013). 'In practice, what looked to many like an albatross around our necks has turned out to be a big winner with customers across the world who positively want to deal with providers who behave ethically. This year, our order book outside the US and UK is twice the size of a year ago'. 'We're winning more business. And we're doing it in our own way, and on our own terms'. That an

arms company should find ethics and values good for business is refreshing.

Other companies have embraced the importance of good conduct since their early years. A well-known example is the Credo written in 1943 by Johnson and Johnson (n. d.). It sets out and prioritises its responsibility to its various stakeholders, putting the users of its products first and its shareholders last.

An earlier and perhaps lesser known example (see the case study in Box 9.1) comes from Panasonic – it dates back to 1929.

Having the right values is essential to good business and good governance. It is essential to consider how boards can ensure that their companies get this right.

Richard Barratt offers an innovative approach (see, for example, Barratt 2006) to how corporations can assess their values and those of their staff, and work with the staff to improve the firm's culture. Companies should report on how their boards ensure that the right culture and values prevail. Brief details of this approach are given in *Risk and Reward: Tempering the Pursuit of Profit* (Davies et al. 2010)

## CONSULTATION QUESTIONS

### **Q9.1 Is lack of trust a problem? What should policy makers, businesses, and investors do to restore trust?**

- Q9.2 Should institutional shareholders, on behalf of those who entrust money to them, take an interest in how companies contribute to the public good?
- Q9.3 Could sharper focus by investors and others on how companies contribute to public good help ensure that companies act as responsible citizens and reduce the need for regulation?
- Q9.4 Do you agree about the importance of values?
- Q9.5 Can you supply examples of where a focus on values has helped company performance?
- Q9.6 Is there a need to review the purpose of the corporation and its role in society?

## 10. Implementing the framework

Everyone should have an interest in helping to ensure businesses create value but conflicts of interest abound. Regulation may be part of the answer but a renewed focus by businesses, regulators and investors on creating value both for the business and for society is what is really needed.

### REGULATION AND THE STAKEHOLDER ECOSYSTEM

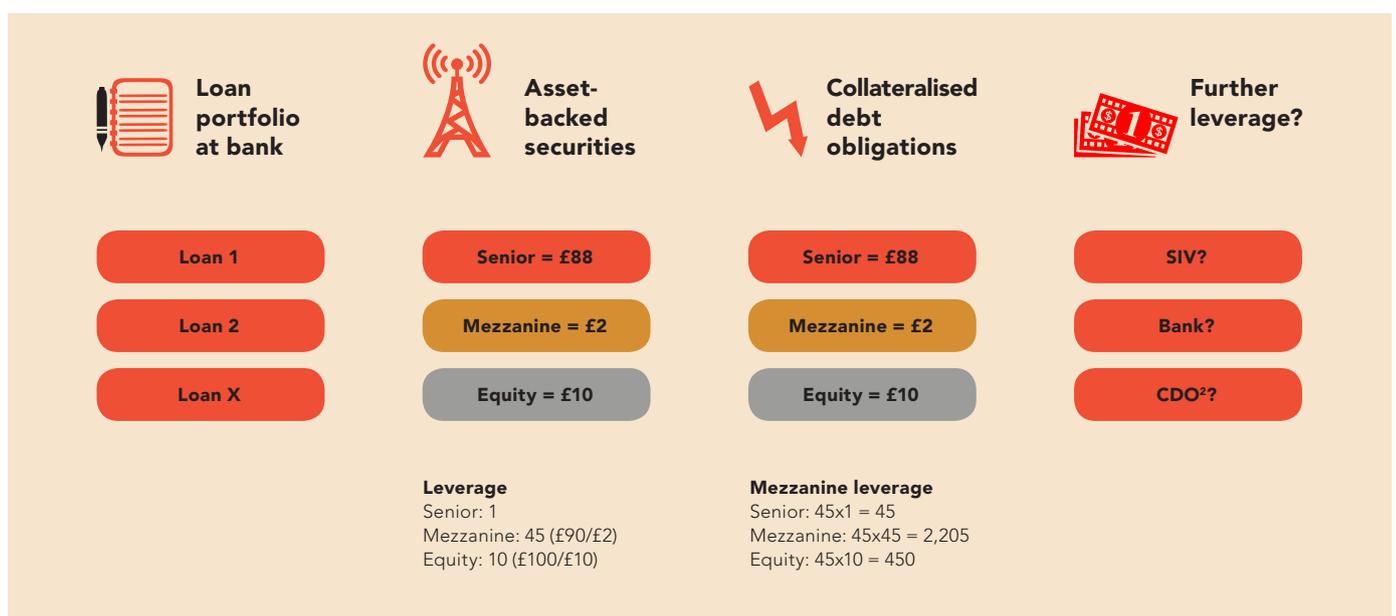
The 2008 financial crisis highlighted the unintended consequences of regulation. These are discussed in some detail in *Risk and Reward: Tempering the Pursuit of Profit* (Davies et al. 2010).

Perhaps the worst example of an unintended consequence comes from the Basel regulations on bank capital adequacy. In 1988 the Basel Committee on Banking Supervision (BCBS) met in Basel, Switzerland, to establish minimum capital requirements for banks. *Basel I*, introduced in 1988, contained 28 pages. It was superseded by *Basel II*, published in 2004, totalled 333 pages (plus definitions and index). Banks used their own risk models, further enabling them to fine-tune their holdings to minimise their capital requirement. Rather than ensuring

adequate capital reserves, the Basel regulations allowed banks to gear up risk several thousand times, through the use of off balance sheet vehicles, collateralised debt obligations and credit default swaps. *Basel III*, agreed in 2010–11, added a further 69 pages on capital and 69 on liquidity – making something 15 times bigger is unlikely to make it 15 times better. Will *Basel III* also spawn unintended consequences? It is too soon to say, but not inconceivable, particularly if Goodhart’s law applies.

Figure 10.1 shows how simple loans were ‘sliced and diced’ during the sub-prime mortgage credit boom using asset-backed securities, collateralised debt obligations (CDOs) leveraging return and risk over 2,000 times, and then further leveraged using structured investment vehicles (SIV), credit default swaps (CDS) and CDOs of CDOs.

Figure 10.1: The 2000s sub-prime mortgage credit boom bust



CDS can be likened to an insurance policy, with one vital difference. Whereas insurance cannot normally be taken out on something you do not own, anyone can take out a CDS and many CDS contracts were issued on the same financial instruments. In fire insurance terms this is like lots of people taking out insurance on one particular person's house. If perchance that house burns down, lots of people could cash in, giving arsonists a great incentive. CDSs gave a great incentive to the arsonists' counterparts in financial services and was a major contributor to the crash that followed the credit boom.

Regulation seems to be proliferating. The US 1933 Glass–Steagall Act after the 1929 great Wall Street crisis was 37 pages long. The 2010 Dodd–Frank Wall Street Reform and Consumer Protection Act, whose long title is 'an Act to

promote the financial stability of the United States by improving accountability and transparency in the financial system, to end 'too big to fail', to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes', has 848 pages. It has 1,600 sections and requires regulators to create 243 rules, conduct 67 studies, and issue 22 periodic reports. These rules are likely to take up several thousand pages and it seems inconceivable that none of the requirements created will be contradictory. This will create much work for lawyers and lobbyists. It will boost the army of experts employed in Wall Street to find ways around regulation. It is likely that enforcement will end up being more a political issue than a technical or legal one. There are bound to be unintended consequences.

There is something about regulation and the need for compliance that encourages some people not to behave responsibly – effectively outsourcing personal responsibility to regulation introduces moral hazard.

It is hardly surprising that some see compliance as negative; attitudes range from 'needless box-ticking' to 'a barrier to profit', or, worse, a profit opportunity – a constraint to work around and be gamed. Governance is often seen in the same way. In some cases, compliance brings many benefits – safety in aircraft and cars. Well-implemented governance can bring similar benefits.

Clear rules or procedures, and compliance with them, can also give people more freedom and actually empower them. This may seem a paradox but managers and parents alike understand that clear rules and a

**Table 10.1: The primary interests of the main stakeholders in the corporate governance system**

Stakeholder	Primary interest	Risk
Politicians	Get elected	Short-term focus, prefer simple solutions, little interest in root cause analysis, limited debate
Regulations	Keep job	No incentive for thorough solutions, multiple regulations with overlapping responsibilities
Audit firm	Revenue	Lose independence, apply rules not judgement
Asset managers	Short-term performance	Fail to distinguish between companies that create lasting value and those that emphasise capturing short-term value
Company executives	Bonuses	Short-term focus, manipulate earnings, destroy long-term value

justified trust in people's intentions to follow them mean that people can be allowed a freer rein to work or to play and constant supervision is unnecessary. What matters is the spirit or intent with which people approach compliance, further highlighting the importance of having a good culture.

The 2008 financial crisis revealed that financial regulators had too many objectives. They aimed to: protect the public, protect depositors, protect the banking industry, prevent individual banks from failure and protect the financial system as a whole. When crisis came, the conflict between these aims became apparent and, in many countries, the public had to bear the cost of protecting the banking industry to prevent failure of the financial system.

There can also be problems when multiple rules interact. The Basel rules may not have had such an unfortunate impact without the financial reporting regime at the time. While many of the flaws in Basel were pointed out at the time, the financial reporting framework was seen as more intellectually sound. The combination of the two sets of rules meant, for example, that bonuses could be paid on profits that were never realised, which provided a strong incentive to game the system. It is still not clear to what extent those responsible for reporting standards or capital adequacy feel the need to consider how their requirements will work in practice. Another unintended consequence of interaction of a different set of rules has been the demise of most defined-benefit pension schemes.

There is a need for regulators and standard setters to take a holistic look at the system rather than their more usual linear approach of identifying an

action to each identified problem. When doing such joined-up thinking, regulators and standard setters should also consider the motivations and incentives for the various stakeholders to act. In the absence of a referee, children playing football follow the spirit and usually the letter of the rules of the game. It is in their collective interest to do so as to do otherwise would spoil the game for everyone else. In the absence of a referee, children will also make sure that a player committing a foul is suitably dealt with. It is, however, hard to envisage how self-regulation could work in a professional football match. The financial incentives to cheat are just too strong. Incentives are crucial to understanding how people behave.

Despite the risk of making sweeping generalisations, the incentives of some of the key stakeholders and the related risk are considered in Table 10.1.

This superficial analysis of the financial food chain suggests an absence of incentives to protect the wealth of the end investor or the long-term health of the system as a whole. The absence of incentives to sustainable wealth creation, without boom and bust, is a major concern. Regulation will not work if there are incentives for people to frustrate it, and a more flexible, voluntary governance system will need commitment from those involved in the system.

Regulators and supervisors that were accused of having too light a touch prior to the financial crisis promise to be more proactive and 'hands on'. UK regulators have stated recently that they will intervene if 'a firm's judgement is at variance to a regulator's objectives' (FSA 2012) and will review board effectiveness, as well as assessing the

suitability for office of new members. While this appears laudable, there is a risk of unintended consequences. Prior to the financial crisis some bank staff outsourced any sense of personal responsibility to the regulator. More intervention might exacerbate this tendency. Will directors be able to blame the regulator if anything goes wrong? If the rules allow something, how can regulators intervene if the spirit of a rule is flouted?

## IMPLEMENTING THE NEW FRAMEWORK

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This paper argues the need for the new accountability framework set out in Chapters 3 to 6. How can it be implemented? As a first step, existing systems of governance should be evaluated using the framework to determine if each of the three components, performing, informing and holding to account, are working at each of the three interfaces: between boards and shareholders, management and boards and between fund managers and savers. If any aspect is not working in practice then there will be a problem.

Codes are almost certainly part of the solution but they need to contribute to the framework and they should be evaluated to determine whether they do – both in theory and in practice. Codes may be necessary but they will not be sufficient. Enterprises in different sectors and across the world operate in diverse environments of culture, regulation, legislation and enforcement. Governance will vary between enterprises and needs to evolve and improve over time. To some extent governance codes attempt to fill the gaps left in a system of legislation and regulation but they can only work if people want them to work.

In order to assist innovation and improvement, any governance framework needs to:

- be clear
- evolve and improve over time
- be sufficiently adaptable to be relevant for enterprises operating in different sectors and in diverse cultural, regulatory and legal environments around the world

- avoid being a straitjacket that prevents innovation and improvement in enterprises
- demonstrate value creation.

The accountability framework aims to meet all five criteria. *King III* and the *International <IR> Framework* (IIRC 2013b) offer useful guides to improving company performance and value creation.

Boards can find it difficult to know how closely to be involved in the running of a company. They need to avoid micro management but they must ensure they do not leave gaps in their oversight and direction. One approach which boards may find helpful is a system called Policy Governance devised by John Carver (see Figure 10.2). Essentially the system involves four sets of policies which it practices and which clearly articulate the role of the board and how it delegates to and oversees management.

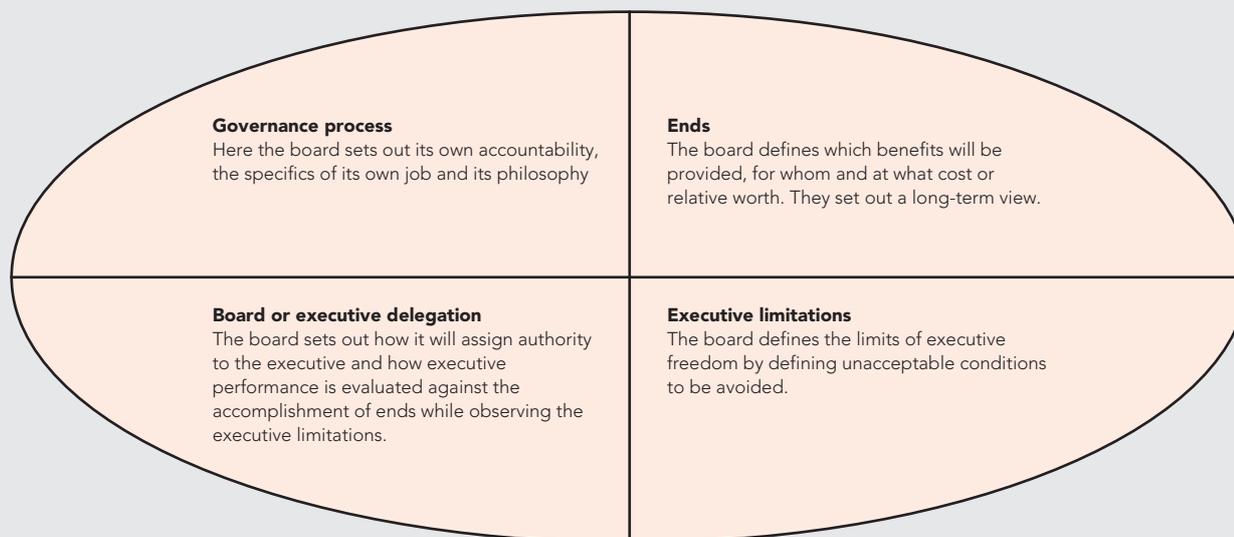
## FIGURE 10.2: THE POLICY GOVERNANCE® MODEL

In providing leadership boards must provide vision. This is only possible if the board has a clear vision of its own job – the role of trustee-owner.

The policy governance system emphasises values, vision, empowerment of the board and of the executive.

A board which observes the principles of Policy Governance sets out its values in policies of four types, which then enable the board to concentrate its wisdom into one short document.

The four types are shown in this diagram:



Contributed by John Bruce

® Policy Governance is a registered service mark of John Carver.

A voluntary approach to governance is usually most appropriate, under which boards say how they apply good principles of corporate governance and where stakeholders can hold boards to account. Such an approach allows enterprises to innovate and improve, and it should encourage different models to develop while enabling stakeholders to exert pressure on firms to follow best practice. Most importantly, such an approach has the best chance of being welcomed and, therefore, adopted.

The main danger is that a voluntary approach will allow poor practices to continue. This is a risk, but experience suggests that a flexible system will work with the right incentives in place. The framework and its three components – performing, informing and holding to account – will be successful if the participants in the system want it to work. A key requirement is to ensure that the right incentives are identified and implemented. The accountability framework will help to reveal where incentives do not contribute to good governance.

While regulation may be needed, its probable impact on behaviour must be carefully thought through and unintended consequences avoided. Fewer, broader regulations enforced more rigorously would be better, including the threat of holding directors personally accountable.

All interested parties need to engage in designing a system to enhance innovation, and appraisals are invited of whether the framework proposed in this paper is a better approach to governance than those currently applied.

## RECOMMENDATIONS

The following five provisional recommendations are proposed as a means of introducing the new framework and making it effective through a voluntary approach.

1. There should be general acceptance that the purpose of governance is to create value sustainably.
2. Governance codes and policies should be assessed against the accountability framework at each of the interfaces between management, boards, institutional shareholders and providers of funds.
3. Companies and investors should develop and report using more suitable measures of performance and value creation.
  - A) Performance should be considered in terms of both value created by the company and the contribution of boards, management and staff.
  - B) Corporate reporting should additionally include:
    - i. probabilistic information on confidence and uncertainty
    - ii. information on the ethical health and values of the organisation, including the assessment and assurance system
    - iii. information to convey how, and by how much, companies create sustainable value and contribute to public good
    - iv. governance reports based on the principle of 'apply and explain' rather than 'comply or explain'
4. Policymakers and institutional shareholders should:
  - address the asymmetry in the risk : reward ratio between management, shareholders and other stakeholders. Ways should be found to enfranchise savers in order that they can hold institutional investors to account
  - examine ways to give investors incentives to favour companies that create long-term value for themselves and for society against those that rely on short-term economic rent for their profits.

## CONSULTATION QUESTIONS

Q10.1 To what extent do the primary interests of the main stakeholders in governance and capital markets support or not support the well-being of the system as a whole?

**Q10.2 Is it a major problem that much regulation, particularly in financial services, has allowed people to avoid personal responsibility or to fail to apply moral judgement? What can be done?**

Q10.3 Is enforcement of the spirit of a rule likely to be a hope rather than an outcome?

Q10.4 What incentives are needed to make the framework effective using a voluntary approach?

Q10.5 Would it be better to have fewer, broader, but more rigorously enforced regulations?

Q10.6 How could the proposed accountability framework be improved?

Q10.7 Do you agree with each of the five recommendations? If not, with which do you not agree, and why?

Q10.8 Do you have any other recommendations?

Q10.9 Have you any further suggestions for how the recommendations could be made to work?

## Appendix 1: Glossary

### Capital adequacy

Measure of whether a bank has enough capital in relation to possible losses.

### Collateralised debt obligations (CDOs)

Tradable derivatives whose income payments and principal repayments are dependent on a pool of different financial instruments which themselves are loans and are due to pay interest and ultimately be repaid. CDOs are called collateralised because the promised repayments of the loans are the collateral that gives the CDOs value.

### Compliance

The act of complying (with the established rules and procedures).

### Corporate culture

a term with a variety of meanings, it refers, in this paper, to factors such as a set of shared values and norms of behaviour, as well as the incentives structures that influence behaviours within an organisation. In practice, any large corporation would have multiple sub-cultures.

### Corporate governance

The system by which companies are controlled and directed.

### Corporation

Large company or group of companies acting together as a single organisation. In Britain, a large company or a public organisation.

### Credit crunch

The widespread credit and liquidity crisis in 2007–08 precipitated by falling house prices in the US and rising interest rates.

### Credit default swap (CDS)

Essentially a form of insurance contract designed to hedge the risk that an underlying asset will rise or fall in value. Unlike normal insurance, the contract can be taken out by a person who does not own the underlying asset and many contracts can be taken out on the same underlying asset.

### Defined-benefit pension scheme

Type of pension plan in which an employer promises a specified benefit on retirement that is predetermined and based on earnings records.

### De-list (companies)

Remove a company's stock from a stock exchange.

### Economic rent

Difference between the actual payment for a factor of production such as land, labour, capital or intellectual propriety, compared with the amount that owner would have expected in a perfect market.

### Fund manager

An individual or an institution that invests a pool of money, usually provided by third parties.

### To game

To seek advantage from a particular situation, often in a way that is unfair or unscrupulous.

### Goodhart's law

Any measure used as an instrument of policy will lose its efficacy as a measure because it will be gamed. It is named after the London School of Economics professor Charles Goodhart.

### Gross domestic product (GDP)

An aggregate measure of production equal to the sum of the gross values added of all institutions engaged in production. The sum of the final uses of goods and services (all uses except intermediate consumption) measured in purchasers' prices, less the value of imports of goods and services, or the sum of primary incomes distributed by resident producer units (OECD).

### Institutional investors

Mainly investment banks, pension funds, managed funds and insurance companies.

### Integrated reporting:

An approach to corporate reporting that demonstrates the linkages between an organisation's strategy, governance and financial performance, and the social, environmental and economic context within which it operates.

### Leverage

Employing techniques such as borrowing money to buy fixed assets to magnify the potential gains (or losses) on an investment; can be defined as capital plus borrowed funds, divided by the amount of capital only. Also known as gearing, leverage can turn a low positive or negative return on assets into a high return on, or large loss of, capital.

**LIBOR**

London Interbank Borrowing Rate, a benchmark for short-term interest rates. Previously set by the British Bankers' Association (BBA), based on input by large international banks, the system is due to change in 2014.

**Liquidity**

Cash, cash equivalents and other assets (liquid assets) that can be easily converted into cash (liquidated). Some markets are highly liquid; some are relatively illiquid, and as was seen during the credit crunch, a market can switch from highly liquid to very illiquid very quickly.

**Money laundering**

Process by which the identity or the origin of illegally obtained proceeds is disguised or concealed so that they appear to have originated from legitimate sources.

**Non-executive director**

Part-time member of the board of directors, who provides expertise and advice, and who is part of board decision making but has no individual authority or responsibility for making or carrying out decisions. Most governance codes specify that independent NEDs constitute a significant proportion of a board.

**Off-balance sheet vehicles**

Assets or debts controlled but not technically owned by a company that do not appear on a company's balance sheet, or 'statement of financial position'. Often used to frustrate the intent of regulation.

**Path dependence**

The idea that decisions taken to a great extent depend on past history and trajectory.

**Perverse incentives**

Incentives that have unintended consequences, sometimes working against the primary goals trying to be achieved.

**Procyclicality**

The growth of one phenomenon leads to the increase of the other, and so on.

**Purchasing power parity (PPP)**

Rates of currency conversion that equalise the purchasing power of different currencies by eliminating the differences in price levels between countries.

**Shadow banks**

Financial institutions that are not subject to traditional bank regulation engage in maturity transformation where they raise short-term funds in the money markets and use those funds to buy assets with longer-term maturities. Because they do not have traditional depositors whose funds are covered by state-sponsored deposit insurance, they are said to be in the 'shadows'.

**Stakeholders**

Anyone with an interest or stake in a company, what it does or is affected by it; eg shareholders, employees, clients, consumers, suppliers, or the general public.

**Silo**

A system, process or department that operates in isolation from others.

## Appendix 2: About the authors



### PAUL MOXEY

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Paul Moxey is head of corporate governance and risk management at the ACCA. He is responsible for ACCA's technical policies on corporate governance and risk management and has participated in committees and projects on corporate governance and risk around the world. He has spoken on corporate governance and risk at major conferences and events in five continents and written numerous articles.

A qualified accountant and MBA, Paul held senior positions in industry including spending several years as company secretary and as group financial controller of a UK public company. Before joining ACCA, he was a consultant specialising in corporate governance in the NHS and wrote much of the Department of Health's corporate governance guidance to health authorities and trusts.

Paul has a particular interest in the behavioural and cultural aspects of governance and risk management. He is also co-chairman of the Control and Risk Self-Assessment Forum and a senior research fellow at Kings College, London.



### ADRIAN BERENDT

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After three decades in line roles in the City of London, Adrian is now a leading independent consultant to the financial services industry on regulation and risk management. He specialises in advising clients on the impact of regulatory change, particularly the capital implications of the latest Basel regulations and on EMIR/Dodd-Frank. Most recently Adrian was an executive director with LCH.Clearnet, the largest independent clearing house, working on a number of change projects, particularly in the regulatory area.

Adrian chairs ACCA's Global Forum for Governance, Risk and Performance and has previously chaired its Financial Services Panel and was a member of its Research, and Corporate Governance and Risk Management Committees. He has appeared on a number of panels discussing regulation, risk and corporate governance. He co-wrote ACCA's *Corporate Governance and the Credit Crunch* with Paul Moxey.

Married with four children, Adrian still finds the time (and the energy) to play cricket and will sing (baritone) at any opportunity.

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John Watts

John Webb

Graham Wilson

## Appendix 4: Consultation questions

ACCA invites comments on this paper and particularly on any or all of the consultation questions listed below. The most important questions are probably the ones in bold text, which are also included in the executive summary.

- Q1.1 Do you agree with the seven hypotheses? If not, in what way(s) do you disagree?
- Q1.2 Should there be more research into links between governance practice and organisational performance?
- Q1.3 Are you aware of convincing evidence about whether there is, or is NOT, a causal link between good governance and better performance?
- Q1.4 Has corporate governance become too focussed on form and compliance at the expense of the quality and integrity of decision making?**
- Q1.5 Is there a 'right' amount of gearing or leverage and a 'right' speed of money, and debt, creation?
- Q1.6 Is the UK an appropriate case study? Do other, better governance examples exist elsewhere in the world? Does the primacy of the shareholder in UK company law make it uniquely difficult to include proper consideration of other stakeholders in the UK, compared with other countries?
- Q1.7 How can the conflict of interest between shareholders and the company and other stakeholders best be addressed?
- Q1.8 Is risk management part of corporate governance or is it separate?
- Q2.1 Have current governance systems made it harder to hold people to account for company failure?
- Q2.2 Are there any examples of corporate failure where the board was not in any way responsible for the failure?
- Q2.3 Have the problems of remuneration that encouraged people to take excessive risk been properly addressed?
- Q2.4 Is it a governance failure if a board makes a bad business decision that severely damages the company but complies with governance requirements such as having a separate CEO/chair and sufficient independent NEDS?
- Q3.1 Should creating sustainable value be the overarching purpose of governance? If not, can you suggest a better purpose?**
- Q3.2 Do you agree with the three complementary purposes: performing, informing and holding to account? If not, why not?
- Q3.3 How important is it to have a complete circle of accountability linking staff, management, boards, professional fund managers and savers to ensure the governance system works as a whole?
- Q3.4 Do you find the framework likely to help to improve corporate governance and help focus companies on creating sustainable value? What could make it better??**
- Q3.5 Of the three interfaces shown in Figure 3.4, a, b and c: (i) at which one is accountability most problematic? (ii) which should be addressed first by policy makers?
- Q4.1 Is the CoCo model useful for understanding performance? What alternative models could be used?
- Q4.2 Do you agree that boards (or chairs of boards) should assess and report publicly:
- on the results of their effectiveness reviews?
  - on their satisfaction with their enterprise's ethical culture? If not, why not?
  - how they apply the four principles set out above?
  - how they discharge their responsibility for managing risk?
  - how they ensure diversity of thinking?
- Q4.3 Should we question the assumption that at least half the members of boards should be independent non-executive directors? Could another structure be appropriate in some cases?
- Q4.4 Do you agree that performing, in terms of creating value, should be considered using both of measures of effectiveness (eg of boards) and measures of value actually created?
- Q4.5 Should performance measures include more information on uncertainty of outcome?

- Q4.6 If so, should the information be confined, in the first instance, to boards and their audit committees, or should it be part of public reporting?
- Q4.7 Would graphical representations be helpful in assessing performance of: (a) managers, (b) boards, and (c) professional investors?
- Q4.8 How much validity is there to the corollary to Goodhart's Law that any measure, as soon as it is used as an instrument of management, loses its managerial efficacy?
- Q5.1 Should annual reports convey whether, and how much, value has been created over the reporting period?
- Q5.2 When reporting on the extent to which the various capitals have been added to or reduced, should reports convey information about the confidence or uncertainty of measures?
- Q5.3 Should annual reports set out how boards ensure that they understand their company's culture and that it is appropriate for the company's purpose?
- Q6.1 Must boards be able to hold management to account?
- Q6.2 Must shareholders be able to hold boards to account?
- Q6.3 Must providers of capital be able to hold professional fund managers to account?
- Q6.4 How best can each of the above be carried out?
- Q6.5 Is one more important than the other two?
- Q6.6 What good examples are there of shareholders either (i) holding boards to account or (ii) engaging constructively with companies for their mutual long-term benefit?
- Q7.1 Is the comply or explain approach working as it should?
- Q7.2 Should 'apply and explain' replace 'comply or explain'?
- Q7.3 Do you agree that the three components of governance are not working properly and that the overarching purpose of corporate governance is not being achieved?
- Q7.4 Which of the three areas, performing, informing and holding to account, is most problematic? Are there any simple fixes?**
- Q7.5 What can be done to enfranchise savers who entrust money to institutional investors, so that the former can hold the latter to account for their performance?
- Q7.6 Is there a need for representative bodies to look after the interests of savers?
- Q7.7 Which of these relationships is most problematic? Between: (a) executive management and boards, (b) boards and institutional shareholders, (c) institutional shareholders and savers. Are there any simple fixes?**
- Q8.1 Is there a pressing need to find better measures for performance?
- Q8.2 Is there a public interest purpose in distinguishing how companies create 'value' between competitive profit and economic rent?
- Q8.3 Should economic and other policies to promote growth attempt to encourage companies to create value rather than capture value that others have created? How could regulators, investors and employees do this?**
- Q9.1 Is lack of trust a problem? What should policy makers, businesses, and investors do to restore trust?**
- Q9.2 Should institutional shareholders, on behalf of those who entrust money to them, take an interest in how companies contribute to the public good?
- Q9.3 Could sharper focus by investors and others on how companies contribute to public good help ensure that companies act as responsible citizens and reduce the need for regulation?

- Q9.4 Do you agree about the importance of values?
- Q9.5 Can you supply examples of where a focus on values has helped company performance?
- Q9.6 Is there a need to review the purpose of the corporation and its role in society?
- Q10.1 To what extent do the primary interests of the main stakeholders in governance and capital markets support or not support the well-being of the system as a whole?

**Q10.2 Is it a major problem that much regulation, particularly in financial services, has allowed people to avoid personal responsibility or to fail to apply moral judgement? What can be done?**

- Q10.3 Is enforcement of the spirit of a rule likely to be a hope rather than an outcome?
- Q10.4 What incentives are needed to make the framework effective using a voluntary approach?
- Q10.5 Would it be better to have fewer, broader, but more rigorously enforced regulations?
- Q10.6 How could the proposed accountability framework be improved?
- Q10.7 Do you agree with each of the five recommendations? If not, with which do you not agree, and why?
- Q10.8 Do you have any other recommendations?
- Q10.9 Have you any further suggestions for how the recommendations could be made to work?

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