THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

# Briefing 03.02

## Corporate governance: why should companies care?

Graham Ward

This briefing is based on a presentation by Graham Ward, immediate past President, ICAEW, at INSEAD, 11 July 2001

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The Institute of Chartered Accountants in England & Wales and my profession of Chartered Accountancy recognise the vital importance of the business and education communities working closely together to promote thought leadership and leading-edge research on issues that will promote the future prosperity of business.

And certainly, we very much support INSEAD's aims to be at the heart of a global knowledge network as centres of innovation.

My question is: 'Corporate governance: why should companies care?' The answer to this depends on the answers to a further series of questions:

- Are you worried about the relationships within your board, or the quality of your internal control or financial reporting?
- Are you having trouble raising capital at fine rates?
- Are you in dispute with your shareholders, is your share price fluctuating, is your company undervalued?

Answer 'yes' to any of these and you are probably having trouble sleeping at night and the chances are that your corporate governance practices may well lie at the heart of it.

My aim is to make the clear business case for companies to adopt 'good corporate governance' throughout their organisations and to outline the reasons why companies should care.

However, I do not doubt that there are a large number of different interpretations of what 'governance' means. The 'good' is also open to degrees of interpretation around the world. After all, in many countries businesspeople might say they have a good relationship with their colleagues – but in some places those colleagues end up at the bottom of the harbour.

Nevertheless, the relationship was considered good while it lasted!

## What do we mean by corporate governance?

Our communal understanding of corporate governance is probably like that story about the group of blind people trying to identify an elephant through touch – by each describing totally different parts of the animal.

For clarity's sake, when I talk about corporate governance I draw the distinction between conformance and performance. I am not, therefore, referring to conformance with a mere template of systemic rules for a board to follow that will ensure its accountability to shareholders. The concept of corporate governance has moved on from the financial aspects of internal control to being seen to be about business performance and, therefore, as a key feature of the market system of competitive enterprise.

Academic arguments these days centre on various theories – of the financial perspective, stewardship theory, stakeholder theory, shareholder control, and political models. But governance is not merely about shareholder protection, management control or the famous 'principal-agent' problems so beloved by management and economic theorists. I do not believe that it is helpful in the real business world to concentrate on one model or mode of thought.

The pressures on business – the breakdown of borders, both economic and political, through technology, trade liberalisation and deregulation – all these things have brought in a so-styled 'new governance' that encompasses every activity and relationship in a company's operations and its contribution and role within both domestic and global contexts.

Traditional governance, as developed in the US and the UK, is based on the principles of transparency, integrity and accountability. And, reduced to essentials, having exemplary governance means that the board takes responsibility for two things:

- first, really understanding what the risks and opportunities of the company are and what it does in respect of them to enhance performance; and
- second, informing the outside world about these matters as relevant.

And these are the basic underpinning of all codes of corporate governance currently in various stages of development and adoption in around 30 countries of the world. We also see these principles reflected in the formalised Human Rights codes, such as the European Commission's Social Agenda or the United Nations' Global Compact. So there is general global agreement that these principles are good for the financial prosperity of nations and that business should display them as part of claiming a role in civil society.

Yet, interpretations of what these principles mean will vary from country to country. A culturally acceptable way of doing business in one may be an anathema in another. In some parts of the world trust is everything and your word is enough to ensure that your chosen successor inherits the business.

In others, as a new CEO nobody would give you the time of day unless your selection had followed 'due process' and your credentials had been checked by an army of head-hunters.

But those very principles – of transparency, integrity and accountability – also form the bedrock of the professional code of ethics for Chartered Accountants the world over. The ICAEW has 120,000 members working in over 140 countries. Of the 400,000 accountants and auditors in Europe, just over one in four are ICAEW members. Because Chartered Accountants are fundamentally business-oriented – they range from Finance Directors and CEOs of listed companies, to business advisers of small and medium-sized enterprises or company auditors – it is vital for the reputation of my profession that our code of ethics is strictly adhered to wherever in the world our members practice.

Those who jeopardise our reputation for independence and objectivity are disciplined and, in some cases, are rejected from the profession. The Deputy Chairman of Barings Bank, for instance, was struck off the ICAEW membership list for his part in that particular governance failure.

In a similar way, it is now widely accepted that for businesses, more often than not, bad governance practices result in company failure and rejection by the market. In many respects, therefore, it is the desire to conform to the demands of a larger market that will drive conformity to those principles.

But what the adoption of such principles does not mean to my mind, is the wholesale imposition of domestic US, or even UK, business models on the rest of the world.

## Codes of governance must fit local conditions

US governance was developed in a culture that is highly committed to competition with strong anti-trust laws and large scale impersonal publicly traded corporations. What people forgot was that in the beginning economic transactions were governed by social relationships rather than by markets: that other forms of governance exist in terms of cultural priorities, business related associations, trade, vocational, family, social and political networks that rely on different forms of information and control. And, of course, these are precisely the characteristics of many markets outside of the US.

If the business community really does subscribe to the basic market principles of governance, there is every reason to suggest that codes of governance can, and should, be tailored to domestic operating environments. Indeed, this is currently happening within continental Europe, where the OECD Principles of Corporate Governance are being adopted as the basis for many codes of governance within nation states and, in fact, are also forming the governance framework for transitional economies such as Russia.

## Pressures on companies: investors

Whatever style of running a business you use – whether you are organised by Anglo-Saxon principles, Rhineland capitalism, Latin family orientation, or French governmental direction – one thing is clear: the pressures in the search for capital are driving convergence on overarching principles of running a business and corporate governance guidelines provide a framework that establishes processes which give boards (or owners) confidence that they know what is going on in the business and how this is communicated to a wider audience.

Indeed, in many ways the country in which you operate is beginning to matter less overall. A poll in 2000 by Merrill Lynch in Europe, found that only 10% of fund managers believe that countries matter for their investment decisions – only three years ago the figure was 50% – because fund managers are now tending to manage their portfolios by reference to industrial sectors rather than to countries.

What has been driving the proliferation of codes of governance? The answer lies in what has been described by Thomas Friedman of the *New York Times* as the 'global straitjacket': the set of norms that countries must fit to be attractive to institutional investment, private capital and capital flows.

Many of you will have had dealings with the new breed of powerful institutional investors: word in the City of London is that roughly 25 of these account for 75% of the world's listed company shareholdings. They have long discovered their voice and are insisting more and more on governance criteria as part of their investment strategies. The International Corporate Governance Network, for instance, which features many of the largest US and UK pension funds as its members, with around $10 trillion US dollars under collective management, issues its own corporate governance guidelines for major markets.

Now, entire countries (let alone businesses) that do not subscribe to the principles of transparency and good governance, find it increasingly difficult to attract foreign direct investment, and if they do, it comes at a high premium. This, as you are no doubt well aware, has been precisely the problem for some of the EU accession countries who have been thrown by investors into the same shopping basket as Russia.

Various global governance and sustainability indices are now being developed by the likes of Standard & Poor's, or Dow Jones, and there will be no escape for companies. I will talk more about the power of indices a little later on. But what is clear, is that investors are very serious about the risk-based approach to investment. And who can blame them? The papers are full of premature revenue recognition scandals and too many have had their fingers burnt by that, let alone by the over-inflated and over-optimistic dot.com floatations.

The increasing sophistication of risk-return benchmarks means companies had better be on their toes if they wish to achieve a lower cost of capital.

This awareness on the part of companies is all the more important as continental European companies choose to bypass traditional funding from the banks and go straight to the markets. Some companies, such as Vivendi, have already responded by increasing shareholders' rights. Sadly, greater opportunities for European business were scuppered when, led by German MEPs, the European Takeover Directive was rejected in the European Parliament because it outlawed 'poison pill' defences against bids and it exposed German companies to foreign takeovers.

This development is extremely disappointing. It will set back the single securities market and EU competitiveness and, to my mind, provides a route to protectionism of the inefficient which will damage both employment prospects and prosperity.

## Market-driven governance codes

It might be useful here to look briefly at what the current situation is in terms of existing governance codes. And, may I modestly say, the ICAEW was instrumental in giving the world its first publicly adopted Code on Corporate Governance (the Cadbury Report).

But that was in 1992, driven by major business scandals of the late 80s and early 90s. Since then we have seen the high profile scandals in Russia and the Asian market collapses and governance has become even more of a critical issue worldwide simply because endemic 'bad' governance practices can bring down entire markets, not merely individual companies. Governance has moved from being purely a sideline boardroom issue right to the centre of the world's economic stage.

Over the past decade then, governance guidelines and codes have been issued by stock exchanges, corporations, institutional investors, and associations of directors and corporate managers.

The issue for companies is whether or not compliance with codes is mandatory. Codes linked to stock exchanges are more likely to have a coercive effect. For example, listed companies on the London Stock Exchange do not need to follow the recommendations of the UK's Combined Code on Corporate Governance, issued in 1998. What they must do is disclose *whether* they follow the recommendations in those documents and provide an explanation of where they diverge from them. And, of course, these disclosure requirements exert a significant pressure for compliance. Certainly, I know that it is now standard practice for UK listed companies to disclose this information in their annual reports.

Contrast this with guidelines issued by associations of directors, corporate managers and individual companies which tend to be wholly voluntary, although some of these can have wide influence. General Motors, for instance, created its own guidelines and subsequently, institutional investors encouraged other companies to adopt similar ones.

Developing nations too, have issued both voluntary guidelines and more coercive codes of best practice. In Asia, once-voluntary codes have been made compulsory under the Malaysian Stock Exchange's rules and this trend seems likely to continue in other markets such as India, Indonesia and Thailand as they seek to widen domestic access to global capital. If you are interested in governance codes around the world, I can recommend the European Corporate Governance Network website at www.ecgn.ulb.ac.be which has an up-to-date listing and links to most codes.

What is common to almost all governance guidelines and codes of best practice, is that the board assumes responsibility for the stewardship of the corporation and that board responsibilities are distinct from management responsibilities. They merely differ, in the level of specificity with which they explain the board's role on issues such as strategic planning; risk identification and management; succession planning; communication with shareholders and the integrity of financial reporting.

So globalisation, privatisation, deregulation, re-regulation, changing patterns in share-ownership, market crises, ageing populations and pensions time-bombs – all of these things have driven corporate governance to the top of the global agenda. And this international interest can clearly be expressed by the experience of Sir Adrian Cadbury (after whom the Cadbury Report is named). Before he retired from speaking engagements in late 1999, he had been invited to speak in 27 countries. His last two engagements were in Colombia and Vietnam.

## Boardroom meltdown

Actually, I think boards deserve some sympathy. Many of you must be saying 'Good heavens, is the job even doable?' And we now have the situation where people are predicting 'boardroom meltdown'.

In the early 90s, the 10 largest corporations controlled greater assets than the Gross National Product of Canada, for instance, and fewer than 200 directors were responsible for the resources of the 10 largest employers in the world. And since then, we've seen mega-mergers of the likes of BP Amoco and Times Warner AOL. The pressures and contradictions of serving on a corporate board are making governance and control of the corporation more and more difficult.

Nowadays, the board cannot be that gentlemen's club that was seen as so much of a feature in the City of London, and, I am sure, elsewhere. The rules have changed. To be a board director now you need to have the brain of an Einstein, the vision of a Bill Gates, and the sheer nerve of a lawyer! All the different pressures – from the very real legal and regulatory requirements of directors, the demands of investors, and public and other stakeholder expectations of accountability – are serving to show that the old ways of doing things, and old guard mentality, will not sustain the twenty-first century corporation.

So what matters most is having the right people on board: top quality, intelligent directors that can think outside the box. Of course, that is easy to say but I know that – as we have seen by the difficulties of major corporations in addressing succession issues – it is not so easy in practice. Codes of governance, therefore, are a mechanism to ensure that issues such as succession planning become core board considerations long before they become a crisis.

Of course, subscription to codes is all very well, but as we saw all too clearly in Britain when surveys were undertaken on compliance with that first Code of Corporate Governance, the Cadbury Code of 1992, boards often viewed it as yet another set of quasi rules and ticked in the boxes to show that they had at least paid lip service to its principles.

Attempts to use detailed rules to cover every eventuality result in the worst of all worlds – a system that goes too far in creating expectations while it does too little in achieving results. We might do well to heed the advice in a report published in Canada by the Joint Committee on Corporate Governance: that what boards do, and how they do it, is more important than their structure. The challenge of governance today is to go 'beyond compliance' and build a strong governance culture, using it to enhance performance.

So what matters most is that you have a dynamic and responsible board – not a rubber stamp. What matters is that you have truly independent non-executives that ask those really difficult and challenging questions that always need to be asked. What matters is that they can work as a cohesive team and are not dominated by one individual.

The arguments for non-executive independent directors who, to coin a phrase, 'are free from any business or other relationship which could materially interfere with the exercise of their independent judgement' will not be new to you. The independence of non-executives can help to attract capital in that their presence makes major investors feel more secure that their interests are being defended. In countries where stock markets are weak, and shares illiquid, this is especially invaluable since investors do not readily have the option of voting with their feet.

Sadly, though boards all over the world – from Asia Pacific to continental Europe to Latin America – comprise significant numbers of non-executive directors, few companies differentiate between those non-executives who are considered independent and those who are not.

The recent collapse of HIH, Australia's second largest general insurer, has been attributed by commentators to a lack of independent directors. And with A$4 bn in total liabilities, it is potentially Australia's worst corporate collapse.

Interestingly, even in such a highly developed economy as Australia, audit committees and the presence of independent non-executive directors on boards are recommended but not mandated by the listing rules. Most guideline and code documents highlight the importance of the audit committee, and its functioning and composition receives significant attention because of the key role it plays in protecting shareholder interests and promoting investor confidence. Whether you are looking to list on the New York, NASDAQ or AMEX exchanges, for instance, you now need to have a formal, written audit committee charter that is annually reviewed by the board.

Getting the right people in place also encompasses all the dynamics of working in partnership between the board and senior management. The board needs to have an open mind, be flexible in outlook, trust in the skills of its management yet not be unquestioning. The disempowerment of the board by domination of one individual can have dire consequences, as we saw all too clearly in the case of Robert Maxwell for instance.

## Turnbull – risk management

Probably the most important development for listed companies and their boards in the UK in the last year or so has been the introduction of the Turnbull Report, prepared by the ICAEW at the request of, and subsequent adoption by, the London Stock Exchange. The Turnbull guidance has focused attention on risk management and internal control but, and this is the key point, it does so at board level. The areas of risk boards should be looking at include not only financial, operational or technological risks but others such as reputational risk or environmental risk.

Turnbull requires that UK boards disclose how they discharge their responsibilities for internal control by summarising the process they have applied in reviewing the effectiveness of the system of internal control. It has certainly highlighted the importance of internal audit. In addition, the external auditors are required to review the directors' statement of compliance with this process.

The guidance is intended to reflect sound business practice, take account of the continually evolving business environment and enable each company to apply it in a way which takes account of its particular circumstances.

Listed companies were required to implement fully the Turnbull guidelines for accounting periods ending after 23 December 2000, so this is a recent innovation and the first results of its impact are only now being felt.

Research of developments in London FTSE top 350 listed companies published by Deloitte & Touche in September 2001 made encouraging reading. Principally, the findings confirmed what we had suspected – that risk management has been pushed up the corporate agenda over the last two years and, increasingly, sits in the boardroom. Today, chief executives or managing directors in the UK's top listed companies claim ownership of the risk management process, up from 10% in 1999 to nearly 40% in 2001.

If you would like to see a copy of Turnbull it is available in full on the ICAEW's website at www.icaew.co.uk/internalcontrol.

I know that in other countries across Europe this type of assessment is becoming best practice – driven, for instance, in Germany by the KonTraG or through the Peters Report in the Netherlands – but it is still not common for assessment of risk throughout all areas of a company's operations to be a board requirement. And it can only be of benefit to the capital markets as a whole as this process becomes best practice on a global basis.

## Risks to corporate reputation

If companies think this is all common sense, they'd be right. But common sense is not so common. What further incentive do companies and their boards need to persuade them of the crucial need for a sound system of internal control covering assessment of all risks than the figures from Pricewaterhouse-Coopers' 2001 survey on economic crime. The survey found that at least 43% of major European companies have fallen victim to serious fraud over the last two years, usually perpetrated by employees or management. Euro3.6 billion was lost by over 500 of Europe's leading companies in the last two years alone, a loss compounded by the failure of four out of five companies to recover more than half of their lost assets.

What is telling is that relatively few companies report such losses to the authorities because they consider that the risks to corporate reputation – the negative publicity or drawn out judicial processes – can be as, or more, damaging than the financial loss itself.

We are not talking of corporate reputation in terms of brand equity or corporate identity, but the reputation that is the company's collective stakeholders' view of the entire organisation. And it matters, it matters a lot. We need only recall the riots in Seattle or Prague, or more recently Göteburg, to see that the public responds emotionally to corporations. Today, corporate reputations can be destroyed globally in an instant just through use of the internet. We might say that we are being seen as the B52s of capitalism and this perception is certainly a reason why reputation assurance is such a big business priority.

So nowadays, it is becoming more common to hear the terms triple bottom line, corporate social responsibility, stakeholder capitalism and corporate obligation in business circles. They are becoming part of companies' 'licence to operate' and accountability issues have been pushed to the forefront of board considerations as never before.

## The role of government

Representatives of multinationals, will no doubt say that the governance of public sector institutions in nation states is as important a consideration as the corporate tax rate. If you enter a market rife with 'crony capitalism', what one observer has called 'an unholy alliance between government and business elites' at every level, nationally, regionally and locally, the cost of doing business goes up dramatically. Stories abound of kickbacks to local officials or arbitrary changes in legislation designed to protect domestic businesses.

For such economies, where foreign investment is low and capital flight is high, the premiums charged by institutional investors (their annual currency adjusted internal rate of return) can reach levels of 40%. No wonder. A recent newspaper article quoted the Control Risks Group, the specialist international business risk consultancy, who suggested that foreign investors in Russia do not need to worry about hitmen – 'Russians keep it in the family and rarely bump off or even threaten foreigners'. It is their own security guards that foreign investors need to worry about. They are actually the ones in power, that is because in many cases they are also the police!

I mentioned earlier on of indices. One which has caused interest from all over the world is the PricewaterhouseCoopers' Opacity Index. This survey looks into the effects of corruption on the cost of capital; the legal frameworks in place that determine the flow of portfolio and foreign direct investment; fiscal and monetary policies which, if unpredictable, increase risk premiums on the cost of capital; regulation and enforcement within the capital market; and issues of disclosure, transparency and governance.

These effects are explained in terms of both a hidden corporate tax and a risk premium when societies borrow through sovereign bond issuance and estimates the extent to which all of these things deter foreign direct investment.

We defined opacity as 'lack of transparency, clarity and openness'.

Less opacity (or rather greater transparency) was found to have a positive effect on investor confidence and lowered the cost of capital. Singapore was rated the most transparent nation. High opacity on the other hand was found to inhibit the ability of corporate governance systems to overcome informational asymmetry and agency costs, raising the cost of capital. It highlighted what economists had been saying for a while, that poor transparency in a number of key areas imposes a hidden drag on economic development.

The example of this was Brazil, which topped the list of the 35 countries examined with perhaps $30 billion of deterred foreign direct investment, and was followed by Argentina and South Korea. So the sums we are talking about are not 'small beer': Troika Dialog, the biggest Russian brokerage, estimates that bad corporate governance accounts for a $54 billion discount on what Russian equities would otherwise be worth.

If all this evidence is not enough, consider the pressure being brought about by Standard & Poor's', the international credit ratings agency, recent corporate governance scoring service in Russia, which last year was being rolled out in Asia. It analyses a company's corporate governance standards and issues a corporate governance score based on two levels – country level and company level.

The agency says it recognises why governance practices may differ in different market environments but that it will not compromise on its assessment of how a company's specific governance practices support the broad principles of corporate governance. I quote: 'If Asian companies wish to attract Western investors, these companies will face greater investor pressure to either conform to or reconcile their practices with Western standards'. If this kind of uncompromising stance is not enough to convince companies to care, I don't know what is.

## Disclosure

But, we might ask, is it all worth it? Whilst institutional shareholders say they will pay a premium if certain conditions exist (transparency, accountability and legitmacy in creating long-term value), companies may be considering that enhanced disclosure exposes them to additional risk, not least because of the interest of activist bodies such as the Non Governmental Organisations (or NGOs). The accountability and governance of NGOs themselves is another subject in its own right.

Shell's vice president for sustainable development, Tom Delfgauuw, recently said: 'It seems the more transparent we are, the more flak we get, and it's quite surprising how little flak those companies that do nothing actually get.' It is not an unfair comment. Companies are being buffeted on all sides, very often by special interest groups, and finding it harder to keep their eye on the ball and actually manage the business.

Against these types of comments and arguments, must be balanced the regulators' remit of safeguarding the public interest. According to the Securities and Exchange Commission (SEC), the number of public companies in the US having to restate past financial results because of improper accounting, doubled between 1997 and 2000.

Regulators hold my profession accountable in instances such as these, in 2000 the SEC last year held the audit profession hostage saying that the provision of audit and non-audit services to the same client was impairing auditor independence.

In many respects, the need for transparent forward-looking reporting is made more urgent by the difference between what companies think investors are really interested in first and foremost and what analysts really want to know first and foremost.

Research suggests that the number one performance measure for companies is strategic direction, whereas investors cite earnings and analysts cite market growth. So although all sides look at the same things – cash flow, quality of the management team, gross margins, market share etc – they allocate them to different levels of priority.

There is an old saying: ‘the market can remain irrational longer than you can remain solvent’. Perhaps we should look at it in terms of educating investors. It is no good companies developing new and brilliant performance measures if nobody understands them. Certainly, the development of key performance measures, both financial and non-financial, is something on which the global accountancy profession is currently working.

My personal view, indeed, the accountancy profession’s view around the world, is that at the very least we should all be preparing our accounts with a single financial language: International Accounting Standards. Comparability across markets will be a boon to investors and to companies.

It is the reason why international bodies, such as the International Federation of Accountants, which represents two million accountants and auditors in over 114 countries, very much welcomed the European Commission’s move to introduce IAS for consolidated group accounts across Europe by 2005. It should help to prevent the kind of scenario that meant Daimler-Benz found their reported profit in Germany, under its rules, turned into a reported loss in the US, under US accounting rules.

## Conclusion

Where does all this take us? I began with the question ‘Corporate governance: why should companies care?’

As businesspeople, we look for a lower cost of capital and benign and stable operating environments for our businesses. Many of us here have experienced the difficulties of doing business in countries that lack regulatory, fiscal or prudential stability or prove a minefield due to lack of transparency or corruption. We certainly care about these things where they create barriers to the prosperity of our businesses.

The world has recognised that the principles of governance – transparency, integrity and accountability – have become international touchstones for engaging investor confidence, as vital for companies as they are for governments that strive to build strong and dynamic economies. The international credit rating indices, for countries and companies alike, should persuade us of that.

Codes of governance, whether mandatory or voluntary, should be considered as fundamental frameworks for business prosperity. But we must distinguish between conformance and performance, between the process driven approach and the need for good governance to become part of the business culture.

Truly subscribing to the *principles* of good governance moves us beyond formal compliance and into a more holistic arena. Sustainability has now become the global watchword for customers, employees, politicians, regulators et al as part of companies’ civil ‘licence to operate’ and is now accepted as key to achieving long-term shareholder value.

So whatever your company structure and shareholding make-up, the responsibility of boards of directors or company owners, is now bound up in the confidence that they are doing their best for the company. And good governance builds that confidence.

It ensures that directors understand the business risks and opportunities and know what to communicate and how to talk to the markets and the world at large. (And it helps to mitigate against those ever present risks to corporate reputation.)

If companies do not take charge of their businesses and engage the public’s confidence in their operations, the world’s powerful shareholders will try themselves to take over the reigns of stewardship in the public interest. Companies that do not demonstrate strong governance, will be viewed as out of date, out of control and out of the market.

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