Challenging Corporate Governance Structures

A summary of the main issues covered at the 2010 Airmic conference workshop

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Preface

It is now eighteen years since the Cadbury Report was published in 1992. Since then we have seen a rapid evolution and development of the corporate governance concept in the UK. Today, quite rightly, corporate governance is an area of significant focus for all large companies and this is perhaps most evident from the enhanced disclosure within reporting and financial statements.

The evolution of corporate governance initiatives within the UK, is an area of particular interest to the risk management community and one in which Airmic has been closely involved.

By many metrics we have come a long way, governance standards appear to have improved but is it really working?

The recent financial crisis prompted many questions and the discussion and debate around the effectiveness of corporate governance and the cost of getting it wrong suddenly moved from the boardroom into the wider public domain. As a professional association focused on the management of risk, Airmic has an important role to play in facilitating and participating in this discussion process.

The Challenging Corporate Governance Structures workshop, delivered at the 2010 Airmic conference, produced some interesting debate and fascinating results, many of which should encourage the relevant bodies to think long and hard about the current effectiveness of governance standards in the UK and what is necessary to deliver the right combination of confidence and success.

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October 2010

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Background

This paper summarises the main issues covered at the 2010 Airmic conference workshop; Challenging Corporate Governance Structures. The workshop was presented by Matthew Bates of Heath Lambert and Lisa Connolly a Director of AIRMIC.

The objective of the workshop was to consider the evolution of corporate governance in the UK over the last 18 years and to obtain delegate views on the following key questions:

- Can one governance structure ever fit all organisations?
- Is the current approach towards corporate governance the right one?
- Are we in danger of destroying rather than building shareholder value?
- Will corporate governance deliver expected outcomes?

A number of issues relating to corporate governance were discussed under the following headings:

- What do we mean by corporate governance?
- Corporate governance milestones
- Are the milestones effective?
- Disclosure – is it working?

Interactive software was used throughout the workshop enabling participants to respond to a number of specific questions/issues. At the end of the workshop participants were asked to vote on the key questions (above).

The purpose of this summary document is to provide an overview of the workshop discussions together with the delegate responses to a number of questions concerning corporate governance.

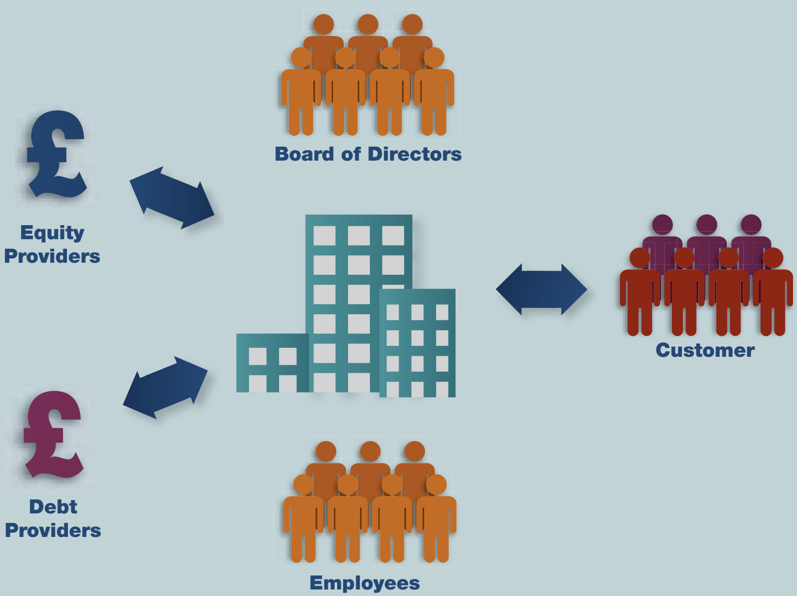
What do we mean by corporate governance?

While there are multiple definitions of corporate governance in the UK there are a number of common themes which have been consistent. These themes are generally positive in nature and the majority indicate some form of active control and/or management. These themes include (but are not limited to) the following:

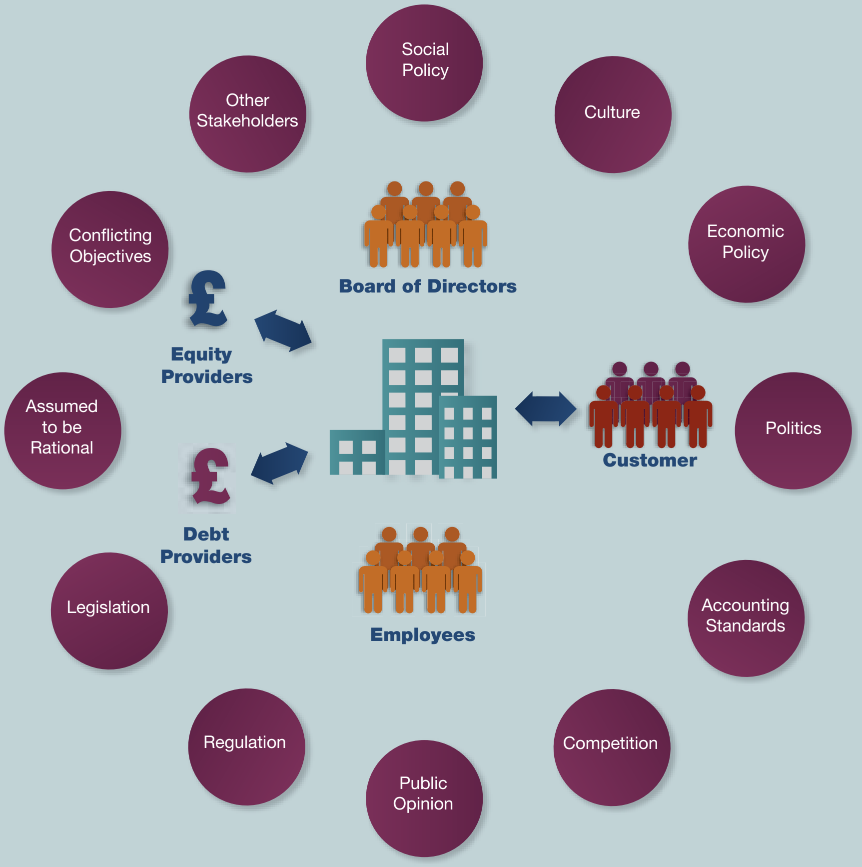
- **Process**
- **System**
- **Code of behaviour**
- **Policy**
- **Law**
- **Direction**
- **Transparency**
- **Practices**
- **Principles**
- **Values**
- **Framework**
- **Control**
- **Supervision**
- **Management**
- **Rules**
- **Relationships**
- **Responsibilities**
- **Performance**

The main corporate governance stakeholders are equity providers, debt providers and the board of directors. The relationships between these stakeholders (including contribution and performance expectations) are, at least in theory, relatively simple.

A Simple Model… In Theory



Complex Reality



The reality is far more complex. Interests are rarely, if ever, perfectly aligned. Critical underlying assumptions such as rational decision making and risk/reward behaviour can be flawed. External factors, and wider stakeholder issues, are given relatively little consideration in assessing the adequacy of a corporate governance framework. A number of other drivers will significantly impact what goes on within the business, examples include:

- **Social policy**
- **Politics**
- **Public opinion**
- **Culture**
- **Accounting standards**
- **Regulation**
- **Economic policy**
- **Competition**
- **Legislation**

The current corporate governance framework reflects the 'simple' model. While this is understandable it is by definition limited as it largely ignores many of the issues surrounding the day-to-day management and development of the organisation.

The objective and expected outcome of the corporate governance framework has evolved over time. Cadbury referred to “the system by which companies are directed and controlled” while the Hampel Report made shareholder value (“the preservation and the greatest practical enhancement over time of their shareholders investment”) a primary focus. The most recent Financial Reporting Council guidance shifts the focus towards the facilitation of entrepreneurial success and the management of risk.

There is some debate about what corporate governance should be about. Should it focus solely on the protection of shareholder interests or should policy makers consider the wider social welfare issues which are inextricably linked to any failings in corporate governance?

Workshop participants were asked “What should corporate governance be about?”. The following options were proposed and delegates were asked to provide a response ranging from strongly agree to strongly disagree:

- Improving confidence in the system
- Reducing probability of corporate/organisational failure
- Reducing the cost of capital
- Shareholder wealth protection/creation
- Enhancing social welfare
- Driving good risk management

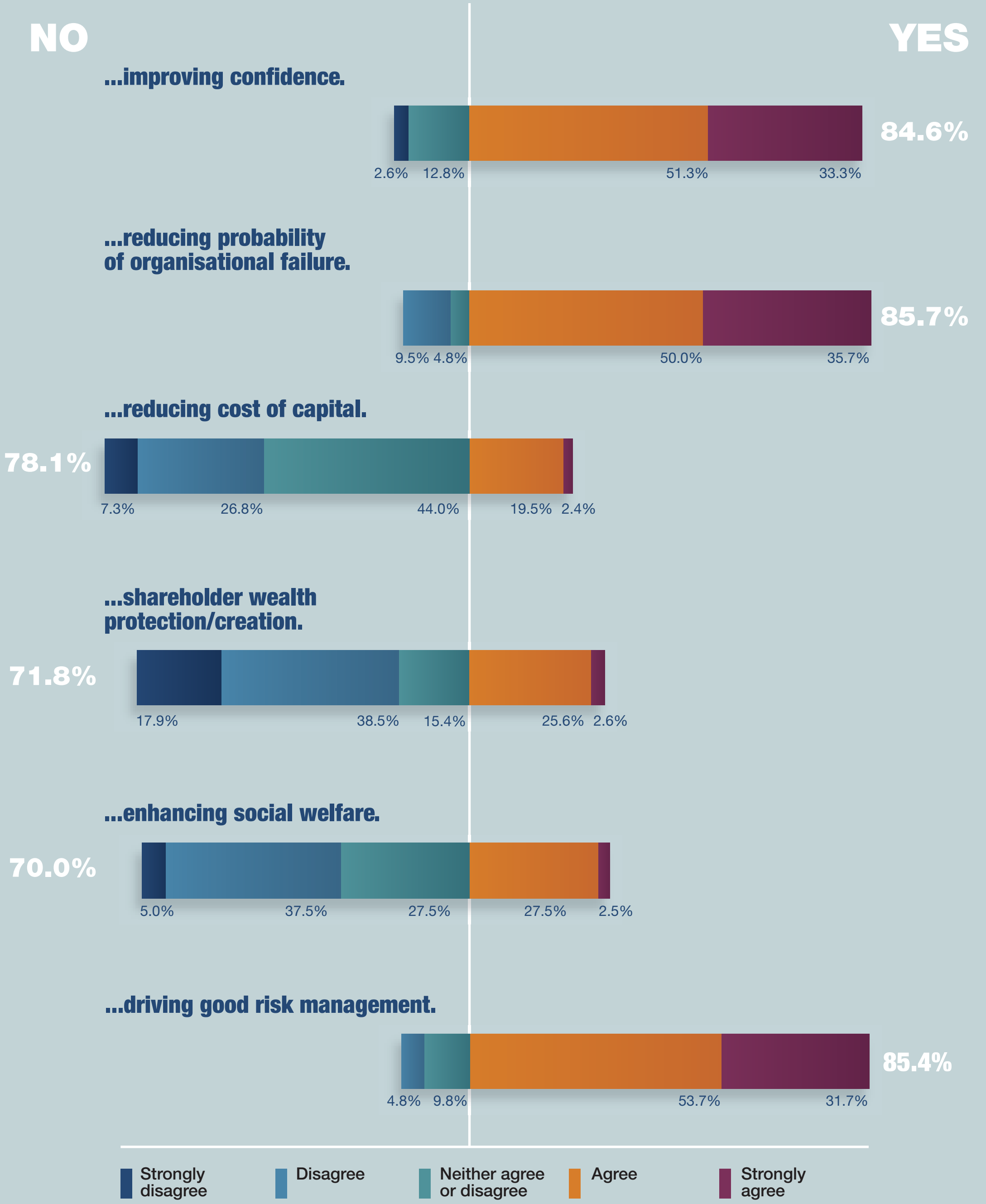
At least 84% of respondents believe that corporate governance should be about improving confidence in the system, reducing the probability of corporate/organisational failure and driving good risk management. The responses were highly consistent with roughly a third of respondents strongly agreeing and half agreeing.

22% of respondents believe that corporate governance should be about reducing the cost of capital. This is perhaps unsurprising as cost of capital is often an argument put forward to support the fairly prescriptive Sarbanes-Oxley approach which has been criticised for both its political expediency (it was rushed through both Houses of Congress with relatively little debate following the Enron failure) and onerous, far reaching nature.

A relatively low 29% of respondents believed that corporate governance should be about shareholder wealth protection/creation. With 38% disagreeing and a further 18% strongly disagreeing. This response contrasts strongly with the 1998 Hampel Report which stressed this objective.

Only 30% of respondents agreed that corporate governance should be concerned with enhancing social welfare. 42.5% disagreed or strongly disagreed with the statement while 27.5% neither agreed nor disagreed. The general consensus seemed to be that corporate governance should focus upon the interests/actions of the primary stakeholders (the simple model) rather than making specific reference to more general stakeholders. This is perhaps surprising bearing in mind the global impact and secondary effects of the credit crunch (which was believed to be a failure in corporate governance by a clear majority of delegates – refer page 17) are still very much in evidence and will be for a long period of time.

Corporate governance should be about...



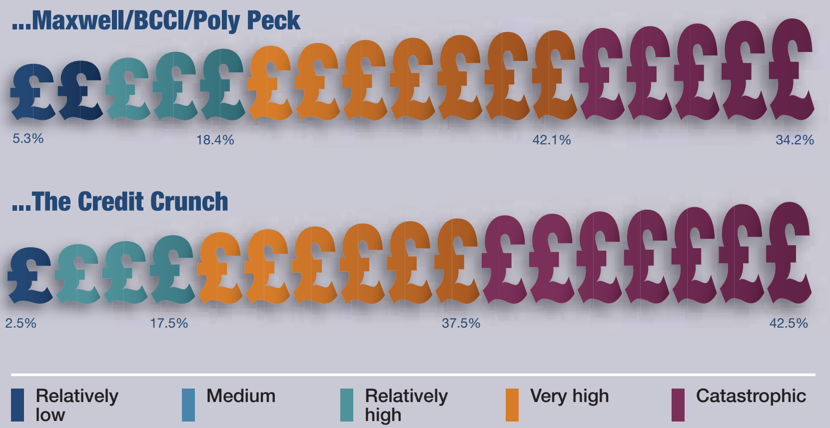
Corporate governance milestones

Corporate governance milestones were reviewed and the main drivers for each were considered. A clear pattern of event, response, review emerges over the last 18 years. Typically a high profile corporate failure (or failures) leads to an independent review and report (or more recently a revision to the Combined Code) which is then implemented on a 'comply or explain' basis.

An early and more recent corporate governance 'trigger event' was reviewed to help consider the impact of corporate governance failure and identify any general trends. Maxwell/BCCI/Polly Peck (the trigger events for the Cadbury Report in 1992) were compared to the credit crunch (the trigger event for the Walker Review in 2009 and subsequent 2010 revision to the UK Corporate Governance Code).

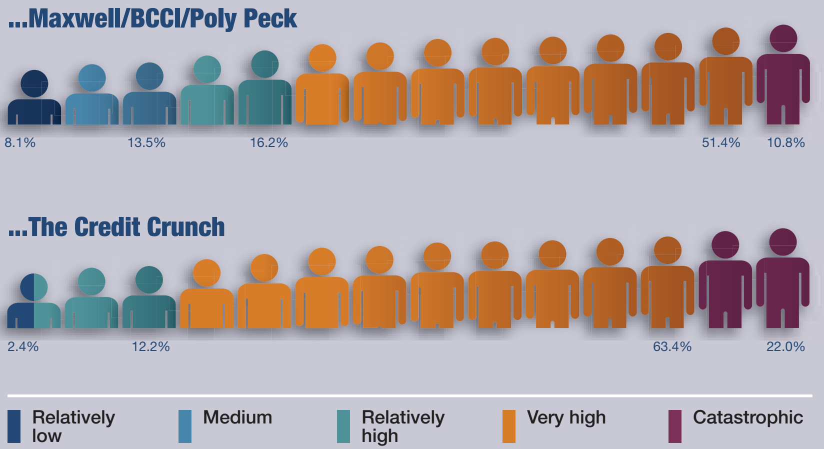
Delegates were asked to evaluate each against three metrics - impact on shareholder value, social cost (a very broad definition) and local/global impact.

What was the impact on shareholder value of...



Perhaps surprisingly delegates saw very little distinction between the two triggers in terms of impact on shareholder value. 76% viewed the Cadbury trigger event as catastrophic or very high compared with 80% for the credit crunch. It would seem that from an individual shareholder's perspective there is little distinction to be made between events as it is the impact on their personal wealth which defines their impact assessment.

...and what was the social cost?

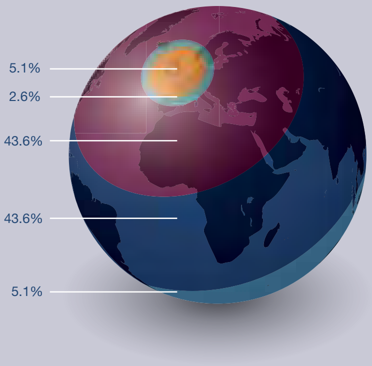


There was a clearer distinction between social costs but perhaps still not as wide as many would anticipate.

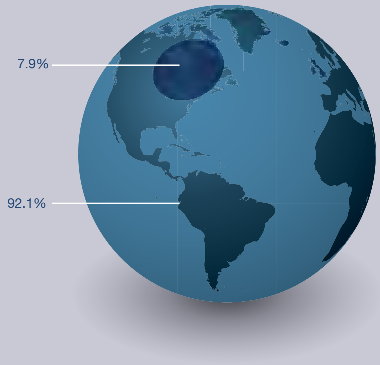
10.8% of delegates viewed Maxwell/BCCI/Polly Peck as having a catastrophic impact in terms of social cost, 51.4% viewed it as high and 16.2% believed it to be relatively high. The credit crunch social cost was viewed as catastrophic by 22% of delegates, very high by 63.4% and relatively high by 12.2%. There was significant variance at the lower end with 21.6% rating Maxwell/BCCI/Polly Peck as medium or relatively low compared with 2.4% for the credit crunch.

What was the global impact of...

...Maxwell/BCCI/Poly Peck



...The Credit Crunch



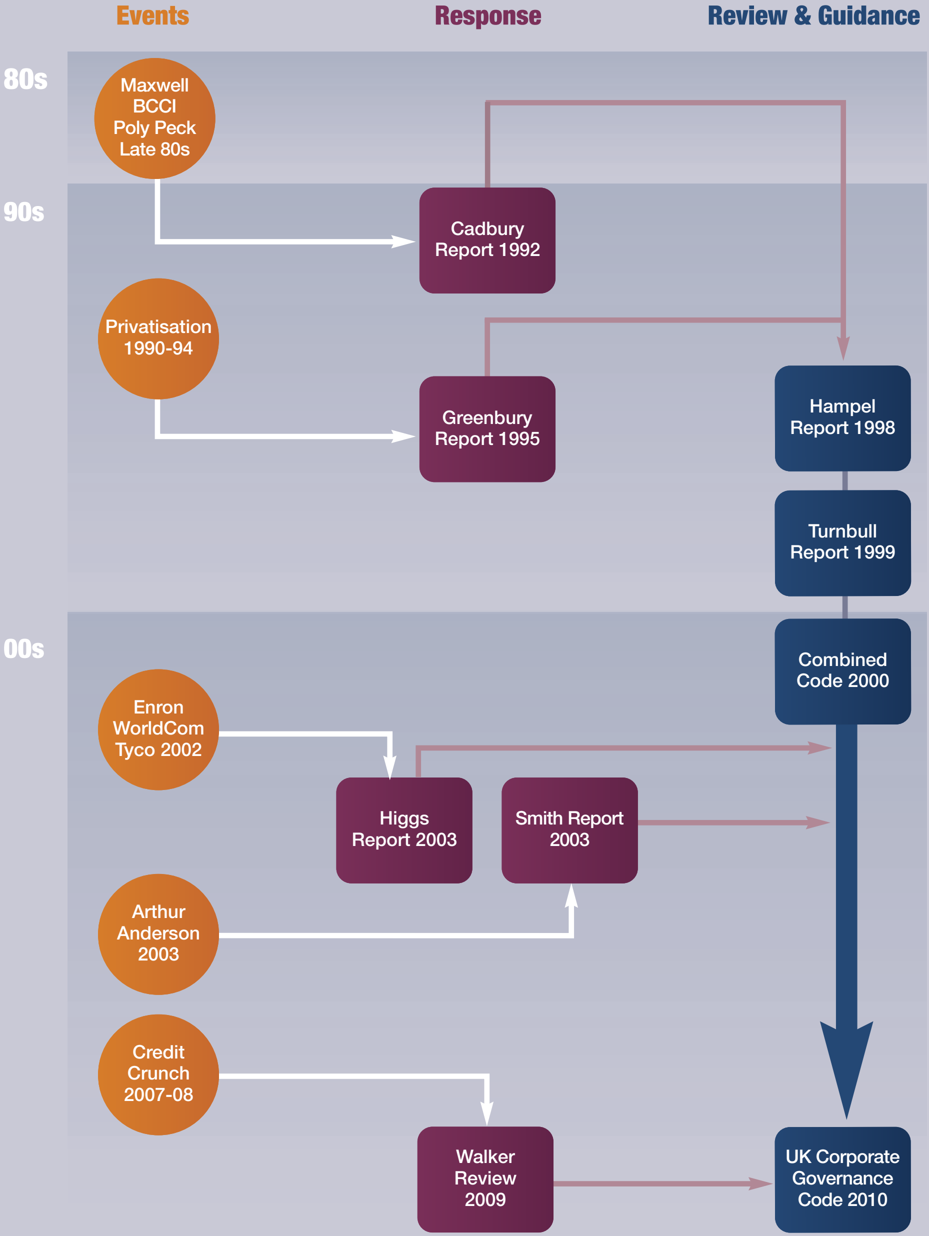
Local | Regional | National | Multi-national | Global

Local/global impact assessments showed real differences with 92.1% of delegates recognising the global impact of the credit crunch and 7.9% believing it to have a multi-national impact. 51.3% of delegates viewed Maxwell/BCCI/Polly Peck as having a national/regional/local impact, 43.6% believed it to be multi-national and 5.1% global.

OBSERVATION

The trend over time appears to be a regular pattern of high profile corporate governance failures. The impact or cost of these failures is growing in terms of shareholder value, social cost and geographic spread. While this is perhaps inevitable as supply chains become increasingly complex and global inter-connectivity becomes the norm, it does raise the question as to how effective the last 18 years of corporate governance initiatives have been? As more and more regulation and guidance has been introduced to the UK, corporate failures have become larger and higher profile – the most recent threatened the existence of the entire financial system.

Evolution: Event Response Review



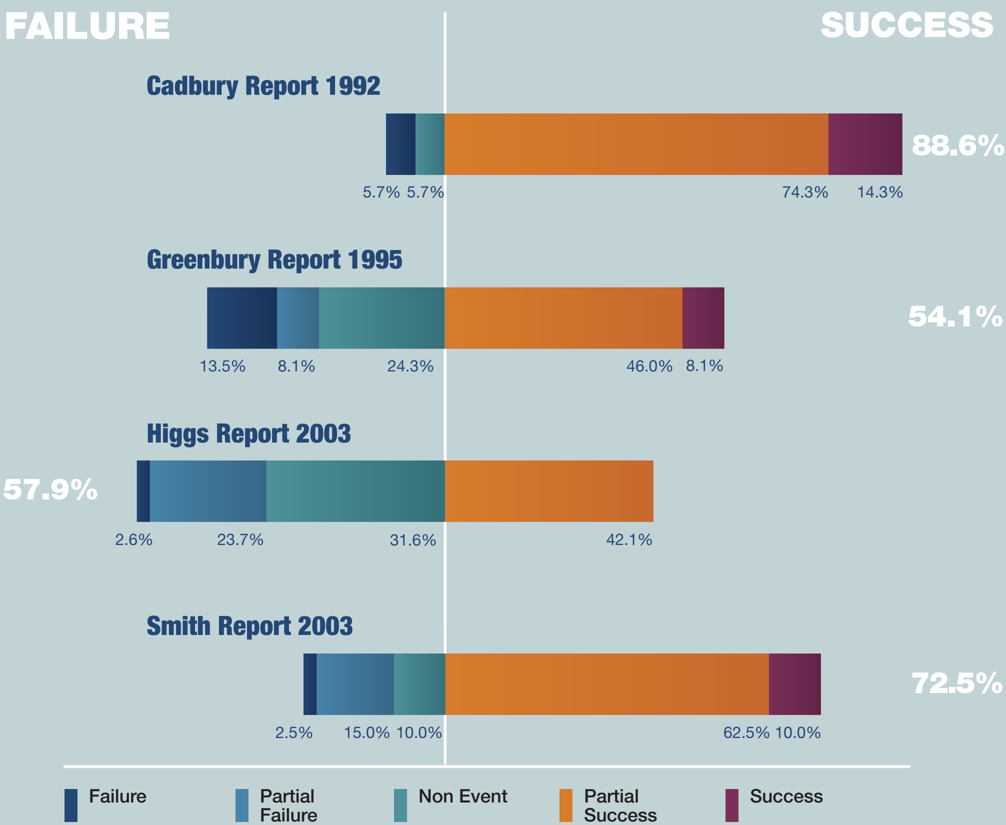
Are the milestones effective?

Recognising the event/response relationship, the workshop went on to consider the main focus and subsequent effect of the following UK corporate governance milestones:

- Cadbury Report 1992
- Greenbury Report 1995
- Higgs Report 2003
- Smith Report 2003
- Walker Review 2009

Delegates were asked to provide their opinion as to the relative success or failure of each milestone. The results are shown below:

Corporate governance milestones



Cadbury is clearly perceived as the most successful with 88.6% of delegates rating it as a success or partial success. This was followed by Smith (72.5%), Greenbury (54.0%) and Higgs (42.1%).

A relatively large number of people viewed Greenbury (24.3%) and Higgs (31.6%) as a non-event and also as a failure or partial failure (21.6% Greenbury and 26.3% Higgs).

Higgs and Greenbury also showed the greatest diversity of opinion as to their success or failure. Delegates generally clustered around 'non-event' for Higgs and there was a significant failure bias for Greenbury.

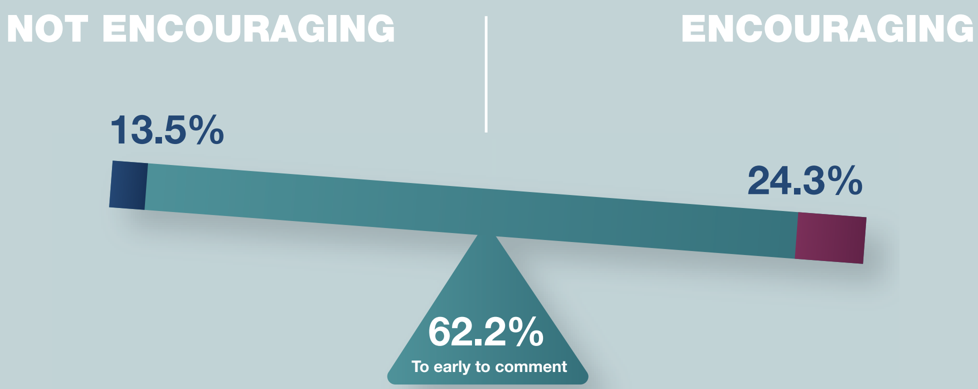
It is important to place these responses in context of what each milestone delivered. At the time, Cadbury represented relatively high profile and fairly radical change. The Greenbury influence is perhaps the most obvious in today's reporting and financial statements and certainly drives most press comment. Less tangible areas were dealt with by Higgs which focused on the role and effectiveness of non-executive directors and the audit committee and Smith which focused on providing greater detail around audit committee issues. In evaluating the effectiveness of corporate governance milestones radical change and a focus on specific high profile and/or contentious issues would seem to be the criteria for perceived success.

In summary, it can be argued that anything that helps drive confidence into the system is positive. However, it must be remembered that overconfidence can lead to less rational risk evaluation and decision making – this was certainly a factor in the recent financial crisis. Cadbury is seen as a big step forward in the right direction but there are more reservations about Greenbury which focused on a single issue that for many has become a distraction to the overall corporate governance debate. Radical change requiring visible action is perceived to be more successful than a lower profile 'tidying up' approach such as clarifying roles and/or responsibilities.

Recognising it is probably too early to comment fully on the effectiveness of the Walker Review delegates were asked to give their view on the early signs – are they encouraging, not encouraging or is it still too early to comment?

24.3% thought the early signs were encouraging, 13.5% saw them as not encouraging and 62.2% are still reserving judgement.

Are the early signs of the effectiveness of the Walker Report encouraging?



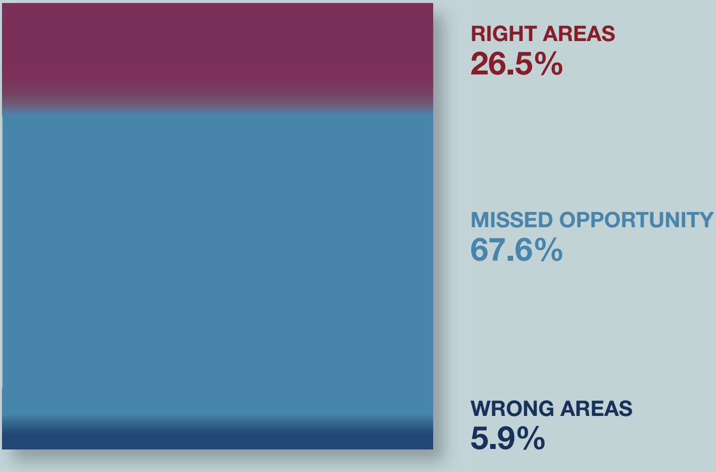
64% of those people who expressed an opinion had a positive stance on Walker - which would rate it significantly below Cadbury in terms of effectiveness. Considering the scale and impact of the credit crunch and the factors highlighted above - which seem to characterise effectiveness from a long term perspective (radical change, visible action) - the early signs are not encouraging.

The Walker Review focused on the way the Boards of banks and big financial institutions function with regards to corporate governance. The Financial Reporting Council decided to bring forward the planned review of the UK Corporate Governance Code so that corporate governance in other UK listed companies could be assessed at the same time and the revised code was issued in June 2010. The workshop considered the main revisions to the code and delegates were asked to give their opinion on whether or not these are focused on the right areas and whether or not the revisions represent an improvement.

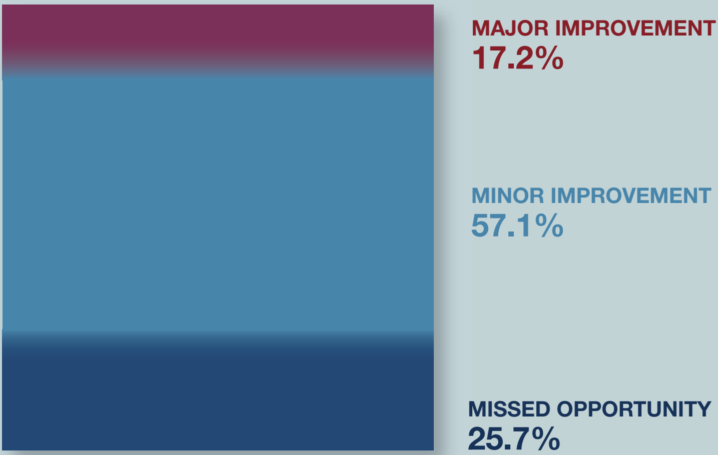
OBSERVATION

Coming after the credit crunch, the largest failure in corporate governance to date, the 2010 revisions to the Corporate Governance Code appear to be some way off what is required.

The Corporate Governance Code 2010 focuses on...

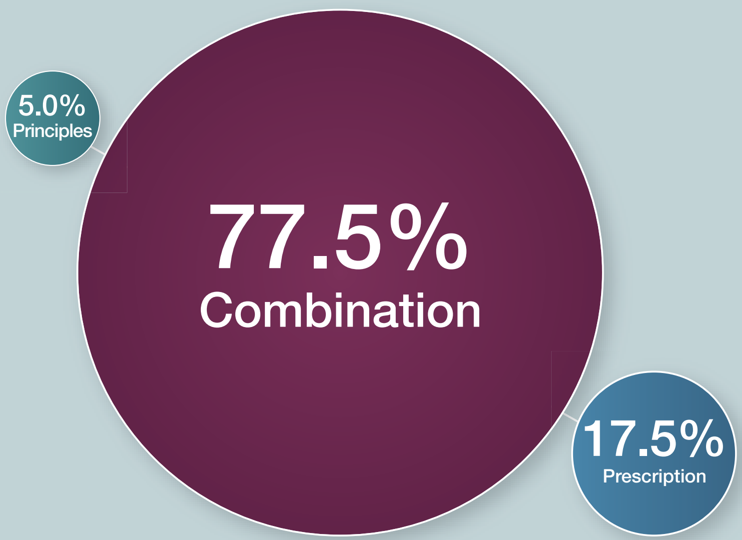


The revisions to the code represent...



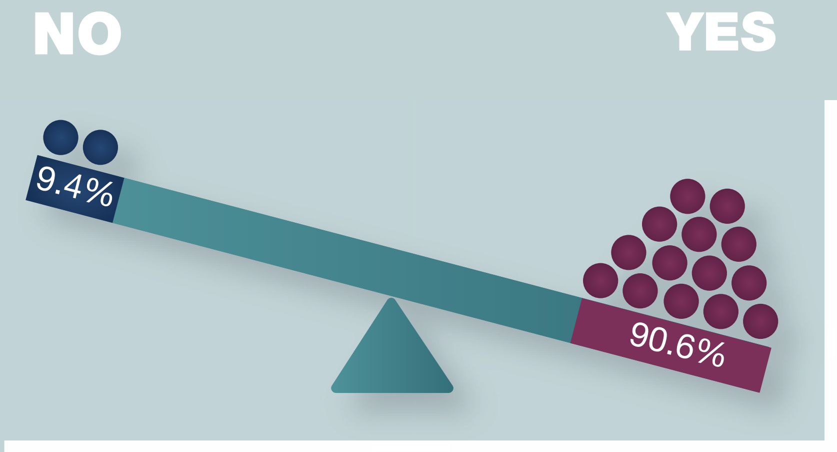
There has, and continues to be, a lot of debate around the relative advantages and disadvantages of principles or prescriptive based corporate governance systems. The workshop reviewed some of the main guidance documents and considered the 'comply or explain' approach which has been followed in the UK. Delegates were asked which system they think works best and whether or not it is possible to have a workable combination of the two.

Which system do you think works best?



A significant majority of delegates (77.5%) favoured a combination approach with 90.6% believing it is possible to have a workable combination of principle and prescription based systems. 'Comply or explain' has dominated UK corporate governance thinking and it would appear that people think a greater level of prescription is desirable and that a combination approach is workable.

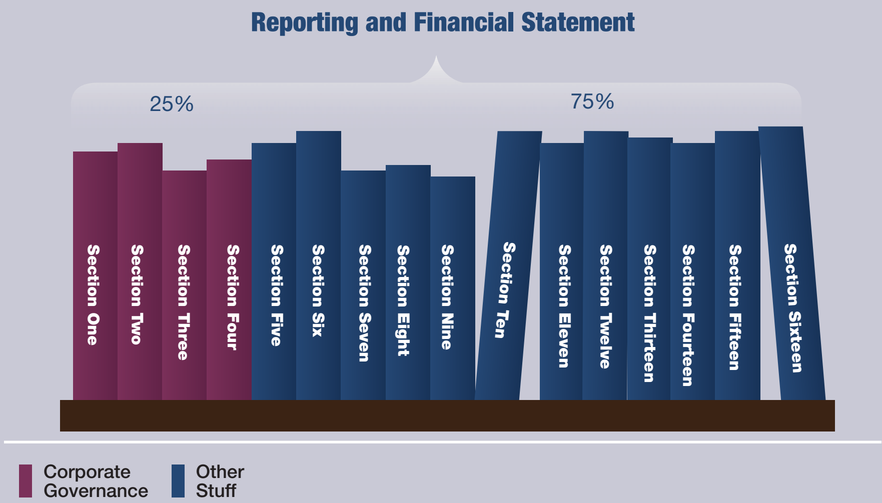
Can you ever have a workable combination of Principle and Prescription based systems?



Disclosure – is it working?

Improved disclosure has been a significant element of UK corporate governance thinking over the last 18 years and companies' financial statements have evolved to reflect this. The workshop considered a disclosure document for a recent 'failed' entity – the corporate governance section accounted for 5% of total content and the Director's remuneration section (a direct result of Greenbury) accounted for another 12%. Taking the governance content from other sections of the report showed that 25% of the total content related to corporate governance. Two more recent disclosure statements were highlighted to further illustrate the problem – more disclosure and better quality reporting does not necessarily improve overall standards of corporate governance.

Credible Disclosure?



The recent financial crisis has highlighted governance issues. How was it allowed to happen? Why did no one see it coming?

The workshop considered some of the main credit crunch drivers. The complexity and diversity of the issues together with the relatively long build up prompted us to question whether the event was a corporate governance failure or a black swan event - these type of events were defined by Nassim Taleb in his 2007 book as follows:

- The event is a surprise (to the observer)
- The event has a major impact
- After the event, the event is rationalised by hindsight as if it had been expected

The Credit Crunch was a...

81.1% of delegates viewed the credit crunch as a corporate governance failure with 18.9% believing it to be a black swan. By implication, for the majority corporate governance initiatives have spectacularly failed, for the minority how can corporate governance initiatives add value?

At a macro level, each organisation will be different in terms of industry sector, size and geography while at a micro level each organisation has its own unique risk profile. The workshop, therefore, considered whether or not one governance structure can really fit all organisations and highlighted some of the barriers to achieving this.

OBSERVATION

Improved disclosure may drive confidence but it is certainly not a guarantee that it is working effectively. In such an environment the overall credibility of reporting and financial statements will inevitably be eroded.

The key questions

Can one governance structure ever fit all organisations?

NO 76.2%

YES 23.8%

Is the current approach to corporate governance the right one?

NO 64.9%

YES 35.1%

Are we in danger of destroying rather than building shareholder value?

NO 68.6%

YES 31.4%

Will corporate governance deliver expected outcomes?

NO 68.6%

YES 31.4%

Less than one quarter of delegates believe that one structure can fit all organisations which means there is no magic solution. Each organisation presents a unique risk profile and therefore what is needed is a way of identifying underperforming organisations and, driving change within them, at an early stage. A more prescriptive approach should help but cultural issues and drive for short term success remain significant (possibly insurmountable) barriers to achieving this.

Roughly two thirds of delegates believe that the current approach towards corporate governance is wrong and that expected outcomes will not be achieved.

Whilst there is little debate than anything which increases confidence in the system is a positive, there is clearly a belief that significant change is required in order for corporate governance to be effective. Earlier questions indicated that this change should comprise a shift away from the 'comply or explain' model towards a more prescriptive approach and the introduction of more radical change requiring visible action.

OBSERVATION

A common theme in all of the high profile corporate failures which have driven corporate governance initiatives over the last 18 years has been a dominant culture, interestingly this is also the very thing that can allow an organisation to deliver above average returns, at least for the short to medium term. A value investor with a long term invest-and-hold strategy will take a very different view from the short term high yield investor – stakeholder conflicts and external influences increase complexity.

In a complex world, our current simple corporate governance model gives confidence but is perhaps too simplistic to actually work.

“The more the cost of governance, regulation and compliance increases, and the bigger and more embedded in business life the governance industry becomes, the harder it is to ask the one question which really matters - will the current approach deliver the outcomes we want? This report asks that fundamental question and asks it of the people in business who are in the ideal position to judge – the risk officer members of Airmic. Their answer is an uncomfortable truth. There is huge scepticism about the current system, the principles which drive it and whether it will live up to the expectations of its supporters. If ever there was a clarion call for an industry to think seriously about where it is heading, this is it.”

Anthony Hilton, *Financial Editor, Evening Standard*

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