The elephant problem

KATHRYN VAGNEUR ARGUES THAT OVER TIME SOCIETY MAY HARVEST THE CONSEQUENCES OF WELL-INTENDED, BUT POORLY CONCEIVED, CORPORATE GOVERNANCE (CG) MANDATES BECAUSE THERE HAS BEEN A COLLECTIVE FAILURE TO DEFINE CG MEANINGFULLY AND CONSISTENTLY.

Executive summary

- It is clear there is significant disagreement about the definition of corporate governance (CG) and what it seeks to achieve.
- Reforms have tended to focus on narrow areas of CG rather than improving the entire mechanism.
- Recent CG reforms have drawn attention away from pressing strategic and managerial issues.
- Corporate behaviour problems will continue to occur and treasurers can expect their CG burden to increase.

Remember the parable about blind men describing an elephant? Each 'blind man' 'sees' a different aspect of the elephant by touch and forms a mental model about the beast from that aspect alone. So, while each may call it an 'elephant', they are all referring to something different. As a result, they "rail on in utter ignorance of that each other mean. And prate about an elephant, not one of them has seen." [1]

Corporate governance (CG) reform may have the 'elephant problem' in spades. Recently, Independent Audit, a London-based consultancy, sponsored an event to introduce its second survey of CG reporting by UK-listed companies. The room was packed. It was a veritable *Who's who* of UK Plc boardrooms.

Lord (David) Currie, Chairman of Independent Audit, introduced the topic and Jonathan Hayward reported on how UK Boards approach the Revised Combined Code requirements for reporting Board effectiveness.

This was a thought-provoking exercise in benchmarking. Implicit in the presentation were debatable notions about what constituted 'appropriate' and 'quality' reporting on CG and what is the difference between compliance in form ('box ticking') and compliance that fulfils the intent behind the requirement.

After the presentation, Alastair Ross Gooby (co-founder and Chairman of the International Corporate Governance Network) and Richard Lapthorne (Chairman of Cable & Wireless) gave formal statements. Then, the audience was invited to comment. Sir Derek Higgs was the first to speak and others followed.

Most expressed quite strong opinions about CG and/or CG reporting. However, as the discussion progressed, it became evident that there was significant disagreement about the notion of CG – what its definition is, what it seeks to achieve and how this is achieved.

Some were far apart in their ideas. For example, Alastair Ross Gooby said that CG is the means to reduce the cost of capital. In contrast, John Plender, *Financial Times* columnist, spoke of CG as a system and its purpose as serving society's needs. While some were less divergent, few appeared to agree.

Despite the obvious differences, no one offered a definition for CG or pointed out the inconsistencies in definitions that were implicit in the discussion. As a consequence, there was little debate. Rather, most made statements of opinion and a few even appeared to talk past one another. This is a real problem. The term 'corporate governance' is widely used, but it has no generally accepted definition. In fact, only a few of those considered CG experts offer a definition for the term and those who do define it, are inconsistent in the definitions that they propose (*see Box 1* for examples).

WHY THIS MATTERS TO TREASURERS If the experts do not agree, CG reform may suffer from the elephant problem. But why should this matter to treasurers? As currently conceived, CG has become a burdensome, unwanted externality. Treasurers bear much of the burden it imposes. In the EU and US, CG mandates have increased substantially. In some instances, requirements even conflict.

As a consequence, some argue for a roll-back of the most onerous mandates. In the US, the combined weight of Sarbanes-Oxley (SOX) and other requirements is encouraging some US companies to take their initial public offerings (IPOs) to exchanges outside the US. Many exchange-traded companies have considered delisting. Private companies have become more cautious about seeking funding in the capital markets.

There is concern that the accounting profession is less attractive to those with the skills needed to audit complex global companies. There is worry that the pool of talent, willing and able to serve on Boards, will shrink. Executives complain about the cost of compliance. Boards may spend more time on CG compliance than they do on business management issues. Over time, society may reap the consequences of well-intended, but poorly conceived, CG mandates. Why?

Firstly, there has been a collective failure to define CG meaningfully and consistently. As a result, while there has been a significant investment in post-Cadbury reform initiatives, these have not been guided by agreement on the definitions, purpose and domain of CG. As a consequence, while each initiative has tended to add to the compliance burden, the investment has not addressed some critical problems that plague the complex CG system.

Secondly, instead of improving the functioning of the entire set of corporate governance mechanisms, each reform has focused on narrow parts of it. So, while SOX provided a wake-up call to US management, it does not fix the reporting model that permitted the Enron, Sunbeam and WorldCom manipulations. The Revised Combined Code does not address the causes of strategic failures like Equitable Life, Marconi and Railtrack. The proposals on the table at

Box 1. Definitions for 'corporate governance' by acknowledged experts

1. "The system by which organisations are directed and controlled" for which the Board of Directors is responsible. (Cadbury Report, 1992)

2. "The systems by which organisations are run and the laws, regulations and best practice with which they are required to comply." (Institute of Chartered Secretaries, www.icsa.org.uk/about/govern.html)

3. "Ensuring compliance with regulations and the implementation of appropriate administrative procedures." (Institute of Chartered Secretaries, www.icsa.org.uk/about/govern.html)

4. "The relationship between the shareholders, directors and management of a company, as defined by the corporate charter, by-laws, formal policy and the rule of law." (The Corporate Library, www.thecorporatelibrary.net/glossary/).

5. "The management of risk within an organisation with a view to ensuring the continuity of that organisation's business and existence." (Information Assurance Advisory Council, 2002)

6. "To add value to as many organisational stakeholders as possible." (Bain & Band, 1996)

7. "A set of structured relationships that determines authority and responsibility for the conduct of an organisation and its management." (MacAoy & Millstein, 2000)

8. "[It] is concerned with the way corporate entities are governed, as distinct from the way businesses within those companies are managed. Corporate governance addresses the issues facing boards of directors, such as the interaction with top management, and relationships with the owners and others interested in the affairs of the company…" (Tricker, 1984)

the European Commission are not likely to prevent more frauds like Parmalat or bubbles like Vivendi Universal.

Thirdly, recent CG reforms have drawn attention away from pressing strategic and managerial issues. The volume and complexity of CG requirements threaten to make compliant businesses less efficient and reduce effectiveness in an increasingly fast-paced and competitive world. They also could stifle innovation. As a result, the current situation poses a real threat to economic performance – and poor economic performance has preceded most CG failures, large or small.

IMPLICIT STRUCTURAL PROBLEMS Corporate behaviour problems will continue to plague society, despite years of well-meaning attention because there are structural problems that allow or even encourage CG failure. Post-Cadbury reforms have not curbed runaway executive compensation or large payouts for performance-related departures. Reforms have not addressed the structural problems implicit in how performance information is developed and delivered. Reforms have not addressed a major problem for investors – valuing companies in a volatile environment. In fact, they may have made valuations more difficult, because many listed companies now restrict the information that they publish and some have stopped giving performance guidance. These all need attention.

Solving the CG issues that vex society requires a better understanding of the CG system than we have today. The first step should be to define a set of terminology clearly and consistently and ensure that everyone working on reform has a common understanding of the purpose of CG and what it encompasses (a proposal is found in *Box 2*).

The next step is to understand that improving a complex system involves viewing and managing it as a system. This is a very different kettle of fish from the CG reforms that have been developed over the last decade or so. Most of those seek to influence personal behaviour through recommendations, rules and punishment for transgressions.

Reforms should seek improved performance of the CG system. W Edwards Deming developed concepts, now used worldwide to improve product and service quality. These can be usefully applied to the problem of improving the performance of CG systems.

At the core of Deming's approach is the notion that when performance failures are significant, it is the process at fault, not the individuals operating within the process. Changing the rules will not improve a faulty process or system. Instead, improvement requires a focus on the entire process, or system, not just a few subsets within it (e.g. the Board and internal controls).

A POORLY UNDERSTOOD ART Those proficient in quality management know that how individual mechanisms interact is as important as how they operate individually. Mechanisms within the CG system should be designed and managed to work together to meet specific needs.

As currently configured, the External CG Framework is a patchwork of elements that lack coherence as a whole. It will remain so until those in control of public policy and the CG Reform Agenda address the lack of logic and structural consistency.

Similarly, the management of Internal Governance Systems is at best an 'art' – a poorly understood art. A few organisations have a better standard of this art than most, but these are not numerous and an understanding about what makes them better is not well developed. As a consequence, managers who have been lucky enough to apprentice with skilled practitioners may gain useful experience but, for those not so lucky, there are few resources to help them.

Box 2. Proposed CG Terminology

'Corporate entities' are not just listed companies. They include many kinds of organisations including private companies, charities, governments and non-governmental organisations. Corporate entities are associations of people.

Humans organise themselves with a set of evolving norms, policies, procedures and processes that are intended to guide individual decision making and thereby behaviour. This is 'governance'.

Society seeks to influence the behaviour of individuals within corporate entities and does so with laws, regulations, codes of conduct and social norms. Please call this the 'External CG Framework'.

Organisations govern themselves internally with a set of rules, guidance, controls and other mechanisms meant to guide, co-ordinate and influence the behaviour of individuals. No two sets are alike. These are unique to each organisation and may vary significantly when units within an organisation are compared. Please call this the 'internal governance system'.

The External CG Framework and Internal Governance Systems are two separate parts of the 'Corporate Governance System' – a structure comprised of interacting functions, or subsets. In other words, CG is a complex system and it has many variations.

Public policymakers need to acknowledge the poor understanding about the management of Internal Governance Systems. Instead of investing in reform initiatives that accumulate and promulgate unsubstantiated opinion, they should invest in research and the development of experiments that address the structural problems that can be found within most Internal Governance Systems. However, the use of experimentation and analysis are foreign concepts to most policymakers and many of the people they are likely to select to lead the next round of CG reform initiatives. Until the mainstream reform agenda addresses these issues, the conundrums will remain and treasurers should expect their load to get heavier.

It is well known that one bad apple can spoil a whole barrel. Likewise, it does not take many financial frauds, especially spectacular or audacious ones, to do enormous harm to the financial markets by destroying trust in the reliability of company reporting. But is individual fraud the problem or is it reliability of the system of financial reporting, guidance and control or is it a lack of trust or human greed or the nature of corporate entities or the methods used to account for performance or the valuation techniques investors use or… or a bit of each that reinforces each other?

The goal should be making it easier for the individual in an organisation to do the right thing. This is a quality management problem. Specify it as one and it can be solved.

1 John Godfrey Saxe (1816-1887) based on a fable told in India many years before.

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