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Short course qualification

Certificate in Corporate Governance

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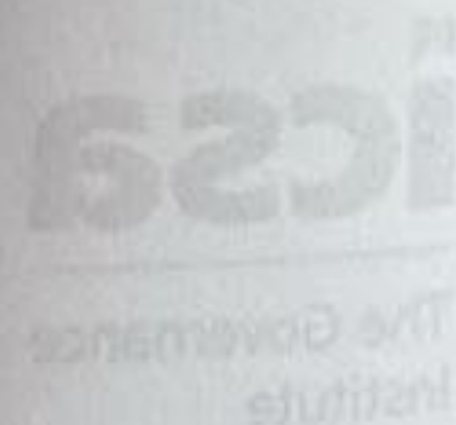

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How to use this study text

This study text has been developed to support ICSA's Level 4 Certificate in Corporate Governance and includes a range of navigational, self-testing and illustrative features to help you get the most out of the support materials.

The text is divided into three main sections:

- introductory material
- the text itself
- reference material.

The sections below show you how to find your way around the text and make the most of its features.

Introductory material

The introductory section includes a full contents list and the aims and learning outcomes of the qualification, as well as a list of acronyms and abbreviations.

The text itself

Each part opens with a list of the chapters to follow, an overview of what will be covered and learning outcomes for the part.

Every chapter opens with a list of the topics covered and an introduction specific to that chapter.

Chapters are structured to allow students to break the content down into manageable sections for study. Each chapter ends with a summary of key content to reinforce understanding.

Features

The text is enhanced by a range of illustrative and self-testing features to assist understanding and to help you prepare for the examination. You will find answers to the 'Test Yourself' questions towards the end of this text. Each feature is presented in a standard format, so that you will become familiar with how to use them in your study.

These features are identified by a series of icons.

The text also includes tables, figures and other illustrations as relevant.

Reference material

The text contains a range of additional guidance and reference material, including a glossary of key terms, footnotes and a comprehensive index.

Stop and think

Test yourself

Making it work

and European Bank for Reconstruction and Development, Commonwealth and international comparative studies.

The UK voluntary code approach has been adopted in many countries but whether or not such an approach will work depends on the authority of the institutions which support it. Cadbury makes the point that the 1992 Code would not have worked without the backing of the London Stock Exchange. Nor should we take for granted the importance to the effectiveness of the UK Code of UK established practices, structures and mechanisms such as well-developed company law, accounting and auditing frameworks. The IFC has issued toolkits for countries wanting to improve governance.

Test yourself 3.1

Where can you find a resource giving access to most of the world's corporate governance codes?

3. G20/OECD Principles of Corporate Governance

Organisation for Economic Co-operation and Development (OECD)
The OECD is an international organisation based in Paris with 35 member countries. OECD helps governments foster prosperity and fight poverty through economic growth and financial stability. It also helps to ensure governments take into account environmental implications of economic and social development.

The **Organisation for Economic Co-operation and Development** (OECD) issued Principles of Corporate Governance[1] (the Principles) in 1999 and revised versions in 2004 and 2015. The latest revision was carried out under the auspices of the OECD Corporate Governance Committee with all G20 countries invited to participate with the 35 OECD Member countries.

Unlike national governance codes the Principles are aimed at national policy makers to help them 'evaluate and improve the legal, regulatory and institutional framework for corporate governance, with a view to support economic efficiency, sustainable growth and financial stability'. The first four are about establishing an appropriate environment for good governance such as company law, ownership rights, functioning capital markets and recognising the rights of stakeholders. The last two are the most relevant to companies: the fifth principle is about company disclosures and the sixth is about the responsibilities of the board.

The OECD has also issued Guidelines for Corporate Governance of State-owned Enterprises[2], the most recent version in 2015, and a large number of reports on such matters as governance in particular countries and regions, supervision and enforcement on corporate governance and a Corporate Governance Factbook

1 G20/OECD (2015) Principles of Corporate Governance, www.oecd-ilibrary.org/docserver/9789264236882-en.pdf?expires=[illegible]2518109&id=id&accname=guest&checksum=149D664F2186F106F6CF4B4430F2140B

2 OECD (2015) OECD Guidelines on Corporate Governance of State-Owned Enterprises, Paris, http://mof.gov.il/gca/about/documents/oecd-guidelines-corporate-governance-soes-2015.pdf

3 OECD (2017) OECD Corporate Governance Factbook 2017, www.oecd.org/daf/ca/Corporate-Governance-Factbook.pdf

comparing governance requirements and structures in different countries. The OECD has also issued extensive guidance on corporate responsibility, including government-backed guidelines for multinational enterprises.

4. The European approach

Following the US scandals at Enron and WorldCom in 2001, the European Commission (EC) convened a high level group of company law experts led by the Dutch corporate lawyer Jaap Winter. At the time there was concern among governance specialists in the UK and several other EU countries that a US-style legislative response, like the Sarbanes-Oxley Act, would be recommended.

The EC might have taken little notice of the subsequent Winter report[4] but for a major scandal at the Italian company Parmalat.

Making it work 3.1

Parmalat

Founded in 1961, Parmalat became a major international group with multiple interconnected subsidiaries largely controlled by the Tanzi family. Parmalat defaulted on a €150 million bond in 2003 and was declared insolvent. It later turned out that Parmalat had been technically insolvent since listing on the Milan Stock Exchange in 1990 but this was hidden by deliberate misstatement through falsification of financial statements which included fictitious transactions, invented assets, overstated earnings and understated debts by around €14.5 billion. A Cayman Islands subsidiary was used as an accounting dump to hide liabilities. The fraud was extensive, sophisticated and complex, taking place over many years. In many ways it was like another Enron.

In the subsequent enquiries questions were raised about the influence of the Tanzi family, the role of the board, board committees such as the audit committee and management, along with the gate keepers involved such as internal audit and the firms of external auditors. Questions were also raised about Italian accounting and auditing standards and why investors and financial analysts failed to spot anything was wrong.

Parmalat meant the EC took the 140-page Winter report on 'a modern regulatory framework for company law in Europe' seriously. It was thorough and laid the way for governance to evolve in EU countries. Winter rejected ideas of a US legislative approach and of a single European governance code but said companies should include in their annual report and accounts a coherent and descriptive statement covering the key elements of the corporate governance

4 High Level Group of Company Law Experts (2002) Report of the High Level Group of Company Law experts on a modern regulatory framework for company law in Europe, www.ecgi.org/publications/documents/report_en.pdf

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rules and practices they apply. He recommended the EC issue a framework directive setting out the principles for such disclosure. He advocated countries develop their own codes, reflecting their own requirements but having regard to the framework directive.

The EU approach, on the whole, has been strongly influenced by the UK approach. The approach has worked and has continued to allow member countries to keep their own corporate laws and corporate structures: for example, several countries, such as Germany, allow two-tier boards with a supervisory and a management board as well as the Anglo-Saxon single board. EU directives have resulted in little new governance legislation in the UK but directives on the content of company annual reports and external auditing, including a requirement on audit committees, have been brought into UK law.

The Netherlands is an interesting example, where enthusiasm for corporate governance may be even stronger than in the UK. Like the UK, the Netherlands has a more dispersed ownership structure than most other EU countries. The first Dutch code was issued in 2003 and the latest in December 2016. Most Dutch companies, like German ones, have two-tier boards with management and supervision divided between the management and supervisory boards. The Dutch code places greater emphasis than UK Codes on long-term value creation, culture, risk management and reporting misconduct. The previous Dutch code was perhaps ahead of its time and based on a principle of 'apply or explain' but the current version is based on 'comply or explain'.

In September 2017 a voluntary group of pension funds, insurers and asset managers led by Eumedion issued a draft stewardship code for consultation. Eumedion is a members' association of c.70 institutional investors dedicated to enhancing the corporate governance, environmental and social performance and strategy of listed companies. The new code was published in July 2018[5] and will come into force as of 1 January 2019.

Stop and think 3.1

The Dutch have also taken the financial crisis very seriously. The Dutch banking Association Code[6] requires bank employees to swear a bankers' oath:

'Bankers' Oath: I swear/promise within the limits of my role that I perform at any moment in the banking sector:

that I will perform my duties with integrity and care;

that I will carefully consider all the interests involved in company, i.e. those of the clients, the shareholders, the employees and the society in which the company operates;

that in this consideration, I will give paramount importance to the client's interests;

that I will comply with the laws, regulations and codes of conduct applicable to me;

that I will observe confidentiality in respect of matters entrusted to me;

that I will not abuse my knowledge;

that I will act in an open and assessable manner and I know my responsibility towards society;

that I will endeavour to maintain and promote confidence in the financial sector.

So help me God/This I declare and promise.

Name [signature]'

Should a similar oath be adopted in the UK?

5 Eumedion (2018) Dutch Stewardship Code, www.eumedion.nl/nl/public/kennisbank/best-practices/2018-07-nederlandse-stewardship-code.pdf

6 Nederlandse Vereniging van Banken (Dutch banking Association) (2014) Future-oriented Banking Social Charter Banking Code Rules of Conduct, www.nvb.nl/english/2273/future-oriented-banking-toekomstgericht-bankieren.html

A possible weakness of the EU approach is that by following the UK approach – where governance practice is supposed to be enforced by active institutional investors – most other EU countries, with the exception of the Netherlands, have investors who are less active and less likely to try to enforce good governance. The UK has the greatest dispersion of shareholdings in the EU with no major shareholder owning 25% or more in about 90% of companies listed on the LSE. This compares with Italy, where about two-thirds of listed companies are controlled by a single shareholder and other countries such as France where some shares have higher voting rights – meaning fewer shares are needed to have effective control[7]. Furthermore, large institutional investors are less likely to want to invest at all in companies listed on the smaller stock exchanges.

The **European Bank for Reconstruction and Development** produced in 2010 a set of 'Core Principles of a Corporate Governance Framework (CGF)'.[8] It provides a succinct two-page set of ten principles, which could be useful for UK readers who may take our highly developed legal framework for granted – to remind them that good governance depends on legal issues such as shareholder rights and not just codes – and to readers from developing countries as a brief summary of governance.

European Bank for Reconstruction and Development
Established to help build market-oriented economies and promote private and entrepreneurial initiative in Central and Eastern Europe in 1991. It has since expanded and is owned by 66 countries from five continents, as well as the European Union and the European Investment Bank.

Test yourself 3.2

Who is the intended audience of the G20/OECD Principles of corporate governance?

7 See OECD Factbook, ibid.

8 The European Bank for Reconstruction and Development (2010) Core Principles of a Corporate Governance Framework (CGF), www.ecgi.org/codes/documents/ebrd_cgprin_2010.pdf

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5. The South African approach

South Africa has some large companies listed on the Johannesburg Stock Exchange, such as Anheuser-Busch Inbev SA/NV, Old Mutual and British American Tobacco, but the majority of South African listed companies are smaller and have a controlling owner or group of shareholders.

South Africa has been a leader in governance since the first King Report in 1994. The King Code is now in its fourth edition and each code has stood out in its time for the way it emphasises ethics, values, stakeholder inclusivity, integrated reporting, and corporate citizenship and responsibility. Like the previous Dutch Code, King III was based on 'apply or explain' but King IV[9] is based on 'apply and explain' so organisations should both apply, and state how they apply, corporate governance principles. This requirement is the same as the UK requirement regarding principles but the UK Code has provisions with which companies must comply or explain.

King IV is intended to apply to all types of organisation regardless of legal form. King IV's objectives are to:

- promote good governance as integral to running an organisation and delivering governance outcomes such as an ethical culture, good performance, effective control and legitimacy;
- broaden its acceptance making it fit for implementation across a variety of sectors and organisational types;
- reinforce corporate governance as a holistic and interrelated set of arrangements to be understood and implemented in an integrated manner;
- encourage transparent and meaningful reporting to stakeholders; and
- present corporate governance as concerned with not only structure and process, but also with an ethical consciousness and conduct and outcomes.

You are encouraged to download and read the King IV Report.

6. The Mauritian approach

The 2016 version of the 'The national code of corporate governance for Mauritius'[10] is an interesting development. It consists of a reduced set of eight principles on just two pages and, like King IV, the 'apply and explain' approach. Public interest and public sector entities required to report on governance must state how they apply the principles and external auditors should assess non-compliance. Other types of organisation are encouraged to use the code. Using external auditors to assess compliance can be a good way

9 Institute of Directors Southern Africa (2016) King IV Report on Corporate Governance for South Africa, www.adamsadams.com/wp-content/uploads/2016/11/King-IV-Report.pdf

10 Ministry of Financial Services (Mauritius) (2016) The national code of corporate governance for Mauritius, www.nccg.mu/sites/default/files/files/the-national-code-of-corporate-governance-for-mauritius_2016.pdf

for countries to improve corporate governance where investors are less likely to apply the necessary pressure on companies. The report also gives useful guidance in applying each of the principles although companies are not required to report on whether they follow the guidance. There are separate sections for different sectors: banks, stock exchange listed companies, statutory bodies, groups and subsidiaries, family companies, holders of a 'category 1' global business licence and management companies. The appendices give examples of board documents such as a board charter and a directors' code of ethics. The Code should be a very useful document, not just in Mauritius but elsewhere too.

Test yourself 3.3

How can corporate governance be enforced?

7. The US approach

It is sometimes said that the UK has a principles-driven approach to accounting and governance, whereas the US has a rules-driven approach, but this may be an oversimplification. In the US there is no voluntary national code of principles equivalent to the UK Corporate Governance Code. Instead, the US has a system of federal and state legislation, plus rules administered by the Securities and Exchange Commission (SEC) and stock exchanges. The federal government has passed two major pieces of legislation: the Sarbanes-Oxley Act 2002, introduced after a series of corporate scandals including Enron and WorldCom, and the Dodd-Frank Act (Dodd-Frank Wall Street Reform and Consumer Protection Act 2010) after the financial crisis. The Dodd-Frank Act created financial regulatory processes to limit **risk** by enforcing transparency and accountability. Although the US approach is often characterised as 'regulator led' compared with approaches in the UK and most other countries which are termed 'shareholder led'[11], such distinctions are also an oversimplification. US public companies generally have dispersed shareholdings and unitary boards.

risk
The 'effect of uncertainty on objectives' or something which might happen which would have a dangerous, unpleasant or costly outcome or doing, or exposing someone to, something which might have a dangerous, unpleasant or costly outcome.

It is more common in the US for the chairman and CEO to be the same person; in the early 2000s, outside directors tended to be friends of the CEO/chairman. Listed companies are rarely under the control of a major shareholder and, certainly in the recent past, many could be described as 'ownerless corporations'[12] controlled by the executives without shareholders or outside directors holding them to account.

11 See speech by Ethiopis Tafara, Director, Office of International Affairs Director, Office of International Affairs U.S. Securities and Exchange Commission given in Madrid and London on 8–9 February 2007, www.sec.gov/news/speech/2007/spch020807et.htm

12 See for example 'Who owns a company?' – speech by Andrew Haldane, Chief Economist and Executive Director, Monetary Analysis & Statistics Bank of England, 28 July 2015. Given at the University of Edinburgh Corporate Finance Conference on 22 May 2015, www.bankofengland.co.uk/publications/Pages/speeches/2015/833.aspx

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Making it work 3.2

Enron was a small energy company formed in 1985 with the merger of a natural gas company and a pipeline company. It grew rapidly in energy trading, taking advantage of deregulation and employing Wall Street corporate finance methods. It reported revenue in 2000[13] of $101 billion and assets of $65 billion. It was widely regarded as one of the most admired and innovative companies in the world. Some people though had trouble understanding the business model and how Enron made money. Analysts who questioned Enron's success were ridiculed by the company as being too stupid to understand. No one would accuse Enron's senior executives of lacking originality. In the 1990s, banks were making increasing use of structured finance vehicles, including special purpose entities (SPEs), to create new financial products. Enron used the same concepts to create new markets such as in gas contracts. It both ran those markets and participated in them. Being both a trader and a market maker gave Enron considerable commercial advantage.

It was a profitable business but not profitable enough to support the stellar stock rating or the credit rating which Enron needed to stay within its borrowing conditions. To boost profits Enron created SPEs (also called Structured Finance Vehicles or Special Purpose Vehicles) and valued them using 'mark to market' accounting which allowed Enron to use values derived from a model of its own construction to create false profits, overstate assets and understate liabilities. The problem with using models is that the model may bear little relation to a market; the model can be gamed (manipulated) allowing modelers to get any answer they want from it, which is exactly what Enron did.

There were many practices which were on the borderline of fraud and legality. A few months before Enron failed, a company vice president tried to blow the whistle over some of the transactions involving other SPEs created by the Enron chief financial officer (CFO) to hide what was really happening and create false profits. Enron booked false profits on transactions with its SPEs matched by the false assets in the form of amounts owed to Enron by the SPEs. The SPE accounts would have shown liabilities and losses but Enron relied on a US accounting technicality, and the opinion of its auditor Arthur Andersen, which allowed Enron to exclude these SPE liabilities from its group balance sheet while Enron group accounts showed the profits and assets.

UK accounting standards and the tests for what results to consolidate were different. It is likely that if Enron had been a UK company it would have had to consolidate the SPEs into its group accounts so that the group accounts would not have shown such profits or assets. In the UK a company's results must be consolidated into the consolidated results of the holding company if the holding company has effective control over

13 Enron (2000) Enron Annual Report 2000, http://picker.uchicago.edu/Enron/EnronAnnualReport2000.pdf

the company. Enron relied on a rule which said that if another person owned 3% or more of a company it would not have to be consolidated. Theoretically there was a similar control test in the US but for some reason the auditors allowed Enron not to consolidate the SPE's results.

When Enron collapsed in 2001 it was the largest corporate bankruptcy in US history. Staff lost their jobs and pensions and some of the executives went to jail. Enron was originally described as an accounting and audit failure. It was, but it was also a systems failure where conflicts of interest triumphed over inappropriate regulation. De-regulation of the energy markets enabled Enron to grow and flawed accounting rules allowed ambitious people to report assets and profits which did not exist and make liabilities which did exist disappear yet stay within the letter of the accounting rules.

Enron's 2000 annual report claimed its cultural values included:

- 'Respect: We treat others as we would like to be treated ourselves. We do not tolerate abusive or disrespectful treatment.
- Integrity: We work with customers and prospects openly, honestly and sincerely. When we say we will do something, we will do it; when we say we cannot or will not do something, then we won't do it.'

This was not really true. The business culture meant that many managers, directors, banks, auditors and lawyers either knew or guessed that seriously unethical practices were taking place yet turned a blind eye, presumably because they were all getting rich.

The directors confessed they 'had no inkling that Enron was in troubled waters until mid-October 2001' after its problems had been reported in the newspapers.

What should Enron teach us?

A number of important corporate governance problems are exemplified by Enron. US financial reporting standards allowed accounts which complied with the letter of a standard while ignoring its intention. The board relied on advice by the auditor and their lawyer in creating corporate structures which complied with the letter of rules rather than their principles. The US board structure did not control the many conflicts of interest between executives.

The chief executive of Enron, Jeffrey Skilling, needed the auditor Arthur Andersen to accept mark to market accounting as Enron's trading strategy depended upon it. Strangely, Skilling took part in an Enron internal video where he parodied himself suggesting that he had come up with a new form of accounting known as 'hypothetical future-value' accounting, which would boost Enron's profits even higher – very close to what happened. The curious thing about mark to model accounting is that the two sides to a transaction can both appear to create a

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profit. This is in effect what Enron's CFO, Andrew Fastow, engaged in so creatively. He could not have done so without involvement from many major banks. People working for major banks such as Citigroup and JP Morgan Chase were actively involved. Although no liability was admitted, in 2003 these two banks agreed to pay $300 million in fines and over $4 billion in settlements to former Enron shareholders three years later. Other banks were involved too and legal proceedings continue and settlements so far amount to around $7 billion.

Banks provided finance to Enron's special purpose entities with which it and others could trade. Raptor and LGM were two such SPEs. Bullet points from a sales presentation given by Enron's CFO to a number of banks described Raptor as 'a structured finance vehicle capitalized with an Enron stock derivative and LJM equity, that will enter into derivative transactions with Enron related investments in Enron's merchant investment portfolio.' In further bullet points, Fastow said 'Raptor helps Enron manage the impact of the price volatility of its merchant investment portfolio on its income statement.' He projected a rate of return of 84%, which should have seemed too good to be true and raised suspicion, and said LGM was used for 'speed, flexibility, complexity of transaction and confidentiality'. 'Complexity' should certainly not be seen as a virtue. Later banks tried to sue Enron for being misled about what they were financing.

The auditor, Arthur Andersen, either looked the other way or actively aided Enron in its deception. We cannot know for sure as Andersen shredded the working papers before itself collapsing.

There a number of similarities between circumstances surrounding Enron and the financial crisis:

- Enron had a complex business model which few, if anyone, outside the organisation fully understood. Questions about the model or detail were met from Enron with comments along the lines of: 'if you do not understand you are too stupid for us to explain it to you.' Analysts and others learned that to question the wonder story of Enron could cost them their job.
- The directors of Enron did not really understand the business model – at least that is what they told the courts. Banks also have a complex business model, which the financial crisis revealed few understood.
- Enron and counter parties were booking profits on the same transactions, e.g. A has a deal with B and both A and B report a profit on the same deal.
- Enron and its special purpose entities entered into large transactions with banks. Banks also use special purpose entities. Many trading transactions entered into by banks are with other banks. It is not clear how much of banks' reported profits in the years leading up to the financial crisis came from trading with other banks.
- Enron special purpose entities were used to hide liabilities and create artificial profits.
- Enron's ability to create new markets owed significantly to deregulation of markets. Banks also benefited from a period of deregulation in the 1980s and 90s and light touch regulation thereafter until the financial crisis.
- Enron lobbied politicians and made friends with them; this helped Enron get deregulation in their markets which increased the opportunity for real and fictitious profits. Banks are also active lobbiers.
- Enron's auditors, lawyers and bankers benefited financially from their involvement. Much attention focused on possible conflicts of interest of the auditors when they perform significant consulting work.
- After the bankruptcy most Enron executives were able to keep the proceeds of Enron stock they had sold although a few went to jail.
- Credit rating companies failed to predict Enron's problems. Nor did they detect the problems that led to the financial crisis.

Enron was an immensely complicated deception. The deception at WorldCom, a telecommunications company, was more straightforward. Operating expenses to do with maintaining phone lines was reclassified by late journal adjustments as additions to fixed assets which boosted both profits and assets. WorldCom filed for bankruptcy in 2002 and the CEO was found guilty of financial fraud. Like Enron, WorldCom was audited by Andersen. Some auditors were incredulous that Andersen had not found these adjustments.

The very detailed provisions of the Sarbanes-Oxley Act 2002 seemed to address each of the issues identified at Enron and WorldCom one by one, treating the symptoms of the problem rather than the causes. Some of the main provisions are:

Section 302, which inter alia required:

- the CEO and CFO to certify that the annual report does not contain any material untrue statement;
- the financial statements fairly presents the company's financial condition; and
- the signing officers have reviewed internal controls over financial reporting.

Section 402 requires certification that having assessed internal controls they are effective and the auditor must attest this assessment.

Section 404 requires public companies' annual reports to include the company's

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own assessment of internal control over financial reporting, and an auditor's attestation.

Section 409 requires companies to disclose urgently information on any material changes to the financial condition or operations.

Section 806 protects whistleblowers.

Section 902 and 6 enables penalties of up to 20 years in prison for altering, concealing or destroying records and 10 years for not maintaining audit papers.

These rules have generated considerable extra work for companies, external auditors and consultants. If people thought Sarbanes-Oxley would prevent financial manipulation, fictitious profits and wrongdoing in the USA they were in for a nasty surprise with the financial crisis. According to McKinsey, global banking profits in 2006 were $788 billion, making it by a margin of over $150 billion the most profitable sector. Global banking revenues were 6% of global GDP and its profits per employee were 26 times higher than the average of other industries. By late 2008 it was clear that this profitability and implied stability of banks was a mirage.

The Dodd-Frank Act is intended to prevent reoccurrence and is more about financial markets regulation than corporate governance, although there is one key set of provisions which are key to governance. The Act requires the SEC to adopt rules requiring companies to disclose the ratio of CEO annual pay to the median pay of their employees. The Act also requires disclosure comparing company performance against compensation paid to executives and, if the CEO is also the chairman, disclosure of the reasons why.

In conclusion, corporate governance in the USA could be considered as something of a patchwork of federal, state, regulator, stock exchange, investor and institution-led rules, regulations, principles and guidance supplemented by individual investor action with some companies.

Test yourself 3.4

Most countries have a corporate governance code and many have several. Does the US have a corporate governance code?

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Chapter summary

- 120 countries now have a corporate governance code – many have more than one.
- The European Corporate Governance Institute maintains a list of most of the world's codes.
- The G20/OECD Principles of Corporate Governance were written for national policy makers to help countries ensure good corporate governance.
- The EU has followed a similar approach to the UK on corporate governance requiring companies to disclose their governance practices and let investors enforce good practice.
- The Dutch require bank employees to swear an oath to encourage ethical behaviour.
- External auditors are charged with assessing non-compliance with the Mauritian Code.
- The King IV Report on Corporate Governance™ for South Africa 2016 uses the 'apply and explain' principle requiring companies to state how they apply the principles. It emphasises ethics and stakeholder interests far more than most other codes.
- Enron was a catalyst for corporate governance reform highlighting problems with regulation, accounting and auditing standards, board oversight of companies, treatment of whistleblowers, ethical failure and other issues. It led to the wide-ranging US Sarbanes-Oxley Act 2002 and reforms in the UK, EU and elsewhere.
- The US does not have a single code for listed companies with which they are all expected to use. Instead there is a range of federal, state, regulator, stock exchange, investor and institution-led rules, regulations, principles and guidance supplemented by individual investor action with some companies.

Chapter four

Current corporate governance issues and likely developments

CONTENTS

1. Introduction
2. Overview of issues in corporate governance
3. Ethics, values, culture and behaviour
4. Value creation and corporate or organisational purpose
5. Sustainability and corporate social responsibility

1. Introduction

This chapter considers some of the main current issues in governance and like developments. It looks at how recent scandals have meant that regulators a taking a greater interest in culture and ethics and the role of business in soc It explains how there is increasing interest in how organisations create value a how organisations need to be socially and environmentally responsible.

2. Overview of issues in corporate governance

2.1 Greed and misconduct

Some of the governance issues concerning greed and misconduct have alrea been picked up in earlier chapters.

The privately owned unlisted company BHS collapsed in April 2016, with the loss of thousands of jobs and a £570 million hole in the pension fund potentially affecting 20,000 ex-employees. This highlighted that the UK Code does not apply to large unlisted companies. Such companies are important to the economy, provide thousands of jobs and can leave large liabilities if they g bust. The BHS collapse suggests the company was run by one person for his a his family's benefit, at the expense of others. This is not against the law but B crossed a line in what is considered socially acceptable. Although BHS's pare board had a board with a chair, neither company did what would be expecte in applying checks and balances over a dominant individual. There is arguabl

strong case for applying governance standards to large, economically important private companies. As noted in Chapter 2, the Government announced action on this in August 2017, leading to the Companies (Miscellaneous Reporting) Regulations 2018.

There has been a stream of bad news in the banking sector, highlighting unethical and illegal behaviour by banks. Governor of the Bank of England, Mark Carney, in his capacity as Chairman of the Financial Stability Board (FSB) wrote in an open letter in 2015 to G20 leaders: 'in recent years, the incidence of financial misconduct has risen to a level that has the potential to create systemic risks by undermining trust in both financial institutions and markets.' Estimates of penalties for banks involved in foreign exchange manipulation, Libor-rigging and mis-selling in 2016 are around £53 billion for the UK and £190 billion worldwide. Banks have also been found to be involved in money laundering in a number of countries. Newspaper reports in March 2017 suggested UK banks helped process at least £15 billion and possibly up to £65 billion from Russia. Deutsche Bank was fined over £500 million by UK and US authorities for failing to prevent $10 billion of Russian money laundering.

The Serious Fraud Office (SFO) conducted a criminal investigation into Barclays, relating to when it raised new share capital in Qatar in 2008 during the financial crisis. The investigation centred on a US$3 billion loan facility made available from Barclays to the State of Qatar, acting through the Ministry of Economy and Finance in November 2008. Barclays plc and four senior Barclays executives, including John Varley, its CEO at the time, were charged in June 2017 with conspiracy to commit fraud and the provision of unlawful financial assistance contrary to the Companies Act 2006. The Serious Fraud Office made a similar charge against Barclays Bank Plc, the main operating company, in February 2018.

Banks which in the financial crisis were said to be 'too big to fail' became referred to as 'too big to jail', amid suggestions that governments had leaned on regulators to be soft on wrongdoing in case their actions triggered another financial crisis.

Test yourself 4.1

What is the estimate of fines in 2016 for banks involved in foreign exchange manipulation, Libor-rigging and mis-selling?

1 Department for Business Energy and Industrial Strategy (2017) Corporate Governance Reform: The Government response to the green paper consultation, www.gov.uk/government/uploads/system/uploads/attachment_data/file/640631/corporate-governance-reform-government-response.pdf

2 Carney, M. (2015) Building a resilient and open global financial system to support sustainable cross-border investment, Financial Stability Board open letter to G20 Leaders, 30 August, www.fsb.org/wp-content/uploads/FSB-Chair%E2%80%99s-letter-to-G20-Leaders-in-advance-of-their-meeting-in-Hangzhou-on-4-5-September.pdf

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2.2 Short-termism

A persistent problem in financial markets has been short-termism: an excessive focus on short-term results at the expense of long-term interests by shareholders. This has led to short-termism in decision making by company executives, who then make decisions which benefit the company's share price in the short term at the expense of creating sustainable value over the longer term. This is considered in more detail in Chapter 6. This exacerbates what some argue has been a persistent problem in the UK of under-investment in infrastructure, research and development (R&D) and other long-term investment. Changes in share ownership over time has meant that UK insurance and pension funds now hold far fewer shares in UK companies than in 1990. There also seems to be fewer shareholders in companies who have a real interest in the long-term performance of their investment and consequently in ensuring a company is well governed. At the same time, fewer companies seem to want to have a Premium listing on the London Stock Exchange (LSE). AIM, intended to help smaller and growing companies raise capital for expansion, has grown while the number of companies with a Premium listing has fallen. Some people argue that stiff regulations, including corporate governance requirements, deter boards from wanting a Premium listing – which used to be seen as the pinnacle of corporate evolution and something to which all boards aspire. Executives are also finding there can be more lucrative opportunities working for private companies than working in Premium-listed companies, where pay is never far from the spotlight.

Test yourself 4.2

Why is short-termism a problem?

2.3 Unsuitable employment practices

Media reports have also revealed concerning employment practices where workers had poor working conditions and were paid less than the legal minimum wage.

Stop and think 4.1

Sports Direct

zero hours contract
A contract between an employer and a worker where the employer is not obliged to provide any minimum working hours and the worker is not obliged to accept any work offered.

Sports Direct International plc is the UK's largest sporting goods retailer with around 600 stores throughout the world and with a Premium listing. It has grown rapidly but has been criticised over its working practices. It employs around 27,000 staff but less than 10% have a permanent contract; most of the others have zero hours contracts. In 2016 its UK headquarters had 200 permanent employees and over 3,000 agency workers employed through two agencies. The House of Commons Business, Innovation and Skills Committee investigated in 2015/16. Their report in 2016[3] found the company business model involved treating workers as 'commodities rather than as human beings'. It found that workers 'were not being paid the national minimum wage, and were being penalised for matters such as taking a short break to drink water and for taking time off work when ill. Some say they were promised permanent contracts in exchange for sexual favours. Serious health and safety breaches also seem to have occurred.' East Midlands Ambulance Service records showed 50 cases of life-threatening conditions at the HQ between 2013 and 2016, including one woman who gave birth in the toilet in the warehouse. The BIS report noted 'for Sports Direct to pay £50 million to agencies that do not seem to have a basic understanding of employment law and practices seems irresponsible, if not reckless.'

The Committee found that Mike Ashley, the Deputy Executive Chairman, founder and majority shareholder did not seem aware of this practice and seemed shocked when he heard testimonies from workers. The Committee considered it 'incredible that the owner, whose name is inextricably linked with the brand of Sports Direct, and who visits the warehouse at least once a week, would have no idea of the working conditions and practices there, when they have been highlighted in the media and in Parliament since 2015'.

'Sports Direct always seeks to improve and do things better, listens to criticism and acts where appropriate. With that in mind, the board has agreed that Mr Ashley shall personally oversee a review of all agency worker terms and conditions to ensure the company does not just meet its legal obligations, but also provides a good environment for the entire workforce. We expect him to start that work in the New Year.'

The Committee concluded: 'Although Sports Direct is a particularly bad example of a business that exploits its workers in order to maximise its profits, it is unlikely that it is the only organisation that operates in such a way.'

What do you consider should be the board's role in ensuring proper working practices? Is it OK to leave it to the executive? What are the relevant director's duties?

2.4 Directors' duties

As highlighted in Chapter 1, the UK Companies Act 2006 lists director's duties in sections 171 to 177. These codified what had previously been established through common and case law. Section 172 confers a duty for directors to promote the success of the company and in doing so to have regard to a number of factors, including the interests of the company's employees, relations

3 House of Commons Business, Innovation and Skills Committee (2016) Employment practices at Sports Direct, 21 July, https://publications.parliament.uk/pa/cm201617/cmselect/cmbis/219/21902.htm

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