

## STUDY GUIDE A1: THE SCOPE OF GOVERNANCE

### Get Through Intro

Whether you end up running a company, being part of a management team or supporting a board of directors as an accountant, you will be involved with governance or corporate governance. Corporate governance is about how companies are directed and controlled.

For some accountants, their involvement will be from an external perspective - as an auditor; in such a case you will need to consider how companies are run and more importantly, how well they are run.

This Study Guide largely focuses on companies and particularly on the larger, listed companies where ownership and control have separated with professional managers running the company – and with potential conflicts between their interests and those of their shareholders.

For the vast majority of companies that are well run, honest and successful, the recent codes and guidance on corporate governance have helped them improve their board, their relations with shareholders and the way they manage their business strategically - not only in the interests of the shareholders but also for the benefit of all stakeholders. The codes and guidance are also aimed at another tiny group of companies - those that put shareholder and other stakeholder interests at risk, whether through poor management, particularly when high risks are involved, or because of dishonesty and fraud.

Corporate governance is about putting checks and balances in place to support the successful, control the risk takers and prevent the dishonest from having their way - all in the interests of those who are stakeholders.

We will also see that corporate governance goes beyond the internal workings to include audit and oversight from outside.

**Learning Outcomes**

- a) Define and explain the meaning of corporate governance.
- b) Explain, and analyse the issues raised by the development of the joint stock company as the dominant form of business organisation and the separation of ownership and control over business activity.
- c) Analyse the purposes and objectives of corporate governance.
- d) Explain, and apply in context of corporate governance, the key underpinning concepts of:
  - i. fairness
  - ii. openness / transparency
  - iii. independence
  - iv. probity / honesty
  - v. responsibility
  - vi. accountability
  - vii. reputation
  - viii. judgement
  - ix. integrity
- e) Explain and assess the major areas of organisational life affected by issues in corporate governance:
  - i. duties of directors and functions of the board (including performance measurement)
  - ii. the composition and balance of the board (and board committees)
  - iii. reliability of financial reporting and external auditing
  - iv. directors' remuneration and rewards
  - v. responsibility of the board for risk management systems and internal control
  - vi. the rights and responsibilities of shareholders, including institutional investors corporate social responsibility and business ethics
- f) Compare, and distinguish between public, private and non-governmental organisations (NGO) sectors with regard to the issues raised by, and scope of, governance.
- g) Explain and evaluate the roles, interests and claims of, the internal parties involved in corporate governance:
  - i. Directors
  - ii. Company secretaries
  - iii. Sub-board management
  - iv. Employee representatives (e.g. trade unions)
- h) Explain and evaluate the roles, interests and claims of, the external parties involved in corporate governance:
  - v. Shareholders (including shareholders' rights and responsibilities)
  - vi. Auditors
  - vii. Regulators
  - viii. Government
  - ix. Stock exchanges
  - x. Small investors (and minority rights)
  - xi. Institutional investors (see also next point)
- i) Analyse and discuss the role and influence of institutional investors in corporate governance systems and structures, for example the roles and influences of pension funds, insurance companies and mutual funds.

## Introduction

The two case studies for this Study Guide illustrate two fundamentally different stories of how companies are run. The Tesco case study is about ultimate success whilst Polly Peck is concerned with failure.

## Case Study

The Tesco story begins in 1919 when a young man called Jack Cohen sets up a market stall in the East End of London using the £30 he received upon leaving the army. Jack was good at selling and had entrepreneurial flair and although he didn't think about stakeholders he was liked by his customers. By 1924 Jack had several stalls and even sold branded tea under the Tesco name, an amalgamation of a supplier's name T E Stockwell and his own name Cohen, some say he used the supplier's boxes and changed the name to save money.

By 1929 Jack had a proper store on Edgware Road and his business philosophy emerged as 'pile them high sell them cheap', an approach that fitted with the customers of the time. His stores did not have the genteel service of traditional grocers but gave great value. Jack also made the transition from a sole trader to a company but with only a limited board of directors. Jack ran the show.

Jack sold aggressively at rock-bottom prices and by the outbreak of war had over 200 stores and a new corporate headquarters including an efficient centralised warehouse.

Tesco was now a group of companies with a main board but still controlled by shareholder, chief executive and chairman Jack. He was the driver of the success of the company.

Following a visit to the USA and after a battle with his family board members Jack introduced a self-service approach in 1947 increasing the range of goods on sale. His nickname 'Slasher Cohen' summed up the focus of his strategy as a cost leader.

By 1947 Tesco was a listed company with layers of professional managers below a board that was still dominated by Jack. With additional capital Tesco acquired more and more stores in a ruthless attack on every high street. Jack knew how to pursue the policy and attacked his rivals with low prices.

By the 1970's Tesco had lost its way in a market dominated by larger out of town stores with wider ranges of products for a more affluent society. The Tesco business model was no longer appropriate as it lacked the quality and service of companies like Sainsbury's and Marks & Spencer.

By 1973 with Tesco at a crossroads that would have been failure for some companies Jack was forced out after a fierce battle and a falling share price. Jack was still a significant shareholder but did not have control any more and it was time for a new breed of young professional managers to take over. That is what investors wanted.

Ian MacLaurin became chief executive and dismantled the Tesco model and with substantial cash investment moved to larger stores with low prices but a much larger range of products on the shelves. Change was risky but Tesco managed the change and turned around.

MacLaurin described board meetings under Jack as like meetings of the Chicago mafia with Jack as godfather and openly criticised his autocratic style.

Terry Leahy, now Sir Terry Leahy succeeded MacLaurin and Tesco has gone from strength to strength and is now a global business with a mix of stores of all types, a low cost efficient and automated supply chain and an IT platform that has enabled it to become the largest on-line grocer in the UK, indeed Tesco now sells everything from music to insurance and banking services! With over 1,000 stores and 250,000 staff Tesco is the market leader.

From a corporate governance perspective Tesco began as an entrepreneurial autocracy but with a crystal clear simple business model that created success but ultimately nearly created failure as the company dominated by Jack Cohen failed to respond to changes in its environment. But waiting in the wings was a new breed of professional Tesco managers who understood the new market and the business and drove it forward again but now using a management team and a new style of management. This story is real corporate governance and a lesson in change and with a message that maybe one size does not fit all, governance must fit with the circumstances of the business.

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Our second case study is fundamentally different but with a similarity in that Polly Peck was run by a dominant chairman and chief executive in Asil Nadir but unlike Jack Cohen there were issues of fraud surrounding his management, not proven but sufficient to bring down a listed company.

### Case Study

Nadir came to the UK with his father and set up a successful business selling clothes in London. When the Turks invaded Northern Cyprus Nadir took the opportunity to purchase a factory in Nicosia and was soon a major exporter. His companies expanded and Polly Peck plc was the darling of the stock market with its growth and portfolio of successful fruit businesses including the Del Monte label. By the 1980's Polly Peck was capitalised at £12 million and Asil was a wealthy man.

However at its peak Asil became the subject of bankruptcy proceedings by his firm of stockbrokers and at this point with the Polly Peck shares suspended and the company in collapse the serious fraud office began investigations. Asil was arrested but jumped bail and escaped to Cyprus. The SFO had bungled his arrest and whilst being hot on the trail of apparently missing funds of \$43 million they have to date been unable to press charges. The Polly Peck group collapsed with debts of \$2 billion.

What was clear was that Asil Nadir had dominated his board and was able to do pretty much as he liked with no checks and balances in place and audit failures that allowed the group to operate despite the alleged fraud and its insolvency. The failure of the financial statements to give any warning and the rising share price meant that few questions were asked. The complex web of companies and mysterious transfers of funds enabled much to be hidden.

The losses of jobs, money and confidence led to the creation of the Cadbury Committee on corporate governance to examine the lessons that could be learned.

**1. Define and explain the meaning of corporate governance.<sup>[2]</sup>  
Analyse the purpose and objective of corporate governance.<sup>[2]</sup>** [Learning Outcomes a and c]

Businesses are run by people who have diverse capabilities, values, ethics, attitudes, risk appetites and integrity and have differing objectives and ambitions. Cases such as the collapse of Enron in the USA and the collapse of the Maxwell empire in the UK illustrate how ambitious risk takers, who are ultimately dishonest, can dominate businesses so much that they bring down the company in their greedy pursuit of personal financial gain and power. Executives in these companies went largely unchallenged by their board, managers and staff and the external auditors failed to provide an adequate check or balance to their behaviour. As a result, employees lost their jobs and suppliers, shareholders and others lost out financially.

If there had been proper challenge, proper mechanisms and processes of corporate governance, and proper independent audit and oversight then these cases may never have happened.

#### 1.1 What is corporate governance?

In a narrow, technical sense, corporate governance is about two key areas: first of all corporations (in this case, companies) and secondly governance (how the companies are run; in this case how the directors run them).

Companies are legal entities registered at Companies Houses (or its equivalent) and have to operate in accordance with their constitution, statute and, where appropriate, case law (e.g. companies formed in England will have to function in accordance with The Companies Act 2006).

The study of corporate governance focuses on the processes, mechanisms and structures that are put in place to enable directors to manage businesses operated as companies, and to provide checks and balances on the directors and executives. **Corporate governance** represents the **set of policies and procedures that determine how an organisation is directed, administered and controlled**. It sets the broad framework or parameters within which the people in the organisation must operate.

The study of corporate governance also requires you to think about the purpose or role of enterprises in the economic and social framework of a state including their economic and potential social and environmental roles and responsibilities and the extent to which government intervention may be required.