Corporate governance: the need to know

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Introduction

This article concentrates on reviewing major developments in the two significant economies of the UK and USA. Corporate governance is not a fledgling issue in either of these economies. It may be dated to the time when incorporation with limited liability became available in the nineteenth century, with the need for legislation and regulation. Nobody can doubt that corporate governance is by now firmly on the business agenda. This contrasts with as recently as the early 1980s when the term had a jarring sound, and either was taken to refer to government, or was regarded as an unfortunate term not used since the time of Chaucer. Recent debate has focused upon more specific concerns. These revolve around the accountability of those in control of companies to those with the residual financial interest in corporate success, normally the shareholders, but when the company is approaching insolvency, then also its creditors, as well as widening discussion to consider stakeholders. Those involved in industrial and commercial training will soon need to know about such issues, as well as incorporate them in training programmes.

This focus seems to reflect six contemporary developments:

(1) There is the economic analysis of corporate law. This places priority on the efficiency of the allocation of scarce economic resources which will be achieved if companies are accountable to those who take the profit or bear the loss after all other claims on the company have been met.

(2) The redistribution of tasks between the public and the private sectors (especially but not only through privatisation), and between public and charitable sector of the economy requires full public confidence in the way companies are run and securities markets are organised. This has also led to corporate governance concepts entering into both the public and charitable sectors as all sectors of the economy appear to be in fluid interaction and mutual dependence.

(3) Issues of public confidence can be assessed in terms of levels of managerial remuneration and the effectiveness with which the boards of major companies...
carry out the task of monitoring executive management (with some such companies unexpectedly collapsing in recent years).

(4) Of increasing future importance, the shift in most countries from pay-as-you-go pension schemes (often part of the state welfare system) to a greater role for funded pensions is increasing the flow of funds on to the capital markets.

(5) The globalisation of the economy has driven the largest companies to access international capital markets. This has produced greater risk exposures.

(6) Abuse and fraud, sometimes on a global scale, have led to greater awareness of inadequacies of governance, and demand for reform; even entire models of operating within a country are up for re-evaluation, such as the role of the chaebol within Korea.

Other conceptions of what influences should be recognised within governance systems provide for accountability to representatives of the employees or even to the state.

USA – The Treadway Commission Report

Both the Treadway report (National Commission on Fraudulent Financial Reporting, 1987) and the COSO report (The Committee of Sponsoring Organizations of the Treadway Commission, 1992) were precedent influences on the Cadbury Report. All involved in the financial process – management, audit committee, internal auditors, and external auditors – were encouraged to consider specific risk factors when planning or reviewing audits. The AICPA, the American Accounting Association, the Institute of Internal Auditors, the Financial Executives Institute, and the Institute of Management Accountants (formerly the National Association of Accountants) agreed in 1985 to form an independent National Commission on Fraudulent Financial Reporting, chaired by James C. Treadway Jr, a former SEC commissioner. In 1987, the Treadway Report offered 11 recommendations to enhance the effectiveness of audit committees, which were to be the keystone of corporate financial governance:

(1) They should have adequate resources and authority to discharge their responsibilities.

(2) They should be informed, vigilant, and effective overseers of the company’s financial reporting process and its internal control system.

(3) They should review management’s evaluation of the independence of the company’s public accountants.

(4) They should oversee the quarterly as well as the annual reporting process.

(5) The SEC should mandate the establishment of an audit committee composed solely of independent directors in all public companies.

(6) The SEC should require committees to issue a report describing their responsibilities and activities during the year in the company’s annual report to shareholders.

(7) A written charter for the committee should be developed. The full board should approve, review, and revise it as necessary.

(8) Before the beginning of each year, audit committees should review management’s plans to engage the company’s independent public accountant to perform management advisory services.

(9) Management should inform them of second opinions sought on significant accounting issues.

(10) With top management, the committee should ensure that internal auditing involvement in the financial reporting process is appropriate and properly coordinated with the independent public accountant.

(11) Annually, committees should review the programme that management establishes to monitor compliance with the company’s code of ethics.

Most audit committee chairs see the recommendations as having exerted a positive influence on corporate reporting and internal controls.

The financial community is building a strong case for self-regulation, and has made significant progress in improving the quality of financial reporting.
Committee of Sponsoring Organizations

In a response to a recommendation by the Treadway Commission, a study and exposure draft was commissioned by the Committee of Sponsoring Organizations (COSO), representing CPAs, internal auditors, management accountants, financial executives and accounting educators. The Committee's report "Internal Control – Integrated Approach" (The Committee of Sponsoring Organizations of the Treadway Commission, 1992) provides a definition serving the needs of all interested parties – management, audit committee, internal auditors, independent accountants, legislators and regulators, as well as a standard against which organisations can assess their control systems and determine improvement.

Cadbury and UK

Although the larger economy of the USA had given more explicit attention to corporate governance issues, the Cadbury Code, albeit in the wake of the two American reports, established itself as the world leader. Despite this, the various sequel reports within the UK have evoked controversy, as has the practical workings of the Cadbury Committee, albeit that there is general support for and compliance with the core recommendations. The burden on business has been seen as excessive, and a December 1996 report from Deloitte Touche Tohmatsu International was entitled "Avoiding Corporate Governance Overload". Questions have been raised as to effectiveness, particularly in minimising fraud and abuse. Reporting on the effectiveness of internal control also became a political hot potato, with the Institute of Internal Auditors arguing strongly in favour, but those representing other constituencies being less supportive, and recommending merely commenting on the reasonableness of internal control, rather than effectiveness.

The Institute of Chartered Accountants of England and Wales in a statement of 27 September 1997 criticised the confusion in the business community between the Committee on Corporate Governance proposed statement of principles and the existing Cadbury and Greenbury Codes. It is opposed to replacing the provisions of the codes by such a statement, believing that it would result in "boilerplate" disclosure in many instances. The Auditing Practices Board, in its October 1997 comments on the preliminary Hampel Report, agrees with this approach, but states that it would not like to see a relaxation of the existing requirement for directors to confirm that they have undertaken a process to review the effectiveness of the internal control system. A way forward on this is suggested by Mills (1997).

In the final Hampel Committee Report (Committee on Corporate Governance, 1998), there was a call for tougher action. The key changes to the preliminary report are summarised as follows:

Companies
- Should include in their annual reports a narrative account of how they apply the broad principles;
- Should explain their governance policies, justifying departure from best practice.

Directors
- Should receive appropriate training;
- The majority of non-executive directors should be independent, and boards should disclose in the annual report which of the non-executive directors are considered to be independent;
- Separation of the roles of chairman and chief executive is preferred, other things being equal, and companies should justify a decision to combine the roles;
- A senior non-executive director should be identified in the annual report, to whom concerns can be conveyed;
- Names of directors submitted for re-election should be accompanied by biographical details;
- It may be appropriate and helpful for a director who resigns before the expiry of his term to give an explanation.

Accountability and audit
- It is suggested that the audit committee should keep under review the overall financial relationship between the company and its auditors to ensure a balance between the maintenance of objectivity and value for money.
Directors’ remuneration
- The committee sees no objection to paying a non-executive director’s remuneration in the company’s shares, but do not recommend this as universal practice.
- Boards should set as their objective the reduction of directors’ contract periods to one year or less although it is acknowledged this cannot be achieved immediately.
- The committee sees some advantage in dealing with a director’s early departure by agreeing in advance on the payment to which he or she would be entitled in such circumstances.
- The board should establish a remuneration committee made up of independent non-executive directors.
- Decisions on the remuneration packages of executive directors should be delegated to the remuneration committee.
- The broad framework and cost of executive remuneration should be a matter for the board on the advice of the remuneration committee.
- Shareholder approval should be sought for new, long-term incentive plans, but we do not favour obliging companies to see shareholder approval for the remuneration report.

Shareholders and the AGM
- Institutional investors have responsibility to their clients to make considered use of their votes and we strongly recommend them to vote the shares under their control.
- Institutions should make available to clients information on the proportion of resolutions on which votes were cast and non-discretionary proxies lodged.

The Turnbull Report
The 1992 Cadbury Committee has achieved renown as a world first, like British Standards on quality and environmental management which have equally gone global. Cadbury (Committee on the Financial Aspects of Corporate Governance, 1992) had recommended that directors should report on the effectiveness of internal control. Then we had various sons of Cadbury: Rutteman, Greenbury, Hampel and now finally Turnbull, names which read as a Who’s Who of the British business world, Nigel Turnbull being Director of Finance at Rank plc. There have been concerns at corporate governance overload, but conceptually and practically Turnbull completes the almost decade-long cycle of development, and is likely to be the last word for the foreseeable future.

Rutteman had watered down the Cadbury recommendation that directors should report on the effectiveness of internal control, to the requirement that, unless they determined otherwise, directors should simply confirm that they (or a board committee) had reviewed the effectiveness of the system of internal financial control (Joint Working Party on Internal Control and Financial Reporting, 1994). The guidance pertained to accounting periods commencing on or after 1 January 1995.

Shortly afterwards the Hampel Committee (Committee on Corporate Governance, 1998) modified this to directors needing to review the effectiveness of the entire control system, no longer restricted to mere financial control. This was then incorporated into the Combined Code of the London Stock Exchange which now stated:

D2 Internal Control Principle
The board should maintain a sound system of internal control to safeguard shareholders’ investment and the company’s assets.

Code Provisions
D2.1 The directors should, at least annually, conduct a review of the effectiveness of the group’s system of internal controls and should report to shareholders that they have done so. The review should cover all controls, including financial, operational and compliance controls and risk management.
D2.2 Companies that do not have an internal audit function should from time to time review the need for one.

This guidance applied as from 1 January 1999. What Turnbull (Institute of Chartered Accountants Internal Control Working Party, 1999) did was to develop a framework for such effective internal control, thus guaranteeing that it would be more of the same. The guidance is split between five key areas:
(1) The importance of internal control and risk management. These are connected with
the achievement of business objectives, and securing shareholder investment and company assets.

(2) Maintaining a sound system of internal control. This involves the policies, processes, tasks, behaviours and other aspects of a company which in combination permit a company to:

• respond to significant business, operational, financial, compliance;
• consider other risks to achieving objectives;
• ensure the quality of internal and external reporting;
• comply with relevant laws and regulations.

(3) Reviewing the effectiveness of internal control. The respective responsibilities of the board of directors, board committees and management are set out here and for the previous section, which adds employees to the list. The board at the very least needs an effective and continuous monitoring process, to receive regular reports, and to carry out an annual assessment to guarantee that all significant risks have been considered prior to the public statement being issued.

(4) The board statement on internal control. Narrative should be included in the annual accounts setting out how there has been compliance with Principle D2 of the Combined Code. Minimum disclosure would need to indicate the existence of an ongoing process to identify, and evaluate significant business risks, which has been present throughout the year in question and up to the date of the approval of the accounts, which is regularly reviewed, and which complies with the Turnbull guidance. The board must acknowledge its responsibility for the system of internal control, admitting that this can only provide reasonable but not absolute assurance. Turnbull encourages the provision of additional information, but does not mandate this.

(5) Internal audit. The need for this is based on many factors, although it is stated that an internal audit function can provide objective assurance as required by senior management and the board. The question of other functions being able to provide similar assurance is also mentioned. The board will need to consider the adequacy of such assurance. Where there is no internal audit, the board needs to consider annually the need for it. Where does exist, the board must review annually its scope of work, authority and resources.

How does all this relate to the public and even not-for-profit sector? In May 1994 the Chartered Institute of Public Finance and Accountancy published a discussion paper in the wake of Cadbury entitled “Corporate Governance in the Public Services”. This indicated how there were similar concerns in the public sector to those which precipitated Cadbury – Bank of Credit and Commerce International and Maxwell. In the public sector they were the different culture brought about by compulsory competitive tendering, internal markets, and the more commercial style of management. Since Turnbull (Institute of Chartered Accountants Internal Control Working Party, 1999) completes the Cadbury cycle, it is logical that the implications to the public and indeed voluntary sector will soon be drawn. Like Cadbury, Turnbull is set to become a major intellectual property export, and will certainly never be a “prophet without honour” in its country of origin.

Epilogue

With the common issues impacting on the economy, and the globalisation of business, corporate governance, a term virtually unknown 20 years ago, has now entered into world parlance. Despite the differing contexts, the core issues sound familiar, and this accounts for the world currency of the Cadbury Report.

Some of the detail is still being argued about, and there are some interesting variations on the theme. Much of the need to encourage firm corporate governance hangs on the supply of suitable management, director, shareholder and perchance stakeholder information.

Those involved in industrial and commercial training will very soon need to take cognisance of these developments which infiltrate every sinew and every tissue of an organisation.
References