1 Introduction to corporate governance

Introduction

This chapter looks at definitions, concepts, approaches and elements of corporate governance. It also discusses whether countries should regulate corporate governance practices or leave them to be applied by organisations in a voluntary manner.

Corporate governance defined

Corporate governance is a misunderstood and often misused term. It was first used in a code to describe a series of best practices suggested for listed companies to protect investors in the UK. These best practices had been created to deal with a series of high-profile corporate collapses in the UK in the late 1980s and early 1990s, most notably Polly Peck International (1990), the Bank of Credit and Commerce International (1991), the Mirror Group News International (1991) and Barings Bank (1995). Corporate scandals in other parts of the globe, such as Enron (2001) in the USA, have led to other countries adopting corporate governance best practices to protect their investors. Since 2000, further corporate collapses and the global financial crisis have led to corporate governance best practices being expanded to deal with other stakeholder issues, among them pension protection, climate change, scarcity of natural resources, community issues and ethical malpractices.

Corporate governance best practices have also spread in many countries to non-listed companies and other organisations across all three sectors: private, public and not-for-profit.

Since no two organisations are the same, there is no 'one size fits all' corporate governance solution. Organisations, therefore, have to consider which best practices to adopt to help their organisations to develop sustainably and create better performance and increased value. This requires organisations to have the capacity to recognise which practices should be adopted at what stage of an organisation's development. This

has been lacking and has led to either an avoidance of corporate governance best practices or the bland adoption of inappropriate practices. It has also led to a belief by many entrepreneurs and senior executives that corporate governance is costly, bureaucratic and something to be avoided.

In many parts of the world, corporate governance has become synonymous with compliance. Many companies (as was evidenced by the 2008 global financial crisis) still see corporate governance as a mere box-ticking exercise against laws, regulations, standards and codes rather than an important tool which, if truly embraced, can lead to better-performing and more sustainable organisations.

Many companies still see complying with the letter and not the spirit of laws, regulations, standards and codes as sufficient as seen in the 'tax avoidance' cases, such as Starbucks (see case study below), Apple, Google and Amazon. In the Starbucks case, the company actually issued a statement which said that they had done nothing illegal. They had complied with the law. This response created a backlash from the general public who seemed to care not whether what the company did was right or wrong in terms of the law but whether it was right or wrong morally. Simply complying with regulations, standards and codes seems to create reputational risk; the management of this, as we will see later in the chapter, is a key concept of corporate governance. Organisations should see governance as 'doing the right thing' which may take them above the letter of the law but that, after all, is a minimum standard.

The evolution of corporate governance will be discussed in more detail in Chapter 2. It has, however, led to confusion about the term and how and when it should be applied.

CASE STUDY: STARBUCKS

In 2012, Starbucks, known for its strong corporate responsibility and customer service, came under scrutiny for its UK tax payments. In the previous year, 2011, despite making sales of £398 million, Starbucks paid no corporation tax. The company showed a loss in its annual financial statements of £32.9 million due to a charge of £107.2 million of 'administrative expenses' which appeared to represent, in part, royalty fees for UK division franchises.

In a statement, Starbucks insisted that it had 'paid and will continue to pay its fair share of taxes in full compliance with all UK tax laws, as it always has'. It went on to say that Starbucks was considered to be a good tax-payer by UK regulators and behaved in a moral way, balancing profit with social conscience.

The UK public was outraged by Starbucks' comments and started to boycott and protest outside the company's coffee shops. Starbucks' response was to offer to pay, over a period of years, £20 million in corporation tax despite its continued loss making, 'to please its customers'. In a statement, the company said, 'We felt that our customers should not have to wait for us to become profitable before we started paying UK corporation tax.' Source – *The Week* (June 2013)

What is corporate governance?

'Governance' refers to the way in which something is governed and to the function of governing. All organisations, therefore, practise governance. The question should be how well they practise it – if they do this well, their organisation should survive and flourish.

The term governance was first associated with corporations in 1984 when coined by Bob Tricker. The term was picked up by Sir Adrian Cadbury for the 'Report of the Committee on Financial Aspects of Corporate Governance' (the Cadbury Report) which was published in the UK in 1992. The Cadbury Committee was set up to identify how investors could be protected against the bad practices of the managers of listed companies.

Since 1992, the term corporate governance has gained a great deal of prominence, with most countries around the world adopting some measure of corporate governance best practices. However, if you gather together a group of people interested in corporate governance, there will be significant differences in how they define what corporate governance is, and in some cases disagreement about what corporate governance seeks to achieve and how this should be achieved. This is due to the differences in the types of organisations, markets, economies and issues that the best practices are being introduced to deal with.

There is, therefore, no one definition of corporate governance. Every document referring to corporate governance seems to use its own definition.

This probably reflects the earlier statement that all organisations are different, so 'no one size fits all'.

Some of the more well-known definitions are as follows.

> The system by which companies are directed and controlled.

This definition is from the 'Report of the Committee on Financial Aspects of Corporate Governance' (the Cadbury Report). The Report included a Code of Best Practice (the Cadbury Code), which applied to all companies listed on the London Stock Exchange. This was the first corporate governance code of best practice.

> Involves a set of relationships between a company's management, its Board, its shareholders and other stakeholders … also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.

This definition is from the Organisation for Economic Co-operation and Development's (OECD) Principles of Corporate Governance, issued in 1999 and reviewed and amended in 2004 and 2015. In 2015, these Principles became known as the G20/OECD Corporate Governance Principles when they were endorsed by the G20 leaders. The revised Principles stated that the purpose of corporate governance is 'to help build an environment of trust transparency and accountability necessary for fostering long-term investment, financial stability and business integrity, thereby supporting stronger growth and more inclusive societies'.

The Principles are intended to serve as a reference point for countries when they are evaluating their legal, institutional and regulatory provisions for corporate governance. They also offer guidance and suggestions for stock exchanges, investors, companies and other bodies involved in developing good corporate governance practices.

> The exercise of ethical and effective leadership by the governing body towards the achievement of the following governance outcomes:
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> - Ethical culture
> - Good performance
> - Effective control
> - Legitimacy

This definition comes from King IV (2016) which was developed in South Africa by the Institute of Directors to cater for the specific governance issues facing organisations in South Africa. The definition brings into

corporate governance the concepts of corporate citizenship (ethics and corporate responsibility) and also of organisation sustainability.

The UK Corporate Governance Code 2016 stated that 'the purpose of corporate governance is to facilitate effective, entrepreneurial and prudent management that can deliver the long-term success of the company'. It refers back to the definition of corporate governance from the Cadbury Report, and states that the 2016 Code is still set within the context of this definition: 'corporate governance is therefore about what the board of a company does and how it sets the values of the company. It is to be distinguished from the day to day operational management of the company by full-time executives.' The 2018 UK Corporate Governance Code expands the definition, recognising that companies do not exist in isolation: 'To succeed in the long-term, directors and the companies they lead need to build and maintain successful relationships with a wide range of stakeholders.'

The African Peer Review Mechanism (APRM) defines organisations as conducting good corporate governance if they are seen to pursue eight distinguishing characteristics: discipline, transparency, independence, accountability, responsibility, fairness, ethical conduct and good corporate citizenship. These traits are believed to be important because evidence shows that they lead to better-performing organisations which are sustainable in the long term. This results in economic development as these organisations contribute more to the economy and to society as a whole directly through the wages and taxes they pay, and indirectly through the money they pay their supply chain, the vendors, retail outlets, service and training firms, and resellers of their products and services.

Should it matter that there is not one definition of corporate governance?

We will see in the next chapter when we look at the development of corporate governance that the lack of a clear definition has resulted in a plethora of corporate governance regulations around the world. These have mainly been reacting to a particular circumstance and some, though well intended, have been poorly conceived. Each initiative has tended to add to the compliance burden of organisations, especially companies listed on a stock exchange. This presents a problem in many countries where companies, some of which are not listed, are encouraged to comply

with often inappropriate international governance standards as a means of attracting investors.

Many organisations that could benefit from some aspects of corporate governance best practice also dismiss it as not being applicable to them because they are not corporate. For example, much of the service and product delivery in developing countries is by organisations in the public and not-for-profit sectors, many of which are not accountable for or transparent about their activities. Non-corporates therefore lose out on the benefits of adopting good governance practices, such as sustainability, cheaper capital, less risk, etc. For organisations in developing countries, this is particularly important since for sustainable economic development, organisations across all three sectors (private, public and not-for-profit) are needed. Corporate governance in the non-listed private sector is also in its infancy and needs to develop to produce the much-needed engine for growth. The UK is considering introducing a new code for larger private companies.

Corporate governance practitioners within developing countries are therefore undertaking initiatives to reposition corporate governance in the region as a method of achieving organisational sustainability and growth in addition to the traditional view of attracting capital through protection of investors. The introduction of good corporate governance practices within an organisation should therefore always be aimed at providing long-term benefits in terms of sustainability and growth to an organisation that substantially exceed the cost of their implementation. Organisations should consider, as part of their strategic planning, how they can make their business more sustainable and profitable in the long term through introducing these practices. Organisations in developed countries should arguably also be taking the same approach.

The plethora of laws, regulations, standards and codes around the topic of corporate governance are intended to help organisations identify best practices which should improve their governance. Deciding 'what' best practices should be adopted and 'why' is, however, only part of the governance equation. Practitioners in governance have realised that 'how' these best practices are implemented and maintained effectively in an organisation creates true governance and the benefits which are associated with it.

Figure 1.1 explains why. True governance revolves around how people in the organisation operationalise the infrastructure of structures, policies