Flaws at the top: corporate governance needs to improve despite progress made since the Cadbury Report

GOOD GOVERNANCE: PUTTING THE UK BUSINESS HOUSE IN ORDER

As recent scandals from the City to the high street made clear, most of us know bad governance when we see it. But how do we spot good governance, what determines it and how can it best be facilitated? As the IoD launches its 2016 report, head of corporate governance **Oliver Parry** outlines why UK companies must move beyond the tick-box compliance culture

SNAPSHOT

- The corporate governance debate has become the preserve of the policy community and consultants. We hope to change this with the Good Governance Initiative, which aims to answer two crucial questions: what is good governance, and how do we measure it?
- Governance cannot be reduced to a simple tick-box exercise and crude compliance. An individual director's behaviour is organic by nature, and driven by different factors: physical, chemical, even inexplicable.
- The IoD's aim is to provide directors with an understanding of the many factors that combine to determine good governance, so enabling them to configure their organisations in ways suited to their strategic purpose.
- There is a growing acceptance that dispersed shareholding leads to an absence of stewardship by investors and therefore poor accountability of the board.
- Corporate scandals inevitably tempt governments to reach for regulatory solutions, all of which take directors' time and attention away from their companies' long-term success. If UK companies don't get a grip, government will – to the detriment of free enterprise.

Corporate governance has come a long way since Sir Adrian Cadbury published his groundbreaking review into boardroom best practice in 1992. The UK Corporate Governance Code is now copied and replicated around the world. The comply-or-explain process is used across Europe. And yet, despite the success of the Code, the UK market is still experiencing shocking lapses from HBOS through to Sports Direct. The saga at both of these companies has shown that boards can comply with all of the principles of the Code and yet still experience big governance problems.

Regulators seem uninterested in examining the effectiveness of governance in its present system. The purpose of the *2016 Good Governance Report* is, therefore, about taking a step back and assessing what matters in governance and, uniquely, whether one can measure governance. No doubt Cadbury himself would be fascinated with this project. After all, he identified that corporate governance is as much about behaviours as it is about complying with the principles of the Code. We are not claiming that this project will solve all of the corporate governance problems in the UK market but it is the beginning of what I hope will be a long and thought-provoking discussion. Welcome to round two of the Great Governance Debate.

Good governance is as much about relationships, trust and transparency as it is about codes and regulations. While this is embodied in the flexible nature of the UK's strong governance framework, most of the FTSE appears to have developed a system whereby governance is seen in pure compliance terms. FTSE companies simply produce standard boilerplate statements year on year which tell investors little. This is as far removed as possible from the intentions of Cadbury's landmark report, which laid the foundations for a more practical approach to governance.

Another problem that has developed in this time is that the debate around corporate governance has become the preserve of the policy community and consultants. We hope to change this with the *2016 Good Governance Report*, published jointly with Cass Business School and the Chartered Quality Institute. Not only is this a groundbreaking piece of research but we hope it will stimulate debate beyond regulators and government.

Our approach includes two important innovations. First, we use a new list of indicators that goes beyond simple compliance with the Code. Although the emphasis is on public information, we combine data contained in the annual reports with other sources. Second, the weights assigned to the individual

For each of the 100 companies, the table below reports the model score.

Full Ranking

Rank	Name	Model Score
1	British American Tobacco Plc	793
2	Unilever Plc	778
3	Diageo Plc	775
4	Sage Group Plc	769
5	Next Plc	763
6	Kingfisher Plc	762
7	DS Smith Plc	761
8	United Utilities Group Plc	758
9	Royal Mail Plc	755
10	Admiral Group Plc	755
11	Royal Dutch Shell Plc	750
12	RSA Insurance Group Plc	750
13	Compass Group Plc	750
14	Marks & Spencer Group Plc	750
15	Smith & Nephew Plc	747
16	Aviva Plc	746
17	Intercontinental Hotels Group	745
18	Vodafone Group Plc	744
19	National Grid Plc	744
20	Whitbread Plc	742
21	Intertek Group Plc	740
22	Reckitt Benckiser Group Plc	739
23	ARM Holdings Plc	737
24	Smiths Group Plc	737
25	Capita Plc	736
26	Merlin Entertainment Plc	736
27	Severn Trent Plc	734
28	Legal & General Group Plc	733
29	Rightmove Plc	733
30	Old Mutual Plc	733
31	Standard Life Plc	731
32	Experian Plc	731
33	DCC Plc	730
34	St James's Place Plc	729
35	Astrazeneca Plc	729
36	Pennon Group Plc	728
37	Lloyds Banking Group Plc	728
38	BHP Billiton Plc	728
39	GlaxoSmithKline Plc	728
40	BT Group Plc	727
41	Croda International Plc	727
42	Barratt Developments Plc	725
43	ITV Plc	725
44	Mondi Plc	724
45	Intl Consolidated Airlines Group	724
46	GKN Plc	724
47	Rio Tinto Plc	724
48	Hargreaves Lansdown Plc	724
49	Imperial Tobacco Group Plc	723
50	Coca-Cola Hbc Ag-Di	723
51	Johnson Matthey Plc	722
52	Rexam Plc	722
53	Wolseley Plc	722
54	Centrica Plc	720
55	Burberry Group Plc	720
56	RELX Plc	719
57	Persimmon Plc	719
58	Ashtead Group Plc	717
59	London Stock Exchange Group	715
60	Inmarsat Plc	715
61	Easyjet Plc	714
62	Carnival Plc	713
63	Babcock Intl Group Plc	711
64	WM Morrison Supermarkets	711
65	Glencore Plc	711
66	Bunzl Plc	711
67	Shire Plc	706
68	Fresnillo Plc	706
69	BAE Systems Plc	706
70	Taylor Wimpey Plc	705
71	Informa Plc	704
72	3I Group	700
73	Royal Bank Of Scotland Group	699
74	BP Plc	694
75	Direct Line Insurance Group	694
76	HSBC Holdings Plc	693
77	Standard Chartered Plc	691
78	Randgold Resources Ltd	689
79	SSE Plc	689
80	Pearson Plc	687
81	Schroders Plc	686
82	Barclays Plc	686
83	Antofagasta Plc	685
84	Provident Financial Plc	683
85	Sainsbury (J) Plc	681
86	Auto Trader Group Plc	679
87	Prudential Plc	678
88	Hikma Pharmaceuticals Plc	675
89	TUI Ag-Di	673
90	Sky Plc	672
91	Dixons Carphone Plc	671
92	Worldpay Group Plc	665
93	SABMiller Plc	664
94	Travis Perkins Plc	661
95	Investec Plc	661
96	WPP Plc	660
97	Associated British Foods Plc	655
98	Rolls-Royce Holdings Plc	648
99	Berkeley Group Holdings	641
100	Tesco Plc	603

"A reliable index – a combination of individual indicators capable of measuring the overall quality of a firm's governance – is regarded as the holy grail of governance"

components are inferred on the basis of surveys of customer, investor and employee assessments of the quality of the corporate governance regime of the rated companies. This methodology automatically adjusts for the perceived importance of different governance mechanisms and implicitly creates a link between the index and firm performance. This will also significantly reduce the scope for gaming and preserve the relevance of the index over time.

The Great Governance Debate is now seen by investors and corporates alike as a set-piece event, with interested parties holding their breath in anticipation of the report. And we know from our own engagement with companies that there is widespread support for the initiative, even if they do not always agree with the methodology. Over the coming years we will look to build on the report, with an investible index still the ambition. For now, however, we can reflect on this year's report. There are two crucial questions surrounding the initiative: why have we chosen to do this? And what lessons have we learnt? Let's begin with the first.

The IoD is required by its Royal Charter to promote the study, research and development of the law and practice of corporate governance. With that in mind, the Good Governance Initiative (GGI) was aimed at answering two crucial questions: what is good governance and how do we measure it?

Crucially the GGI was focused on adding to the understanding of good governance by triggering a wider debate with the publication of the initial findings of our research. In 2015, the standout, but unsurprising, conclusion of the research was that defining and measuring good governance is not easy.

As Ken Olisa, chairman of the GGI and deputy chairman of the IoD, has said: "This is because we have come to realise that the structures that drive behaviours are essentially organic." As with any other living organism, a particular action is the result of the interaction between many separate elements. An individual director's behaviour is driven by a host of different factors: some physical, some chemical and some inexplicable. It would therefore be naive to believe that, when many directors get together, their collective behaviour can be reduced to a small list of code-defined mechanistic items susceptible to a tick-box analysis and a red-top call to action.

A reliable corporate governance (CG) index – a combination of individual governance indicators capable of measuring the overall quality of a firm's governance – is regarded as the holy grail of governance research. Ideally a CG index would measure all of the characteristics that matter for corporate outcomes, and would be a valuable tool for informing both CG decisions within firms and investment decisions across them.

Over the past 20 years, academics and practitioners have made several attempts at producing CG indices, so far with limited success. Existing indices have often been criticised for adopting a kitchen-sink approach to the problem by simply combining large numbers of indicators (typically between 50 and 100) and using an arbitrary weighting scheme to produce CG index scores for companies. Critics have also argued that the tick-box approach used to compile the basic CG databases for such indices can easily be gamed by companies. Our approach, as demonstrated by the 2015 and 2016 reports, moves beyond this.

For this second report, we have continued our successful partnership with Cass Business School and we have refined our methodological approach. Specifically:

- We are using a refreshed list of indicators that assesses factors well beyond simple compliance with the Code.
- The Perception Survey from which we derive the list of instrumental factors is based on a wider and arguably more expert set of commentators. It is used to identify correlations between experts' perceptions of good governance and objectively measurable factors.
- The weights assigned to the individual components are inferred on the basis of surveys of customer, investor and employee assessments of the quality of the corporate governance regime of the rated companies.
- We have been much clearer in our explanation of how the rankings are produced.

The result is a workable hypothesis describing, within the limits of what can currently be measured, what constitutes good corporate governance and how the many variables can be measured and judged. This is a very long way from the currently widespread box-ticking regulatory approach to the topic. The Financial Reporting Council (FRC) does, of course, allow for "explanations".

Nevertheless, due to its focus on the Code, many FTSE 100 companies see governance in pure compliance

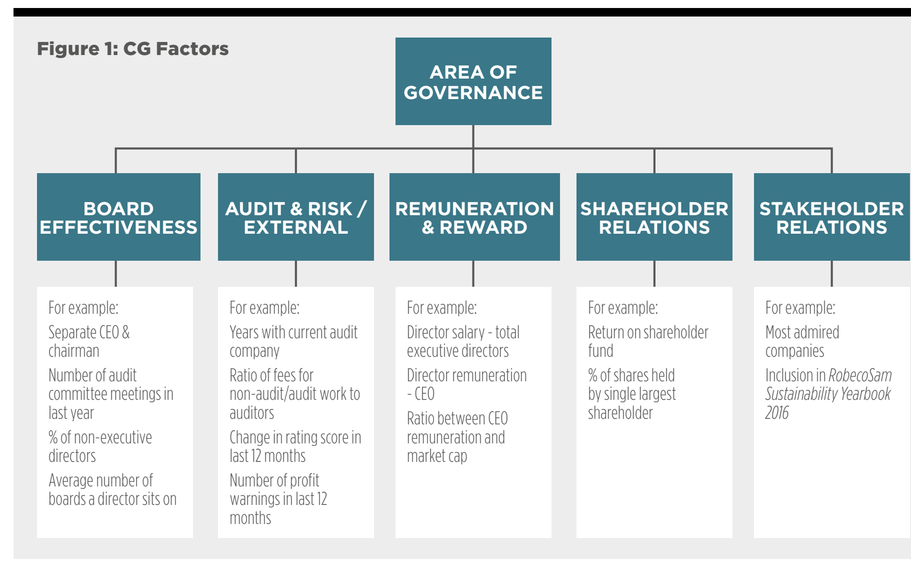

Figure 1: CG Factors

Responses/ratings by affiliation

	Responses	Ratings
Institute of Directors	508	1,376
FTSE 350 company secretary	54	151
Institute of Chartered Secretaries and Administrators	35	77
Journalist	18	72
Association of Chartered Certified Accountants	11	22
Tomorrow's Company Good Governance Forum	4	5
Chartered Institute for Securities and Investment	7	2
The Investment Association	5	8
CFA Institute	2	0
Institute of Chartered Accountants in England and Wales	29	109
Other	71	155
Total	**744**	**1,977**

Top decile

Rank	Name	Total Score
1	Smiths Group Plc	860
2	Rexam Plc	850
3	Auto Trader Group Plc	850
4	Compass Group Plc	843
5	Ashtead Group Plc	833
6	National Grid Plc	832
7	Legal & General Group Plc	825
8	Unilever Plc	823
9=	Investec Plc	817
9=	Worldpay Group Plc	817

Bottom decile

Rank	Name	Total Score
91	Berkeley Group Holdings	613
92	Mondi Plc	600
93	Sky Plc	583
94	RELX Plc	567
95	Glencore Plc	557
96	Royal Bank Of Scotland Group	548
97	Carnival Plc	542
98	Shire Plc	540
99	Tesco Plc	526
100	Hikma Pharmaceuticals Plc	500

terms and it has mainly been reduced to the production of boilerplate paragraphs in annual reports. Like the FRC's recent report on corporate culture, the IoD's aim is to provide directors with an understanding of the many factors that combine to determine good governance, so enabling them to configure their organisations in ways that suit their strategic purpose. We hold that good governance isn't a question of meeting minimum requirements but rather the consequence of tuning many variables to produce optimal performance.

But this doesn't mean this year's report is perfect. We recognise there is room for improvement. However, it is crucial to acknowledge that since the Cadbury Report, with each new corporate scandal the temptation has been for the regulator to introduce further layers of rules or recommendations, all of which require the attention of the directors. As the board spends more time navigating this, it has less to spend on the long-term drivers of value.

Indeed, as Mark Goyder of Tomorrow's Company has explained: "The increasing regulatory burden not only takes up boardroom time, but it also makes NEDs nervous and less likely to take risks. NEDs become focused on getting through the regulatory process to discharge their duties and there is then a steady shift of boardroom time away from essentials such as innovation, competitive opportunity and threat,

Ratings by relationship with company

	Ratings
Customer	687
Investor	302
Supplier	222
Media	108
Employee	26
Analyst	35
Regulator	9
Other	588
Total	**1,977**

"The increasing regulatory burden not only takes up boardroom time, but it also makes NEDs nervous and less likely to take risks" Mark Goyder, Tomorrow's Company

BY ESTELLE CLARK
HEAD OF PROFESSION, CQI

The IoD has initiated a vital debate around governance. A common criticism of the UK Corporate Governance Code is that it has led to compliance with a limited set of mechanistic corporate governance factors and has ceased to provide the level of confidence in performance that organisations and their stakeholders require in our fast-moving and globalised world.

While some might argue that these factors were never designed to be predictors of behaviour and culture in the context of 21st-century business, others may say they remain relevant. Society rightly believes that a corporate fish rots from the head, a complex operating environment being no excuse for doing business at the expense of doing the right thing. And society not only judges but also sentences organisations through deterioration in reputation and an impact on business value. Indeed, a head with a weak nervous-system link to the corporate 'body' can no longer be accepted as a reasonable way of going about things when the body's actions and decisions compromise the organisation's intent and its stakeholders' interests.

So, how does the head of a large complex organisation ensure that the operational body is fit to deliver strategy and to take account of the balance of stakeholder needs? Put another way, how do the executive and non-executive teams have confidence that the organisation does not have a horsemeat scandal waiting to emerge in its supply chain? How can it be sure that ever-shorter cycle times are not resulting in product design decisions that compromise safety or compliance requirements? And how will it understand the potential impact of its own decisions on the operation and its stakeholders?

The Chartered Quality Institute (CQI) and its community of 20,000 quality professional business partners exist to provide that insight and confidence through a closed-loop system of operational governance, assurance and improvement. This acts as the nervous-system link between leadership teams and their organisations, answering key questions for all:

- Is leadership intent defined so as to capture the full range of stakeholder requirements?
- Is leadership intent effectively implemented, producing the desired outcomes for the organisations and its stakeholders?
- Is there a culture of objective evaluation and a commitment to continually improve?

In line with our Royal Charter, the CQI will be working over the coming months and years to help business leaders reinvigorate operational governance.

The CQI sponsors the *2016 Good Governance Report* and contributes to the Great Governance Debate.

St Paul's in the City of London. Boardrooms in the UK's financial centre have been rocked by corporate governance scandals

business model, customer trends and, most important, the engagement, motivation and performance of people in the business."

The challenge now for boards and regulators is to remain faithful to company law – which says that directors owe their duty to the company, not to shareholders – and to the spirit of the Code, without allowing time and energy spent on following its every letter to distract from their focus on promoting the long-term success of the company.

Goyder adds that the issue for the GGI is the challenge that "faces all innovation in measurement". The most important qualitative factors – for example, the quality and impact of boardroom conversation – need measuring but are hard to measure. The less important process factors – such as the frequency of committee meetings – are easier to determine and tend to be dominant.

There is also the risk that the factors chosen as proxies for good governance prove to be outdated. For example, in the real world there is a growing acceptance that dispersed shareholding leads to absence of stewardship by investors and therefore poor accountability of the board. Yet in the criteria used by the proxy agencies and the GGI itself the presence of a dominant or anchor shareholder is judged to be bad.

As the IoD and all who sit on its advisory panel have accepted, the GGI is imperfect. It is an emergent hypothesis; it cannot claim to be definitive. It is by the process of publication, challenge and counter challenge that it – like the usefulness of boardroom conversation – will ultimately improve. Nevertheless, our approach is an important step forward in trying to assess the importance of CG risk factors and, we hope, a key contribution to the debate.

Finally, it is important to remember that the UK market faces a challenging time: a combination of corporate failings and the new prime minister's commitment to reforming governance mean that British companies, especially those listed on the UK stockmarket, will either have to reform themselves and improve, or face government and regulatory intervention. We wholeheartedly want to avoid the latter, but companies do need to grasp the nettle. We hope this report and the subsequent editions will ensure boards across the FTSE strive to improve their governance arrangements and that the debate goes some way to changing behaviour.

To read the report, visit **iod.com/news-campaigns/good-governance-report**

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