RETHINKING THE BASICS OF CORPORATE GOVERNANCE

By Bob Garratt

The publication of the Walker Report on aspects of corporate governance in the banks, and the forthcoming Financial Reporting Council Report on corporate governance in the companies listed on the London Stock Exchange, are raising some fundamental questions about how corporate governance will be developed.

There is no doubt that corporate governance is considered a 'good thing' but it usually refers to a set of rules to which a company's board must demonstrate compliance but then do little else. Most current corporate governance is seen as a blockade to executive freedom and not as a major

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force for business effectiveness. This is demonstrated well in Sir David Walker's attempts to redress the executive excesses of the banks, particularly Northern Rock, HBOS and Royal Bank of Scotland, where the non-executive directors (NEDs) failed to provide critical oversight. Walker's overriding recommendation is that NEDs should develop much stronger 'independence of thought', but given the way most boards operate today, this seems an unrealistic aspiration.

To understand why this ideal seems so out of reach, one must go back to basics. The essence of corporate governance, 'the Director's Dilemma', is about striking a balance between driving an enterprise forward whilst keeping it under prudent control. The Companies Act 2006 is clear about the roles and tasks of a director, and that their work must ensure their duties of Care, Skill and Diligence to fulfil their Fiduciary Duties thus ensuring their company's healthy future. But many directors have little induction and therefore a hazy view of what these responsibilities really mean or the legal consequences of not delivering these duties.

Matters have been made worse, and the Financial Reporting Council has been the leading offender here through Main Principle 3 of their Combined Code, by creating a mindset in which there are two types of directors; executive directors (EDs) and non-executive directors. This is dangerous nonsense. The Companies Act makes it quite clear that you are either a statutory director or not. At law there is no such thing as a NED or an ED. Yet we persist in talking and behaving as if there were. The Act mentions only directors, chairmen and company secretaries as members of a board.

Interestingly, there are no mentions of 'managing directors' or 'chief executives' in the Act. Yet, as Walker points out, when it comes to the boardroom table, we are in an executive-dominated culture . There are two main reasons for this, and three clear paths out of the problem. The first reason is that because the executives are full-time in the business they have total control of the information flows, especially to the board. Walker makes this point strongly and his call for more 'independence of thought' and critical questioning of executive proposals and performance builds on this.

The second reason is more complex. Directors calling themselves 'NEDs' or 'independents' have fallen into the trap of consciously differentiating themselves from the EDs when the law insists that all directors are equal. What is worse is that most haven't had any real induction and consequent behavioural training as to how to act as a director as distinct from an executive.

As the majority of these 'NEDs' also hold executive roles they bring automatically with them their executive mindsets, thus trapping the board into executive-dominated, and strictly functionally-defined, thinking rather than adopting the 'helicopter view' approach. This rises above functional divides and sees the business as a whole, which needs board-driven policies and strategies developed to drive it forward successfully.

There are, in my view, three ways out of this 'exec-centricity'. The first is to develop this helicopter view by a board and individual director development programme which aims to break down functional disciplines and thus encourage a more strategic view driven by the board *with* the executives, not *by* the executives.

Secondly, (and more controversially), is to grasp the problem of directors' contracts whatever their remuneration. An executive who is also a statutory director of a business (wrongly called an ED) should have two employment contracts. The first is a normal contract of employment for, say, 90 per cent of his or her time as an executive. But then all statutory directors have the same contract for services as a director, which would cover the 10 per cent of the executive's time when on board activities. In this way, when statutory directors enter the boardroom they are all, as the law demands, equals. In practise, this approach immediately changes the board dynamics and opens up the strategic thinking capabilities of both the board and the executives whilst ensuring proper oversight of executive performance by the board.

Finally, there is an urgent need for much more rigorous and regular board and individual director appraisal. I declare an interest here, so was delighted to see that Walker is recommending two yearly board reviews by external agents, with the results being published to the owners. This will create great controversy. All I can say is that when it has been done, it has proved highly beneficial, redefining what is meant by corporate governance and how it must be developed for future business effectiveness.

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