

Corporate Governance – is it really working?

First Published in March 1995 - Tony Taylor of ATP Recruitment Ltd on developments taking place in Corporate Governance

Two years on from Sir Adrian Cadbury's first report into the Financial aspects of Corporate Governance there is considerable debate as to the effectiveness of the Committee's recommendations in real terms. The headline news regarding Barings serves to demonstrate that proper controls regarding corporate governance still have a restricted role in avoiding some of the incredible business collapses that give sleepless nights to many shareholders.

Not Mandatory

That apart, a number of other concerns have been mooted. The recommendations of the Cadbury Report were voluntary and there have been suggestions from a number of sources that they should have statutory authority.

Executive Pay & Perks

There is also a strong argument that the Report needs to address the subject of executive remuneration more effectively. The arguments about "excessive pay" particularly when it is not correlated to "exceptional performance", especially in respect of the recently privatised utilities, have even prompted certain figures in Government circles to look at this. The Prime Minister, commenting on "distasteful" pay rises has said he is not ruling out legislation (February 28 1995). The Greenbury Committee which is looking at pay awards for senior executives is expected to be disinclined to favour legislation. The committee whose eleven constituent members collectively earn £3.75m a year) has a little harshly been described as being akin to Dracula being placed in charge of a blood bank, is probably going to recommend yet another code of practice when it reports in the summer.

Legislation May Follow

On the same day as the Prime Minister's comments, the board of Grand Metropolitan came in for heavy criticism at its Annual General Meeting. Share values in Grand Met had declined some 16.5% over the preceding two years whilst the FTSE 100 had risen by 6%. On learning that the Chairman's salary had increased by 13% on the previous year to £928,958 (plus an additional £415,279 from exercising options), one shareholder was prompted to describe the situation as "obscene" and "greed taken to the ultimate". The public cynicism about executive pay rises is growing, but this needs to be balanced by an acceptance that companies have to have the best available executives. The role of the Remuneration Committee (hopefully staffed by Non Executive Directors) and

its influence on the executive directors is still not widely understood or recognised. It could be argued that since directors are technically appointed by the Shareholders, increases in their remuneration should always be approved at the AGM before implementation.

There are immense practical, not to mention political, difficulties in implementing legislation in respect of top end executive pay, but it is an area of corporate governance that requires further scrutiny. Whilst The Institute of Directors makes quaint, clubbable pronouncements and The Greenbury Committee proposes a code of practice, perhaps it is inevitable that firm political action will eventually be taken - this will not serve to benefit shareholders or directors in the long run. The First Cadbury Report has failed to rectify one of the most important and, now, publicly examined area of corporate governance.

Personal Shareholders Speak Out

Naturally, the changing trends in share ownership have taken the whole debate into the public domain. ProShare - set up to promote wider share ownership - has



"You'll be pleased to hear that we have managed to pinpoint the department mainly responsible for this year's financial loss."

announced that the proportion of the adult population owning shares is around 22% compared with 9% in 1979. 59% of shareholders have a stake in only one or two quoted companies and only represent around 17% of the total shareholding in these businesses. Institutional investors still continue to dominate the voting at AGMs, but personal shareholders regard their holdings as very special. There are no figures published regarding attendance at AGMs or EGMs, but there is clear empirical evidence to suggest a more proactive stance from personal shareholders. The personal shareholder is therefore becoming far more vociferous and it is not surprising that their voice (but not their voting power) has become recognised.

In general, institutional shareholders, unlike the general public and politicians, are not so much concerned with the actual levels of executive pay but more with the motivational aspects of the package - in other words the Director should be rewarded for providing long term returns for the shareholders. There is some disparity of opinion amongst shareholder groupings on this subject with the National Association of Pension Funds focusing its attention on reciprocal arrangements for Non-Executive Directors. It has expressed concern that where reciprocal Non-Executive Directors are appointed, each approves the other's hefty pay increase; the interests of the shareholders are not best represented even though the stricter "mechanical" aspects of corporate governance have probably been fulfilled.

It has also been suggested that the maximum term of a Director's contract should be shortened from three years to one year with a maximum retirement age of 70.

The National Association of Pension Funds would also like shareholders to have more detailed information regarding full terms of Directors' contracts. Other shareholder organisations have adopted a more conservative approach, demanding less specific information but a more detailed explanation as to the rationale behind pay awards and benefits to executive directors.

NED's Contribution

The Non-Executive Director should be appointed for the uniqueness of the contribution that he/she can add to the existing Board's experience. They should be regarded as having input into overall corporate governance and not, as one suspects is commonly considered to be the case, seen as the sole bastions of shareholder protection. There must surely be a fear amongst shareholders that compliance with the Code recommended by Sir Adrian's committee is becoming a structural process without any real, positive, input into the direction of the business.

More Regular Information

This wider dimension of corporate governance - away from the more publicised recommendations regarding Non-Executive Directors - is an area that needs to be developed. There is, for instance, growing support for more regular financial information to be published, with many calling for US style quarterly reporting. All too often, corporate accounts fail to include the information that most investors wish to

see. One area that shareholders are pressing for is information on segmental analysis by business line and geography, planned expenditure, together with a comment on current performance against targets. According to one recent survey, leading institutional investors noted serious deficiencies in the disclosure practices of 170 of the world's largest companies; corporate accounts are failing to inform investors.

Role of Auditors

There is also a considerable groundswell of opinion regarding the role of the auditor and the audit report in terms of corporate governance, with a suggestion that the auditor should be named as an individual when he presents his report on the company.

Furthermore, there is a case to be argued that for Public companies the appointment of an auditor should be for a maximum period and thereafter a change should be required under legislation. The accountancy profession will of course argue against this on the grounds that the longer the firm acts as an auditor for a particular client the more it becomes au fait with the nuances of that business. The auditor is then able, it is claimed, to prepare a more effective report to the shareholders. This argument is, perhaps, countermanded by some of the more spectacular collapses of recent times shortly after a routine endorsement of the Annual Report by the auditors.

There is no doubt that the accountancy profession is becoming more "aware" of its obligations and involvement with corporate governance per se and the move towards incorporation by the profession suggests a concern in respect of personal liability. It is very much a case of "watch this space".

Representing Shareholders

Another major area of concern regarding the report on corporate governance must be that it has been sponsored by a number of bodies, with the exception of one truly representing shareholders, for whom the whole subject ought to be the prime motivation.

The German Experience

The UK debate surrounding corporate governance and the protection of shareholder interests is progressive and responsible. In Germany, a similar dialogue is under way, following criticism of the dual board structure (where shareholders and labour representatives act, effectively, as Non Executive Directors on Supervisory Boards). The debate in Germany has been fuelled by a spate of domestic corporate disasters; Metallgesellschaft, an industrial and trading operation, suffered heavy losses in US oil futures trading and had to be rescued by the banks to the tune of £1.45bn.

Germany's biggest bank, Deutsche Bank, had a stake in the business and a director headed up the Supervisory Board. This

led to considerable criticism of the banks' failure to be aware of the impending crisis. A senior bank official has now publicly proclaimed that the bank is taking a more detached view on Supervisory Boards and that representation should come from industrialists who have the more appropriate experience. In Germany, the banks take a far more direct and proactive role in shareholdings than their UK counterparts and their resolution of corporate governance policy is some way off. An integrated European approach to this vital area is even less likely to take place.

The General Motors Guidelines

The United States has, of course, been at the forefront of developments and General Motors recently introduced new guidelines for the role and composition of its Board of Directors. Throughout the 1980s, GM was headed by Roger Smith as Chairman & Chief Executive Officer. Ros Perot, the former US Presidential candidate and one time GM Board member, described other members of the Board as "pet rocks" because of what he saw as their lack of involvement. In 1992, the Non-Executive Directors of GM forced the removal of the then Chairman and Chief Executive, Roger Stempel, and replaced him with John Smale in the role of Chairman - Smale had led the battle from his position as a Non-Executive Director. The power shift in General Motors has hailed a new era in corporate governance with a majority of Non-Executives on the board. The guidelines published by GM do not resolve the argument between separating the role of Chairman and Chief Executive, arguing that the Board should be free to exercise choice in this matter in the best interests of the company. The GM guidelines do, however, require Non-Executive Directors to evaluate the performance of the CEO and this assessment is to be taken into account by the compensation committee in settling pay for the position.

Independent Judgement

The economic climate in 1995 has been less inclined to produce the spectacular corporate collapses, which characterised the late 1980's and early 1990's and it is therefore difficult to quantify the results of the report at this stage. On a positive note, more and more companies provide testimony to the split between the role of Chairman and Chief Executive becoming an accepted principle in practice - a move proposed, but not required, by the Cadbury Report.

Corporate governance has become an issue of great significance throughout the world. The effectiveness of the first Cadbury Report is still open to debate, but what it has achieved is to open a forum for dialogue on the proper issues of corporate governance. The raised profile of Non-Executive Directors and their spirit of independent judgement is positive but the broader aspects need to be addressed. The archetypal comments of the archetypal chairman - "Will all those who disagree with the proposal indicate

by saying 'I resign'" - are, hopefully, banished from Boardrooms for good.

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'Labour can do nothing without capital, capital can do nothing without labour, and neither labour nor capital can do anything without the guiding genius of management'

MacKenzie King 1917

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