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The extent to which Corporate Governance may be successfully implemented by the Business Community: the role of Public Entities and Non profit-making Organisations

LLM 2011-2012
International Corporate Governance, Financial Regulation and Economic Law (ICGFREL)

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Abstract

The concept of corporate governance has been dealt with by a very large number of authors from different perspectives but the main theme that runs across all the published work is easily identifiable - that corporate governance is the real panacea for bad management of organisations. The thesis propounded by these authors, proceeds on the assumption that corporate governance is an absolute concept and can be easily implemented by institutions, both profit-making and non-profit making. This research aims at establishing that the concept of corporate governance could be employed by public entities and non-profit making entities differently. Profit-making organisations will conduct their businesses with a view to maximizing their profits and in doing so they may be required to compromise the requirements of corporate governance, whereas the concept may be successfully implemented by non-profit making organisations. This research has developed this idea by means of empirical studies and it also concludes that all organisations must go through a preparatory stage for a successful implementation of corporate governance and that there is a correlation between corporate governance and democratic governance of institutions

Introduction

The introductory chapter discusses the background to the study, the problem statement, the objectives, the research questions and the scope and limitations of this study.

Chapter 1 examines the concept of corporate governance and looks at some of the definitions of corporate governance, features/principles of corporate governance and the differences between corporate governance and corporate management.

Chapter 2 looks at boards' composition within both sectors, and examines their similarities and differences. Discussion is made of the primary objectives of profit making organisation, comparing those objectives with that of non-profit making organisations generally. This research looks at some of the difficulties in implementing corporate governance by profit making organisations and identifies some of the strengths of non-profit making organisations in implementing corporate governance.

Chapter 3 looks at corporate governance in practice, citing examples of departures from corporate governance within the financial sector. In addition, the research will discuss why the implementation of corporate governance may be possible by public entities and non-profit organisations; and the role of public awareness in corporate governance.

Background to the study

The background to this research looks at the importance of corporate governance in today's business environment.

With the recent collapse of several high-profile corporations such as Barings Bank, WorldCom and Enron to name but a few, and the given reasons behind such collapse as bad corporate governance, there has been renewed interest in this topic. Public awareness has increased regarding the importance of good corporate governance in the ways corporations are managed and controlled. Among the issues raised are: who should be allowed to participate in corporate governance, to whether other stakeholders should play a more active role in the process. Concerns regarding corporate governance transcend national borders affecting all types of organisations and industries worldwide within the public and private sector, and deal with diverse issues ranging from ownership and control to accountability of its members.

Its objectives are (i) to enhance the performance and ensure conformity of corporations; and (ii) facilitate and stimulate the performance of corporations, resulting in the generation of economic wealth of the organisation and society.

Good corporate governance aims to also establish a system whereby the business ethics of managers can be monitored to ensure corporate accountability and, at the same time, cost-effectively protect the interests of investors and society alike. It can also serve as a "best practice" guide to what is considered to be acceptable behaviour and ensuring corporations comply with those standards.

Corporate governance is in essence the governance of corporations. It is conducive to national development. Many case studies show that it plays an immensely important role in increasing the flow of financial capital to organisations in developing and developed countries. Good corporate governance is also important in securing benefits to overcoming barriers, including the actions of vested interested groups and for achieving and sustaining productivity and growth.

Improved corporate governance is not abstract, but must be considered in light of the country's financial sectors, its competition policy and the regulatory reforms of the specific sectors.

Those who are in favour of improved corporate governance include private and public investors and members of the general public, as well as the players in international portfolio equity flows to corporations in the countries affected.

Those against improving corporate governance include those giving "lip service" to the need for improvement, among which are dominant shareholders and corporate bodies (both in the private and public sectors). Their concerns are primarily client-based relationships (as opposed to rules-based systems of governance).

Essentially, good corporate governance requires good political governance, and vice–versa.[1]

Other studies in corporate governance have looked at different areas, however very limited research has been carried out in this particular area.

[1]C.P, Oman *Corporate Governance and National Development, OECD Development Centre Working Paper No. 180, OECD Publishing Development,* 2001, doi: 10.1787/11353558826*.*

Statement of the problem

The implementation of corporate governance has been fraught with various challenges adversely affecting the characteristics of good corporate governance:

Democracy; Accountability, Fairness and Transparency

It has been argued that failure to effectively implement corporate governance, especially in the financial sector has in some way contributed to the current financial crisis being faced globally. Therefore this study argues that corporate governance has not successfully been implemented in profit-making organisations.

The objectives of the study

This study examines:

1. The importance of corporate governance in the effective management of organisations.
2. The key elements of corporate governance
3. How effectively corporate governance has been implemented by profit-making organisations.
4. How effectively non-profit making organisations have implemented corporate governance.
5. Some of the key challenges in the implementation of corporate governance by profit-making organisations.

Research questions

1. What is the importance of corporate governance in the effective management of organisations?

2. What are some of the key elements of corporate governance?
3. How effectively has corporate governance been implemented by profit making organisations?
4. How effectively has corporate governance been implemented by non-profit making organisations?
5. What are some of the key challenges in the implementation of corporate governance by the profit making organisations?

Methodology

This study is desktop research-based, using documentary evidence gathered from various sources including coursework, an interview with Dr Roger Barker, Head of Corporate of Governance, Institute of Directors, books, reports and the Internet.

The study looked at the Basel Principles for Enhancing Corporate Governance, specifically board practices and senior management and its implementation. The Basel Principles and corporate governance coursework previously completed will form the basis of the financial sector. This as well as other documentary sources will be analysed in order to answer the research questions of the study.

This study is an extension of work previously done.

Scope and limitations of the study

Due to time and resource constraints this research could not focus on a specific institution, however, this can be taken up in future research work.

Attention was also given to the general principles, issues and challenges confronting the successful implementation of corporate governance in the business community.

CHAPTER 1

The Concept of Corporate Governance

1.1 Introduction

This chapter examines the concept of corporate governance against the background of the widely held view that both profit and non-profit making organisations should be bound by its values. It is, however, a matter of debate that the extent of successful implementation of corporate governance is not as clear in non-profit making organisations as it is in commercial organisations. To this end, this chapter explores the meaning of corporate governance; principles of corporate governance, such as democracy, accountability, fairness and transparency; and the difference between corporate governance and corporate management. The chapter concludes that the concept of corporate governance varies in substance and form from country to country. For example, issues concerning the levels of information disclosure and corporate transparency are balanced differently against issues of corporate oversight and control, depending on the country and the organisation involved.

When addressing issues of corporate governance, three areas must be addressed: firstly, the structure of the company; secondly, the membership of the company, i.e. who are the shareholders or stakeholders and thirdly the process used in implementing corporate governance.

Corporate governance in the UK is based on a vastly “liquid” stock market, where organisations are measured by profits, market share, return on investments to name but a few. The legal system in the UK permits organisations widespread freedom to accumulate wealth on behalf of their shareholders in an environment of self-regulation. Formerly, there was insufficient guidance on the roles and responsibilities of boards in the discharge of their obligations to shareholders. In the 1980s the focus on corporate governance was brought to the forefront as a result of various corporate scandals.

Instead of legislating against the inadequacies, the government consented to self-regulation. As a result, the Cadbury Committee (1992) was borne out of investigations, which resulted in the increase of proponents of corporate governance. Principles of good corporate governance which were contained in the Cadbury Committee's Report were later embodied in a Code of Conduct.[2] Cadbury looked at the financial aspects of corporate governance.

Subsequently, further Codes were drawn up to counter scandals, e.g. Greenbury Report (1995) on executive remuneration, Hampel (1988) on broader governance issues, Turnbull looked at "internal control", Higgs examined the roles of Non-Executive Directors (NEDs), while, Smith looked at audit committees. These codes have been deliberated and received by the business sector and the financial community.[3]

Although non-profit organisations practice corporate governance, the original codes were aimed primarily at listed companies, i.e. corporations.[4] Technically, NPOs are not corporations, but there is nothing to prevent such companies from complying with the Codes aimed at profit-making organisations, if they so choose. Corporate governance is therefore relevant in both profit and non-profit making organisations. However, for the purposes of this chapter the focus will be on profit making organisations only.

1.2 Meaning of corporate governance

The fact that many businesses failed in the wake of global economic recession of 2008 almost led to the belief that corporate governance is a new subject, which should be understood in the context of that recession. While the recession brought about dominant focus on the subject matter, it is a fact that corporate governance has indeed been associated with the conduct of businesses and therefore has existed across time and ages.

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[3] Stephen, Wilks, Boardization and Corporate Governance in the UK as a Response to Depoliticizatio and Failing Accountability, University of Exeter available at www.socialscienes.exeter.ac.uk/politics/research/readingroom/Wilks%20PPA%20Article.pdf

[4] A. Cadbury, *The Financial Aspects of Corporate Governance: A Report of the Committee on Corporate Governance*, London, Gee & Co (1992), (Cadbury Report) para.3.1

Whatever meaning corporate governance is given largely depends on the context and many people have taken different angles to it. According to Shleifer and Vishny corporate governance 'deals with the way in which suppliers of finance to corporations assure themselves of getting a return on their investment.'[5] This is considered to be a very narrow definition as governance applies equally to all types of corporations and institutions. In this regard, Sir Adrian Cadbury takes the view that corporate governance is 'concerned with holding the balance between economic and social goals and between individuals and communal goals…the aim is to align as nearly as possible the interests of individuals, corporations and society.'[6]

The Organization for Economic Co-operation and Development (OECD) on the other hand, sees the subject in the context of relationships between a company's board, its shareholders and other stakeholders, stressing that 'it provides the structure through which the objectives of the company are set, and the means of attaining and communal goal those objectives, and monitoring performance, are determined.'[7] Elements of good corporate governance include the provision of correct incentives for the board and its managers to attain its objectives in the interest of the company; shareholders putting in place effective monitoring. This increases the level of confidence necessary for a healthy market economy. [8]

From the above definitions, it is clear that corporate governance deals with how corporations are governed and controlled together with the practices and procedures, which are implemented to ensure the organisation achieves its objectives. These objectives differ according to the nature of the organisation. A public company raising capital by way of

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[5] C.A. Mallin, 'Corporate Governance', Oxford, Oxford University Press, (3rd ed.), p.7

[6] Ibid

[7] Ibid

[8] Philips, Heyes, Strengthening the corporate governance of financial institutions: A hopeless but necessary task? February 2012, denning.law.ox.ac.uk

issuing shares will have as one of its main objectives the maximisation of the investment of its shareholders and other stakeholders just as the objectives of non-profit making institutions are for the benefit of the community as a whole. However, corporate governance applies not only to companies within the private sector but equally to those in the public sector. The aim of good corporate governance is to minimise risks at all levels by implementing proper checks and balances, ensuring any abuse of power are kept to a minimum. In this context corporate governance can be understood as a system with different component parts, each part has a role to play and each component must work in harmony with the other to produce the desired outcome.

1.3 Features of corporate governance

There are four key principles used in implementing corporate governance, namely: democracy, accountability, fairness and transparency. Each element will be examined in detailed.

(i) Democracy

The concept of democracy relates to having a voice and being heard, i.e. the decision making process should reflect the interests of the shareholders and other stakeholders. The board of directors is accountable to the shareholders who are responsible for electing them. In governance this means that the role of the board is to better represent the interest of shareholders and other beneficiaries.[9] It is also in the interest of the shareholders to ensure that one person does not dominate the board.[10]

In examining the structure and composition of a typical public company the board of directors is seen as the primary decision making body. According to the Cadbury Report the

[9] C. Cornforth, 'The Governance of Public and Non-Profit Organisations: What do boards do: London, Routledge, 2006, p.9

[10] Cadbury Report, para, 4.2

responsibility of the board is to provide effective leadership and control.[11] To be able to do so, the board of directors must be equipped with the essential skills and knowledge.[12]

The composition of the board however, differs depending on whether it is a unitary or two-tier board system. In a unitary board system, predominant in the United Kingdom (UK) and the United States of America (US), there is one single board consisting of executive directors, NEDs, a Chairman of the board and a Chief Executive Officer (CEO). It is important to note that all are employees of the company except for the NEDs who are external and believed to be independent and objective. It is often argued that as the role of Chairman is crucial towards implementing corporate governance and smooth working of the board, as such should be separated from that of CEO.[13]

A two-tier system on the other hand, consists of a supervisory board and a management board with distinct separation of supervision and management. Shareholders choose members of the supervisory board who in turn select the management boards. The supervisory board keeps an eye on the way the business is run by the management board. This can lead to asymmetries of information between managers and shareholders[14] and it is a system that operates largely in European Union in particular Germany and Sweden. This system is hierarchical in the sense that they are governed from top down as opposed to the bottom-up approach of the unitary system.

In practice however due to the hierarchical nature of board structures, particularly those operating within a unitary board system employees role within the decision making process is very limited. An example of a profit-making corporation, which has successfully implemented corporate governance, is the John Lewis Partnership (John Lewis), which

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[11] R. Hampel, *Committee on Corporate Governance: Final Report*, London Gee & Co (1998) para. 2.3

[12] B. Coyle, *Corporate Governance*, Icsa Publishing, 2010, p.21

[13] Cadbury Report, para. 4.5, See also UK Corporate Governance Code 2010

[14] Cadbury Report, para. 4.5

includes Waitrose, a leading retail business in the UK. The success of John Lewis is attributed to the vision of the founder, John Spedan Lewis of a business powered by its people.[15] An essential feature of John Lewis is the involvement of the employees in the decision making process of the company. Every employee is a partner of John Lewis and are involved in the decision making process of the organisation. The partnership is governed by a written Constitution.[16] Democracy plays an important part in the process of governance giving every partner a say in a business that they own together, each having a single vote. Also of equal important is the structure of the company, which is considered to be horizontal (i.e. everyone involved in the process of governance at the same level). There are three governing bodies, consisting of: the Partnership Council, the Partnership Board and the Chairman. The Council is responsible for electing the four Trustees who serve as Directors and the four members who serve on the Committee for Management.[17] All the partners of John Lewis share in the 'knowledge, reward and profits' of the company. Advantages of this system include loyalty from the employees and a successful business, with everyone working together in unity for a common purpose.

Under the Chairmanship of Charlie Mayfield by involving its shareholders in the process of corporate governance, did not leave its implementation solely up to the board of directors.

(ii) Accountability

There is no universally agreed definition of accountability. The idea however, is that those responsible for the decision-making of the company must be accountable for their decisions and actions. Systems must be in place to effectively allow for accountability and provide

[15] *The Constitution of the John Lewis Partnership: Introducing, Principles and Rules,* December 2011, John Lewis/Waitrose, available at: www.johnlewispartnership.co.uk/about/waitrose.html (last accessed 4th July 2012)

[16] *Ibid*

[17] *Ibid*

investors with the means to examine the actions of the board and its committees. This increases the level of trust and confidence in the organisation.[18]

The Cadbury Report stated that the Board is accountable to shareholders for the progress of the company. Shareholders in turn appoint auditors to provide external checks on directors' financial statements.[19] Members of the board are accountable to shareholders and other stakeholders both present and future. Therefore it is expected that the board must give proper account of its activities in terms of full disclosure about audited accounts, remuneration and governance of the organisation and be transparent in the way it operates and controls the organisation.

The board of director owes a fiduciary duty to its shareholders because of the proximity of the relationship; however, this does not apply where the director is also a shareholder. Boards are under a legal obligation (in their position of trust) to act in the best interests of the organisation. Its powers and duties are usually laid out in the company's constitution, which defines the nature of the governing body as well as the rights and duties of its members. The Companies Act 2006 codified directors' duties to include amongst other things, duty to exercise reasonable care, skill and diligence, formulating strategies, policymaking and supervision of the management team. This is to ensure that there is a system of checks and balances and clear separation of powers with no one person having 'unfettered powers'.[20]

One concern is that the board is unlikely to be free from conflict of interests, which in effect may undermine any process of accountability. Jensen and Meckling who represent agency theory sees directors as agents and shareholders as principals[21] and as such, the concept of separation of ownership and control gives rise to conflict of interest between the board and

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[19] Cadbury Report, para.6.1

[20] Ibid, para.1.2

[21] C. Mallin, p.14

shareholders.[22] Agency theory assumes that the shareholders and board of directors will have different interests.[23] It is the view of agency theory that the fact that shareholders are not involved in the day-to-day operations of the business may give rise to inequality in the information they have access to, as opposed to the directors. This can lead to several identifiable problems. Firstly, abuse of powers by the board acting in its own interest as opposed to the best interest of the shareholders as principals. There is a tendency to take excessive risks, which may run contrary to that of the shareholders.[24] It is therefore important that proper systems are put in place for the monitoring of the activities of the board in order to prevent any abuse of power, resulting in protecting the interest of the shareholders.[25] The Cadbury Report further stated that shareholders could insist on a high standard of corporate governance by requiring their companies to comply with the Code.[26] If shareholders play a more active role in the process this may go some way in addressing the weaknesses in the current process. It is important to note that agency problem only arise where the director is not a shareholder and the common practice is that most directors are also shareholders.

The long held view is that the role of NEDs is crucial in relation to accountability. They are perceived as custodians, as stated in Equitable Life Assurance v Bowley & Ors[27], which concerned action against former directors and non-executives directors for breach of fiduciary duties. The two main functions of NEDs are to review the actions of the board and its executives in relation to their performance, strategy, standard of conduct and key

[22] J. McCahery, P. Moerland, T. Raaijmakers, L. Renneboog, *Corporate Governance Regimes, Convergence and Diversity*, Oxford University Press, 2006, p. 386

[23] C. Cornforth, p.7

[24] C. Mallin, p.15

[25] *Ibid*

[26] Cadbury Report, para.6.6

[27] [2003] EWHC 2263 (Comm)

appointments and where conflict of interest arise to take the lead.[28] The Cadbury Report recommended that NEDs must be experts in their field, commanding the respect of the Executive and be able to work together cohesively to further the interest of the organisation. In selecting NEDs, the same level of care is required as those used in appointing senior executives.[29] A key role of NEDs is to be able to hold the executive to account.[30] As a result they need to have the necessary skills and time to be able to have a sound grasp of the organisation in order to exert any real power and influence in governance.[31] For NED's to be effective they will need to be properly informed but there is a concern that as they are external and are not involved in the day-to-day running of the corporation, they may not have access to necessary information in a timely fashion. The board should ensure that all material information about the company is available in an accurate and timely manner.

The effectiveness of NEDs is based on the quality and use of the information they receive,[32] for which they are reliant on managers. If not, this will impede their performance and affect their ability to exert any real power of holding the executive to account. The Warwick study highlighted this as a problem and questioned whether this is realistic.[33] Their view is that the role can be compromised by familiarity and result in complacency, and their ability to remain objective is being questioned.[34] While it is vital for NEDs to be properly involved in the organisation in order to have a solid grasp and understanding, which will in turn enable them to be more effective, too much involvement may compromise their objectivity.[35] In the event of conflict of interest NEDs are expected to take the lead in resolving the issues but if

[28] *Cadbury Report*, paras.4.5-4.6

[29] Ibid, para. 4.15

[30] C. Cornforth, p.215

[31] *Ibid*

[32] *Cadbury Report*, para. 4.14

[33] C. Cornforth, p.215

[34] *Ibid*

[35] Ibid, p.215

their independence and objectivity are compromised this may adversely affect the implementation of effective corporate governance.

The Combined Code 2010 is also in favour of a board structure comprising mainly NEDs of at least half of the board, the idea being to bring a balance to the board although collectively they are responsible for the success of the company.[36] However, Lord Turner in a review of the banking crisis for the Financial Services Authority (FSA) doubted the contribution of NEDs because of their lack of knowledge.[37] Whereas, Sir David Walker in his report raised the question whether the long held belief that NEDs made a significant contribution to governance remains as practical as previously thought.[38]

There is clearly a need to have a proper 'balance'; however, this may be easier said than done.

(iii) Fairness

The concept of fairness refers to the premise that all stakeholders should receive equal treatment, i.e. they play by the same set of rules where there is no outside interference. For example, the rights of minority shareholder should be upheld in the same way as that of majority shareholders.

The OECD issued guidelines dealing with the 'equitable treatment of shareholders.' Within those guidelines are three principles directed at promoting fairness. Firstly, equal treatment for all shareholders of the same class. Secondly, it prohibits insider trading and abusive self-dealing. Thirdly, board members and executives are required to disclose any direct or indirect material interest in any transactions or other matters affecting the corporation.[39]

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[36] C. Mallin p. 163

[37] The Turner Review, *A regulatory response to the global banking crisis*, March 2009, para.2.8

[38] Walker, *A review of corporate governance in UK banks and other financial industry entities, Final recommendations,* November 2009, para.2.2 (Walker Review)

[39] OECD Principles on Corporate Governance, 2004, p.20

They further recommended that all shareholders should have the opportunity of obtaining effective redress in the event of violation of their rights.[40] In the UK, Company law protects minority shareholders' rights and therefore the risks are minimized. Although in other jurisdiction this is not always the case. An example of the legal protection afforded to minority shareholders was mentioned for the first time in the case of Foss v Harbottle.[41] This issue was later addressed on appeal in O'Neill and Another v Phillips and Others,[42] a case decided under sections 459-461 of the Companies Act 1985. It considered the scope and remedies of a minority shareholder who believed that the company conducted its affairs in a way, which was unfairly prejudicial to their interest.

This provision is now codified in section 994(1) of the Companies Act 2006.[43]

It is important to note however, the diversity of shareholders, ranging from the larger institutional investors to individual investors but for the purposes of this research will not be explored.

(iv) Transparency

Transparency is the ease with which outsiders can understand the actions of the organisation and its structure. In governance it is concerned with whether the information presented by the company reflects its true position.

The Oxford English Dictionary's definition of 'transparent' is 'easily seen through, recognised, understood, or detected, manifest, evident, obvious, clear.'[44] Transparency has been and remains the most challenging and controversial principle in the successful implementation of corporate governance for profit-making organisations. The aim of

[40] C. Brian, Corporate Governance, Isca Publishing, 2010, p.44

[41] (1843) 67 ER 189

[42] [1999] UKHL 24; [1999] 1 WLR 1092 (20th May, 1999)

[43] See Kohli v Lit and others [2009] EWHC (Ch), a case decided under the Companies Act 2006.

[44] *Oxford English Dictionary Online*, Second Edition 1989, Oxford University Press, Oxford, 2010

transparency is to ensure timely and accurate disclosure of all relevant matters, including the financial situations, performance, ownership and control of the corporation. Some corporate scandals have highlighted that at the root of their failure is the lack of transparency, for example, the collapse of Barings Bank in 1995, in which one individual managed to lose over £850 million. Clearly there was insufficient supervision and a lack of proper internal controls.[45] Transparency is the foundation for establishing trust.[46] The aim of greater transparency is to restore investor confidence, which was damaged by some of the previously mentioned corporate collapses.

Various Codes such as the Greenbury Report[47] and the Cadbury Report, which establishes "Codes of Best Practice", exist for boards to observe, giving guidelines and setting benchmarks on how best to achieve corporate governance. While these Codes are aimed primarily at listed companies, it is hoped and recommended that other companies will also endeavour to meet their requirements. The disadvantage is that companies can choose whether or not to comply with the codes. There is however, a provision that any organisation, which does not comply with the codes, must give reasons for their non-compliance.[48] The reality is that banks which have collapsed including Northern Rock and Royal Bank of Scotland complied with the codes of corporate governance as confirmed by their published annual reports, yet these boards failed. Among the reasons cited was lack of transparency.[49]

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[45] C. Mallin, p.2

[46] B., Hanningan, *Board failures in the financial crisis - tinkering with codes and the need for wide corporate governance reforms:* Part 1, Comp. Law, 2011, 32(12), 363-371

[47] *The Greenbury Committee was set up due to concerns about the size of remuneration of directors' packages and the inconsistencies in relation to disclosure in the annual report of their company*.

[48] *Ibid*, p.28

[49] *Ibid*

1.4 Differences between corporate governance and corporate management

While governance consists of a governing body, i.e. the board of directors or trustees directing the management on all aspects of a company, it is the governing body that oversees the overall function of an organisation. They are also responsible for appointing management personnel to whom power is delegated to administer the policies and procedures of the organisation in accordance with the wishes of the governing body

The responsibilities of governance include choosing senior executives, evaluating their performance, authorising plans/commitments and evaluating the organisation's performance. On the other hand, management has the responsibility for managing and enhancing the overall performance of the organization. Management has the responsibility to implement the day-to-day operations of the operation.

Governance sets the vision of an organization, translates it into policies, management is concerned with making decision for implementing those policies.

Governance provide the direction, leadership and oversight of the functioning of the management, however, it has no role in the actual management.

1.5 Conclusion

This chapter looked at the concept of corporate governance and some of its key principles and argued that corporate governance differs from country to country. Also, that the level of implementation of corporate governance between profit and non-profit making organisations varies because of the different structures of the various companies, their memberships and the processes used in implementing corporate governance. There is no uniform approach in the way corporate governance is implemented, even within the same sector and each company has its own system, including implementing their own Codes of Best Practice.

The fact that businesses collapse as a result of bad corporate practices rationalises and indeed reinforces the need for corporate governance to be enforced in both commercial and non-commercial enterprises. The principles of democracy, accountability, fairness and transparency are critical toward delivering the goods that come with the reality that businesses which survived many turbulent times got wiped out during the recent global recession, something which helps to drive home the point that board decision making was not what it might have been. While it is important to note that corporate governance can define issues, the way that board behaves is all that counts. After all, the Highway Code does not stamp out bad driving and so it is inconceivable that corporate governance eliminates failure completely.

Chapter 2

Difficulties in achieving corporate governance by profit-making organisations

2.1 Introduction

Chapter I examined corporate governance and its components, in its traditional application in relation to profit-making organisations.

This chapter looks at board composition within the profit-making organisation (PMOs) and non-profit making organisations (NPOs) and examines their similarities and differences. It compares the primary objectives of PMOs and NPOs and examines some of the difficulties in achieving corporate governance by PMOs. This requires an examination of some of the organisational structure and different corporate governance models in the private and public sector. It also identified some of the strengths of NPOs in implementing corporate governance. In this research, NPOs refers to charities, non-profit organisations and other types of organisations not operating for profit.

The principles of corporate governance apply equally to public and private sector organisations, regardless of whether their governing bodies are elected or appointed, or whether there is one individual or a group.[50]

2.2 Comparing the primary objectives of PMOs and NPOs

Globally, there are various models of corporate governance in operation. Reason attributed for this is that this is an indication of how organisations are financed and also the different legislative controls and the external regulations governing them.[51]

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[50] Governance in the Public Sector: A Governing Body Perspective PDF International Public Sector Study IFAC Public Sector Committee August 2001 Study 13, para, .062, available at: www.ifac.org/sites/default/publications/files/study-13-governance (accessed 08.09.2012)

[51] John, Fisher, UnconfuseU Corporate Governance and Management of Risk, White Paper 2010 available at: http://www.best-management-practice.com/gempdf/Corporate_Governance_and_Management_of_Risk.pdf (accessed 11.09.2012)

Within different jurisdictions regulators have created diverse ways to regulate organisations with a view to protecting assets, increase revenue and earning capacity and boost the market economy. Examples of governance models include:

1. The Anglo-American model is the most widely used and its shareholders are the main stakeholders, to whom the boards are accountable. How they perform internally, i.e. profit maximisation, and how they operate within the confines of the legal structures and regulations are geared at achieving these objectives.

2. The Franco-German model perceives an organisation as a "collective entity" who has duties and responsibilities towards their principal stakeholders. Within this model, shareholders are not the principal stakeholders; they are just one of many.

3. The Japanese model ("keiretsu") is based on a framework of inter-relationship between large banks and organisations who engage in widespread "cross-shareholding". An advantage of this system is development of long-term stable relationship. There has been an increase in foreign acquisitions and "global competition"[52]

The Board composition, similarities and differences

Boards are responsible for setting the long-term vision and safeguarding the reputation of the organisation. Good governance is Indispensable to the success of an organisation, and the effectiveness of a board is underpinned by the structures and procedures adopted, regardless of the sector.[53] The legal composition of the governing boards in PMOs is based on company law and other related legislations.

The non-profit sector is wide and varied ranging from well-known organisations to small informally run associations. As their sizes are diverse so are their functions. A variety of

[52] Ibid

[53] Cadbury Report, para 4.2

legal structures exist for NPOs, e.g. trusts, mutual societies, co-ops, companies limited by guarantee, church ministries and Charitable Incorporate Organisations (CIOs). No single Code of Governance can reasonably be expected to apply equally to all organisations because of their different objectives, governance models and sizes. However, in spite of their diversity, certain characteristics differentiate NPOs from PMOs, for example:

- They are voluntary organisations, formed by the general public as opposed to government institutions;
- They exist to fulfil a social and public benefit element;
- They are prohibited from advancing self-interest or amassing personal wealth;
- Their revenue must be applied for the benefit of the general public;
- They can be legally formed by mutual consensus of at least three people;
- On termination, surplus assets must be allocated to NPOs with similar objectives.

There is a requirement that the governing body of NPOs must consist entirely of people having the ability to govern it, with an interest in its objectives and provide strategic forward planning of the organisation, overseeing management's administration of its objectives. Depending on its mission, history, and geographical link, NPOs may also have specific stakeholders or different groups of stakeholders, some or all of whom may be represented by categories of board members under the organisation's regulations. The governing body of PMOs do not purport have to have an interest in the aims and objectives of the company.[54]

One essential aspect of board structure is the selection of the various board committees, e.g. within PMOs, the audit and remuneration committees etc. Board committees vary for both PMOs and NPOs, depending on the organisation's size, its structure and its objectives, e.g. within NPOs, standing committees, investment committees and facilities committees.

[54] Anona Armstrong, Xinting Jia and Vicky Totikidis, *Parallels in Private and Public Sector Governance*

The purpose of the committees is to act as a system of checks and balance on the operation of the board.

The Chairman and CEO

The Chairman plays a vital role in implementing good corporate governance. They are responsible for the effective operation of the board, while the CEO is responsible for leading and managing the organisation.[55]

Auditors

According to some auditors act as "gatekeepers"[56], however, this analogy is incorrect. The Oxford Dictionary defines "gatekeeper" as an attendant employed to control who goes through a gate...a person or thing that controls access to something."[57] Their function is much wider than simply manning the gates and providing information. Auditors' responsibility is to supply shareholders with an "external and objective check" on the financial statements of the director. According to the Cadbury Report, the annual audit is one of the "cornerstones of corporate governance".[58] Although the director's reports are addressed to the shareholders, they are essential to a broader audience, especially its employees whose interests boards have a statutory duty to consider.[59]

Within the NPO sector, the board is responsible for directing the company. They are known by many names, e.g. Board of Trustees, Board of Directors, Board of Governors Management Committee. For the sake of simplicity, however, they will be referred to as "the board".

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[55] John, Lessing, The Checks and Balances of Good Corporate Governance, Bond University, 27th September 2009

[56] Ibid, p.4

[57] Oxford Dictionary available at http://oxfordictionaries.com/definition/English/gatekeeper (accessed 12.09.2012)

[58] Cadbury Report, para 5.1

[59] Ibid, para 2.7

In many ways the governance board of NPOs and PMOs are similar but for their attitudes: the board's oversight role, its decision-making power, its structural position within the organisation, and its members' fiduciary duties. The similarities end, however, where shareholder interest in maximising returns rank in priority over the fulfilment of the NPO's objectives, its diversity of stakeholders, the more complex business models, and self-accountability rather than external accountability.[60]

The role of governing boards, in NPOs, however, is not always clearly defined. In government-run NPOs the board is perceived as public servants. They manage the organisation for the purpose of the best interests of the general public (which is usually set out in its mission statement and/or other governing documents). Conversely, in PMOs, the board act as agents for the shareholders, however, this does not apply where the director is a shareholder. They oversee the day-to-day management of the company and its objectives.

It would appear that board members of NPOs are able to develop the organisation's relationship with the donors and must carry out their role in a manner which will not conflict with the board's duties.

All NPOs are subject to governmental control. In the United Kingdom, the Charity Commission is the governmental body which regulates non-profit making bodies and accounting principles by the Audit Commission). They are under pressure to meet performance targets but some are restricted by political bias. However, donors may show their disapproval of the Board by removing their support (fiscal or otherwise). In the likelihood of failure of profit-making organisations, losses are incurred by the owner, while failure may result in NPOs, Government and non-Government run ventures being bailed out

60 H. B. Hansmann, *The Role of Non-Profit Enterprise, 1980*

and losses absorbed. Responsibilities are usually enshrined in legislation and their governing documents.[61]

Guidelines for the voluntary sector setting out good practice can be found in *"Good Governance: A Code for the Voluntary and Community Sector ("the Codes")"* and sets out the responsibilities of charity trustees. They identify 6 principles which are aimed at voluntary and community sectors worldwide. Its application will differ, however, depending on the type and size of the organisation.[62]

The success of PMOs is ultimately measured by the level of the return on its investment, i.e. profit maximisation. PMOs purport to offer a good return for their investors. Increased profits attract investors, resulting in greater economic stability. In this regard, one would conclude that the primary objective of PMOs is to maximise profit.

Due to legal constraints NPOs are prevented from distributing additional revenue by way of profit to management or the governing body, including trustees. There should be no direct link between the control of its operation and its distribution of profits. Profits are used to advance its public interest objectives. On dissolution, surplus assets are not distributed to its members, but are transferred in accordance with legal requirements set out in its governing documentation. NPOs consist of a wide range of unrelated organisations from the arts to health care, charities, churches and local authority leisure services, to name but a few.[63]

The primary objective of NPOs is not profit maximisation (which is seen as a means to an end). The end is perceived as the organisation fulfilling its public interest/benefit objective. Profit is of course, important as they must be profitable in order to attract donors. The reality is that they are not prevented from making a profit, but are legally restricted in distributing

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[61] Anona, Armstrong; Jia, Xinting and Totikidis, Vicky, *A comparative study Parallels in Private and Public Sector Governance* available at http://vuir.vu.edu.au/948/1/Parallels_in_Private_and_Public_Sector_Governance.pdf (accessed 15 July 2012)

[62] Good Governance A Code for the Voluntary and Community Sector, Second Edition, October 2010

[63] H. B. Hansmann, The Role of Non-Profit Enterprise, 1980, The Yale Law Journal, Vol. 89, pp-838-39

it.[64] Such profits must be ploughed back into the organisation in order to fulfil its objectives. In spite of the public interest element, however, NPOs may choose one venture over another because of its propensity to generate profit. Equally, PMOs may fail to identify and capitalise on socially advantageous investments which generate increased public benefits rather than profit, if profits are not deemed sufficient to justify its investment costs.[65]

Finance is necessary for NPOs for the following reasons:

- Donors expect the cause they support to make a profit to justify its existence and to fulfil its objectives, e.g. feeding the homeless.
- Profit increases the organisation's ability to perform its objectives, just as much as the distribution of profit to shareholders becomes a strong influence to increase the share price on the Stock Market, attracting more investors or provide an impetus for existing shareholders' continued or increased investment.[66]

There is a growing consensus among those who control PMOs that these organisations should not only serve the best interests of the organisation, but also that of its stakeholders, e.g. employees, customers, suppliers (including the local community in which the organisation is situated).[67]

2.3 Difficulties in implementing corporate governance by PMOs

In order to assess how corporate governance is implemented within the profit making sector, it is necessary to analyse the application of the principles of corporate governance, namely, democracy, accountability, fairness and transparency.

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[64] Ibid

[65] Steven, A. Ramirez, *Rethinking the corporation (and race) in America: Can law (and professionalization) fix "minor" problems of externalization, internalization, and governance?* St John's Law Review Vol.79:979-80 available at www.tci.edu/media/3/11f03c9652054f9087cf1957b6d6cd6.pdf (accessed August 2012)

[66] Jody, Blazek, Non-profit financial planning made easy, Hoboken, N.J. (2008), p10-11

[67] Peter Noble, *Social Responsibility of Corporations*, 84 Cornell L. Rev. 1255, 1998-1999

The framework for corporate governance with the UK functions at various levels, through legislation, in particular the Companies Act 2006; the Listing Rules, the Disclosure and Transparency Rules and the Prospectus Rules which emanate from and implemented by the Financial Services Authority; the UK Corporate Governance Code and the Financial Reporting Council's UK Stewardship Code for institutional shareholders, the Takeover Panel's Code, to name a few.

Democracy

As discussed in Chapter 1, we have seen that the board is the primary decision-making body responsible for implementing corporate governance, and that its decision-making should reflect the interest of the stakeholders. The majority of shares in listed companies are now owned by institutional shareholders i.e. pension funds, insurance companies and mutual funds etc**.** Institutional investors are not generally involved in the decision making process. One reason is that they are not motivated to as their primary objective is profit maximisation and they are not usually interested in the decision making process. Therefore, on the face of it, the boards could not be construed as truly democratic.

There is a correlation between corporate governance and democratic governance of institutions. For there to be true democracy, other stakeholders, especially employees must be encouraged to participate in the decision-making process, i.e. corporate governance. This will result in loyalty, without which, there cannot be effective corporate governance.

Accountability

This section will focus mainly on shareholders duty in relation to accountability. The directors are elected by the shareholders (i.e. the owners) and are therefore accountable to them for the organisation's progress. They act as stewards on behalf of the shareholders. The shareholders also appoint external auditors to oversee the organisation's financial reports.[68]

[68] Cadbury Report, para 6.1

The UK Corporate Governance Code 2010 (which replaced the Combined Codes) requires annual re-election of all FTSE 350 company directors. When selecting and appointing board members, due regard should be had to the diversity of the applicants, whose skills, experience and independence (including gender) must be taken into account.[69] The board owes a fiduciary duty to its shareholders.

Fiduciary duty is a common law creation. This was first mentioned by the courts in the case of Foss v Harbottle.[70] In this case, the courts decided that in actions where a wrong is alleged to have been done to a company, only the company itself has the *locus standi*. There are now, however, many exceptions to this rule. In case law, a fiduciary is defined as 'someone who has undertaken to act for and on and on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence'.[71] The Law Commission defined a fiduciary relationship as one where there is 'discretion, power to act, and vulnerability'.[72] It is said that vulnerability arises when the agent in receipt of the funds has greater knowledge/expertise than the agent placing the funds. In this regard, vulnerability is closely linked with information asymmetry.[73]

One vital aspect of accountability is for shareholders, as owners, to be able to effectively hold the board to account.

Most shares in listed companies are owned by institutional shareholders. As such, they have great power to influence the board and are able to affect the standard of governance. For example, in the US, institutional shareholders hold more than 60% of voting shares of the larger organisations.[74] Their use of this power, however, depends largely on whether

[69] Linklaters - UK Corporate Governance New Code published, June 2010

[70] (1843) 67 ER 189

[71] Bristol & West Building Society v Mothew [1998] Ch1 at 18 per Lord Millett Kay Final Report July 2012 p.65

[72] Ibid

[73] Ibid

[74] Gilchrist Sparks, *Corporate Democracy – What it is, what it isn't, and what it should be,* February 2006

they see this as their responsibility, as owners, to effect the change required rather than disposing of their shares whenever they perceive there to be a potential problem.[75] It has been said that many institutional shareholders do not perceive themselves as the "ultimate owners" of the investments they make. On the other hand, institutional investors may not see corporate governance as a profit generating activity warranting the requisite time and effort needed to vote appropriately.[76]

Historically, in the UK the large institutions dominated shareholding, who had long term investments in both the shareholder and the organisation to be acquired and could therefore consider the benefits of the investment. Today, there appear to be an increase in those whose only interest is "rapid, profitable exit."[77] Many do not hold shares long enough to be able to participate in corporate governance.

The UK's independent regulator, the Financial Reporting Council (FRC) published the UK Stewardship Code in 2010. Its purpose is to improve the standard of engagement between institutional investors and organisations in order to assist in advancing "long-term returns to shareholders and the efficient exercise of governance responsibilities."[78] The principle of "comply or explain" in the corporate governance since the Cadbury Report 1992 is that a mandatory requirement. While it appeared to operate satisfactorily, it has been stated that the European Commission was concerned about this principle, in particular on the basis that "explanation, when given is sometimes thin."[79] The FRC, however, has issued a report on what comprises an 'explanation'. The FRC's guidelines for good practice recommends that

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[75] Ibid, para 6.10

[76] Gilchrist Sparks, p.3

[77] John, Kay, Professor The Kay Review of UK Equity Markets and Long-Term Decision Making, Interim Report, para 3.6 (Kay Interim Report)

[78] Financial Reporting Council, The UK Stewardship Code, July 2010, available at: http://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Stewardship-Code.aspx (accessed 04.09.2012)

[79] Kay Interim Report

institutional investors should seek to engage with "investee companies" on a "comply or explain" basis and believe that this is the standard to which institutional investors should aspire.[80] UK authorised asset managers must report on whether they apply the Stewardship Code or not.[81]

The issue for corporate governance is how best to strengthen the board of directors' accountability to its shareholders.[82] The shareholders should insist on a high standard of good corporate governance which is a significant test of the directors' stewardship role.[83] The board and its committees must be accountable for their actions and decisions in providing investors with mechanisms to examine them. The boards' accountability to the shareholders could be reinforced if shareholders insisted that the board adhered to the Code.[84]

Institutional shareholders have been criticised for not actively adhering to the principles of the Stewardship Code. Further concerns made are: (i) the failure of shareholders to bring "underperforming or poorly managed companies to account."[85]

The role of NEDs in accountability is crucial in the governance process, as previously discussed in Chapter I. From the outcome of the various inquiries[86], this is an area which is proving difficult for the board.

Concerns have been raised regarding the appointment of NEDs, e.g. by a board committee with considerable influence from the Chairman, which generally results in the board's

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[80] The UK Stewardship Code

[81] Ibid

[82] Ibid

[83] Ibid, para 6.6

[84] Ibid

[85] Pension Funds Online available at www.pensionfundsonline.co.uk/527/pension-funds-insider/UK-stewardship-code-set-for-changes-after-Kay-criticism (accessed 04.09.2012)

[86] Walker Review

composition being ineffective and not able to challenge executive decisions. Further issues relate to lack of diversity in non-executive appointments, including, appointment of women and NEDs holding the same position on many boards which may result in their inability to fulfil their obligations.[87]

Fairness

All stakeholders should receive equal treatment, e.g. the rights of the minority shareholder versus those of majority shareholders. Within the UK, this does not pose a problem. Company law and other legal remedies provide adequate protection for shareholders. As discussed in Chapter I. In an interview with Dr Roger Barker,[88] his concern was not about the rights of minority shareholders, rather the issue was one of getting them to fulfil their responsibilities. Dr Barker's recommendation was for minority shareholders to exercise more responsibilities in governance and play more of an active role. He recognised that, within other jurisdictions, minority shareholder's rights lacked adequate protection, especially in organisations where there are dominant block shareholders. In these circumstances, minority shareholders would feel vulnerable and there is a need to address that vulnerability, partly through legal protection.

Transparency

As discussed in Chapter 1, the aim of transparency is to ensure timely and accurate disclosure of all relevant matters, including the financial state of affairs, performance ownership and control organisations. Transparency is defined by Basel Committee on Banking Supervision ("Basel Committee") as "public disclosure of reliable and timely information that enables users of that information to make an accurate assessment of a bank's financial condition and performance, business activities, risk profile and risk

[87] Kay Interim Report, para 3.21

[88] Head of Corporate Governance, Institute of Directors, London

management practices."[89] The various corporate scandals mentioned earlier, have highlighted that one of the primary causes is lack of transparency. Although the OECD Principles appear to be adequate, the issue of implementation remains a challenge. While regulatory framework is in place to enhance good corporate governance, PMOs, in pursuit of their primary objectives, i.e. profit maximisation may well compromise governance standards. As the regulations are suggestive (i.e. comply or explain) rather than mandatory the tendency to flout the regulations either by "cherry picking" or operate unethically in order to meet their objectives. This will be discussed further in Chapter 3.

In the context of corporate governance, transparency can be better achieved by having systems in place which enable those with vested interest in the corporation to have free and open access to material information on the organisation, such as, financial statements, budgets and the decision-making process. However, the information, in particular, those relating to the organisation's financial situation must be clear and unambiguous, honest and reflect its true financial position.

The aim of the EU Transparency Directive[90] is to ensure "a high level of investors' confidence through equivalent transparency for securities issuers and investors" within the European Union. It is a requirement of the Directive that issuers of securities traded on regulated markets produce "periodic" financial details relating to the performance of issuer during the accounting year and continuous reporting on "major holdings of voting rights"[91].

Both the Cadbury Report and the OECD Principles for Corporate Governance highlighted the requirement for transparency and disclosure of a company's independently verified financial statements. The Cadbury Report highlighted the need for open and honest

[89] Basel Committee on Banking Supervision, 'Enhancing Corporate Governance for Banking Organisations', September 1999

[90] 2007/14/EC; 2008/22/EC and 2010/78/EU

[91] European Commission Proposal for a Directive of the European Parliament and of the Council amending Directive 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and Commission Directive 2007/14/EC, Brussels, 25.10.2011 COM (2011) 683 Final 2011/03/07 (COD)

financial reporting. Additionally, there is a recommendation that the relationship between the board and auditors be sufficiently detached in order to maintain the latter's "professional objectivity"[92]. A further suggestion made is for auditors to be compulsorily rotated in order to deter familiarity between the board and auditors.[93]

2.4 Identifying the strengths of nonprofits in achieving governance

Research has identified that the two main areas which have proved difficult for PMOs in the implementation of corporate governance are: accountability and transparency. We will now examine how NPOs measure up in the implementation of these two areas.

Accountability

There is no universally agreed definition of accountability. However, accountability may be defined as "a means of making public sector entities (politicians and officials) accountable to the "public" and is distinct from political accountability, for example, in situations of political accountability directly to the public (e.g., through an election), and managerial accountability, e.g. an official's accountability to their managers through the hierarchy up to the political leaders.[94] GuideStar UK is a database which works in partnership with the Charity Commission providing information on UK charities. The public has direct access to important data on charities. The aim is to endorse accountability and transparency.[95]

Public sector organisations have to assure a wider and more complex range of political, economic and social aims which subject them to a divergent set of external controls and influence. They are also controlled by different rules of accountability to diverse stakeholders, differing from those of the private sector and its shareholders.

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[92] Cadbury Report, para. 5.7

[93] Ibid. 5.12

[94] Governance in the Public Sector: A Governing Body Perspective PDF, International Public Sector Study, IFAC Public Sector Committee Study 13, August 2001, para 142, (thereafter Public Sector Study 13) available at **www.ifac.org/sites/default/publications/files/study-13-governance**, (accessed 12.09.2012)

[95] Ibid, p.63

Characteristics of public sector governance have been considered by the Nolan Committee. The Nolan Report identified and clarified seven common principles which should undergird public life. This Report made a recommendation for public sector organisations to draw up codes of conduct consolidating these principles. These are: selflessness; integrity; objectivity; accountability; openness; honesty; and leadership.

These characteristics have been defined as the responsibilities of holders of public office.[96]

There are however, various levels of accountability to which NPOs are subjected, such as:-

(a) Statutory Accountability

Effective governance which complies with all relevant statutes and regulations and best practice guidelines reduces the risk of fraud, negligence and other misbehaviours which have caused failures of many organisations.[97]

Most NPOS have been established for specified objectives which are outlined in the documents of incorporation. NPOs are accountable to their stakeholders to deliver directly or indirectly services to the public (nationally or internationally), to incur limited expenditure for specified purposes. They are required to ensure that appropriate systems are in place to prevent them exceeding their powers or functions and encourage them to comply with any obligations imposed on them, whether by statute, regulations or best practice guidelines.[98]

Social and environmental matters (e.g. the changing economy, generational interests) should be considered in the interests of fairness.[99]

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[96] Cornforth, C. p.4

[97] Public Sector Study 13, para 137

[98] Public Sector Study 13, para. 138

[99] Ibid

Consequently, the governing bodies of NPOs should supply senior executives with specific responsibility to make sure that correct advice is given to them in order that they (the governing body) comply with their obligations.[100]

Additionally, these governing bodies should set up pro-active systems to deal with anticipated events as well as post-incident action, to avoid the incidences of possible breaches of the law.[101]

(b) Public spending

Public money is money used to advance economic and social objectives for the welfare of the general public. Therefore NPOs are accountable to the general public for the money spent on delivery of these objectives and implementation of the policies.[102]

Appropriate arrangements must be put in place to safeguard public funds and resources which are to be "used economically, efficiently and effective, with due propriety and with the statutory or other authorities that govern their use".[103]

(c) Public Accountability

NPOs are stewards of both the assets and funds assigned to them. Therefore they are accountable to the general public for financial expenditure and any liabilities incurred in the delivery of their objectives, how the system is run and the quality of services they deliver.[104]

By establishing an effective framework of internal control they are able to satisfactorily discharge their responsibility of "timely, objective, balanced" and unambiguous reporting to

[100] Ibid, para. 139

[101] Ibid, para. 140

[102] Ibid, para. 143

[103] Ibid, para. 141

[104] Public Sector Study 13, para. 144

beneficiaries and others with vested interests.[105] Therefore, the governing body of NPOs must delegate to senior executives clear accountability to ensure correct advice is provided to them on all financial matters, the keeping of accurate financial records and accounts, and for maintaining an efficient mechanism of financial management.[106]

The board acts as a group in the interests of its members and not individually. Statements made by individual board members lack legal authority. The exception is where an individual board member contributes to the final board product. It is the board as a whole which has authority, e.g. passing an official motion at a meeting which has been properly constituted. It speaks on behalf of the board with one voice. Board decisions can only be changed collectively by the board, not by individual board members.

Transparency

A study carried out in the European Union[107] recently, assessed the primary public and self-regulatory initiatives of NPOs in relation to transparency and accountability across 27 member states. Although the study was aimed at improving transparency and accountability in order to address the risk of NPOs being used as a channel for terrorist financing, the findings are relevant. The study assessed the various strategies across the member states and identified the practices that have proven effective, with a view of sharing best practices.[108] The most common trend identified was the endorsement of both accountability and transparency.[109] The study identified more than 140 "self-regulatory and public regulations initiatives.[110] The standards, that regulators impose takes various forms,

[105] Ibid, para. 145

[106] Ibid, para. 146

[107] Study on Recent Public and Self-Regulatory Initiatives Improving Transparency and Accountability of Non-Profit Organisations in the European Union, commissioned by the European Commission's Directorate-General Justice, Freedom and Security of the European Commission, April 2009

[108] Ibid, p.7

[109] Ibid, p.5

[110] Ibid, p.8

however, in most cases they are enshrined in laws, accompanied by "legal obligation", ensuring they are met[111]. In addition to setting minimum standards most regulators also have in place measures ensuring those standards are continually met. There are systems in place across Europe to encourage greater transparency. Within the non-profit sector much more has been done than in the profit making sector.

In NPOs, transparency is more easily achievable because they are required to commit unequivocally to openness and transparency regarding all their activities. The only exception is in circumstances where there is a need to preserve confidentiality.[112]

One of the NPOs greatest strengths can be attributed to the fact that their decisions are not driven by profit, but by fulfilment of the public benefit objective(s).

The table below highlights some comparables in governance between NPOs and PMOs.

	Profit	**Non-Profit**
Structure	**Commercial Enterprise**	**Public Bodies**
Primary Objective	**Profit maximisation**	**Public benefit**
Democracy	**Limited**	**Possible**
Accountability	**To Shareholders (limited)**	**Disperse (possible)**
Fairness	**Fair**	**Fair**
Transparency	**Limited**	**Possible**

[111] Ibid
[112] Study on Recent Public and Self-Regulatory Initiatives

Conclusion

Although in many ways there are striking similarities in the governance boards of PMOs and NPOs, there are also marked differences. The objective of PMOs is profit maximisation whereas NPOs is that of public benefit. In applying the various principles of corporate governance, i.e. democracy, accountability, fairness and transparency, democracy is limited within PMOs because of the lack of motivation on institutional shareholders to actively participate in the governance process.

The area of accountability raises many concerns, including the board's accountability to its shareholders which may result in conflict of interest.

On the other hand, there are greater levels of accountability in NPOs because of the different stakeholders compared to PMOs who are only accountable to their shareholders.

Based on the objectives of NPOs compared with their counterparts, it could be argued that the former's success is measured differently from the latter and their decisions are not usually profit-driven. Their judgement is not clouded by focussing on profits; therefore NPOs do not have to compromise their standards. As long as the focus of PMOs is solely driven by profit maximisation they may never effectively implement corporate governance because there may be a tendency to compromise their standards.

Corporate governance is not an absolute concept. It does not have all the answers. The board alone cannot effectively implement corporate governance. There is a requirement for other stakeholders to be involved in the process, otherwise we will continue to see corporate failures.

For PMOs to successfully implement corporate governance requires a move away from the traditional organisational structure to the apparently successful horizontal structure in place at John Lewis where other stakeholders, mainly, employees play a more active role corporate governance.

The Board of PMOs, though they have the necessary skills and expertise, yet we still see high profile collapses and disasters of corporations. The Board of NPOs on the other hand lack the necessary skills and yet they perform adequately well. Provided the boards of NPOs are “enlightened” i.e. possess the necessary training skill and expertise then they would be able to implement corporate governance.

Chapter 3

Corporate Governance in Practice

3.1 Introduction

Chapter 2 examined some of the similarities and differences in governance in both sectors. It also looked at some of the difficulties faced by PMOs in implementing corporate governance.

This chapter examines corporate governance in practice by looking at examples of departures from corporate governance within the financial sector, namely, Enron Corp, WorldCom and Barings Bank. It will consider arguments to support why implementation of corporate governance may be possible by public entities and NPOs and the role of public awareness.

While corporate governance failures are said to occur mainly in the banking sector, scandals due to governance failures have been reported within the commercial sectors among large organisations. Reasons attributed to the failures include: fraudulent conduct, mismanagement, accounting irregularities and selfish ambitions among boards. The extent to which failures in corporate governance played a role in the current financial crisis is inconclusive; however, what is certain is that the issue of corporate governance has been brought to the fore as a result of the recent financial crisis.

The importance of good corporate governance is fundamental in order to gain and maintain confidence in the entire banking system. Conversely, inadequate corporate governance may result in a bank's failure leading to much wider macroeconomic repercussions, such as the risk of contagion.

The recent global economic crisis of 2007/2008 saw large scale failures of many well-known companies (including banks) in the UK, and also worldwide in particular, the US. This negatively affected customer confidence which had a disastrous effect on the economic community as can be seen from the recent economic crisis.

On the face of it, it would appear that the boards had complied with the relevant Codes of Corporate Governance, as confirmed by their Annual Reports. However, in the UK the HM Treasury investigation concluded that there was "widespread corporate governance failures"[113] by their boards, especially in regard to understanding and questioning their corporation's "risk management processes"[114]. This suggested that they supervised extraordinary losses which occurred as result of "excessive leverage and risk taking…"[115] amongst other things.

The view taken by the European Commission is that at the heart of the crisis was the board's failure in identifying, understanding and eventually controlling their exposure to risk.[116]

The crisis arose as a result of self-interest and "compensation-culture" mentality of the Board and its CEOs, aided and abetted by shareholders. Although previous structures were in place, these appear to be either overridden or disregarded by the board and CEOs based on incentives, which were geared to unnecessary risk-taking for the benefit of the board, fuelled by pressure from shareholders, rather than long

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[113] See HM Treasury, *Reforming **financial** markets* (July 2009), CM 7667), pp.3-4, 36

[114] Ibid

[115] Ibid

[116] European Commission, *Corporate governance in **financial** institutions and remuneration policies,* COM (2010) 284, June 2, 2010, (hereafter European Commission Green Paper), para. 3.3; see also accompanying Commission Staff Working Document, SEC (2010) 669.

term investment for its customers. Common practices particularly among large investment banks were to pay huge bonuses as incentives for short-term gain.

3.2. Examples of departures from corporate governance within the financial sector

It is widely recognised that failures in governance occurred mainly in the financial sector, in particular, the banking sector. The reasons for failures in corporations such as Enron, WorldCom, Barings Bank Lehman Brothers include, fraudulent conduct, mismanagement, accounting irregularities – i.e. dubious business ethics on the part of the Boards, management's aggressive drive for earnings and profits.

Enron Corp

A classic example of corporate governance failure is Enron Corp (Enron), formerly known as one of the most novel companies of the late 20th century. Enron is now recognised as one of the largest governance failures of the 21st century. The organisation had internal control systems; however, these were circumvented by the conflict of interest which meant executives profited at the expense of shareholders.[117]

In an apparent attempt to deceive the market by creative accounting, and cultivating the impression of greater credibility and financial liquidity than was the case; billions of shares were wiped, jobs were lost and so were savings and investments, including many pensions. Enron's attempt at manipulating the markets was exposed, and as a

[117]Enron: Corporate Failure, Market Success International Swaps and Derivatives Association 17th Annual General Meeting Berlin, 17 April 2002, available at: http://www.isda.org/whatsnew/pdf/enronfinal4121.pdf

result, the market handed out the decisive sentence against them, which was harsher than any legislation could have done. Public disclosure of their deliberate avoidance of self-regulatory systems, “partnership arrangements” and fraudulent accounting systems used resulted in a lack of confidence and their ultimate demise.

There appears to be no evidence of market failure. On the other hand, the market performed as it was meant to do, responding positively to the reputation that Enron had cultivated. Enron’s use of their reputation at first brought them the desired result.

There appears to be no evidence that the regulations which existed at the time was inadequate to resolve the issues which arose. It may well be that further legislation which increased moral responsibility may well have inadvertently increased the likelihood of company failures and market volatility.

Enron attempted to set itself up as a major player in the field of energy and in so doing, tried to avoid market regulations and bolstered its credibility through its “well-documented failures in corporate governance, accounting and disclosure.”[118] In attempting to do so, they sealed their own fate.[119]

In the case of Enron one of the US largest scandals it would appear that, prima facie, it had all the systems in place for good corporate governance, including regulatory framework, however, corporate governance was not implemented. If it was properly implemented any potential problems would have been detected at an earlier stage. Management was allowed by the board to flout the codes, accounting

[118] Enron Corporate Failure, p.4

[119] Ibid

irregularities were not dealt with by the Audit Committee and there was failure by the auditors in the performance of their duties.

The lack of transparency and accountability resulted in unethical accounting and disclosure practices which were ratified by the board and approved by auditors as a result of factors such as demands to meet quarterly forecasts and sustain share prices.

In all these companies, governance failure arose as a result of self-interest and "compensation-culture" mentality of the Board and its CEOs. The structures which were in place appeared to be either overridden or disregarded by the board and CEOs took unnecessary risks for their benefit rather than the benefit of its investors and other stakeholders. Common practices particularly among large investment banks were to pay huge bonuses as incentives for short-term gain.

2. BARINGS BANK

Barings Plc was one of the most established banks in the UK and on 26 February 1995 was pronounced bankrupt as a result of "rogue trading" activities in Singapore by one of its employees, Nick Leeson. His trading tactics was assumed to possess little or no risk exposure. In his first year of his employment with Barings, he amassed wealth of approximately 10% of the bank's profits. As a result he was placed in a position of considerable trust and had "unfettered powers" to trade on the futures market, being in charge of both booking and reporting the day's trade without supervision. This meant he was solely in charge of checking whether the records tallied. Consequently, he was able to cover his tracks, concealing the true financial status of his errors. As a result, Barings Plc, formerly the Queen's bank, lost over 1 billion dollars ($1bn.) and was sold for an embarrassing one pound (£1).

Most of the organisations which have failed, including Enron and Barings were very large corporations which appeared to have effective governance systems in place. The challenge is, when an organisation becomes so large, how does one properly implement corporate governance?

As a result of Enron Corp. three essential areas of inadequacies were identified and addressed in order to put in place a system for international public policy:

1. Prior to their collapse in January 1995, Barings was perceived as a reputable bank of good standing. Ironically, less than two months later, Receivers were appointed. Their "capital ratio" was over and above the 8 per cent required under the Basle Agreements**.** This highlighted the inadequacy of the regulatory mechanism for "capital requirements".

2. Poor systems of internal controls were insufficient to sustain the actions of its traders; and

3. Evidence revealed the lack of communication between regulators worldwide which would have in part addressed the asymmetry of information created by globalization.

As a result, a new structure was formulated by the Basle Committee, giving banks the opportunity to utilise their own models of internal risk management, with regard to their capital.[120]

[120] Sam, Bhugaloo, *Commodities Trading: Nick Leeson, Internal Controls and the Collapse of Barings Bank*, available at, http://www.tradefutures.co.uk/Nick_Leeson_Barings_Bank.pdf (accessed 13.09.2012)

A common theme highlighted after most of the failures was the inability to manage risk. Risk management is defined as: the identification, analysis, assessment, control and avoidance, minimization, or elimination of unacceptable risks.

"An organisation may use risk assumption, risk avoidance, risk retention, risk transfer, or any other strategy (or combination of strategies) in proper management of future events."[121]

Several studies on risk management were carried out prior to the collapse of many large profile organisations. It has been suggested that financial risk management systems can fail in five ways:[122]

(i) they can collapse, as is evidenced by companies such as Enron Corp, Barings Bank, WorldCom etc.

(ii) failure to utilise proper risk measurements

(iii) inability to measure the level of known risks

(iv) failure to take into account the dimension of known risks

(v) failure to manage and effectively monitor risks

Studies carried out in 2008 with 125 senior executives in the financial sector in the US revealed that roughly 72% of the participants voiced their concerns regarding the risk management practices of their own companies and its capability to comply with strategic plans.[123] Likewise, a survey conducted in 2008 by the "Economist 500 senior management" participants from worldwide top banks involved in risk

[121] http://www.businessdictionary.com/definition/risk-management.html#ixzz24zYPAYJC

[122] Gheorghe Voinea, Sorin Gabriel Anton, Lessons from the Current Financial Crisis. A Risk Management Approach, available at: www.rebs.ro/articles/pdfs/37.pdf (accessed 12.08.2012)

[123] Ibid

management highlighted flaws in risk management which added to the recent financial crisis, such as:

- flaws in risk practices and governance;
- senior executives and non-executive management lacked the appropriate level of risk experience and skills required;
- a lack of influence of the risk function;
- the manner in which risk is assessed and reported;[124]
- a culture of compensation intensely geared towards yearly profit maximisation.

WorldCom

After the discovery of considerable accounting irregularities, WorldCom, formerly the world's second largest telecommunications company, filed for bankruptcy in 2002. Many of those in management have now been prosecuted.[125]

It was found that most of the deviations from appropriate corporate conduct occurred as a result firstly, of failure by the Board of Directors to acknowledge and to pro-actively take action to counter the "culture of greed" which was found to be endemic among the company's senior executives; secondly, there was a complete failure by those responsible to discharge their fiduciary duties to shareholders; thirdly, there was a "lack of transparency" between Board of Directors and senior executives. The Bankruptcy Examiner found there was "complete breakdown of the system of

[124] Ibid

[125] "A Crisis in Corporate Governance? The WorldCom Experience" An Address By Dick Thornburgh Counsel, Kirkpatrick & Lockhart LLP Former Attorney General of the United States and Court-Appointed Examiner in the WorldCom Bankruptcy Proceedings to The Executive Forum California Institute of Technology The Athenaeum Pasadena, California Monday, March 22, 2004, available at: http://www.klgates.com/files/Publication/5ca1eda3-acd7-47e1-9431-6f0511d1e7e4/Presentation/PublicationAttachment/ee2da30a-

corporate governance".[126] The very mechanisms designed to deter unprofessional conduct were completely disregarded.

The judge presiding in the Securities and Exchange Commission (SEC) trial in New York, recorded that the organisation "overstated" its income in the region of $11 billion, its balance sheet by approximately $75 billion, resulting in losses in shares of around $250 billion. Most of these losses were felt in the retirement funds of its employees 401(k).[127]

As with Enron, WorldCom's credibility was considerably improved in the 1990s as a result of a succession of acquisitions. While on the face of it they looked successful, they were under great pressure to maintain high stock price levels, both to enhance further acquisitions and supply money-spinning backing for "executive stock options".[128] In order to do this, WorldCom had to meet the earnings projection required by Wall Street.

In 2000 the US government did not approve a proposed merger with "Sprint" and at the same time the market's interest in telecommunications was satiated. As a result, management attempted to employ "aggressive" accounting practices to augment the true financial situation. When these practices could no longer be used, management turned to false accounting entries to "make [up] the numbers" in order to maintain the earnings expectations of Wall Street. While their records reveal that they met those targets, in reality, they failed to meet the targets "11 out of 13" quarters. Their impropriety was exposed when internal auditors identified extensive unprofessional

[126] Ibid

[127] Ibid, p.5

[128] Ibid

conduct. The company finally filed for bankruptcy and criminal proceedings began against senior executives.[129]

It would appear that because of their size and apparent “success” those charged with the responsibility of governance (i.e. the board), especially the audit and compensation committee was dominated by two of WorldCom CEOs, who were more concerned with empire building. As a result, there was no due diligence on the part of the other board members and it simply became a “rubber stamp[ing]” exercise for the CEO’s decisions.[130]

An argument has been made that the apparent inability to prevent repeated failures occurred as a consequence of flaws in the structure of corporate governance in publicly traded organisations. There is a wrongly held assumption that corporate governance is an absolute concept and a panacea for bad management of organisations; that it can easily be implemented. In fact, even with corporate governance systems in place, bad management may still exist as a result of lack of implementation, e.g Enron and WorldCom.

One of the issues raised in Enron is the “external” director’s potential liability for losses incurred by the organisation. The director’s duty of oversight is an extension of the principle of duty of care. Formerly, the director’s duty of care was in connection with specific decisions made by the board which, if their judgement was impaired, they were protected by the “business judgement rule” from incurring losses resulting from bad decisions. On the other hand, the duty of oversight deals with the failure of the board to take action.

[129] Ibid, p.6

[130] Ibid, p.7

After Enron's collapse major corporate governance reforms included a proposal by the New York Stock Exchange to revise its listing standards, as a result of its Corporate Accountability and Listing Standards Committee report of 2002; and the Sarbanes-Oxley Act 2002 (SOA), which came into force on 30 July 2002 recommended that the audit committee should be responsible for hiring, compensating and supervising external directors. They should put in place procedures to deal with the organisation's accounting and audit functions. To do so, they must have the appropriate powers and resources.[131]

The SEC examined the full role of the board, including the Audit Committee, and the main focus was on the independence of the board. The recommendation was that the majority of the directors, nominating and compensation committee must be independent. A director is considered independent if there is no "significant link"[132] with the organisation.

Many of the scandals surrounding the collapse of many large companies, including Enron Corp. and WorldCom are linked together by either the eagerness of corporate managers to "inflate" financial results, either by exaggerating profits or to understate costs, by diverting company funds to the private uses of managers (i.e, to defraud the organisation).

Some famous examples of fraudulent "earnings management" are (i) WorldCom's intentional "misclassification" of as much as $11 billion in expenses as capital investments; (ii) Enron's creation of off-balance sheet partnerships to hide the company's deteriorating financial position and to enrich Enron executives. There are

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[131] Kenneth B. Davis, *The Director's Duty of Oversight – Pre-Enron; Post-Enron, Fortieth Anniversary of the Korean Commercial Code, Seoul, September 2002*

[132] This means that, neither they, nor the external auditor should have been employed by the organisation within the previous 5 years.

examples of worldwide managerial misdemeanours which raised fundamental questions about the impetus and incentives of business managers and the effectiveness of corporate governance worldwide.

Investigations within the UK highlighted three areas of concern, which are:

(a) competent boards

(b) Risk management procedures and principles

(c) Mechanisms to deal with incentives and remuneration.

The Walker Report made several recommendations, many of which have now been implemented in the UK and these underline areas where steps have been taken to reinforce governance. These are:-

1. The size, composition and qualification of boards and its members
2. The board's function and performance evaluation
3. The function of institutional shareholders; the Stewardship Code
4. The importance of risk management procedures and independence of chief risk officers
5. Remuneration practices

In the UK, the FSA, through the SIF process, assess the suitability of individuals for the roles to ensure there is a qualified functional board and senior managers. They ensure that the appointment process is "robust and rigorous". Both senior and non-executive directors who hold key positions must be technically competent in order to perform their function. Adhere to governance practices for effective functioning and be supported by skilled, strong and independent risk and control operations for which the board "provides effective oversight".[133] One criticism is that there are no set criteria for the appointment of the board of directors. Therefore, board failure could be attributed to incompetent management. One of the key problems is the appointment of boards. There are no set criteria. The objectivity and independence required for effective boards appear to be lacking.

An effective board is one that has a clear understanding of its business model, understands and focuses on its risks while at the same time being able to "challenge the executive on the execution of its strategic plan."[134] The Chairman role is to formulate a board that has the relevant technical skills and competence. There must be a balance with particular focus on the material risks.

3.3 Why implementation of corporate governance may be possible by public entities and non-profits organisations

In an interview with Dr Barker, of the Institute of Directors, he gave two reasons why he did not believe NPOs implemented corporate governance better than their counterparts: (i) NPOs have only recently started developing Codes of Best Practices geared specifically for that sector and (ii) boards within that sector lacked the necessary professionalism and training.

If NPOs were apparently operating well without the implementation of the Codes of Conduct without failures that is argument to support the view that NPOs are better able to implement corporate governance. Secondly, if directors are "enlightened" i.e. receive the necessary training, then they will effectively implement corporate

[133] Speech by Hector Sants, Chief Executive FSA at Merchant Taylors' Hall, Delivering effective corporate governance: the financial regulators role, 24 April 2012

[134] Ibid

governance. It can be argued that because NPOs' objectives are not profit-driven they may better implement corporate governance.

3.4 The role of public awareness in corporate governance

Business ethics

Corporate governance failure is a real threat to the future of every organisation and the economy at large. If corporate governance is perceived as the sum total of customs, practices, regulations and guidelines steering the way organisations are directed and controlled, then ethical business practices are the bedrock of corporate governance. Ethical standards must be implemented, observed and adhered to in order to effectively manage the interrelationships of the diverse stakeholders of organisations.

Therefore, if those responsible for implementing corporate governance i.e. the board fail to discharge their obligations or permit others to do so, the long-term consequence would mean that the rights of those connected to the organisation i.e. its employees, customers, suppliers and the community would not be protected.

The Institute of Business Ethics define business ethics as "is the application of ethical values to business behaviour". It relates to all facets of business relationship, e.g. employer and employee relationship, sellers and buyers, and accounting practices, extending over and above an organisation's legal obligations is made up of a series of discretionary judgment and conduct directed by principles.[135]

[135] Institute of Business Ethics, available at: http://www.ibe.org.uk/index.asp?upid=71&msid=12#whatbe

An organisation should be guided in the way it conducts its business affairs by its principle ethical standards and beliefs.

Corporate Social Responsibility (CSR) is the way in which organisations responds to the "social and environmental impacts of its business operations" and its chosen involvement in the welfare of the economy in which it operates, both nationally and internationally. In my opinion corporations do not necessarily owe social responsibility to society, as it is a wide concept, however, they have a duty to conduct their affairs in such a way which does not negatively impact on the society in which they operate. This can only be achieved where business is conducted ethically.

"Organisations must not only strive to be ethical, they must be seen to be ethical".[136]

An organisation applying core values such as integrity, trust and fairness are more likely to have economical lead in the marketplace. An organisation that practises good professional ethics are more likely to attract and maintain customer and employee loyalty.

One definition of business ethics is "the application of a moral code of conduct to the strategic and operational management of a business". Good corporate governance can be accomplished by implementing a set of values and best practices built firmly on sound business ethics.

While it is essential for organisations to generate profits in order to continue to exist and develop, the quest for profit maximisation must be balanced with sound ethics.

[136] Terblanche ,Nic; Leyland, Pitt; Nel, Deon; Wallstrom, Asa Corporate Governance and Business Ethics: Pictures of the Policies available at http://pure.ltu.se/portal/files/2740335/Article.pdf

There should be greater public awareness in the way PMOs conduct business. They must be more transparent in the way they operate. There should be a system in place whereby the general public can scrutinise their actions, from the way boards are appointed to financial statements. This will create a greater public awareness and increase public confidence. Public awareness is about informing the general public. PMOs do not operate in a vacuum – they are part of society and their decisions impact negative or positively on society, and as such, this information must not be shrouded in secrecy.

3.5 Conclusion

Although the OECD Principles are considered to be fairly adequate, its application is still a concern. While there are sections of the Principles which require further development e.g. supervision of remuneration systems, risk management systems, and public disclosure of voting, the Principles continue to be extremely pertinent. An apparent failure by policy makers and organisations stemmed from lack of its implementation.[137] There are calls for mandatory compliance by way of legislation and regulation, which would enable improved implementation.

There is a need to strike a balance. Legislation alone cannot resolve the flaws in corporate governance. There is a need for organisations in both sectors to be proactive in improving governance standards.

CONCLUSION

Corporate governance is important in that ultimately, it exist to hold boards and managers accountable. It enhances their ability to make sound decisions by

[137] Roger Barker, IOD

challenging management perspectives at board level. While corporate governance is not directly involved in the management of an organisation, effective governance structures have a significant role in improving the quality of management.

The different elements of corporate governance depend on whether one is referring to structures or principles of governance. In terms of structures, a key component of governance requires boards to take a reasonably independent view of what is in the organisations best interest, and conduct effective oversight of the company management, regardless of whether it is a profit-making organisation or not.

There also need to be a chain of accountability over boards. This accountability can be to other stakeholders whether they are shareholders or some other body, that effectively hold boards to account.

In terms of principles of governance, accountability and transparency in the way organisations operate must be evident at all times. There need to be an awareness of conflicts of interests. The different players involved in governance require a continued awareness of the potential for conflicts of interests, so that the ultimate interests of the organisation is not distorted in any way as have been evident in high profile failures within the commercial sector.

Corporate governance has evolved over the last 20 years, creating a more effective framework of governance although one continues to see corporate problems. There is still a long way to go. It is work in progress. There remains an ongoing flow of high profile corporate scandals and disasters; the current financial crisis highlighted a lot of problems emerging in many organisations, which could be viewed as a failure of governance.

The challenges and issues arising depend on the country, and the specific type of organisations i.e. those issues facing large listed companies are very different to those facing small private companies. What is common from the organisations looked at are: (a) lack of transparency and accountability, (b) inadequate implementation, even with the correct systems in place; (c) conflicts of interests where boards make decisions that better suits their objectives rather than the organisation.

The perception in many non-profit organisations particularly in charitable organisations is that corporate governance is at an early stage of development. This is true, especially in terms of the role of the board of directors/trustees. Another view is that there is a lack of professionalism on the board of NPOs, i.e. that board members lack the necessary professional training required to fulfil their role.

Recent efforts have been made to implement codes of governance for NPOs. Also the governance in such organisations tends to be more highly regulated. In spite of this, NPOs appear to better implement corporate governance.

Ultimately, the wider society is a stakeholder and should be regarded in some sense as a stakeholder of organisations whether they are profit-making organisations or not. Part of corporate governance is to establish the legitimacy of organisations in the eyes of society and so they are viewed by society as a whole as a reasonable organisation playing a valid role either directly or indirectly. Good governance should enhance that legitimacy. Organisations should not operate in a vacuum, fulfilling the interest of a particular group of individuals, thereby narrowing its constituency and ignore the rest of society; no organisations should operate along those lines.

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