'Does good governance require a fresh approach?'

Achieving the objective of good governance has developed through a plethora of sources, from regulation, to public policy makers, to private individuals, to working groups. Despite these developments, there is a lack of an accepted metric for measuring success for corporate governance. The result can often be a patchwork approach that is at times ill-suited to the individual needs and individual realities of each company. There are accepted standards to which corporations hold themselves. In spite of these accepted standards there exist numerous examples of hugely successful corporations who seemed too big to fail, who nonetheless did. This essay argues that these failures can be attributed largely to the gulf that exists between corporate governance as written down, and corporate governance as practiced - checklist governance vs effective governance.

One positive impact of Enron’s demise was that it highlighted the importance of corporate governance debates. Unfortunately, many people still reduce the fall of Enron to ‘accounting fraud’. This simplification, fails to paint a full picture of the plethora of factors which accounted for Enron’s failure and could provide valuable lessons to other company’s corporate governance strategies. From a corporate governance perspective, even if one takes the simplified view that the fall of Enron was totally attributable to accounting fraud, even that analysis fails to take account for the fact that what was at issue was not simple accounting fraud but accounting fraud at scale. That analysis throws up different questions in essence - how did corporate governance fail Enron and similar companies. Simply, where was good corporate governance?

This essay argues that good corporate governance should reduce corporate arrogance by encouraging the views of dissenters. To discuss this theme this essay will first consider modern examples of failed corporate governance, second will follow a discussion of a ‘too big to fail’ corporate atmosphere and finally ways in which the views of dissenters can result in good corporate governance.

1) Modern Examples of Failed Corporate Governance

Most companies are aware of the popular list of values circulated and seek to transpose them into their own corporate governance strategy. Yet, the incorporation of the ‘spirit’ of these principles, even if they did not encompass all of them verbatim would be much more valuable

---

to a company. For many, corporate governance is a system to solve the moral hazard problems business produces, and how to best deal with this through managers keeping industry accountable to shareholders. In this way suppliers of finance to corporations assure themselves of getting a return on their investment. The following quotes show that many high profile companies attest to the highest standards in pursuing good corporate governance:

“We foster this trust through transparent and responsible corporate governance, which takes the highest priority in our daily work.”

“We maintain our commitment to the best corporate governance practices. Our board of directors consists of ten people, nine of whom are independent. Our audit, nomination, and governance, finance and risk, and remuneration committees are formed exclusively of independent directors with expertise in their respective areas. Our board meets regularly without the presence of the CEO. Committees and Board conduct an annual self-assessment. Last year the attendance rate of the directors at meetings was 96%. We have a programme to introduce new directors and the continuing education for all of them. We have a risk committee, an independent chief risk officer and the highest standards of risk management at all levels of the company. Our internal controls are adequate, as certified by independent auditors. We have incentive plans based on stocks to promote greater alignment of interests of our executives.”

“We want to be proud of Enron and to know that it enjoys a reputation for fairness and honesty and that it is respected.”

What is of note is not what these statements espouse as to what is good governance, but rather the practical working reality of the businesses who apparently held themselves to these standards. The first of these quotes appears from Volkswagen’s Corporate Governance guide, the second quote from Lehman Brothers’ 2007 Annual Report and the final quote from Enron’s Ethics Handbook 2000. The question is, when corporate governance strategies seem clear, where does it all go wrong? The answer to this question lies in the lack of congruence between corporate governance policies as written down and corporate governance in reality.

4 Corporate Governance Policy of Volkswagen. Available at <http://www.volkswagenag.com/content/vwcorp/content/en/investor_relations/corporate_governance.html>
In essence, this failure to properly practice corporate governance lies in an absence of belief that these corporate governance values are valuable. But corporate governance is much more than system of rules; it is a philosophy of management. If companies are to exhibit truly good governance, that requires a fresh approach to corporate governance. This means not, treating corporate governance as a checklist of requirements or mere pro forma. At times accepted standards of practice can be viewed as hoops to jump through. However, some of the greatest and most widely populated corporate failures of both the 20th and 21st century can be stripped away to times where proper principles were not followed, or indeed were ignored.

2) Too Big to Fail

The reality is that often the ‘corporate governance’ objectives can seem quite aesthetically pleasing – but they do not go far beyond this.

The quote of Volkswagen cited above warrants consideration in this regard. An unanswered question at Volkswagen is what level of knowledge did members of the management boards have of the rigging of emissions tests. The 2014 report for the supervisory report claimed “the Supervisory Board was directly involved in all decisions of fundamental importance to the Group”. That might at first reading seem a worrying statement in light of recent events, however the reality is that this was probably the opposite of what was in fact happening inside Volkswagen. The issue here is that there is a direct link between poor governance and a dip in confidence in Volkswagen, resulting in significant value destruction for Volkswagen’s shareholders with a 23% drop in share price following the admission.

If one looks at some of the starkest failures of corporate governance one of the most interesting facets of the debate is this juxtaposition of corporate governance failures, and yet at some point all of the above mentioned companies, Enron, Lehman Brothers, were successes, if not giants. But the problem is that at times this success only serves to entrench an atmosphere of corporate arrogance which only further serves to cement bad practices. The sense that they cannot lose; that they are too big to fail. The problem with this sort of approach is that it is incredibly short sighted and relies more on luck than design.

---

7 Quote available at <http://www.volkswagenag.com/content/vwcorp/content/en/misc/ir/Arbeitsweise_von_Vorstand_und_Aufsichtsrat.html>

At times it can seem as though corporations increasingly view governance as a box ticking exercise. Principles tend to be viewed as restrictions rather than an integral part of the success story, instead having the status of being sterile and repetitious. A central issue is that when companies are successful there is an inherent bias towards thinking that the current business model is working and in this way is beyond criticism. The above examples demonstrate that although successful companies may seem to be running perfectly, corporate arrogance, or indeed even banal corporate satisfaction can mean that successful companies can eventually crash. This essay argues that good corporate governance requires and is indeed dependant on dissenters in order to test and develop robust governance.

3) A Fresh Approach – The Need for Dissenters

Against the backdrop of corporate governance failure often co-exists an atmosphere of corporate arrogance. Symptomatic of this is an approach to corporate governance, and in particular incentives, that is extremely short sighted. At Enron, shortly before its collapse, there was a wholly inadequate incentive scheme in place that placed its entire emphasis on contracts signed.9 The impact of an incentive scheme like this is that managers and employees’ attention is focused almost entirely on short terms results and closing deals. This will always be an essential part of successful business. But it should not be all that a company and its employees focus on. Indeed, in the case of Enron much effort was placed in earning million-dollar bonuses for investments that would later lose the company money.

The problem is that the current framework allows no room for dissonance, or at least no structured method by which it can be harnessed. Indeed, dissonance is not implemented as a fundamental part of the overall corporate ecosystem. This lack of dissonance results in an atmosphere of corporate arrogance, where companies are thought too big to fail. The way to counter this is by incorporating the views of dissenters.

Whistleblowers Welcome

It makes it virtually impossible for a board to fully satisfy its oversight obligations in the absence of real programs that encourage employees to identify risk exposures in a company.

Cases of corporate governance failure such as Enron, Lehman Brothers and Volkswagen’s emissions certificates, have significant differences. However, a common thread throughout

---

these cases is that independent directors did not have the information required to properly discharge their oversight duties even though such information was available and known by certain members of the company. This lack of knowledge results in the need for retrospective calls for information, as evidenced by Volkswagen’s November call for information from staff regarding the diesel emissions tests.\(^{10}\) These are the results of corporate governance failure and, in particular, a failure to encourage any controlled method by which dissenters could supply information that would have been in the long term interests of the company. A method by which this could have been rectified would have been through establishing a robust whistleblower system

Often independent directors of companies place heavy reliance on clean audit opinions from independent auditors; however this often means that independent directors think that this is all the information that is needed. In fact, independent sources of information would at times be the most important source of information. It is clear from the perspective of corporate governance oversight that the information available will not give a complete corporate picture if the sole information available is from the C-suite and independent auditors. Of course in the wake of several shareholder blows in the 2000s the US introduced the Sarbanes- Oxley Act of 2002 and of course in the UK the Public Interest Disclosure Act 1998 protects whistleblowers. The problem with this system is that from a legislative view it offers protection, but from a business perspective it offers no incentive. The result has been that these internal whistleblower schemes act more as an important method by which employees can anonymously report occurrences of bullying and harassment at work - but less so a method for making important disclosers as to accounting, auditing or business practices.

By way of example, against the backdrop of AIG Financial Products Divisions’ writing of subprime CDOs an individual did in fact reveal the potential risk AIG was taking. AIG executive Gene Park noticed that AIG’s Financial Products Division was insuring a significant portion of mortgaged-backed CDOs with credit scores of only 598, meaning that the average homeowner had a 4.28% likelihood of being 60 days or more late on repayment.\(^{11}\) Gene Park allegedly revealed this information to Al Frost of AIG’s Financial Products Division. However, this came to nothing. Matthew Lee of Lehman Brothers communicated in a letter to his superior Martin Kelly his concerns over accounting


improprieties at Lehman Brothers.\textsuperscript{12} There was no reply to this letter. These are examples where important information was known by employees and yet was unknown by the audit committee.

How might this information have been communicated to AIG’s or Lehman Brothers’ audit committee? Here that information might have proved valuable. The central issue is that large companies do not harness the available information of employees within the company and most importantly do not encourage it. This is not disclosure for disclosure’s sake, to satisfy some ‘moral’ standard. This is disclosure which would have actively benefited the running of these companies. It is disclosure that would have been profitable, and indeed company saving perhaps.

There are two problems with the current system. The first is that people are not incentivised to report. People should not simply be protected, they should be incentivised. Even by using the word ‘protection’ it implies the whistleblower has done something wrong which means they need to apprehend and thus be protected against virtually inevitable reprimand. Instead there should be a meaningful reward for making a disclosure. It is not simply that incentives encourage the employee to act for personal gain; it is that incentives implicitly say that the information they share is valued – and treated as such. Whistleblowing is currently viewed as something to be tolerated rather than something of benefit. The second issue is that even once a discloser is made there is no guarantee it will land on the right desk. As such this essay proposes that disclosures should be compiled and put forward to the audit committee and disclosures that are subsequently deemed valuable by the audit committee should be rewarded. This should be the imperative here. To encourage people to act in their own best interests in a way that maximises the benefit of the company.

\textit{Final Words}

The answer to good governance does not necessarily lie in writing a new code. The corporate governance principles as outlined above have ranged from the aspirational to the average. The problem has never really been what has been put into writing, the problem has been what has (or indeed has not) been put into practice.

As Jeff Bezos put it, “[i]f we had a good quarter it’s because of the work we did 3, 4, 5 years ago. It’s not because we did a good job this quarter.” Good corporate governance plays the

long game and those whose views may not be the most popular may in fact be the most beneficial for the company in the long run. Success stories may do well for a company’s ego, but they are not all that a company must hear.

Corporate governance can do better, and with significant investment, capital and jobs on the line, it must. Good governance requires a new approach, because governance has become a formality to be satisfied rather than something which can be hugely valuable. This approach would not be new, so much as governance as it should be.