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ICSA STUDENT GUIDE

Health Service Governance

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ICSA STUDY GUIDE

HEALTH SERVICE GOVERNANCE

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The Governance Institute

Contents

How to use this study guide

This guide has been developed to accompany *The ICSA Health Service Governance Handbook* for candidates following the ICSA's Chartered Secretaries Qualifying Scheme (CSQS). It sits alongside the Handbook and the syllabus for the Health Service Governance (HSG) module. The guide includes learning outcomes and a range of navigational, self-testing and illustrative features to help you get the most out of the support materials.

The Handbook is set out in five parts, each exploring key themes within the subject matter. Each part is broken into chapters, which include checklists for practitioners. These checklists provide a useful starting point for candidates to apply the learning outcomes of each chapter to their own work experiences. This study guide will outline the key learning outcomes for each part of the Handbook, then sets out 'Test your knowledge' questions and 'Stop and think' challenges.

The introduction, glossary and appendices in the Handbook contain explanations of all acronyms, governance codes and frameworks, guidance and reference materials, and key terms. Candidates should be familiar with the key aspects of these codes, frameworks and guidance as they are referred to within the Handbook. However, candidates are not required to quote sections of the codes, frameworks or guidance verbatim. Other reference material contained within the Handbook includes a glossary of key terms, a directory of further reading, web resources and a comprehensive index.

Candidates will also be required to demonstrate an understanding of the theoretical approaches to, and frameworks for, governance set out in the first section of this study guide. This background knowledge is a foundational part of the syllabus for the HSG module.

Health Service Governance aims and learning outcomes

Module outline and aims

The aim of the Health Service Governance module is to equip the company secretary with the knowledge and key skills necessary to act as adviser to boards or governing bodies across the NHS in England. The advice of the company secretary will include all aspects of the governance obligations of NHS organisations in England, covering not only legal duties, but also applicable and recommended standards of best practice.

The module enables the development of a sound understanding of health service governance principles and practices in the NHS in England. It will also enable you to support the development of good governance and stakeholder dialogue throughout the organisation, being aware of legal obligations and best practice.

Learning outcomes

On successful completion of this module, you will be able to:

- advise on governance issues across all principal types of NHS organisation, ensuring that the pursuit of strategic objectives is in line with regulatory developments and developments in best practice
- analyse and evaluate situations in which governance problems arise and provide recommendations for solutions
- apply the principles of risk management and appraise the significance of risk management for good governance
- appraise the frameworks underlying governance law and practice as they apply to the NHS in England
- assess the relationship between governance and performance within organisations
- compare the responsibilities of NHS organisations to different stakeholder groups, and advise on issues of ethical conduct and the application of principles of corporate responsibility or corporate citizenship
- demonstrate how general concepts of governance apply in a given situation or given circumstances

- distinguish between and compare the legal obligations for governance and recommended best practice
- provide authoritative and professional advice on matters of health service governance from the perspective of a company secretary.

Theoretical frameworks and approaches to health service governance

Theoretical frameworks

It is useful to consider the theoretical justification for systems of rules or guidelines on governance when understanding the underlying differences between health service governance in the NHS and corporate governance in the private sector.

There are a number of different frameworks to consider, including:

- stakeholder theory
- stewardship theory
- agency theory
- transaction cost theory
- policy governance theory
- generative governance theory.

Stakeholder theory

Stakeholder theory takes the view that the purpose of governance should be to satisfy, as far as possible, the objectives of all key stakeholders – customers, employees, the general public, the government, investors, local communities, and major suppliers and creditors. The board of directors should therefore consider the interests of all major stakeholders. However, some stakeholders are more important than others, so management should give priority to their interests above those of other stakeholder groups.

In the introduction to its principles of corporate governance, the Organization for Economic Cooperation and Development (OECD) comments that an aim of government policy (public policy) should be 'to provide firms with the incentives and discipline to minimise divergence between private and social returns and to protect the interest of stakeholders'.

The OECD Principles of Corporate Governance recognise the role and rights of stakeholders. They state that a corporate governance framework should:

- recognise the rights of stakeholders that are recognised in law or through mutual agreements
- encourage active cooperation between organisations and stakeholders in creating wealth, jobs and the sustainability of financially sound enterprises.

Stakeholder theory states that the organisation's managers should make decisions that take into consideration the interests of all stakeholders. This means trying to achieve a range of different objectives, not just for the aim of maximising the value of the organisation for its shareholders. This is because different stakeholders each have their own (different) expectations of the organisation, which the organisation's management should attempt to satisfy.

Stakeholder theory also considers the role of organisations in society and the responsibility they should have towards society as a whole. It could be argued that some organisations are so large, and their influence on society so strong, that they should be accountable to the public for what they do. The general public are taxpayers; as such, they provide the economic and social infrastructure within which organisations are allowed to operate. In return, organisations should be expected to be 'corporate citizens', acting in ways that benefit society as a whole. This aspect of stakeholder theory is consistent with the arguments in favour of corporate social responsibility (CSR).

Agency theory

Agency theory is based on the separation of ownership and control in an organisation – namely, the ownership of an organisation by its shareholders and the control over the organisation's actions by its directors and senior executives.

The agency relationship is a form of contract between an organisation's owners and its managers, where the owners (as principals) appoint an agent (the managers) to manage the organisation on their behalf. As part of this arrangement, the owners must delegate decision-making authority to the management. This gives rise to an inherent conflict of interest between the organisation's owners and managers.

- The owners (shareholders) want to increase their income and wealth over the long term. The value of their shares depends on the long-term financial prospects for the organisation. Shareholders are therefore concerned not only about short-term profits and dividends; they are even more concerned about long-term profitability.
- The managers run the organisation on behalf of the shareholders. They have an employment contract and earn a salary. If they do not own shares in the organisation, managers have no direct interest in future returns for shareholders or in the value of the shares. Unless they own shares, or unless their remuneration is linked to profits or share values, their main interests are likely to be the size of their remuneration package and their status within the organisation.

Ideally, the 'agency contract' between the owners and the managers of an organisation should ensure that the managers always act in the best interests of the owners. However, it is impossible to arrange the 'perfect' contract because any decisions managers make affect their personal welfare as well as the interests of the owners.

Agency conflicts are differences in the interests of owners and managers. They arise in several ways:

- **Moral hazard**: a manager has an interest in receiving benefits from his position in the organisation. These include all the benefits that come from status, such as a car, use of a plane, a house or flat, attendance at sponsored sporting events, and so on. A manager's incentive to obtain these benefits is higher when he has no shares, or only a few shares, in the organisation. For example, senior managers may pursue a strategy of growth through acquisitions, in order to gain more power and 'earn' higher remuneration, even though takeovers might not be in the best interests of the organisation and its shareholders.
- **Level of effort:** managers may work less hard than they would if they were the owners of the organisation. The effect of this lack of effort could be smaller profits and a lower share price.
- **Earnings retention**: the remuneration of directors and senior managers is often related to the size of the organisation (measured by annual sales revenue and value of assets) rather than its profits. This gives managers an incentive to increase the size of the organisation, rather than to increase the returns to the organisation's shareholders. Management are more likely to want to reinvest profits in order to expand the organisation, rather than pay out the profits as dividends. When this happens, organisations might invest in capital investment projects where the expected profitability is quite small, or propose high-priced takeover bids for other organisations in order to build a bigger corporate empire.
- **Time horizon:** shareholders are concerned about the long-term financial prospects of their organisation, because the value of their shares depends on expectations for the long-term future. In contrast, managers might only be interested in the short term. This is partly because they might receive annual bonuses based on short-term performance, and partly because they might not expect to be with the organisation for more than a few years.

Agency costs are the costs of having an agent make decisions on behalf of a principal. In the context of corporate governance, agency costs are:

- the costs of monitoring the actions and performance of management to ensure that management is acting in their best interests
- bonding costs that may be incurred in providing incentives to managers to act in the best interests of the shareholders (such as remuneration packages)
- residual losses, or the cost to the shareholder which occurs when managers take decisions that are not in the best interests of the shareholders but are in the interests of the managers themselves (such as when managers pay too much for a large acquisition).

The key elements of agency theory

Agency theory is based on the view that the system of corporate governance should be designed to minimise the agency problem and reduce agency costs. One approach to reducing the agency problem is to make the board of directors more effective at monitoring the decisions of the executive management. Another approach is to design schemes of remuneration for directors and senior managers that bring their interests more into line with those of the shareholders.

Agents should also be accountable to their principals for their decisions and actions. Accountability means reporting back to the principals and giving an account of what has been achieved, and the principal having power to reward or punish an agent for good or bad performance. Greater accountability should reduce the agency problem, because it provides management with a greater incentive (obtaining rewards/avoiding punishments) to achieve performance levels that are in the best interests of the shareholders.

Agency theory may therefore be summarised as follows.

- In large companies, there is a separation of ownership from control. Professional managers are appointed to act as agents for the owners of the organisation.
- Individuals are driven by self-interest.
- Conflicts of self-interest arise between shareholders and managers.
- Managers, because they are driven by self-interest, cannot be relied on to act in the best interests of the shareholders. This creates problems in the agency relationship between shareholders and management.
- These agency problems create costs for the shareholders.
- The aim should be to minimise these costs, by improving the monitoring of management and/or providing management with incentives to bring their interests closer to those of the shareholders.

Stewardship theory

Stewardship theory has its roots in psychology and sociology. It is concerned with the behaviour of executives and directors who act as stewards to protect and maximise shareholders' wealth: in so doing, the stewards maximise their own potential. In this theory, stewards are executives and directors within an organisation, working for the shareholders, who protect and make profits for the shareholders. Unlike agency theory, stewardship theory stresses not the perspective of individualism, but rather the role of top management acting as stewards, integrating their goals as part of the organisation. The stewardship theory suggests that stewards are satisfied and motivated when organisational success is attained.

This theory also sees the need to engage with a range of interests but prioritises a positive connection between public bodies and civil society. The key role of those who govern is to create a framework of shared values, then to engage with key stakeholders and a suitably skilled and autonomous workforce – all of whom benefit from helping the organisation to achieve its goals.

Whereas agency theory assumes that being a manager or employee suppresses an individual's own aspirations, stewardship theory requires organisational structures that empower the steward and offers maximum autonomy built on trust. It stresses the position of employees or executives to act more autonomously so that the shareholders' returns are maximised.

Stewardship theory can also be seen in the behaviour of executives and directors when decisions are made to maximise financial performance, as well as shareholders' profits, in order to protect their reputations as decision-makers in organisations. In other words, executives and directors are also managing their careers in order to be seen as effective stewards of their organisation.

Transaction cost theory

Transaction cost theory provides a different basis for explaining the relationship between the owners of an organisation and its management. Although it is an economic theory, it attempts to explain companies not just as economic units, but as organisations consisting of people with differing views and objectives.

The operations of an organisation can be performed either through market transactions or by carrying out work in-house. For example, an organisation could obtain its raw materials from an external supplier or it could make the materials itself. Similarly, an organisation could hire self-employed contractors to carry out activities or it could hire full-time employees. In economic terms, a firm's decision about whether to arrange transactions in the open market or whether to do the work in-house (itself) should depend on which is cheaper. When a firm does work in-house, it needs a management structure and a hierarchy of authority with senior management at the top. According to transaction cost theory, the structure of a firm and the relationship between the owners of a firm and its management depends on the extent to which transactions are performed in-house.

Total costs are defined as the sum of production costs and transaction costs.

- Production costs are the costs that would be incurred by the organisation in an ideal economic market. In an ideal economic market, production costs are minimised.
- Transaction costs are additional costs incurred whenever the perfect economic market is not achieved. For example, an organisation might buy goods from a supplier who is not the cheapest available, because it is not aware of the existence of the cheapest supplier. An organisation might sell goods on credit to a customer, not knowing that money owed will become a bad debt.

Transaction costs are sometimes higher when a transaction is arranged in the market, and sometimes higher when the transaction is carried out in-house. Carrying out activities in-house rather than arranging contracts externally is referred to as vertical integration. Total costs are minimised when transaction costs are minimised. This should determine the optimal size of the firm and the size of the management hierarchy in the firm.

The way in which an organisation is organised, and the extent to which it is vertically integrated, also affect the control the organisation has over its transactions. As a general rule, it is in the interests of an organisation's management to carry out transactions internally, rather than in the external market. Performing transactions internally:

- removes the risks and uncertainties about prices of products and product quality
- removes all the risks and costs of dealing with external suppliers.

Traditional economic theory is based on the assumptions that all behaviour is rational and that profit maximisation is the rational objective of all businesses. Transaction cost economics changes these assumptions by attempting to allow for human behaviour and the fact that individuals do not always act rationally. The theory is based on two assumptions about behaviour:

- bounded rationality
- opportunism.

Bounded rationality

Human beings act rationally, but only within certain limits of understanding. For example, the managers of an organisation will, in theory, act rationally in seeking to maximise the value of the organisation for its shareholders, but their bounded rationality might make them act differently.

Business is very complex, and large businesses are much more complex than small businesses. However, in any business, there is a limit to the amount of information that individuals can remember, understand and deal with. No one is capable of assessing all the possible courses of action and no one can anticipate what will happen in the future. In a competitive market, no one can anticipate with certainty what competitors will do.

Playing chess has been used as an example of bounded rationality. The game is very complex and there are many different possible moves. The actions of the opponent in a game of chess cannot be predicted, so it is impossible to predict what the opponent will do in response to a particular move. The same problem applies to managing an organisation. It is impossible to predict with certainty what will happen, because there are too many factors and too many possibilities to consider.

When individuals reach the boundaries of their understanding because a situation is too complex or too uncertain, there is a greater tendency to carry out transactions in-house and to have vertical integration.

Opportunism

Transaction cost theory also assumes that individuals will act in a self-interested way and 'with guile'. They will not always be honest and truthful about their intentions. Opportunism is defined as 'an effort to realise individual gains through a lack of candour or honesty in transactions'. For example, an individual might try to take advantage of an opportunity to gain a benefit at the expense of someone else.

Managers are opportunistic by nature. Given the opportunity, they will take advantage of any way of improving their own benefits and privileges. A problem with opportunism is that external parties (such as contractors and suppliers) cannot always be trusted to act honestly. As a result, there may be a tendency for an organisation to carry out transactions itself, rather than to rely on external suppliers.

However, there is also a risk that by taking control of transactions internally, managers will have opportunities to take decisions and actions that are in their personal interests. This self-interested behaviour needs to be controlled. In this respect, transaction cost theory has similarities with agency theory. Although they are based on different assumptions, both agency theory and transaction cost theory support the need for controls over corporate governance.

Policy governance theory

Policy governance theory sharply distinguishes between the role of 'owners' (the local public in the context of the public service) and 'operators' (those who deliver the service).

According to John Carver, this theory sees boards act as 'owner representatives' who set objectives but fully delegate the running of the organisation to operators through the chief executive as the main point of contact. A framework of policies limits the freedom of the management, ensuring that the effectiveness of an activity is not prioritised over its being ethical or prudent.

Under this theory, good governance will enable the board (owner representatives) to:

- cradle the vision and explicitly address fundamental values
- force an external focus
- enable an outcome-driven organising system
- force forward thinking
- enable proactivity
- facilitate diversity and unity in board composition and opinion
- describe relationships to relevant constituencies
- delineate the board's role in common topics (ensuring the board's specific contribution to any topic is clear)
- determine what information is needed
- balance over-control and under-control.

Generative governance theory

A new approach has recently emerged from the experience of not-for-profit boards in the US, described by Richard Chait, William Ryan and Barbara Taylor as 'governance as leadership' or generative governance. They set out three modes in which the board should be effective: fiduciary, strategic and generative. The main contribution of this tri-modal model is to emphasise the role of 'generative thinking' in producing a sense of what knowledge, information and data mean. This requires an active process of dialogue and engagement between the board, staff and service users.

The fiduciary mode is where boards are concerned primarily with the stewardship of tangible assets that makes up the core of governance. The fiduciary work is intended to ensure that nonprofit organisations are faithful to their mission, accountable for performance, and compliant with the relevant laws and regulations. Without this, the organisation, including its stakeholders, could be harmed.

The strategic mode is where boards develop strategy with management to set the organisation's priorities and course, and to deploy resources accordingly. Without this, there is little power or influence and governance would primarily be about staying on course rather than setting the course.

The generative mode, is where boards, along with executives, frame problems and make sense of ambiguous situations – which in turn shapes the organisation's strategies, plans and decisions.

This theory of governance claims that most organisations lack the frameworks and practices for this work.

Approaches to governance

There has been considerable debate about what the objectives of sound corporate governance should be. The different views can be divided into broad approaches:

- the shareholder value or owner approach
- the stakeholder approach, also called the stakeholder-inclusive approach or pluralist approach
- the enlightened shareholder approach
- an integrated approach, as recommended by the King Report (a report on recommended corporate governance practice for South Africa).

There are other approaches for governance in not-for-profit organisations, which should also be considered:

- the policy governance approach
- the governance as leadership approach.

While corporate governance may be restricted by company law, which underpins the primary role of shareholders as key stakeholders, there are nevertheless some points of interest that would frame a wider remit for corporate governance. All of these broad approaches can be considered in respect of health service governance. Indeed, no one approach should be seen as providing the only approach to governance. It is more likely that the interplay of a number of these approaches will frame the development of good health service governance that is not bound by the company legislation that enshrines the legal rights of shareholders.

Shareholder value approach

The shareholder value or owner approach is the well-established view for corporate governance, supported by company law in advanced economies, that the board of directors should govern their organisation in the best interests of its owners (the shareholders).

The main objective of an organisation should be to maximise the wealth of its shareholders in the form of share price growth and dividend payments, subject to conforming to the rules of society as embodied in laws and customs. The directors should be accountable to the shareholders, who should have the power to remove them from office if their performance is inadequate. The shareholder view is closely linked to agency theory or transaction cost theory.

The OECD, in the introduction to its Principles of Corporate Governance, states that, from an organisation's perspective, corporate governance is about 'maximising value subject to meeting the corporation's financial and other legal and contractual obligations'.

It adds: 'This inclusive definition stresses the need for boards of directors to balance the interests of shareholders with those of other stakeholders in order to achieve long-term sustained value.'

The strength of this approach to corporate governance is its general acceptance. Many people hold the view that public companies are in business to earn profits for the benefit of their shareholders. Successful companies are perceived as those that pay dividends to shareholders and whose share price goes up. Within the broad objective of maximising shareholder values, the board of directors will also act fairly in the interests of employees, customers, suppliers and others with an interest in the organisation's affairs.

Despite its wide acceptance within corporate governance, this approach is of limited application within health service governance. As has already been established in this text, the role played by the shareholder or financial stakeholder is very limited within the NHS.

Stakeholder approach (pluralist approach)

An alternative approach is based on stakeholder theory. This argues that the aim of sound corporate governance is not just to meet the objectives of shareholders, but also to have regard for the interests of other individuals and groups with a stake in the organisation – including the public at large. This resonates more widely with health advice governance, where the objectives of NHS organisations are influenced by a wide-ranging variety of stakeholders.

From a 'stakeholder view', governance is concerned with achieving a balance between economic and social goals and between individual and communal goals. Sound governance should recognise the economic imperatives organisations face in competitive markets and should encourage the efficient use of resources through sound investment. It should also require accountability from the board of directors to the stakeholders for the stewardship of those resources. Within this framework, the aim should be to recognise the interests of other individuals, companies and society at large in the decisions and activities of the organisation.

A problem with the stakeholder approach for corporate governance is that company law gives certain rights to shareholders, as well as placing legal duties on the board of directors towards their organisation. However, the interests of other stakeholders are not reinforced to any great extent by company law. The stakeholder approach expects that cooperative and productive relationships will be optimised only if the directors are permitted or required to balance shareholder interests with the interests of other stakeholders who are committed to the organisation. For the approach to be more applicable to corporate governance, then changes in company law would be required to introduce such an approach in practice.

This approach is also limited in its application to health service governance as the concept of competitive markets is limited within the NHS. While there is an increasing emphasis on a market economy within healthcare, this is still limited in reality. The concept of individual goals for stakeholders is also tempered by the overriding objective of the NHS to provide healthcare at the point of need for all.

A further distinction for health service governance is that the rights of other stakeholders, such as employees, suppliers and the general public, although not well protected by company law, are protected by health law (such as the Freedom of Information Act and the NHS Constitution) as well as other aspects of law, such as employment law, health and safety legislation and environmental law.

Enlightened shareholder approach

The enlightened shareholder approach to corporate governance says that the directors of an organisation should pursue the interests of their shareholders, but in an enlightened and inclusive way. It is a form of compromise between the agency view and the stakeholder view.

The directors should look to the long term, not just the short term, and they should also have regard to the interests of other stakeholders in the organisation, not just the shareholders. Managers should be aware of the need to create and maintain productive relationships with a range of stakeholders having an interest in their organisation.

A criticism of the enlightened shareholder view is that most shareholders do not fit the image of enlightened investors. Most shares in public companies are owned by institutional investors, who themselves may be relatively unaccountable to their beneficiaries. When companies become a target for a takeover bid, speculative investors such as hedge funds may acquire large but short-term shareholdings, with a view to making a quick profit from their investment. However, the role of institutional investors in corporate governance is likely to evolve in the future, with institutions expected to be more proactive in promoting the rights and interests of shareholders.

This approach is of greater application to health service governance as it does address the need to balance the competing needs of the different stakeholders. Its limitation, however, is in its lack of clarity on how to balance diverse and/or differing stakeholder interests. This is still largely a shareholder-driven approach to governance and is limited in its application to health service governance.

The King Code: an integrated approach

The King Code or King Report was first introduced in 1994 and was developed by the Institute of Directors in South Africa. A revised Code (King II) was published in 2004, with a further revision (King III) published in 2009. King III (and King II before it) rejected an enlightened shareholder approach to governance in favour of a 'stakeholder-inclusive' approach.

This approach is explained in some detail in the introduction to King III. The enlightened shareholder model and the stakeholder-inclusive model both take the view that the board of directors should consider the interests and expectations of stakeholders other than shareholders; however, the two models differ significantly in their emphasis.

- In the 'enlightened shareholder' approach, the legitimate interests and expectations of stakeholders only have an instrumental value. Stakeholders are only considered in as far as it would be in the interests of shareholders to do so.
- In the case of the 'stakeholder-inclusive' approach, the board of directors considers the legitimate interests and expectations of stakeholders on the basis that this is in the best interests of the organisation, and not merely as an instrument to serve the interests of the shareholder.

The King Code, therefore, states that a board of directors should consider what is best for the organisation; in doing so, it should have regard to the legitimate interests and expectations of all stakeholders. It should then integrate these, or decide how they should be traded off against each other, on a case-by-case basis, with the aim of making decisions that are in the best interests of the organisation.

The shareholder does not have any predetermined precedence over other stakeholders. The 'best interests of the organisation' are defined not in terms of maximising shareholder wealth, but 'within the parameters of the organisation as a sustainable enterprise and the organisation as a corporate citizen'.

Policy governance approach

The policy governance approach requires a clear direction from boards in setting the objectives of the organisation. These objectives need to be established in direct correlation with the wishes of the owners (or beneficiaries) of the organisation. Having established clear objectives, the board then fully delegates the running of the organisation to the management team via the chief executive as the main point of contact.

This form of governance can be seen clearly in charitable trusts where the trustees act as the representatives of the owners, and the chief executive is held to account at the board meetings of the trustees. In this approach, it would be unusual for members of the management team to also act as a trustee. The trustees are responsible for establishing a framework of policies within which the chief executive and their management team operate, ensuring that the effectiveness of an activity is not prioritised over its being ethical or prudent.

This approach has been adopted by some foundation trusts within the NHS, although they differ from the trustee model outlined earlier in that their executive directors are also voting members of the foundation trust board. One of the advantages of this approach is the direct focus on the objectives of the organisation with a clear set of policies within which the chief executive and team may operate. The success or otherwise of this approach for health service governance lies in the extent to which the board can define the objectives for the organisation and balance the competing interests of the diverse variety of the stakeholders.

The governance as leadership approach

The governance as leadership or 'generative' approach relies on the interplay of three key roles for boards. This requires an active process of dialogue and engagement between the board, staff and service users.

The approach requires boards to understand their stewardship role in respect of the public assets of their organisation, to be accountable for performance and to ensure compliance with the relevant laws and regulations. At the same time, boards need to work with the executive management to set the organisation's priorities for the future and to deploy resources accordingly. None of this seems significantly different to the approaches already outlined and relies on the key relationship between the board and the executive management team.

The final aspect to this approach is what distinguishes it from the others, however, and relies on sharing knowledge, experiences, information and the analysis of organisational data. This final role for the board is to lead, along with executives, on framing problems and making sense of ambiguous situations – which in turn shapes the organisation's strategies, plans and decisions. This third role is of significant importance for health service governance as it provides an opportunity to manage the competing interests of a diverse stakeholder base.

Conclusions

Governance can be defined as a system that allows organisations to be effective in the delivery of their strategic objectives.

In order to understand the underlying differences between health service governance in the NHS and corporate governance in the private sector it is useful to consider the theoretical justification for a system of rules or guidelines on governance.

There are different approaches to corporate governance, which vary according to the extent to which the interests of stakeholders other than the organisation shareholders are recognised. The differing approaches may be summarised as a shareholder approach, an enlightened shareholder or inclusive approach, and a stakeholder or pluralist approach. The approach taken by the directors of an organisation affects decision-making at a strategic level.

A stakeholder in an organisation is someone who has an interest or 'stake' in it, and is affected by what the organisation does. A stakeholder, in turn, has an influence on what the organisation does. Each stakeholder or stakeholder group may expect the organisation to behave or act in a particular way with regard to the stakeholders' interests. A stakeholder can also expect to have some say in some of the decisions an organisation makes and some of the actions it takes.

The importance of good governance is often only highlighted in circumstances where an organisation has failed or is in crisis. It is often seen in organisations where there is a wide separation between stakeholder interests and management. For example, the separation between NHS stakeholders and Parliament is vast; it is only through the health service governance regimes of the individual parts of the NHS that stakeholders can exercise the relatively limited powers they have to hold the boards of directors to account.

Learning outcomes

- Explain the different approaches to governance, which vary according to the extent to which the interests of stakeholders other than the company shareholders are recognised.
- Define who a stakeholder is and how they influence the organisation.

Test your knowledge

a. Name the different theoretical frameworks of governance outlined in this text.
b. Which theories are more relevant to health service governance?
c. In agency theory, what are agency costs and what are the three main elements?
d. Why is this theory an appropriate framework for corporate governance?
e. What controls are there within the NHS to manage opportunism?
f. Who are the 'owner representatives' in the policy governance theory?
g. Name the different stakeholders that are specific to health service governance.

h. How are these different to the stakeholders that are specific to corporate governance?
i. Why is the board also classed as a stakeholder?
j. Which approaches to governance are most applicable to health service governance?
k. What will limit the integrated approach of the King Code in its application to corporate governance?

Stop and think

Do you agree with the view that a board of directors should give more consideration to the interests of other NHS stakeholders rather than individual third sector groups? Give your reasons.

Part 1

The governance landscape

Learning outcomes

Part one should enable you to:

- understand the basic principles of governance and the development of corporate governance
- understand the specific dynamics that apply to health service governance within the NHS
- discuss the underlying differences between governance in the NHS and the wider corporate commercial world
- describe the key aspects of the NHS Constitution and their relevance to health service governance
- distinguish between and compare the legal obligations for governance and recommended best practice
- understand the current NHS governance structures and their implications for best practice
- understand that health service governance is key to ensuring that there is effective leadership, responsible stewardship of public assets and services and public accountability
- define governance as a system that allows organisations to be effective in the delivery of their strategic objectives
- consider the impact for organisations where the separation between stakeholder interests and management is wider, particularly in relation to the NHS
- identify the underlying differences between health service governance in the NHS and corporate governance
- understand the interplay of regulation and voluntary codes of governance
- explain the difference between 'comply or explain' and 'apply or explain' regimes
- identify the key voluntary codes that apply to health service governance
- identify the key voluntary codes from corporate governance that underpin health service governance.

Chapter 1: Definitions and issues in governance

Test your knowledge

1.1 Why is health service governance challenging for NHS organisations?
1.2 What is the difference between governance and management?
1.3 What are the 'overarching corporate governance principles'?
1.4 How can accountability for an NHS organisation be measured?
1.5 What is accountability? What is transparency in governance, and why is it a feature of good governance practice?
1.6 How did the Cadbury Code define corporate governance?
1.7 What is the 'comply or explain rule' in corporate governance?
1.8 What are Nolan's Seven Principles of Public Life, and how do they compare to the NHS Board Standards?
1.9 What are the arguments in favour of and against the application of governance codes of practice?

Stop and think

From what you have read or heard in news reports, identify a recent example of pressures for better corporate governance that is bringing about changes in a company's management, policies or practices.

What challenges or opportunities might such improvements bring to an NHS organisation?

Chapter 2: The NHS landscape

Test your knowledge

2.1 What are the guiding principles of the NHS?
2.2 What have been some of the key reforms introduced by the Francis Report?
2.3 How would you define health service governance, and what are the common aspects of poor governance?
2.4 How does health service governance differ from corporate governance? Why is good governance particularly crucial within the NHS?

2.5 The NHS Constitution enshrines a variety of objectives, rights, responsibilities and principles. What changes have been introduced following the Francis Report?
2.6 What is the difference between rights and pledges as set out in the NHS Constitution?
2.7 What does the Statement of Accountability describe?
2.8 What is the difference between primary and secondary care?
2.9 Describe the role of NHS England and clinical commissioning groups? How do they inter-relate?
2.10 What is the NHS Mandate?
2.11 How have the duties of local authorities changed since April 2013?
2.12 What is the main aim of Health and Wellbeing Boards?
2.13 Who are the key regulators within the NHS?
2.14 What is Monitor's role under the Health and Social Care Act 2012 (HSCA)?
2.15 Explain the key aspects of the special measures regime.

Stop and think

What are the significant governance risks posed by the latest NHS governance structure?

Give six examples of bad governance practice. Include both NHS organisations and other corporate bodies.

Chapter 3: The law and other regulatory frameworks

Test your knowledge

3.1 What key pieces of legislation regulate health service governance in the NHS?
3.2 What changes were introduced to patient and public involvement as a result of HSCA 2012?
3.3 What are the remedies available for a judicial review of a failure to involve?
3.4 How does the Public Interest Disclosure Act 1998 (PIDA 1998) work alongside the whistleblowing process in an NHS organisation?
3.5 What is the relevance of the law on freedom of information to health service governance?

3.6 How can organisations best protect themselves against claims under the Bribery Act 2010?
3.7 What aspects of corporate governance are regulated by company law (the Companies Act 2006) in the UK?
3.8 What are the key codes or guidance for health service governance?
3.9 What are the key issues for health service governance that can be identified in the corporate governance case examples?
3.10 What is the difference between principles and provisions in a code of governance?
3.11 How does the 'comply or explain' rule apply to foundation trusts?
3.12 What is the difference between 'comply or explain' and 'apply or explain'?
3.13 What is a 'box-ticking approach' to compliance with governance requirements and how might such an approach be harmful for NHS organisations?
3.14 What principles does *The Intelligent Board* guidance apply to the information that boards use to govern?
3.15 What risks was the *Integrated Governance Handbook* trying to address?
3.16 What specific disclosure requirements are imposed on foundation trusts under the *Foundation Trust Code of Governance*?
3.17 What are the three key roles of an effective board, according to *The Healthy NHS Board* guidance?
3.18 The report *Taking it on Trust* raised some key concerns about the NHS assurance process – what were these concerns?
3.19 What are the five sections of the *UK Corporate Governance Code*?
3.20 Why is the King Code distinctive from other codes of corporate governance?

Stop and think

Explain the interplay of legislation and codes – is there duplication or confusion or do they complement each other?

Part 2

The board's role and directors' responsibilities

Learning outcomes

Part Two should enable you to:

- advise on the structure and composition of the board to maximise effectiveness and meet regulatory requirements
- understand, interpret and apply the principles of the *Foundation Trust Code* of Governance in relation to boardroom practice and behavior, and how the principles apply across the NHS
- understand the role and responsibilities of the key board committees
- understand the role and duties of the directors
- explain the liabilities of directors and to what extent they are limited.

Chapter 4: The board's structure and its committees

Test your knowledge

4.1 According to the *UK Code of Corporate Governance*, what are the governance responsibilities of a board of directors?

4.2 How does the Department of Health (DH) define the responsibilities of the board?

4.3 According to the *FRC Guidance on Board Effectiveness*, what are the characteristics of an effective board?

4.4 What is a unitary board? What are the benefits of a unitary board?

4.5 What are the respective roles of a management board and a supervisory board in a two-tier board structure in Germany?

4.6 What are some criticisms of a two-tier board structure?

4.7 What would be the disadvantages of a large NHS organisation restricting the total size of its board to eight members?

4.8 What are the provisions in the UK Code for the size and composition of the board of directors of a listed organisation in the FTSE350?

4.9 List the main statutory committees that are required. What are the criteria for membership?

Stop and think

Select any NHS organisation that you know. Given the size and complexity of its business, make an estimate of how large its board of directors might be. Next, find the organisation's website and check the size and composition of its board. (If you have difficulty in finding this information, it should be contained in the directors' report in its report and accounts.) See how close your estimate was to being correct.

List ten matters that should be reserved for decision-making by the board of directors.

Chapter 5: Directors' duties and liabilities

Test your knowledge

5.1 Why are the common law duties relevant for NHS organisations?
5.2 What is the fiduciary duty of a director? What are the seven statutory duties of directors under the provisions of the UK Companies Act 2006?
5.3 In what circumstances is it acceptable for a director to have an interest in a third party transaction with the organisation?
5.4 In what circumstances can personal liability arise?
5.5 What kind of indemnity is provided by HSG 1999/104?
5.6 What are the main principles of the NHS Code of Conduct?

Stop and think

How do the common law duties underpin the statutory duties of directors?

Part 3

The effective board and its officers

Learning outcomes

Part Three should enable you to:

- identify key board behaviours that lead to effective boards
- understand the role of the nomination committee in succession planning and board appointment
- explain the importance of induction and training for directors
- describe the various aspects of performance evaluation for the board, its committees and individual directors
- understand the role played by ethics and codes of conduct in underpinning good governance
- describe the importance of the role of the chair and the key relationships the role requires
- describe the role of the executive directors
- understand the role of the remuneration committee in setting remuneration levels for executive directors and NHS senior managers
- identify the key issues in setting remuneration levels
- understand the principles of fair pay and the need for control of severance payments in cases of poor performance
- discuss the role of the company secretary in providing authoritative, credible and professional advice on governance both within the NHS and the corporate commercial world.

Chapter 6: Maintaining an effective board

Test your knowledge

6.1 List the techniques and practices that support and hinder the effectiveness of a healthy board.

6.2 According to the *UK Code of Corporate Governance*, how often should a board of directors meet?

6.3 How does the agenda for board meetings contribute to good governance?
6.4 What are the characteristics of best practice in boardroom behaviour, as identified by the ICSA report *Boardroom Behaviours* (2009)?
6.5 Explain the meaning of the statement that directors should look on best practice in governance as a 'business facilitator', not a 'business killer'.
6.6 Explain the composition of an NHS trust board as outlined by DH's model standing orders.
6.7 What are the key principles that the NHS Trust Development Authority must follow in the appointment of NHS non-executive directors (NEDs)?
6.8 What are the responsibilities of a nomination committee?
6.9 What are the provisions in the UK Code relating to nominations and appointments to the board?
6.10 How much time should NEDs be required to commit to the organisation, and should this be a contractual commitment?
6.11 What were the recommendations of the 2011 Davies Review?
6.12 Why is it desirable to plan for board succession?
6.13 How is the board of an NHS organisation regularly refreshed?
6.14 What are the requirements in the UK Code regarding the re-election of directors?
6.15 What should the induction of a new director consist of?
6.16 What are the requirements in the *Foundation Trust Code of Governance* and the UK Code for the performance evaluation of the board, its committees and its individual directors?
6.17 What is the purpose of an annual performance evaluation of the board and its directors?
6.18 What factors should be considered when reviewing the performance of a NED?
6.19 How might a chairman arrange for the evaluation of the performance of the board and its directors?
6.20 What are the most common types of conflicts of interest?
6.21 What is the definition of a 'connected person'?
6.22 In what ways do personal ethics differ from business ethics?
6.23 What are the typical contents of a code of business ethics?
6.24 What kind of gifts and hospitality are acceptable?

Stop and think

Conflicts of interest can arise in any organisation – why are they of particular importance in an NHS organisation?

Chapter 7: The chair of the board

Test your knowledge

7.1 What is the role of a chair? Why should this role not be combined with the role of CEO?

7.2 What are the requirements of the *Foundation Trust Code of Governance* with regard to the independence of the chair?

7.3 Name the specific areas where the chair and company secretary work closely together.

7.4 In what circumstances is it acceptable for an individual to be the chair of more than one FTSE 100 companies at the same time?

Stop and think

How does the leadership style of the chair have an impact on the effectiveness of the board?

The chairman of a foundation trust who is facing a re-appointment process in order to continue as the chairman of the trust is insisting on chairing the governors' nomination committee that would be carrying out the appointment process. What is your advice to the nomination committee about the conflict of interest that would arise, and how would you resolve it?

Chapter 8: Executive directors

Test your knowledge

8.1 Describe the role of the executive directors and how they are appointed

8.2 Who is the accountable officer and what is their role?

8.3 Describe the role of the remuneration committee in setting remuneration levels for executive directors. What are the principal responsibilities of a remuneration committee?

8.4 What should be the composition of a remuneration committee for an NHS organisation and who may be its chairman?

8.5 Is it appropriate for a remuneration committee to consult the chair or chief executive officer on remuneration packages for individual executive directors?

8.6 What is the proposed Fair Pay Code for senior pay based upon?

8.7 How do the Fair Pay Code's recommendations help to improve openness and transparency?
8.8 Why is it vital that the discussion on high pay is extended beyond the public sector?
8.9 What are the problems with linking rewards to performance for senior executives?
8.10 What are the advantages and problems with the remuneration committee using the services of remuneration consultants?
8.11 What steps must an NHS organisation take with regard to severance payments?
8.12 What items are to be included in the directors' remuneration report that are not subject to audit?
8.13 Where are the details of executive remuneration disclosed?

Stop and think

Why is reward for poor performance a particular issue for NHS organisation?

From your general reading, awareness of the business and/or NHS news, can you name any other example of public anger or concern about remuneration for senior executives? Is there a difference between the corporate sector and the NHS?

What are the potential problems for good governance when the annual remuneration of senior executives rises at a significantly higher percentage rate than the salaries of other employees over a period of several years?

In response to the threat of measures by the UK government to levy a higher rate of tax on bonuses for bank executives, UK banks might consider increasing the basic salaries of many of its executives instead. Is this an example of poor government policy, bad corporate governance by the bank, or both?

What do you think would be the key areas of discussion for the remuneration committee of an NHS organisation if they were going to consider a remuneration package for the chief executive that included bonuses, incentive payments or performance-related schemes?

Chapter 9: Non-executive directors

Test your knowledge

9.1 What are the intended functions of independent NEDs?
9.2 According to the Higgs Report, what are the four broad roles of NEDs?
9.3 According to the UK Code, what are the roles of NEDs?
9.4 List six circumstances in which a NED would not normally be considered independent.
9.5 Describe the role of the NHS Trust Development Authority in the appointment of NEDs.
9.6 Why, in the interests of good corporate governance, should NEDs be paid a basic annual fee and no incentive?
9.7 Why does the *Foundation Trust Code of Governance* stipulate that NEDs should serve no more than two three-year terms of office?

Stop and think

What issues should an individual consider before accepting the offer of an appointment as an independent NED of an NHS organisation?

What are the main criticisms that have been made about NEDs?

How much time should NEDs of an NHS organisation be required to commit? Should this be a contractual commitment?

Chapter 10: The company secretary

Test your knowledge

10.1 List 15 governance responsibilities that could be given to a company secretary.
10.2 What is the meaning of 'conscience of the company'?
10.3 Why is it important that a company secretary should be independent, and how can this independence be protected?
10.4 Why is it inappropriate to give governance responsibilities to an individual who acts as the company's in-house lawyer?

Stop and think

The role of company secretary within many NHS organisations is a bolt-on role to an executive director's existing portfolio or is a role reporting to an executive director (who sometimes is not a board member themselves). By comparison the company secretary in a listed company is a senior role, on a par with being a board director and reporting directly to the chief executive and accountable to the chairman for governance arrangements.

What are the risks to NHS organisations in structuring the role in this way?

Part 4

Foundation trusts and clinical commissioning groups

Learning outcomes

Part Four should enable you to:

- understand the health service governance principles that are required of foundation trusts and clinical commissioning groups (CCGs) and the interplay with corporate governance principles
- identify how foundation trust membership and council of governors redefines the involvement of stakeholders in the governance of the NHS
- describe the membership arrangements for CCGs and how they impact on the governance arrangements for the governing body
- identify the key issues of good governance that are specific to foundation trusts and CCGs.

Chapter 11: Governance of foundation trusts

Test your knowledge

11.1 What is a public benefit corporation?

11.2 Describe the two-tier structure in a foundation trust? How is it different to the two-tier structure used in Germany (outlined in Chapter 4)?

11.3 What freedoms do foundation trusts have?

11.4 Who is a foundation trust accountable to?

11.5 Describe the governance structure for a foundation trust.

11.6 What are organisational forms identified by the Dalton Review as alternatives for those trusts which are not foundation trusts?

11.7 What are the four extra conditions that exist for foundation trusts under Monitor's new licensing regime?

11.8 What intervention will Monitor exercise if a trust is at risk of breaching its licence conditions?

11.9 Outline the key aspects of the *Foundation Trust Code of Governance*.
11.10 Describe the main elements of the Model Core Constitution?
11.11 What are the statutory duties of a foundation trust director?
11.12 What are the constituencies required for the membership of a foundation trust?
11.13 What are the eligibility criteria for members wanting to stand as governors?
11.14 What is the makeup of the council of governors?
11.15 What are the statutory duties of the council of governors?
11.16 In what circumstances would Monitor make direct contact with the lead governor?
11.17 Describe the appointment process for new foundation trust NEDs.
11.18 What reporting requirements are imposed by Monitor's Risk Assessment Framework (RAF)?
11.19 Describe the governance and continuity of services risk ratings under the RAF?
11.20 Where does the board publicly disclose its self-assessment under the *Quality Governance Framework*?
11.21 What are Monitor's requirements in connection with significant transactions?

Stop and think

What are the advantages and disadvantages of the legal requirement for all foundation trusts to hold their board meetings in public? In practice, does this mean that governors should be included or excluded from observing any private sessions of the board?

Chapter 12: Governance of clinical commissioning groups

Test your knowledge

12.1 What is the legal duty of CCGs in relation to commissioning?
12.2 Describe the lines of accountability for a CCG governing body.
12.3 What are the three roles played by the local area teams in relation to the CCG?
12.4 What are the six domains of the CCG Assurance Framework?
12.5 What are the statutory duties of a CCG?

12.6 Who is disqualified from being a member of a CCG's governing body?
12.7 What are the six core principles of good governance outlined by the Good Governance Standards for Public Services?
12.8 Do these principles presuppose a unitary board?
12.9 Describe the main elements of the CCG Core Constitution?
12.10 How can a governing body ensure the effective participation of its member practices?
12.11 What is the role of a locality committee?
12.12 How are executive members of the governing body appointed?
12.13 Describe the composition of a CCG governing body?
12.14 What is the role of a CCG's remuneration committee?
12.15 Describe the distinctive roles played by the governing body chair, lay member and the accountable officer.
12.16 What reporting requirements are imposed by the CCG Assessment Framework
12.17 What interventions are available to the local area team in exceptional circumstances?
12.18 Who are the independent and non-independent members of the governing body?
12.19 Why are conflicts of interest more complicated for CCGs to monitor and manage?
12.20 What are the other significant governance issues are faced by CCG governing bodies?

Stop and think

If CCGs are also invited to participate in commissioning primary care, what are the governance issues that are created by that invitation?

Part 5

Risk management, assurance and audit

Learning outcomes

Part Five should enable you to:

- apply the principles of risk management
- appraise the significance of risk management for good governance
- advise on the appropriate arrangements for an effective risk management system
- advise on the board's responsibility for internal control to meet good governance guidelines
- appraise the effectiveness of an internal control system
- understand and apply the NHS principles and guidance in relation to internal audit
- develop appropriate policies and procedures to mitigate the impact of operational disaster and devise a whistleblowing procedure.
- explain the combined role of internal and external audit in NHS reporting to stakeholders
- identify the range of reporting requirements that NHS organisations are subject to
- describe the importance of the board assurance framework and annual governance statement
- identify the key mechanisms for communications with stakeholders
- describe the role of the audit committee, its memberships and main responsibilities
- identify threats to the independence of the external auditors
- describe the main aspects of a whistleblowing procedure

Chapter 13: Risk management

Test your knowledge

13.1 What is the responsibility of the board for business risk?
13.2 What is risk appetite and risk tolerance?
13.3 What may be the consequences of failing to consider business risk strategy or failing to establish an effective business risk management system?
13.4 What is business risk and how could it be measured?
13.5 How might business risks be categorised?
13.6 What is the difference between business risk and internal control risk?
13.7 What is the difference between a board risk committee and a risk management committee?
13.8 What are the main implications of the *FRC Guidance on Risk Management*?
13.9 What are the main elements of a business risk management system?
13.10 What is a risk register?
13.11 What is the purpose of stress testing?
13.12 What are the main elements of a system of internal control?
13.13 Give six examples of financial risk within an organisation.
13.14 For what reason are procedures for the authorisation of expenditures and approval of payments for expenditures an internal control?
13.15 For what reason are procedures for the selection of appropriate applicants to fill job vacancies a part of an internal control system?
13.16 What are the main provisions relating to internal control?
13.17 Why should emergency preparedness planning be a part of the internal control system of an NHS trust?

Stop and think

A high performing foundation trust board is considering establishing its own consultancy business to support other NHS organisations preparing for CQC inspections. Looking at the NPSA risk matrix, identify the risks posed by this opportunity.

Chapter 14: Assurance

Test your knowledge

14.1 What are the three areas of reporting included in health service governance?
14.2 What guidance is issued in respect of performance reporting?
14.3 What are the board's responsibilities for quality?
14.4 What are the four component parts of the guidance on quality governance?
14.5 What guidance is issued in relation to performance reporting?
14.6 How does the annual report and accounts deliver accountability and transparency?
14.7 What are a director's duties in relation to financial reporting?
14.8 Describe the concept of going concern and how its relationship with the duty to break even.
14.9 How is an annual governance statement (AGS) different to a statement on internal control (SIC)?
14.10 What is the role of the audit committee in the production of the AGS?
14.11 What are the main disclosures that must be made in the AGS?
14.12 What are the main elements of a board assurance framework (BAF)?
14.13 How does the board benefit from a well-informed BAF?
14.14 What are the eight elements of an integrated report?

Stop and think

An NHS organisation is considering a integrated approach to health and social care with its local authority. What risks should the board ensure are covered by the board assurance framework?

Chapter 15: Audit

Test your knowledge

15.1 Describe the changes being made to the framework for local public audit.
15.2 What are the main elements of the work of external audit?
15.3 What tasks may be delivered by internal audit?
15.4 What is the purpose of internal audit?

15.5 Why is their relationship to external audit important?
15.6 What is the purpose of the audit report?
15.7 What are the responsibilities of the external auditors with regard to the financial statements of an organisation?
15.8 Who is responsible for detecting fraud or errors in financial statements?
15.9 Who is responsible for detecting fraudulent activity within the organisation?
15.10 What types of audit opinion might be given in an audit report? What is the significance of a modified audit opinion?
15.11 Give examples of non-audit work for an organisation by a firm of auditors.
15.12 What are the five categories of threats to auditor independence?
15.13 What is the difference between audit firm rotation and audit partner rotation?
15.14 What are the responsibilities of the audit committee for business risk and the business risk management system?
15.15 What are the responsibilities of an audit committee with respect to internal control and internal audit, as stated in the UK Code?
15.16 Who should be the members of an audit committee?
15.17 What induction or training might be provided for members of an audit committee?
15.18 What does the *HFMA Handbook* say about the frequency of audit committee meetings?
15.19 What measures might an audit committee take to monitor the independence of the external auditors on a regular basis?
15.20 What changes were made to the NHS Constitution to highlight the importance of whistleblowing?
15.21 What are the main elements of a whistleblowing policy?

Stop and think

As company secretary of an NHS organisation, you have been asked to develop the appropriate internal procedures for dealing with a whistleblower's allegations. What would you advise?

What are the main problems with whistleblowing systems in the NHS?