ICAEW THOUGHT LEADERSHIP
CONNECT AND REFLECT

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Marking governance out of 10

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About Connect and Reflect

Connect and Reflect is ICAEW's framework for a new era of corporate governance. We want to inspire companies to go beyond legal and regulatory requirements. If companies recognise the challenges they face and develop their own solutions, they will benefit. Although initiating a step change can seem like taking an unnecessary risk, in fact, in the modern environment, it is more dangerous to cling on to old stereotypes and outdated processes. Improving corporate governance is key to building trust in business, and ideas that may have seemed radical in the past are becoming mainstream.

Introduction

Companies and boards of directors are constantly being marked. This may be formal or informal, structured or unstructured. Such external judgements are unavoidable and therefore it is better for companies to be proactive and dictate how they will be assessed for themselves. Volunteering to have governance marked demonstrates companies' willingness to go beyond strict legal compliance, and it also signals an appetite for self-improvement. Being marked is self-serving because marks are a valuable leading indicator which will help predict the future.

Investors need reassurance that companies are resilient, and good marks give all stakeholders confidence in the board of directors and the companies they lead. Even mediocre marks are better than none. It is far more difficult to criticise a failing company if it has proactively sought an in-depth analysis and made improvements to weak areas.

The main beneficiaries of better insights on governance are individual company directors. After all, governance structures are what grant their authority and underpin their work. Directors scrutinise a wide range of interrelated information about companies, and they should welcome the addition of governance marks as they are a logical addendum and an important consideration for risk management.

Deciding to be marked, choosing a methodology, considering marks and implementing recommendations is a lengthy process and a unique opportunity for directors to reflect on how their role fits into the company's ecosystem. However, the advantages don't stop there. Governance professionals are usually unsung heroes because their work tends to be ignored during business as usual. Moving governance out of the back office and into the spotlight will increase appreciation of the importance of governance to the company's long-term success. Bringing directors and governance experts closer together will improve communications, prevent misunderstandings and avoid inefficiencies. Regular marking will ensure that the company stays up to date with best practice and guard against complacency.

Despite these benefits there remain pockets of resistance to marking. Voluntarily submitting to a thorough analysis does take courage. It can be more comfortable to focus on superficial points of style, but a more limited review is bound to have a smaller pay-off.

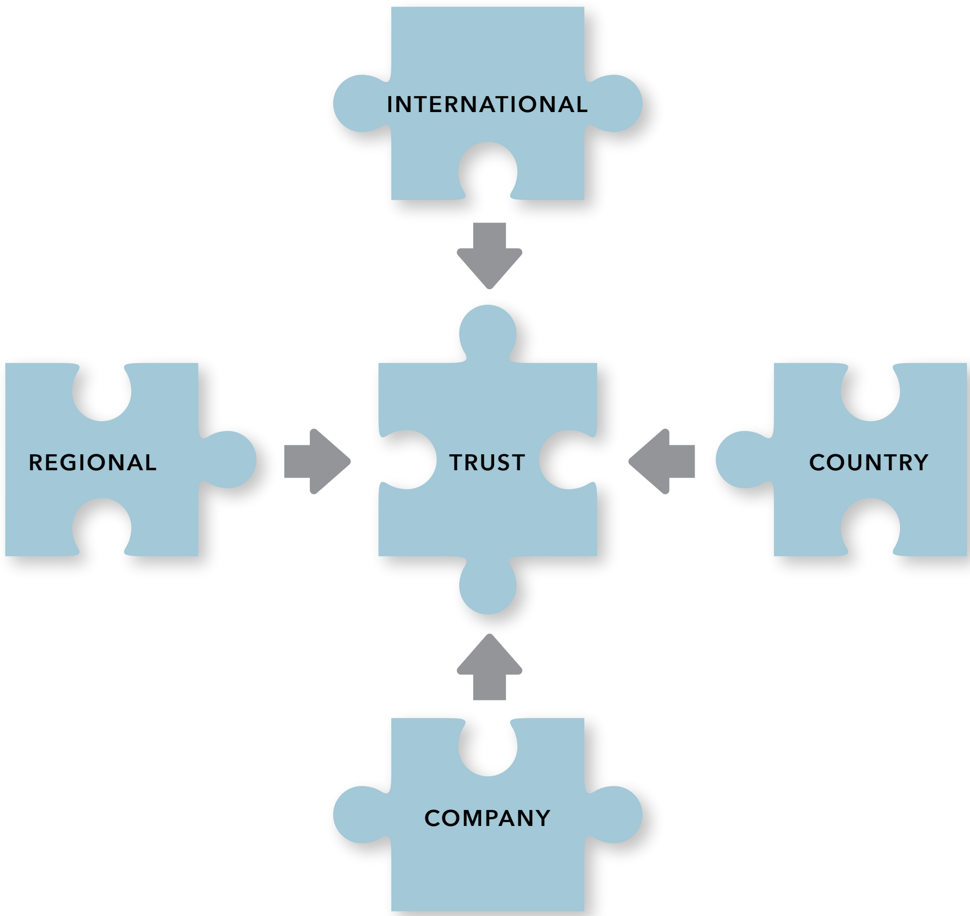
THE GOVERNANCE ICEBERG

Critics of marking governance accept that only a minority of what they do is visible, or above the water line. However, they want the majority of what they do to stay underwater. One of the common objections is that marks can't do justice to such a complicated and subjective area as governance eg, although trade-offs are inevitable it is difficult to fairly reflect these compromises in marks. Although putting total faith in the board of directors is also imperfect, some still regard it as a superior approach.

Reasons to mark governance

1. ACKNOWLEDGE THE BIG PICTURE

There is a symbiotic relationship between the governance of individual companies and economic governance performed at the country, regional and international levels. The pieces relate to each other like tectonic plates. When one piece changes shape or subtly changes its position there are broader consequences. For example, company failures bring the effectiveness of governments and regulators into question. However, the opposite is also true. Good corporate governance is the foundation of socio-economic stability.



As there is so much at stake, the soundness of macro-level governance is constantly under review by politicians, policy makers, civil society and the media. The same attention should be paid to the health and stability of the governance of individual companies.

2. BOOST PROFILE

There is an increasing focus on how companies can perform better environmentally and socially, and experts are developing appropriate marks and metrics for these areas. It's no accident that investors and other specialists include governance in the same bracket. Success requires all three elements of Environmental, Social, and Governance (ESG) to work in sync. In other words, governance is critical to the things that matter to people and planet.

GOVERNANCE IN ACTION

Governance failures have real-life consequences. Employees and local communities are the groups who are most likely to suffer the negative consequences which can arise from governance failures. They usually have to rely on government bodies or shareholders' willingness to take action, but there is a notable exception. The OECD Guidelines on Responsible Business Conduct (the Guidelines) recommend that multinational enterprises support and uphold good corporate governance principles and develop and apply good corporate governance practices. Countries which formally agree with the OECD that they will adhere to the Guidelines must establish an independent and centralised process for handling specific instance complaints about any alleged breaches, and this function is undertaken by what are known as National Contact Points. Decisions on complaints are publicly available.

There are a growing number of specialist ESG investment funds. Companies will want to ensure that they are eligible for these funds. Ambitious companies will want to go further and ensure that their ESG credentials make them a particularly attractive investment opportunity.

3. TAKE THE INITIATIVE

The publication of annual reports and associated information means that companies don't necessarily have to give consent to being marked. There is already enough information in the public domain to allow third parties to mark and rank companies. Companies tend to want to know their results even if they disagree with the marking scheme or would have preferred to have been ignored. Companies which feel disappointed with their marks should remember that they can learn valuable lessons regardless of whether or not they have consented to their participation or agree with their results.

4. FEED FASCINATION

Curiosity is inevitable, and satisfying curiosity is preferable to fearing it. We all want a glimpse of what really happens behind closed doors, especially if we aren't supposed to be there. If secrecy is taken to the extreme it can trigger suspicion which everybody wants to avoid.

Interest goes far beyond knowing that the company is stable. There is a keen interest in knowing the fundamentals of how the company is glued together in the first place.

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How juries deliberate and decide guilt or innocence has been a scholarly obsession ever since juries were invented. Although technology, market research and jurisdictional variations have refreshed how and when jury studies are conducted, the core of widespread interest in juries never alters. There is an enduring fascination with the psychological impacts of forcing people to participate in a solemn and unique forum which is probably entirely different from their daily lives. Requiring strangers to reach a life-changing collective decision can induce extraordinary levels of stress for the jury and the accused.

Directors aren't the only ones who crave something different from the slick and controlled internal communications which they receive from their organisations. Employees and ex-employees are just two examples of other groups who want to find out what is going wrong as well as what is going right, and they want a third party to tell them in a straightforward way. A new perspective on governance could also help those who work on the recruitment of directors eg, by identifying gaps in diversity which should be prioritised and rectified.

5. ASSESS VALUE

A great deal of public and private sector resources are spent on governance. It is only natural for this expenditure to prompt interest in what should be celebrated or improved, and whether competitors or peers are doing better or worse.

Some countries give companies flexibility over how to meet the high-level outcomes which typify good governance eg, division and clarity of responsibilities. A risk-based approach requires directors to reach difficult decisions about how to meet the necessary outcomes. Marks can help directors assess whether they have exercised their discretion appropriately ie, whether they have struck the right balance between controlling costs, streamlining and effectiveness.

Action plan

1. DEFINE GOVERNANCE

Before governance is marked it must be defined. There is growing interest in definitions that go beyond traditional agency theory ie, the role of boards in bridging the gap between owners and managers. A much wider picture is required. The number of data points used in marking schemes is increasing in order to cater for these ever-widening definitions of governance.

Some examples of governance topics which can be marked are: board and committee composition including diversity; shareholder rights; stakeholder engagement including engagement with shareholders; remuneration; and board oversight of risk management and internal policies such as health and safety. Effective whistleblowing is critical to good governance but opinions vary about how to mark this area ie, a large number of whistleblowing reports may be a warning sign of a dysfunctional culture or indicate that the whistleblowing policy is trusted and working as intended.

2. DECIDE WHO AND HOW

Directors' preferences about if or how marks are published must be paramount. The starting place should be identification of all stakeholders followed by consideration of whether refusing access to some groups can be justified on a case-by-case basis. Limiting access to internal publication is only a viable option if there is confidence that the marks won't be leaked. Open access minimises the chances of being criticised and avoids leaks altogether.

Choices around access and the audience for marks should inform how it is performed. Being open about why a particular methodology has been chosen will prevent marking falling into disrepute. Unfortunately, the credibility of some industry awards has been damaged because it is unclear whether winners are chosen solely on merit or whether financial incentives play a role, but transparency will prevent the same problems from occurring with governance marks.

Some audiences may prefer a comparison of the company's performance against an objective benchmark, while others may be more interested in a comparison of multiple companies.

Whichever methodology is used it should be possible to produce something fairly brief which can be understood at a glance and complemented by more detailed analysis. This is an analogy with exam results which students receive in two ways ie, as a grade and as a percentage. Some exam boards offer students individualised detailed feedback on their exam scripts on request. It is possible to draw parallels with tiering the presentation of governance marks into formats which are simple, detailed and very detailed.

As a generalisation, when it comes to methodologies, simplicity trumps complexity. Quasi-scientific approaches may not be as sophisticated as they first seem and could even be regarded as deliberately obtuse. It's important to separate sense from nonsense.

Rating	Ratings may be expressed alphabetically (AAA), numerically (1-10) or alphanumerically (A1). The same rating may be assigned to multiple entities.
Ranking	Ranking places each company at an individual level eg, 1st to 100th. Sections of the league table may be labelled using subjective language eg, in a ranking of 100 companies the top 10 may be labelled as 'excellent'.
Index	Companies are assigned a score between 0-100 based on an assessment of multiple areas of corporate governance eg, women on boards, percentage of tax paid and news coverage. Indexing may be followed by a second stage when companies are ranked.

3. CHOOSE YOUR DATA SOURCE AND COMPARATORS

Quantitative or qualitative approaches may be most suitable for marking different areas of governance. Occasionally the best technique entails both approaches, and in these circumstances the challenge is how to strike the right balance between the two eg, marking company's annual reports should take into consideration report length (quantitative) and quality (qualitative).

Surveys

Most people are familiar with surveys. They are often used to gauge opinions and to assess experiences. If survey results identify areas of concern then this can affect priorities and the allocation of resources.

Many companies often use self-administered customer satisfaction surveys. Employee engagement surveys are also common, and quantitative measures such as employees' email patterns are sometimes added to qualitative survey results in order to provide a fuller picture.

Public disclosure analysis

Corporate governance may be measured by analysing public disclosures such as the annual and financial reports. Analysts do not necessarily need to have companies' permission before performing their analysis.

Scorecard

A scorecard is a quantitative tool used to measure the level of compliance with a code or some other standard of corporate governance. Scorecard results can be used to compare a company against benchmarks or to compare a company with other companies.

4. MOVE A STEP BACK

In order for marks to have maximum value they need to be interpreted with reference to the specific company and by people who know the company best. For this reason it is crucial that sufficient time is allocated for detailed and calm consideration of the marks received.

PROOF OF THE PUDDING

Building a capable board is not the same as baking a cake. Even if you follow the recipe very carefully the result may still be disappointing. Conversely, diverging from the instructions may result in a better board (or cake). Part of the problem is that the optimum board often depends on extraneous factors that vary over time and are outside of the company's control eg, market conditions. Just like people, companies must be flexible enough to adapt to the situation they find themselves in. For example, although board chairs should generally be stoic and calm, they must also be capable of asserting their authority when necessary. Some boards may benefit from an employee director, while the employees of other companies may prefer alternative forms of engagement.

5. TAKE ACTION

Marks may be accompanied by detailed recommendations. Areas for improvement may be identified at a high level so that companies can invent their own next steps, or more granular guidance may be given. It could be unrealistic to solve difficult challenges immediately. It may be better to aspire to year-on-year incremental improvements, and to use these as interim objectives.

There must be sufficient follow-up to ensure that marks are not shelved and forgotten, or more likely, improvements implemented but then allowed to slide. Periodic reviews should help prevent these problems and using an external assessor will help support corporate memory about what's been done and not done, and why.

Conclusion

Not everything a board does can or should be made public, however the optimum balance between what is kept confidential and what is published has shifted. Even reluctant companies and directors may struggle to argue that marking governance isn't a logical addition to all of the work that has been done on corporate culture, and to board evaluations which are widely accepted. In time the collation of objective information about governance may be as fundamental to running a company as audited accounts.

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* Source: CAW, 2020 – Interbrand, Best Global Brands 2019