

# The Interface between Theory and Reality in Corporate Governance and Ethics

Monthly Seminar Series for the Birkbeck, University of London  
Centre for Corporate Governance and Ethics (LCCGE)

6:30-8pm Council Room

Friday 28 November, 2008

**Caroline Oliver**

**Chief Executive, Good to Govern Ltd.**

[www.goodtogovern.com](http://www.goodtogovern.com)

# Bits about Me

- **Working with boards in Canada, USA and UK since 1995**
- **Founding Chair of the International Policy Governance Association**
- **Current Chair of the UK Policy Governance Association**
- ***The Policy Governance Fieldbook - Practical Lessons, Tips and Tools from the Experience of Real-World Boards*, 1999, General Editor, Jossey Bass Publishers Inc., Wiley Group.**
- ***Corporate Boards That Create Value – Governing Company Performance from the Boardroom*, August 2002, co-authored with John Carver, foreword by Sir Adrian Cadbury, Jossey Bass Publishers Inc., Wiley Group.**
- ***Governing for Velocity – Getting Started with Policy Governance*, January 2009, Jossey Bass Publishers Inc, Wiley Group.**

# Theory and Reality

“Only human beings guide their behaviour by a knowledge of what happened before they were born and a preconception of what may happen after they are dead; thus only humans find their way by a light that illuminates more than the patch of ground they stand on.”

(Peter and Jean Medawar in *The Life Science* (1977)).

# Theory - what theory??

Without theory, reality (practice), becomes:

haphazard

nonsensical

dysfunctional

inefficient

highly risky for all concerned

# Theory - what theory??

## ***Agency theory***

Addresses the gap between principals and their agents in terms of actual and potential conflicts of interest.

From this perspective, boards operate in the gap between owners and operators, and their job is to act as a watchdog, inspecting and approving in order to prevent any malfeasance.

Dominance of this approach likely increased, particularly in widely held corporations, aided by Enron era corporate scandals and current “credit crunch”.

*(Alchian and Demsetz, 1972; Jensen and Meckling, 1976; Eisenhardt, 1989)*

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# Theory - what theory??

## ***Stewardship theory***

Less well defined but tends to see the gap between principals and their agents, at least in part, as involving actual or potential CEO incompetence.

From this perspective, the board 's job is to be the CEO ' s coach, reviewing, advising, and guiding as well as opening doors to new markets and providing needed expertise in particular areas (for example, legal issues marketing, international development, information technology, or accounting). This approach is very common in closely held corporations such as those with a controlling shareholder, family firms, and joint ventures.

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# Other theories??

Administrative	Executive	Philanthropic
Adolescent	Founding	Policy
Advisory	Fundraising	Political
Balanced scorecard for boards	Governance as leadership	Relationship
Collective Membership	High impact	Representational
Committee	Hybrid	Results based
Community	Infant	School board effectiveness
Community driven	Institutional	Stakeholder
Complementary	Junior	Traditional
Constituency representative	Knowledge based	Venture
Contingency	Last resort	Volunteer
Corporate	Life cycle	Working
Cultural trustees handbook	Mature	Zoning commission
Cupped hands,	Mission based	
Dynamic	Operational	
Effective	Participatory	
Emergent cellular	Partnership	
Established	Patron	
	Peter Drucker' s	

# Reality

## haphazard

Who's in Charge?

Chair?

Board?

Lead Director?

Non-Executives?

Chief Executive?

Other Executives?

Committees?

Regulator?



# Reality

## nonsensical

Reacting - not leading - *and yet the first and last authority*

Approving/rehashing/reviewing the past - *which already happened*

Role confusion - *leader/advisor/constituency advocate/watchdog?*

Discussing things for no obvious purpose - *was there a decision?*

Sham or overwhelm agendas - *keep them busy*

Wheel reinvention - *didn't we discuss this before?*

Trivial pursuits - *getting mired in detail*

Fixing the wrong thing - *e.g. independence and expertise of audit committee rather than the full board: "What is the use of having an independent and expert subcommittee if the board which appoints it, and to which it is accountable, is too much in management's pocket, too large to function effectively and financially illiterate"?*

(The Strange World of Audit Committees by Caroline Oliver. Ivey Business Journal, University of Western Ontario, March-April 2003)

# Reality

## dysfunctional

Personality dominated rather than group leadership

Battlefield mentality - *I fight for my constituency harder than you can fight for yours*

Use of force rather than reason

Impossible quest to mirror management skills and knowledge

# Reality

## inefficient

Unclear alignment between board and executive

Inflexibility of board approved strategies

Overlapping roles

Unclear accountability

# Reality

## highly risky for all concerned

Unchecked conflicts of interest

Things “falling between stools”

A slave with two masters is a free man

# Ethics - What Ethics?

T.O.O.

Think of Others

An Intelligent Person's Guide to Ethics, Mary Warnock, Chapter 3

# Ethics - Theory

Are boards the mechanism that legitimates capitalism in a democracy?

*In other words.....*

Are boards there to ensure that the corporations licensed to operate in our society “think of others”?

*In other words.....*

Without boards can/should capitalism survive?

# Ethics - Reality

Are boards....

Being accountable for thinking of others?

Even capable of doing the job we theoretically expect of them?

Or, are boards...

Mere “fig leaves of decency”?

# Policy Governance®

## **A theoretical and practical approach to owner-accountable, ethical and effective corporate governance**

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# Sir Adrian Cadbury on Policy Governance®

“as near a universal theory of governance  
as we at present have.”

Foreword to *‘Corporate Boards That Create Value’* (John Carver with  
Caroline Oliver, Jossey Bass 2002),

# A Cautionary Note!

They constantly try to escape  
From the darkness outside and within  
By dreaming of systems so perfect that no  
one will need to be good.

Choruses from the Rock: T. S. Eliot 1934

# Policy Governance Theory

Corporate governance exists .....to ensure that shareholders values, as informed by knowledgeable agency, are transformed into company performance.

To the extent a board fails in this, no matter how many other useful things it accomplishes, it has failed. To the extent it succeeds in this, no matter that it accomplishes nothing else, it has succeeded.

The worldwide surge of corporate governance codes, while acting to protect investors, does little to enhance the integrity and effectiveness of the governance process itself. Significant improvement in boards ability to fulfil their roles as shareholders agents requires going beyond the codes and today's best practices to develop conceptually coherent governance theory.

(The Promise of Governance Theory: Beyond Codes and Best Practices  
by John B. Carver, *Corporate Governance: An International Review*, Vol. 15, Issue 6, pp. 1030-1037, November 2007)

# THE BOARD'S JOB



Success  
and  
Safety

**BUT ....**

**BY WHOSE DEFINITION?**

# FOUR KEY POLICY GOVERNANCE® PRINCIPLES

- OWNERSHIP
- ACCOUNTABILITY
- GROUP AUTHORITY
- EFFECTIVE DELEGATION

*Derived from 10 principles to  
be seen at:*

[http://www.policygovernance  
association.org/PG\\_Source\\_  
Document.html](http://www.policygovernanceassociation.org/PG_Source_Document.html)

# PRINCIPLE ONE

## **Ownership:**

The source of board legitimacy – to which the board must legally and morally connect its authority and accountability for the organization.

# More on OWNERSHIP

- Board Authority *is* Owners' Authority
- Other “stakeholders” such as employees, customers and suppliers are *not* “owners” unless they independently qualify as such.
- Linking with Owners – the board’s first job



# PRINCIPLE TWO

## **Accountability:**

As the highest and initial authority within the organization, the board is fully accountable for the value produced on behalf of those who own the organization.

# PRINCIPLE THREE

## **Group Authority:**

Board authority lies in the group's one voice honed from the diversity of the whole group

# BOARDS CAN'T DO IT ALL

*All board members  
are accountable to all owners  
for everything that does and does  
not happen in the organization -  
but they can't all be in the  
drivers' seat!*



# BUT THEY MUST CONTROL IT ALL

Boards are obliged to exercise unambiguous control on behalf of owners - *yet the imposition of controls on delegates can be destructive to owner interests.*

Therefore, boards need controls that:

1. Safeguard owner values
2. Optimally empower their delegates
3. Provide for clear accountability

# PRINCIPLE FOUR

## **Accountable, Effective, Delegation:**

- a) Pre-states ALL Expectations
- b) Gives Freedom to Do the Job
- c) Enables Rigorous Monitoring

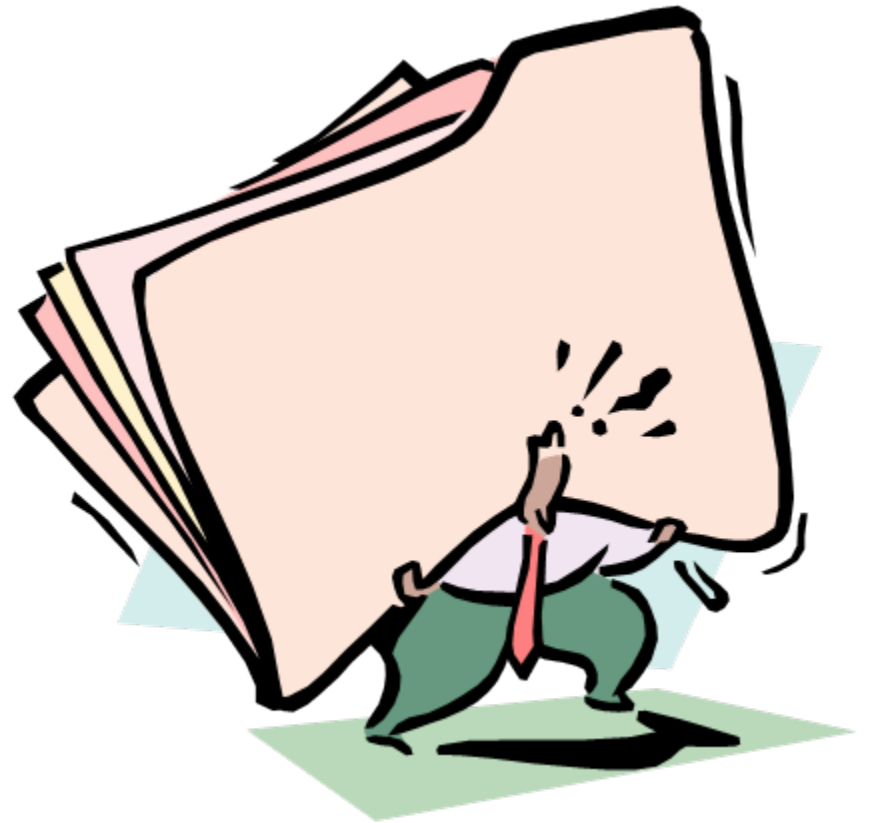
# POLICY GOVERNANCE SYSTEM FEATURES

# ONE VOICE = POLICY



# THE PROBLEM WITH POLICY

So much  
to say ...





# DIFFERENTIAL CONTROL

ENDS - POSITIVE  
CONTROL



MEANS - NEGATIVE  
CONTROL



# THE WRONG WAY TO CONTROL MEANS

WE KNOW  
BETTER  
THAN  
YOU HOW  
TO DO  
YOUR JOB



**THE RIGHT WAY TO CONTROL MEANS**

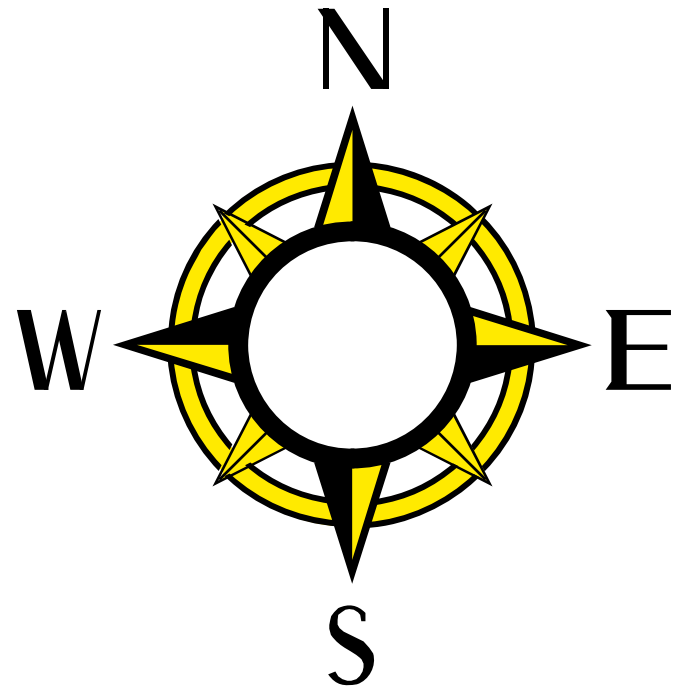
**EVERYTHING IS  
PERMITTED**

**UNLESS IT'S FORBIDDEN**

# DEFINITION OF ENDS

ENDS DEFINE WHAT THE ORGANISATION IS **FOR** (*RATHER THAN WHAT IT DOES*) BY ANSWERING THE FOLLOWING QUESTIONS:

- **What Benefit** does this Organisation exist to produce?
- **For Which People?**
- **With What Cost-Effectiveness or Relative Worth?**



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# DEFINITION MEANS

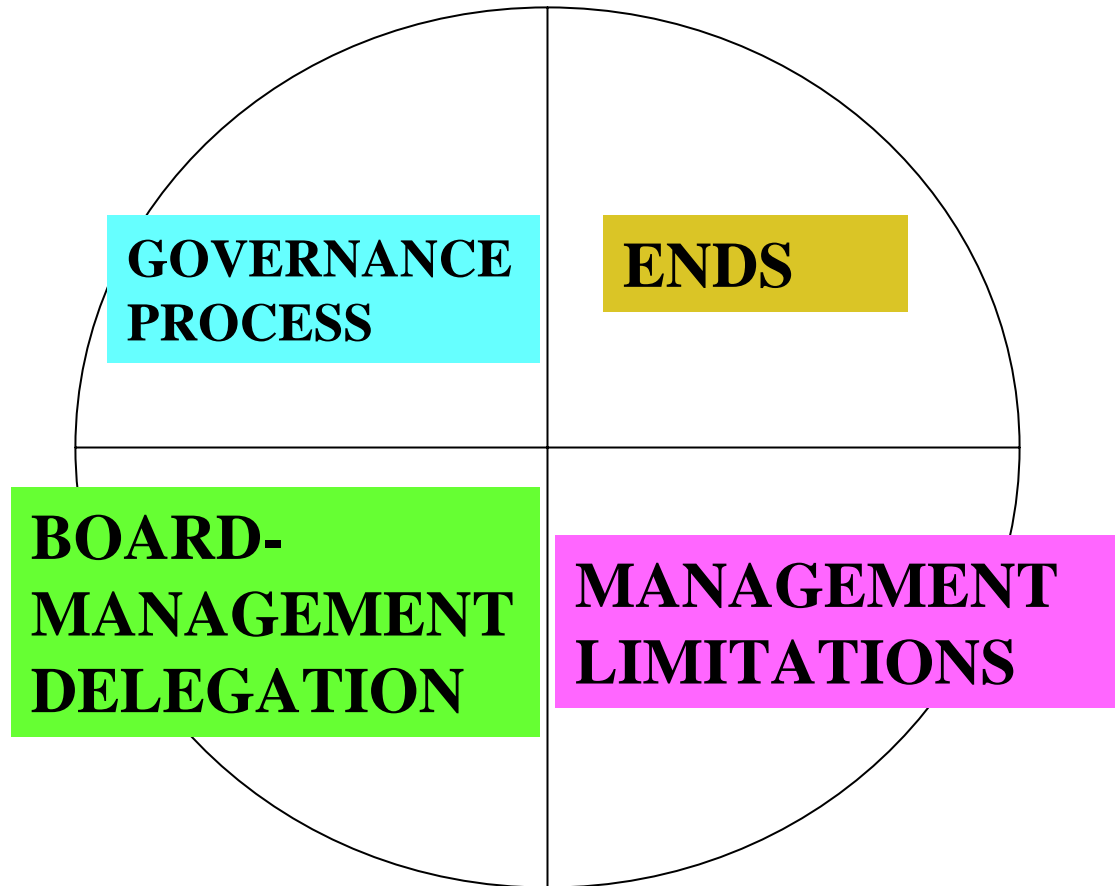
## ANYTHING THAT ISN'T ENDS

*(Two Types: Delegate's means and the board's own)*

# FOUR POLICY CATEGORIES

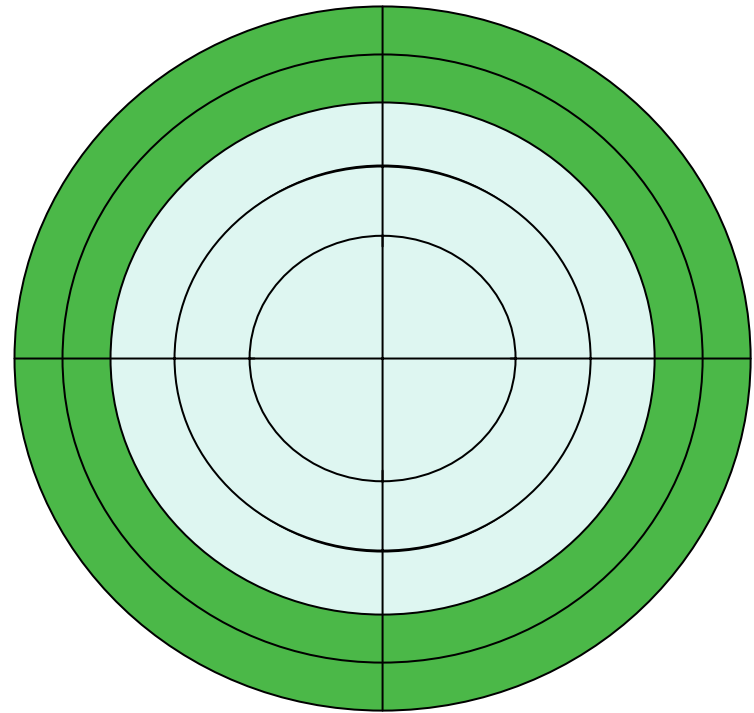
- + **Ends** – The specific benefits, for specific people, with a specific cost or relative worth that must be produced
- **Management Limitations** – The *means* that cannot be chosen (even if they would help to produce the Ends)
- +/- **Governance Process** – The board's *means* choices regarding its own conduct
- +/- **Board-Management Delegation** – The board's *means* choices regarding how it delegates and monitors use of its authority

# THE POLICY CIRCLE





# CONTROL THROUGH POLICY BREADTH



# ANY REASONABLE INTERPRETATION

The board pre-authorizes  
all decisions and actions  
that are made within

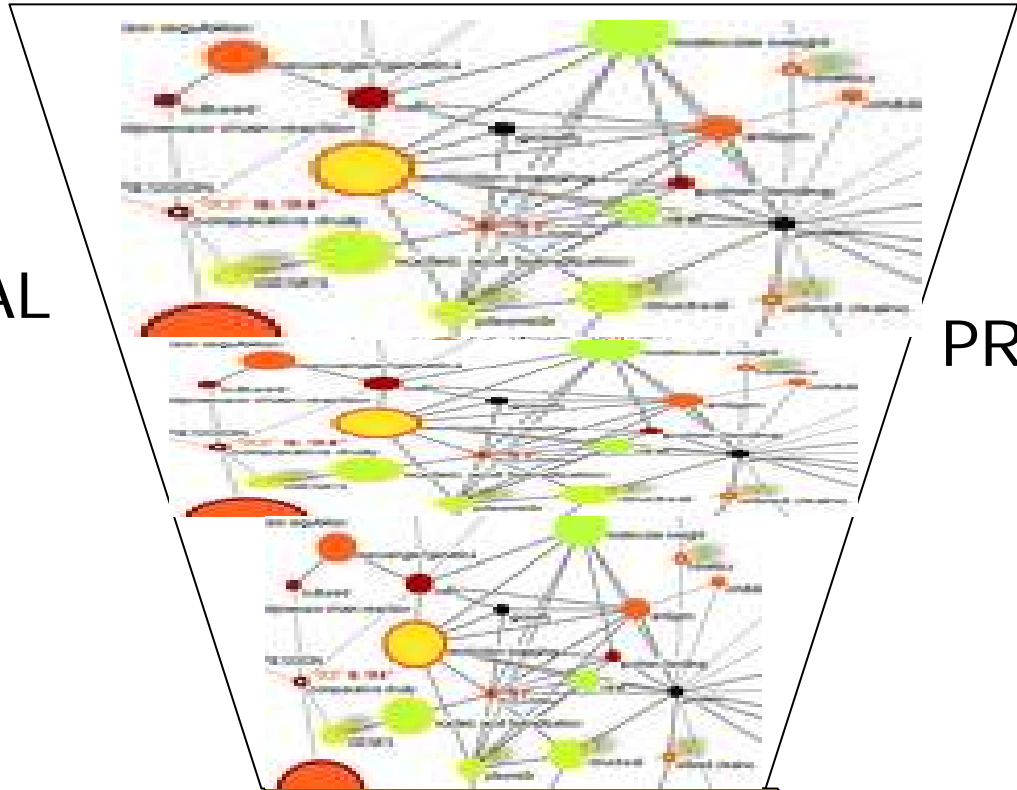
**“*Any Reasonable  
Interpretation*”**

of board Policy

LEGAL

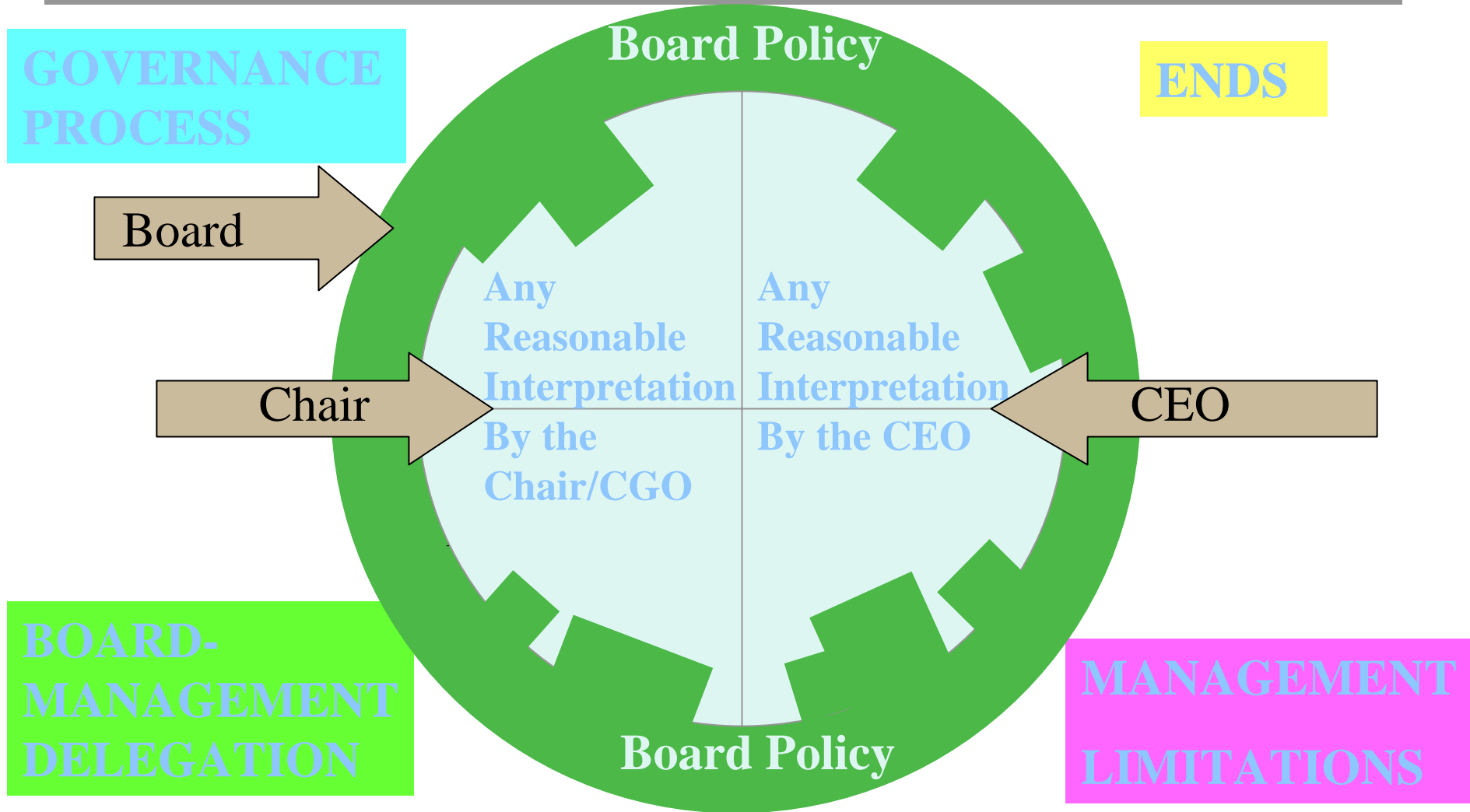
ETHICAL

PRUDENT



**ENDS**  
Specified Benefits for  
Specified People  
At a  
Specified Cost or Relative Worth

# THE BOARD, CHAIR AND CEO DOMAINS



# MONITORING

Regular evidenced assurance that delegates  
are operating within

*“any reasonable interpretation”*  
of board policy

- explicit, justified, compliance standards for fulfillment of every policy
- data on same



# INTERPRETATION

## **Executive Limitations Policy: Treatment of Patients**

The Chief Executive shall not cause or allow unsafe conditions, procedures, or decisions

“I interpret overall compliance with this policy regarding safety to mean:

1. The rate of hospital acquired infections will be less than x per 1000 patients
2. The rate of preventable clinical and non-clinical incidents will be less than x per 1000 patients”

*I interpret safe conditions as:*

- a) the hospital's standards of cleanliness meet the requirements of x and y*
- b) the hospital's emergency preparedness equipment and processes meet the standards of x*

*I interpret safe procedures as:*

- a) 100% of procedures take place using facilities and equipment that meet the standards of y*
- b) no procedure is undertaken by anyone who is not suitably qualified*

*I interpret safe decisions as:*

- a) no medical intervention is undertaken by anyone who is not suitably qualified.*
- b) all persons who make medical decisions are subject to regular supervision or peer review*

# Justification and Data

## JUSTIFICATION

*“The above interpretations can be considered reasonable because they are:*

- 1. In line with the rates achieved by the top 5% of NHS Foundation Trusts, and, or*
- 2. In line with the standards required by x and y authorities.”*

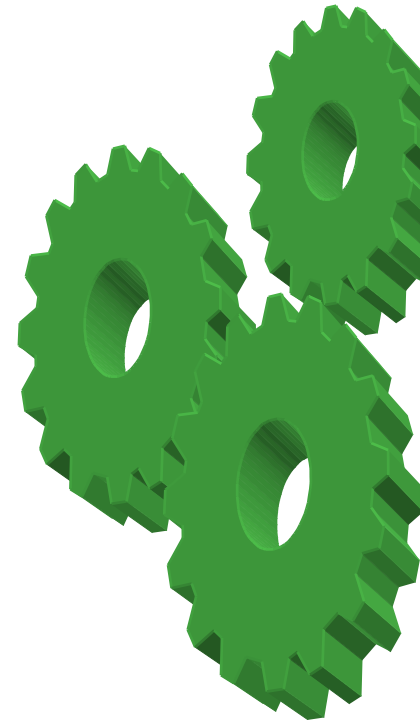
## DATA

[Data that shows where the hospital currently stands regarding compliance with the above interpretations including, where there is currently a gap, information about when full compliance will be achieved.]



# SIX SYSTEM FEATURES

- 1) One Voice = Policy
- 2) + Ends - Means = Precision Delegation
- 3) Four Policy Categories That Encompass
- 4) Broadest to Narrowest in each Category
- 5) Authorize “Any Reasonable Interpretation”
- 6) Monitor Compliance



# ROLES

- **Board**
  - a) link with owners
  - b) produce written policies in the four categories
  - c) assure performance against those policies
- **Chair**

keep a group of equals to their word
- **CEO**

fulfill the Ends within the Limitations
- **Committees**

assist (rather than replace) the board with specific, usually time-limited, governing tasks

# The Ethical Board - Thinks of Others

1. Represents all owners at their best (most responsible)
2. Seeks to create *transferable* value
3. Aspires to transparency
4. Focuses on external impact
5. Focuses on accountability
6. Empowers its delegates
7. Requires evidenced assurance
8. Knows that its job is to **THINK OF OTHERS!**

Alchian, A., and Demsetz, H. “ Production, Information Costs, and Economic Organization. ” *American Economic Review*, 1972, 62, 777–795.

Eisenhardt, K. M. “ Agency Theory: An Assessment and Review. ” *Academy of Management Review*, 1989, 14, 369 – 381.

Jensen, M., and Meckling W. “ Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure. ” *Journal of Financial Economics*, 1976, 3, 305 – 360.