

# Welcome

18 March 2005

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# Agenda

- Ten minute presentations
- Diploma Workshop
- Corporate Governance – Ian Davitt
- AOB

# Presentations

# Paula Speirs

Ernst & Young

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# Programme Risks

Minimising the risk, reducing the cost and increasing the returns on major programmes, projects and long term contracts

## Corporate Concerns

*What will happen to our share price and reputation in the market if we don't deliver?*

*How confident can we be of achieving the declared financial return?*

*What are the show stopping risks to successful delivery?*

*What am I **NOT** being told about this programme of change?*

*How well are ongoing operations and employees coping with the impact of this change?*

## The Evidence

*"The brutal fact is that about 70% of all change initiatives fail".*

**Harvard Business Review**

*"In most project failures, the progress reports being provided to management gave no indication of any issues or problems until it was too late".*

**The Boston Globe**

*"85% of Captains of Industry surveyed agreed that their business is increasingly challenged to assess risks and returns on major programmes."*

**Captains of Industry Survey, MORI**

## We Help clients by:

- Identifying the risks to achieving the programme's expected returns
  - Providing an independent opinion on the most likely return
- Providing specialist advice on solutions to reduce cost, reduce risk and improve return
- Helping manage the financial aspects of change

# Kay Drummond

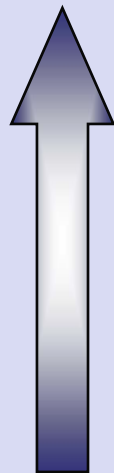
Strathclyde Police

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# Strathclyde Police

- Largest Police Force in Scotland
- Second largest in UK
- 10,000 employees
- Residential pop<sup>n</sup>: 2.2m
- Cover 5,300+ square miles

# Categories of Risk



CORPORATE  
PROGRAMME  
PROJECT  
OPERATIONAL



# Diploma Workshop

Discussion

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# Ian Davitt

IRM Lead Examiner  
on  
Corporate Governance

The logo for the Institute of Risk Management (IRM), consisting of the lowercase letters 'irm' in white on a dark blue square background.

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# CORPORATE GOVERNANCE

PRESENTATION

SCOTTISH IRM

GLASGOW

18<sup>th</sup> MARCH 2005

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# EARLY HISTORY OF CORPORATE GOVERNANCE

1553: Shares in joint stock companies first listed in London

1720: South Sea Bubble/ Mississippi Bubble

1844: Joint Stock Companies Act

1855: Limited Liability Act

1897: Saloman v Saloman & Co

1900: Companies Act

# DEFINING CORPORATE GOVERNANCE

- No single, accepted definition of corporate Governance
- Phrase first used by Robert Tricker in 1976 in a book entitled 'The Independent Director'
- 'The System by which companies are directed and controlled'  
The Cadbury Report 1992

# CORPORATE GOVERNANCE THEORIES

## **Traditional theories based on economics:**

- **Agency Theory (contract and utility theory)**
- **Stewardship Theory (management theory)**
- **Transactional Cost Theory (contract theory)**

# CORPORATE GOVERNANCE THEORIES (Cont)

## **Theories based on the organisation:**

- **Stakeholder Theory (relational not contract)**
- **Social Capital Theory (relational)**
- **Convergence Theory**

# CORPORATE GOVERNANCE IN THE UK

- The Cadbury Report 1992 (BCCI, Maxwell, Polly Peck)
- The Rutteman Report (Internal Control)
- The Greenbury Report 1995 ('Fat Cat' scandals)
- Hampel Report 1998 (The Combined Code)
- The Turnbull Report 1999 (Guidance to Internal Control)
- The Higgs Report 2003 (Reaction to Enron)
- The Smith Report 2003 (Reaction to Enron)
- The New Combined Code 2003 (Some Higgs and Smith)
- Turnbull II 2005/06

# THE INFLUENCE OF CADBURY

- Based on the principles of openness, integrity, accountability
- Key players: Unitary board of directors, auditors and shareholders
- Compliance with a voluntary code coupled with disclosure (comply or explain)
- Introduced a Code of Best Practice

## **MARK I**

**Cadbury (Dec 92)/Rutteman/Greenbury (July 95) Code Of  
Best Practice**

## **MARK II**

**Combined Code (June 1998) Principles Based/ Turnbull  
(Nov 1999)**

## **MARK III**

**New Combined Code (July 03) Principles Plus Supporting  
Principles**

## **MARK IV?**

**Turnbull II/ European/USA influence?**

## **NEW COMBINED CODE 2003: MAIN ISSUES**

- Balance of Power on the Board
- The Role of Non-Executive Directors
- Relations with Shareholders
- Director's Remuneration
- Financial Reporting, Internal Control and Risk Management

# BALANCE OF POWER

- Avoidance of autocratic leadership
- Role of CEO and Chairman to be separate
- Individual directors to have suitable character, experience training and skills
- Board should have a clear set of decision making responsibilities and meet regularly
- NED's to provide balance and prevent dominance of executive management
- Nomination Committee for new appointees
- Board should plan for succession

# NON-EXECUTIVE DIRECTORS

- NED's should be independent and there should be sufficient number on the Board to carry weight (half the Board)
- Senior independent NED to communicate with shareholders
- NED's should bring a range of skills and experience to a board
- Counterbalance power and influence of a CEO or Chairman
- NED's to make up all/majority of key Board Committees (Audit, Nomination and Remuneration)
- Each NED to receive suitable induction and training

# RELATIONSHIP WITH SHAREHOLDERS

- Companies to enter constructive dialogue with institutional investors
- Institutional investors to enter into constructive dialogue with the companies in which they invest
- Growing influence of external bodies representing institutional investors in this area ABI, PERC

# DIRECTOR'S REMUNERATION

- The central issue for CG is concerned with the link between pay and performance
- CA 1985 Director's Remuneration Report Regulations 2002 superseded role of CG
- Remuneration Committee to recommend and monitor level and structure of remuneration
- Higgs outlines the principal duties of the Remuneration Committee
- Targets for performance related pay, pensions, bonuses, share options, severance pay, expenses

# FINANCIAL REPORTING

Annual Report important from a CG viewpoint:

- Annual Report and Accounts (including financial statements) are the principal way that directors make themselves accountable to shareholders
- Financial Statement reflects financial performance over twelve months and position at the end of the financial year
- Director's Report provides supporting information in narrative form
- Shareholders assess stewardship of directors and financial health of the company

# GOVERNANCE AND ANNUAL REPORT AND ACCOUNTS

Clarity, reliability and honesty can be undermined by:

- Fraud
- Errors (incorrect use of accounting policies, omissions of fact, misinterpretation of fact)
- Creative accounting within acceptable accounting practice
- Window dressing of financial performance

# EXTERNAL AUDITORS

Main purposes of the Audit Report is to give an independent and expert opinion about:

- Whether the financial statements give a true and fair view of the financial position of the company
- Whether the financial statements comply with the relevant laws and regulations (including the Combined Code)
- It is **not** the responsibility of the auditor to detect fraud or error in a company's financial accounts; this is the task of management

## C.1 Financial Reporting

C.1 Main Principle: The board should present a balanced and understandable assessment of the company's position and prospects

C.2 Internal Control Main Principle: The board should maintain a sound system of control to safeguard shareholders' investment and the company's assets.

C.2.1 Provision: The board should at least annually, conduct a review of the effectiveness of the group's system of internal controls and should report to shareholders that they have done so. The review should cover all material controls, including financial, operational and compliance controls and risk management systems

## Definition of (Internal) Control

‘Any action taken by management, the board and other parties to enhance risk management and increase the likelihood that established objectives and goals will be achieved. Management plans, organises and directs the performance of sufficient actions to provide reasonable assurance that objectives and goals will be achieved.’

Standards for the Professional Practice of Internal Auditing (Institute of Internal Auditing) 2002

# Convergence of regulation and risk management

- The regulation of business and corporate risk management is converging; regulation through corporate governance enables the management of risks and risk management is a form of self-regulation.
- In the field of regulatory systems and internal control processes the distinction between regulation and risk management has become blurred as the risk management blueprint of assessment, evaluation and control influence the design of regulatory systems.

# Turnbull's definition of internal control:

‘An internal control system encompasses the policies, processes, tasks, behaviours and other aspects of a company that, taken together:

- Facilitate its effective and efficient operation by enabling it to respond appropriately to significant business, operational, financial, compliance and other risks to achieving the company's objectives. This includes the safeguarding of assets from inappropriate use or from loss and fraud and ensuring that liabilities are identified and managed;
- Help ensure the quality of internal and external reporting. This requires the maintenance of proper records and processes that generate a flow of timely, relevant and reliable information within and outside the organisation;
- Help ensure compliance with applicable laws and regulations and also with internal policies with respect to the conduct of business.’

# TURNBULL REPORT

## The Guidance:

- Links internal control to the management of risks that are significant to the fulfilment of the company's business objectives
- Requires directors to exercise judgement in reviewing how the company has implemented the requirements of the Combined Code
- Recommends that internal control be incorporated within the company's normal management and governance processes

# OBJECTIVES OF TURNBULL

- Reflect sound business practice whereby internal control is embedded in the business processes by which a company pursues its objectives
- Remain relevant over time in the continually evolving business environment
- Enable each company to apply guidance in a manner which takes account of its particular circumstances

# FUTURE INFLUENCES

Turnbull II

New Company Law legislation

Sarbanes Oxley Act in the USA

European Union

## TURNBULL II

Under Turnbull, the board of directors only need report on the effectiveness of an ongoing internal control process for identifying, evaluating and managing the significant risks faced by the company and that the process is regularly reviewed.

The board need not describe what that process actually is or what the results were but Turnbull adds that the board may wish to provide additional information to assist understanding of the company's risk management process.

Is this effective for SOX 404 (a)? (does Turnbull '...contain an assessment of the effectiveness of such internal controls'?)

## COMPANY LAW REVIEW

- **Boards should pursue ‘enlightened shareholder value’ by balancing the interests of stakeholders. Best way to protect long-term interests of shareholders.**
- **Review recommended mandatory Operating and Financial Review.**
- **OFR ensures businesses account not only for financial business performance but also account for key relationships with stakeholders and report on environmental and social policies and performance.**

‘...companies are increasingly reliant on qualitative and intangible assets such as the skills and knowledge of their employees, their business relations and their reputation. Information about future plans, opportunities, risks and strategies is just as important as the historical review of performance which forms the basis for reporting at present.’

Modernising Company Law Page 49

# OFR: DYNAMICS OF THE BUSINESS

Risks, opportunities and related responses in connection with:

- Competition and changes in market condition
- Customer/supplier dependencies
- Technological change
- Financial risks
- Health and Safety
- Environmental costs and liabilities

# **The Companies Act (1985) (Operating and Financial Review and Directors Reports etc) Regulations 2005**

## Directors Report: Business Review

- (1) The directors' report for a financial year must contain –
  - (a) A fair view of the business of the company, and
  - (b) A description of the principal risks and uncertainties facing the company

# CORPORATE GOVERNANCE IN THE USA

It is important to understand the events leading up to the US Authorities passing the Sarbanes-Oxley Act (SOX).

The corporate fraud perpetrated at Enron and WorldCom were the main reasons for this hastily prepared legislation and the background to these corporate scandals are reflected in the remedial requirements of SOX and the NYSE Standards.

## Sarbanes-Oxley Act 2002

SOX was introduced by Senator Paul Sarbanes (Democrat, Maryland) and Congressman Michael G. Oxley (Republican, Ohio Chairman of the House Committee on Financial Services)

Became law at the end of July 2002 and implemented by the SEC in August 2002

Sets out a new system of audit regulation and introduces the concept of corporate accountability legislation with criminal penalties for corporate wrongdoing (Comply and sign-off)

# SHORT SUMMARY OF SOX

- Outright ban on nine kinds of non-audit services provided by the independent auditor
- All non-audit work to be approved by the company's Audit Committee
- Ban on corporate loans to officers
- Established the Public Company Accounting Oversight Board (PCAOB) – a private, non-profit making organisation funded by fees from public companies with power to investigate/fine auditors
- Wilful violation of new obligation to certify the accuracy of annual and quarterly accounts carries a prison sentence of up to 20 years
- CEO/CFO must certify within 45 days of year end their companies' financial reports under oath

## **Section 302 - Corporate Responsibility for Financial Reports**

Signing officers (CEO's or CFO's or other equivalent officer of the company) must personally certify that they have reviewed the published results and based on their knowledge, that the report does not contain any untrue or misleading statement (or any omission) of a material fact and based on the officers knowledge, the financial information included in the report fairly represent in all material respects the financial condition and results of the company for a given period.

# Section 404 – Management Assessment of Internal Controls

- Management responsible for establishing and maintaining adequate internal control structure and procedures over financial reporting and contain an assessment of the effectiveness of such internal controls.
- Accounting firms who are appointed to prepare the audit report shall report on the assessment made by the management as part of the external auditing services.
- Section 404 applies to companies listed in the US including overseas companies with secondary listings in the US.

## **Section 406: Code of ethics for senior financial officers**

- Each company is required to disclose whether or not (and if not, why not) the company has adopted a code of ethics for senior financial officers, applicable to its principal financial officer, or persons performing similar functions.
- Companies are required to immediately disclose any change in or waiver of the code of ethics for the senior financial officer.

## **Section 906: Corporate responsibility for financial reports**

The criminal penalties under s906: Whoever certifies any statement as set forth in s309 knowing that the periodic report accompanying the statement does not comport with all the requirements set forth in s309 shall be fined not more than USD\$1,000,000 or imprisoned not more than 10 years, or both; or

Wilfully certifies any statement as set forth in s309 knowing that the periodic report accompanying the statement does not comport with all the requirements set forth in s309 shall be fined not more than USD\$5,000,000 or imprisoned not more than 20 years, or both.

# The NYSE Corporate Governance Standards

The SEC approved the New York Stock Exchange's new corporate governance standards for listed companies in November 2003.

Central to the new standards are the requirements that boards of NYSE listed companies have a majority of independent directors and that nomination and compensation committees consist solely of independent directors.

# CORPORATE GOVERNANCE IN EUROPE

Corporate governance has assumed more importance in recent years as a result of:

- The adoption of the euro and integration of capital markets
- Sarbanes Oxley rules extending to secondary listed companies
- Parmalat

# EUROPEAN COMMISSION PROPOSALS

In October 2004 The Commission published proposals to update the 4<sup>th</sup> and 7<sup>th</sup> Company Law Directives concerning annual and consolidated accounts. As currently drafted there are proposals to:

- Require all listed companies to include a mandatory corporate governance statement in their annual reports, which would include a description of internal control and risk management systems.
- Require a description of the group's internal control and risk management systems in relation to the process for preparing consolidated accounts.

# ETHICAL QUESTIONS

- Can a company be treated as a ‘person’ in its own right with given ethical and moral standards?
- If so, can an organisation be capable of behaving in a socially responsible manner?
- Who should decide the actions of organisations?
- Is it the role of an organisation to become embroiled in politics?
- Should a public company contribute to political parties?
- Who should decide the measures of success or failure for an organisation?

Sir Adrian Cadbury had this to say: ‘Corporations work within a governance framework that is set first by the law and then by regulations emanating from the regulatory bodies to which they are subject. In addition, publicly quoted companies are subject to their shareholders in general meeting and all companies to the forces of public opinion. The influence of public opinion should not be underestimated; it compelled Shell to change its plans for the disposal of the Brent Spar platform. Not only is public opinion a governance force but also it is one whose impact cannot be precisely foreseen in the same way as that of the law and regulations; it is not fixed in form as they are but responds to the mood of the moment. The views of investors and public opinion reflect their current thinking and boards of directors and members of professional bodies need to respond by being continually alert to the changing expectations of those whom they serve.’

# CORPORATE GOVERNANCE AND STRATEGY

*Who* should the organisation serve? This is addressed through the concept of organisational stakeholders and the extent of their interest and influence on organisational purpose.

*How* the direction and purposes of an organisation should be determined? This relates to the power of stakeholders to influence corporate purpose and direction and the process of supervising executive decisions and actions and the issue of accountability.

## GOVERNANCE AND STRATEGY (Cont.)

- Different stakeholder groups will have their own expectations and objectives in relation to organisational strategy and this may result in a conflict of interest with other stakeholder groups that in turn may lead to conflict should they differ.
- Corporate governance is concerned with the expectations of stakeholders and it is such expectations that ultimately shape organisational purposes and corporate strategies.

# FORMAL EXPECTATIONS

- Regulatory and legal requirements of accountability to its owners/shareholders are formal expectations of an organisation.
- In terms of external environment and socio-economic trends, the historic view that the sole aim of an organisation is to maximise profits and shareholder wealth is not in accord with current political thought.

# INFORMAL EXPECTATIONS

The purposes an organisation should fulfil are also heavily influenced by political and ethical considerations as well as regulatory and legal requirements.

- Corporate Social Responsibility
- Sustainable Development
- Socially responsible investment

# GOVERNANCE AND REPUTATIONAL RISK

The risk exposures associated with wider issues of governance, corporate social responsibility and sustainable development are not within the ambit of the traditional internal control view of 'financial' risk; indeed they are very much 'non-financial' risks (at least until they impact on cash flow) and are probably only beginning to be captured by business reporting, ranking and rating systems. Ultimately the area of concern is that of reputational risk.

## CONCLUSION: GOVERNANCE IN THE LONG TERM

- Corporate governance, corporate social responsibility and sustainable development are merging as a result of the development of the concept of accountability.
- The concept of governance is perhaps in the process of evolving from a reactionary regulatory framework following financial scandal to a wider socially inclusive approach.

# Next Meeting

Friday, 24 June 2005

1pm

Clydesdale Bank, Glasgow

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