COMPLIANCE, RISK AND CORPORATE GOVERNANCE!

(Or, DRIFT - Doing it Right First Time)

"If you can make one heap of all your winnings, and risk it all on one turn of pitch-and-toss,
And lose, and start again at your beginnings, and never breathe a word about your loss."

(Rudyard Kipling (1865 – 1936), English author and poet, IF (1910))

Many of us might accept that 'if' is one of the biggest words in the English dictionary. We tend to use it in conjunction with the word 'only' and the combination of the two words implies an amount of frustration at having missed an opportunity, made a wrong decision or failed to do something. In his poem Kipling is suggesting, perhaps, that life is a risk and if you make a decision or gamble on an outcome and it turns out wrong if you can pick yourself up and keep going you will be a better man. But is that really the case? Do we not all look to take only calculated risks such that the roll of the dice or a business venture or personal decision actually goes in our favour? Do we deliberately gamble to fail? And, when it comes down to rules, regulations and legal requirements do we not all, well mostly, look to comply?

Compliance is, basically, acting in response to a request or even a legal or binding directive issued, usually, by a senior body, a government or an international organization. Many companies involved in the design and manufacture of goods and products for sale in national and international markets, for example, already use international and nationally agreed standards that cover such areas as, guides, methods, specifications and codes of practice. And, increasingly in the growing global market economy companies are turning to internationally agreed standards to ensure that their goods or services meet customer and consumer demands whilst also protecting the interests of people and the environment.

Complying with clearly defined legal requirements, regulatory issues and ethical standards is an area of business that affects everyone in a company. However, it is an area of major concern and responsibility for directors and members of boards because they are held to be accountable for establishing clear policies and procedures to ensure regulations are complied with. Further, such policies and procedures must be visited regularly to determine that they are up-to-date and to prevent customers and suppliers embarking on legal proceedings thus risking or damaging the good name, reputation and reliability of company products or services.

Most companies and organizations nowadays have clearly defined lists of regulatory returns, reports or programmes that must be complied with together with appropriately nominated directors or senior managers tasked and empowered to take the necessary action by specific dates. Indeed, there are so many reports and actions to be taken, covering, for example, health and safety and environmental issues that to ensure tasks are completed companies have had to produce a plethora of organizational charts, checklists, worksheets, summaries and guidance booklets for quick and easy reference. Company guidance on compliance and compliance monitoring should cover, among others, the following areas:

- **Finance** - many reported instances of companies failing and going out of business is due to a singular failure to keep a tight rein on accounting procedures and practices and a lack of internal checks and balances. Apparently more than 60 per cent of business failures are due to poor financial management, sometimes due to poor auditing, or, sometimes a finance committee that cannot read between the balance-sheet lines.

- **Environmental** - the public at large are increasingly aware, through the media, of environmental issues that are, will or might affect their or their offspring's lives; such issues as global warming and greenhouse gas emissions, the loss of the ozone layer and soil contamination through chemicals is reported regularly. International meetings in Kyoto and The Hague covering pollution and tighter control on carbon emissions also have a high profile. Companies need to be aware of environmental issues, programmes and legal requirements that affect their business.
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- **Health and Safety** - there are many national regulations and guidelines covering health and safety of employees in the work place. These cover, for example, working with or handling hazardous or flammable materials, the use of safety belts when working on structures above the ground, the use of desktop computers and computer screens and internal pollution from noise, smoke, dust and fumes. Companies must put in place the necessary informative and preventative measures. Safety issues are the responsibility of every level of management.

- **Employment** - employing people within any organization includes adhering to guidelines on employment practices and procedures that cover such areas as discrimination, harassment, the use of drugs and alcohol, pension schemes, labour relations, trades union membership or representation, dress code, behaviour, discipline and grievances and termination of employment.

- **Information Technology (IT)** - it is now widely accepted that IT systems are not only an area of compliance but of considerable risk. Companies should have guidelines on the security of information contained in databases and compliance with the data protection act. Employees should be made aware of company policy on the use of desk top and lap top computers, the security and safe stowage of such attractive items from theft and the need for control of the exchange of data through electronic mail systems and other forms of communication including accessing other commercial sites. This area should also address the introduction of 'firewall' systems to protect against viruses and fallback systems and recovery procedures in the event of the loss of mainframe systems and internal and external networks.

- **Training and Quality** - companies and organizations continue to exist and trade profitably through the attitude, efforts and abilities of their employees and through the general standard and quality of their products or services. So that customers have faith in the availability, reliability and quality of those products or services it is essential that employees are provided with necessary and relevant training on equipment, systems and programmes to enable them to carry out their tasks efficiently and effectively. This also applies to directors and managers.

- **Security** - this area covers not just the physical security of buildings, offices, equipment and systems but procedures to cover additional safety issues as Fire, Flood, Bomb threats and evacuating buildings. Given the possible threat from various sources, including terrorist organizations, it is important to address the issue and under this section it is paramount to have a plan for emergency evacuation, emergency evacuation routes, how many people are normally working in the building and in each section and how long it takes to clear the building using stairways and any other escape routes. If you cannot re-assure your staff that you have addressed these issues then how will they have faith in your planning ability?

- **Plans** - make sure that you produce clear guidelines and plans so that employees know how to respond to emergency situations. Make sure the information is published and widely distributed in handy books or easily accessible information files.

Compliance with rules and regulations is one thing but determining risk and the level of risk in a particular project, product or area of business is a different and more complex programme. At first glance you might say that there is no connection between risk and compliance in business for the simple reason that risks are something we take with any decision but that compliance is a case of following pre-defined rules or regulations.

However, on second glance you may accept that compliance is part of the risk process because it covers the same subjects. Sometimes, and in some areas of business, companies or organizations might, occasionally, choose to ignore or perhaps conveniently forget about a rule or regulation either to expedite financial processes, manufacturing, speed up the production line to meet deadlines, reduce maintenance downtimes or to maintain output and income. That is, perhaps, taking a calculated risk but, choosing to relax or ignore any regulatory guideline is taking a big risk for the simple reason that it could lead to a hazardous situation developing and if found out incur considerable penalties in one form or another.

However, there are some, mainly bankers and economists, who argue that risk in a capitalist society, through the expansion of loans and credit, is important because it is only those who take risks with capital on the possibility of future growth and expansion who achieve anything. But, surely, banks and financial organizations will not allow large sums of credit if they do not take a long, cold, hard look at a business plan and also insist on the borrower having some form of collateral or insurance to cover their risk? That way the banks and financial institutions do not lose if and when something goes wrong with a business, it is those people who chose to gamble, to take a risk and put their monies into such ventures.

I suggest that a calculated risk is one where all possible combinations of pros and cons, well as many as possible, of a situation are discussed and taken into consideration before proceeding with a course of action. If and when greed enters the equation then some are more likely to want to take even greater degrees of risk just as long as they accept the consequences of such actions. Of course it is not always possible to cover every eventuality and sometimes we do not have the luxury of time but risk and the amount of calculation we carry out has an impact not only on a decision but also on the level of success we may achieve.

However, again, whilst business is about taking risks and there is no such thing as a ‘risk free scenario’ this should not include clearly unacceptable or unnecessary risks with shareholders monies nor with the lives and livelihoods of employees and where there is the possibility of increased or higher level risk then organizations must think twice before proceeding. I suggest that because there are some business strategists who believe that management is first and foremost about re-inventing a company accompanies by continual change and about moving into different areas in order to increase returns to shareholders.

That is fine provided that the level of risk involved in such ventures, which include mergers or acquisitions, really has been assessed and that the board is in agreement with the proposed strategy and fully appreciate that change is not always progress. And, if chairman, chief executives, managing directors and boards of directors choose to take such risks then they should not be rewarded for failure.

During World War II, and before the battle of Midway between the US carrier fleet and the Japanese carrier and amphibious fleet, Admiral Chester Nimitz suggested to his subordinate sea Commander, Rear Admiral Spruance, that a calculated risk was making sure that the US carrier group under his command inflicted sufficient damage without incurring too much themselves. That put the onus for determining and defining the operational strategy and for assessing any risks associated with the positioning and tactics of the US carrier group firmly on the shoulders of the on-scene commander. However, given the paucity of real-time intelligence gathering and the unreliability of radio communication systems at that time it made sense.

But, I also suggest that Admiral Nimitz was delegating responsibility for conducting a risk assessment to Admiral Spruance because he, Nimitz, was not close to the scene of possible action and he was not fully aware of the facts and the multiplicity of circumstances that could arise. As another notable military man suggested:

> "Take calculated risks. That is quite different from being rash."
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> **(General George S. Patton (1885 – 1945), WWII US Army General)**

So it is in business. Directors cannot be totally aware of all the changes in conditions that apply to their business and the possible risks to their company but they should know where to find such information and who has delegated responsibility. What they can and should do is accept overall responsibility and accountability for making every effort to put in place plans, procedures and manpower for compliance, for assessing business and company risk and for corporate governance. That includes not only having a 'finger on the pulse' of their business but also on any changes in products or services offered by other companies and organizations in the same area of commerce; and, in the same vein, aware of growth or decline in corporate demand that has an impact on profit and interest rates.

They must be aware of financial constraints and be proactive in considering and determining strategy and risk through conducting a Political, Economic, Social and Technological (PEST) analysis and through carrying out Strengths, Weaknesses, Opportunities and Threat (SWOT) assessments of the area of business and their business competitors. If you do not identify possible risks then how can you control them? These processes could include:

- Continuous assessment to identify potential risks.
- Taking necessary and appropriate action to reduce or avoid unnecessary risks.
- Establishing internal system of sharing relevant information on management reports.
- Delegation of risk management and responsibility to appropriate business areas.
- Clearly defined connections between risks or potential risks and risk management strategies.
- Upgrading risk management plans to take account of changing circumstances.
- Communicating risk policies and plans to reduce confusion among employees.

Again, in an expanding global economy risk is increasing not just because of further competition from developing nations, and more especially China and India, but because of the need to make the best possible use of, in some cases, dwindling resources, such as oil and gas, and includes, in some areas, trained and available manpower. That is why regulatory regimes and corporate governance is paramount to ensure that unnecessary risks are not being taken to protect the employees and protect the investment of shareholders and other stakeholders.

And, there are even bigger risks for multi-national companies looking to expand into other areas of the globe. Companies need to be made aware of such major risk areas as political and economic stability, there is little point putting resources into a country that might default on repayments of where the currency is not worth the paper it is printed on. Under those conditions risk guarantees from worldwide banking institutions would be essential before proceeding with investments.

Other areas that should be assessed are social conditions and working environments for locally employed personnel and the likelihood of industrial unrest leading to strikes. Of course there is an additional risk from the bad publicity likely to emanate from investigative reporting when the jobs of workers in developed countries are exported to developing countries where wages and conditions are that much cheaper and worse. This area in particular could have a huge knock-on effect on profits when customers in advanced nations object to slave labour and wages.

In addition the general state of the infrastructure and radio and telecommunication networks should be addressed so that goods can be shipped in and out and guidance or instructions sent to managers in detached locations. Further, the rapid pace of technological change, particularly in all areas associated with communications and telecommunications, biochemistry and biotechnology, also lead to risk because information on research and development programmes can rapidly be sent from one source to another, by that I mean the increased possibility of industrial espionage.

However, taking a calculated risk is important because it not only helps to concentrate management effort on core business and protecting the company from external threat but because it also helps to make companies think about future direction and possible opportunities.

The whole process of risk assessment is, fundamentally, a balancing act. It is a corporate process where directors and senior managers balance the cost of investment in research and development, in new plant and products and in training people against profit levels and providing a return on investment to shareholders. In some areas it is balancing the speed of manufacture or production to meet deadlines against, possibly, overall quality and reliability of goods or services. And, in public transport systems it is, increasingly, balancing speed of advance against the reliability and efficiency of the type of vehicle, train, boat or plane, and its associated safety systems.

There is a suggestion that organizations that take too few risks tend to fail to develop new products or services and thus stagnate and others are averse to risk. Conversely, taking too many uncontrolled risks can lead to a failure in corporate governance, to the loss of business and to the loss of shareholder and stakeholder interests. Likewise, the failure to communicate policies, plans and procedures can also lead to a degree of misunderstanding or even confusion within an organization and when there is a breakdown in communications then the level of risk increases.

A primary objective of compliance and risk assessment is to enable organizations and their employees, to do things right first time; that is where my acronym DRIFT comes from. The Organization for Economic Co-operation and Development (OECD) has drawn up some general principles on which companies might base their corporate governance. This framework could include, among others:

- Protecting shareholder rights.
- Ensuring the equitable treatment of all shareholders, big and small.
- Recognizing the rights of all stakeholders, customers, suppliers and employees, in the creation of wealth and jobs and the maintenance of sound practices especially in financial dealings.
- Ensuring the timely and accurate disclosure of corporate material relating to governance, ownership and finance especially where risk is increased.
- Ensuring the effective guidance and management of the company and the accountability of directors and boards to shareholders.

However, any company or organization that concentrates purely on achieving a higher share price and a greater return on investment for shareholders whilst ignoring other stakeholders - customers, suppliers and employees - is, to some degree, failing to meet wider social responsibilities. In that respect they may subscribe to the economic theories of the US economist Milton Friedman who wrote,

> "Few trends could so thoroughly undermine the very foundations of our free society as the acceptance by corporate officials of social responsibility other than to make as much money for their shareholders as possible."

(Milton Friedman (1912 - 2006), US Economist. *Capitalism and Freedom* (1962)

Besides, the short-term pursuit of profit sometimes means that insufficient funds are then available for investment in research and development, on the maintenance, decor and furnishings of offices and factories and on recruitment and providing appropriate and relevant training and advancement courses for employees to ensure continued effectiveness, efficiency, productivity and competitiveness.

Successive instances of corporate malpractice, inefficiency, financial failure or tragedy lead to greater public demand for accountability. Whilst that does not necessarily lead to a 'culture of blame' nonetheless people are elected, promoted or accept and are put into positions of authority and they should recognize that with status and remuneration comes responsibility and that includes risk. Poor corporate governance and responsibility can result not just in poor profitability but can also undermine company status, relationships and competitiveness.

There are those who suggest that you can manage risk. What they are really referring to is the process of conducting a review of the way that a company performs and its internal procedures in order to determine plans to ensure continuity in the provision of customer requirements in the event of the loss of systems, equipment or services that assist the organization to meet its obligations. In order to carry out that exercise many companies bring in management consultants to provide alternate views and opinions on future strategy and direction. Whilst management consultants provide advice it is the senior management of a company who are responsible and accountable for making and taking decisions. As John Maynard Keynes suggested,

> "Economists set themselves too easy, too useless a task if in tempestuous seasons they can only tell us that when the storm is past and the ocean is flat again."

(John Maynard Keynes (1883 – 1946), British Economist)

The questions that all Chairmen, directors and senior managers have to continually address are how long could our organization survive without having procedures in place to assess the level and degree of risk in every area of the business, do we have complete understanding of rules, regulations and guidelines to avoid the possibility of unnecessary risk and are we taking every possible precaution to manage those risks? There is no risk-free scenario. There are no certainties in business. What senior managers must try to do is to minimize the risk involved in any venture by addressing efforts to reduce the level of instability between income and expenditure. That is why 'check-off' lists are useful in keeping a weather eye on the business.

According to Lord Skidelsky, who has written a 3-part 'magnum opus' on the economist John Maynard Keynes, Keynes's General Theory concerned the effects of uncertainty on business, the connection between business and finance and the need for stabilisation of market capitalism. Therefore, managing risk is of paramount importance to any organization or company. Corporate governance, apparently according to the City and financial institutions, is the relationship that boards of directors have with shareholders.

However, the fact remains that boards of directors are not only responsible to their shareholders, which increasingly includes institutional investors like pension funds and that means the public, not just for the longer-term performance, competitiveness and financial stability of a company but also for complying with regulatory conditions, legislation and managing or controlling risk.

Perhaps, as part of the annual tripe report, Chairman and Chief Executives or Managing Directors should include a précis on the subject of risk that they have addressed during the year and provide shareholders and employees with an assessment of the level of threat in the coming 12 months or even 2 years and covering financial issues?

This is just an introduction to the subjects of compliance, risk and corporate governance because, in my view, the 3 areas of business are inter-linked. There are no absolute guidelines to best corporate governance practice save to ensure that the board of a company consists of a cross-section of individuals with a cross-section of skills balanced with sufficient numbers of external non-executive directors to provide checks and balances.

However, as at the turn of the new millennium there is no model for corporate governance let alone global guidelines on what makes for best business practice. Given that investors are international and look to invest on a global scale now might be a good time to really concentrate the minds of senior businessmen and governments to produce standards that provide corporate advice on a national and an international scale.

Advice on compliance, risk and corporate governance is already available from management consultancy companies and business schools where 'high flyers' are taught, among others, the principles of marketing, strategy and risk taking.

Other guidance and guidelines on standards and best management practice are contained in the BS EN ISO 9000 and 14000 series of documents and on information security in the British Standard BS 7799. A published document covering the subject of corporate governance PD 6668:2001 - Managing Risk for Corporate Governance provides additional guideline information on corporate governance is available.

And just to introduce levity into the risk equation and provide an idea on higher level thinking on pricing and risk, the following is taken from an article in the Guardian newspaper, I believe, in 2000,

> "If you thought business schools encouraged already anally retentive people to take themselves much too seriously...you were right. A student at Insead, Europe's leading business school, offers peers his thoughts on how to price tickets for their annual ball: "We have two different products, one of which is definitely higher risk (the ball + dinner ticket) than the other...the idea is to give precedence to the riskier product. To me this makes sense only if it yields a significantly higher marginal contribution...but we need to discount the margin we make on them by a yet to be assessed 'overcapacity factor'...I can see our business model is very unstable, because once we have fixed our catering capacity we break even if and only if we sell at capacity: anything less and we make a loss...In brief, if we really think that full price ticket is our primary driver, we should make a higher margin."
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> **(The Guardian newspaper)**

Some, those who do not like the idea of guidelines or guidance, might suggest that too many rules and regulations stifle entrepreneurship, delay progress with the development of products or services and the decision-making process and, subsequently, affect profits.

Others argue that the only way to ensure good corporate governance is through having sufficient non-executive directors who are prepared to question corporate strategy, financial reports and the decisions of the executive. And, others argue the only way to ensure good corporate governance is through strong and healthy competition.

And, yet others, those who believe that information on standards in the capitalist system can be maintained, may insist that if board of directors act not only in the best interests of shareholders but of all stakeholders then the level of risk that companies take might increase and they would be correct for the fundamental reason that when greed enters the equation then all notion of risk taking increases.

Unfortunately self-governance or voluntary codes of practice tend towards inadequacy, complacency, fudges and inadequate reporting. All forms of self regulation tend to be ineffective and only those organizations that are honest and above board in their financial, ethical, political and social dealings are likely to make any mention in their annual reports.

Greed and incompetence at the highest levels are at best unacceptable and at worst downright inexcusable and any director guilty of such failings should not be allowed to serve as a non-executive director in another company. Neither should Chairman, Chief Executives or directors be rewarded for failure.

There are those who appear to have a vested interest in maintaining the ‘status quo’ with enormous inequality and disparity between top and bottom in society, in other words in retaining a feudal system where a percentage of the population remains poor or even very poor. And unfettered capitalism, in the Anglo-American model of ‘laissez-faire’ coupled with considerable income differentials, has led to considerable corporate and personal greed.

Therefore, it requires a degree of legislative order supplemented by pressure from consumers, society and governments. Whatever the case and whatever the merits the present systems of a lack of necessary regulatory systems, corporate governance and ethics, or the lack of them, needs to be addressed at an International level and guidance produced as a matter of some urgency.

Capitalism, if it is to survive in its present format, has to depend, to a large extent, on trust coupled with openness, honesty and integrity and, responsibility and accountability, something that appears to be sadly lacking in many sectors of industry and commerce. The economic system of 'laissez-faire' coupled with a light regulatory touch does not seem to function too efficiently and is leading to increasing levels of greed accompanies by risk. By and large people, investors, shareholders, employees, suppliers and customers, are heartily sick of the business attitude that pays lip service to the idea of values, communication, responsibility and accountability and to the issues of regulations and corporate governance when much of what is written in company reports is mostly hot air and rhetoric.

Just to prove the point that good corporate governance works the Italian stock exchange, according to a McKinsey report in 2002, has a separate list of companies that comply with strict governance requirements. These company requirements include, among others, at least 35 per cent of its new stock listed on the open market, a minimum number of independent non-executive directors on their board, compensation for directors linked to performance and rigorous disclosure of information and reports. Thus far this separate group of companies has outperformed their counterparts in the non-strict corporate governance code by some 16 per cent between 2001 and 2002.

Whatever the case and whatever the merits the present systems of corporate governance, integrity and ethics, or the lack of them, needs to be addressed at, probably, an International level and guidance produced as a matter or urgency. In an effort to improve corporate standards that guidance, or even legislation, should include measures to 'recover' money and shares from directors who benefit from 'creative accounting' that distorts both profit figures and the share price. That is because multi-millionaire businessmen are unlikely to agree to any changes in their lifestyles no matter that the companies they run might disappear down the pan.

Change, in this instance, does not mean the introduction of self-regulation and guidelines but the acceptance of wrongdoing by senior managers when they are clearly at fault, accepting the law of the land and any necessary punishment including custodial, and making restitution to shareholders and other investors when they are clearly responsible for allowing too much risk to be taken in their financial dealings. As Gilbert and Sullivan wrote for the character of The Mikado in the operetta of that name, "My object all sublime I will achieve in time, to make the punishment fit the crime, the punishment fit the crime".

It is time for the bullish or bearish beat of business to accept, understand and comply with guidance and direction on environmental, financial and corporate guidance issues and for financial institutions to pay greater attention to the level of risk that they are prepared to take and more especially with other people's monies. Perhaps one begins by defining exactly, or more precisely, what governance means rather than just suggesting that companies should be managed and controlled in the best interests of shareholders. After all, there is more than one group of shareholders and by that I mean not just those who own the shares but those who also earn from the endeavours of the people who work in any company.

(5000 words including quotations)

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