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Disciplined experimentation

'We need to invest in the way we interact. We need to be curious, to encourage others, to be flexible, to be resourceful, if we are to develop our organisational learning capability, our ability to experiment and learn – to be resilient.'

David Lewis

Governance in China

'Financial fraud is not just the result of individual misconduct or negligence; it has systemic roots. It needs fertile soil to develop, and that soil is the culture in which companies are governed. Instances of fraud expose the flaws in a company's governance model and ethical commitments.'

Lyndsey Zhang

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News

Making corporate purpose tangible

'Companies will need to "walk the talk" as the current crisis is laying bare for all to see which stakeholders companies are prioritising and how they have integrated sustainability considerations in their culture and operations', according to an investor survey by shareholder advisory firm SquareWell Partners. Institutional investors and society have increasingly high expectations of companies' corporate purpose and execution of that purpose. Many now advocate for a vision for corporate purpose that delivers on broader corporate responsibilities and achieves stronger and sustained profitability and impact for the benefit of all constituencies.

The survey Report, *Making Corporate Purpose Tangible: Investor Views*, shows that there is more alignment than disagreement regarding the importance of corporate purpose. Indeed, the results highlight that when creating value most investors expect boards and management teams to put corporate culture and stakeholder considerations at the core of a company's mission and objectives.

The survey results also show that how companies define and articulate their purpose, organise the business of the board and management to achieve and monitor implementation of that purpose and engage with investors to win their support and partnership in delivering on purpose will increasingly impact how a company and its leadership are assessed and valued.

'Corporate purpose is a rapidly evolving area that warrants continued focus …'

Key findings

The survey gathered the views of investors on the relevance of corporate purpose, who should be responsible for delivering it, how it should be measured and how they intend to hold companies to account for putting it into practice.

Ninety-three per cent of shareholders believe that purpose is a necessary grounding for a successful long-term strategy; 86% expect firms to report on the delivery of purpose, with 75% emphasising the need for KPIs; and 64% are currently engaging with companies on their purpose, only 22% reporting that they are not.

Relevance, responsibility and accountability

Seventy-six per cent of investors surveyed expect companies to have explicitly defined their purpose. This is seen as necessary in setting a long-term business strategy that creates value, strengthens corporate culture and helps provide a focus on stakeholders.

Nearly half of the participating investors suggested that they expect the company's purpose to be in line with the UN Sustainable Development Goals. The purpose does not need to be reviewed annually but should be aligned with the company's strategic review. Investors overwhelmingly believe that the board is responsible for defining the company's purpose but that the responsibility for its implementation is shared with the management team.

Disclosure and implementation

To investors how the purpose is implemented is considered to be more important than how it is worded. Seventy-five per cent of investors surveyed expect companies to come up with KPIs to measure progress on fulfilling corporate purpose and 59% expect such KPIs to be included in executive pay programmes.

Most investors suggest that the company's purpose has a dedicated section within the annual report (or equivalent document) with a formal statement from the board addressing the company's purpose. Investors will look to see if there is consistent disclosure regarding the implementation of the purpose, stakeholder concerns and employee turnover, for example, to evaluate whether the company's purpose is effective.

Investor approach to corporate purpose

Just under a quarter (21%) of the participating investors have incorporated the evaluation of a company's purpose into their evaluation of ESG risks and opportunities, and a further 28% are considering incorporating it. Only one-third expect to have a vote on a company's purpose but almost two-thirds are engaging with companies on the topic.

Whilst a quarter of the participating investors suggested that they will not oppose any agenda items if they are not satisfied with a company's purpose, investors will most likely target the election of board members (including the board Chair) and discharge (where possible).

Corporate purpose is a rapidly evolving area that warrants continued focus, attention and leadership by boards, management teams, investors and all constituencies. Investors are looking for a comprehensive approach and appreciate that corporate purpose is inclusive of investor priorities and they view a company's purpose: as the primary force that should guide the company's strategy; as the responsibility of both management and the board; to be reported on thoroughly; and are willing to engage if it is not translated into action.

Companies that have already defined their corporate purpose are likely to be in a better situation than their peers and investors will be able to assess how resilient and sustainable their investee companies really are.

For more information go to: https://bit.ly/2C2Y1aJ

International

Six post-crisis board priorities

The Covid-19 crisis is accelerating a shift toward a more integrated approach to corporate governance according to a report recently published by the World Economic Forum. The Report, *Integrated corporate governance: 6 leadership priorities for boards after the Covid-19 crisis*, outlines a six-point leadership agenda for boards that requires heightened board stewardship and that will be essential for ensuring companies' longer-term competitiveness and resilience.

Strategic alignment with value creation

Boards must align their strategic, and particularly capital allocation, priorities with key drivers of long-term value creation. As companies adapt to a new economic context, changed workplace conditions and raised expectations following the pandemic, as well as ongoing environmental constraints and acceleration toward digital transformation, they must intensify their focus on intangible drivers of value, such as research and innovation, employee well-being, talent development, corporate culture and respect for human rights, and strengthening external stakeholder relationships and trust.

Risk oversight and ESG&D factors

As part of their risk oversight responsibility for operational, financial, reputation and regulatory risks, boards must gain more in-depth understanding of rapidly evolving Environmental, Social, Governance and Data (ESG&D) stewardship risks. They must provide oversight on these material risks and must be able to rigorously evaluate alternative investment, innovation and technology options for mitigating current risks and avoiding future ones. Governance issues include clarity around corporate purpose, ethics, compliance, anti-corruption, tax payments and political engagement and key data stewardship priorities for boards are cyber security, the use and governance of artificial intelligence and machine learning and privacy and data ownership issues associated with data collection, management and use.

Strengthen readiness and resilience

Boards play a crucial role in providing oversight of their company's ability to respond to, and recover from, systemic crises and shocks. To strengthen preparedness, they must undertake more regular and sophisticated scenario analysis and horizon-scanning activities, 'stress-test' the company's resilience against shocks that may have system-wide implications and put crisis response and emergency succession plans in place for mission critical roles at executive and operating level.

Board engagement with management

Boards have a greater than ever stake in the health of their company's operating context and should engage with management to: shape the firm's investment in education and training to prepare the future workforce and support evolving working practices, such as a shift to online and remote working; review global tax policies and practices to ensure fair payment of corporate taxes that are needed to support public goods and services and effective public institutions; identify areas where the company can play a role beyond its own operations in tackling structural inequality and injustice; and consider how their companies can contribute to collective public priorities, including through policy dialogue and advocacy in support of these priorities.

Integrated mainstream reporting

All boards should be familiar with, and able to provide oversight on, the evolving agenda for corporate reporting and accountability. There is a growing imperative for boards and management to prepare the company's mainstream disclosures in an integrated way that combines financial reporting with reporting on material ESG&D risks and opportunities and to ensure greater transparency and accountability to investors and other stakeholders by setting public targets, providing independent assurance on performance against these targets and analysis of strategic risks and opportunities. There is also a drive to identify a core set of ESG metrics and disclosures that are common across industry sectors, which can be integrated into mainstream reporting on a consistent and comparable basis.

Board structure, work and engagement

Boards need to integrate ESG&D issues into the way they are structured, organise their work and their engagement. Key areas for review include: the integration of ESG&D oversight into different board committee charters and whether to establish a dedicated board committee; ensuring the right balance between committee-based work and integrating these issues into full board discussions on corporate purpose and culture, strategy, risk management, scenario and competitiveness analysis, major investment decisions, business planning, target setting and performance oversight, executive compensation and succession planning. Being fit-for-purpose requires much greater diversity of director skills, experiences, gender, race, nationality and age. However, boards also need to increase internal engagement with the company's executive management team and beyond, as well as engagement with external stakeholders.

This six-point agenda for leadership action is applicable to any board regardless of jurisdiction, ownership structure or business model and boards should integrate these principles and practices across industry sectors and countries to create long-term sustainable value for both shareholders and other stakeholders.

For the full Report go to: https://bit.ly/2BiUHIU

Global News

Investors consider companies with sustainability issues

'One in three US investors said they wanted their fund managers to actively engage with management of companies with sustainability issues rather than invest just in sustainable ones', according to a recent survey which examined US and Canadian investor understanding of, and interest in, sustainable investment.

The survey by Newton Investment Management, a subsidiary of BNY Mellon Investment Management, goes on to say that: 'This preference showed up a stark difference between generations, with 43% of millennials wanting engagement compared with just 19% of investors over the age of 50.'

Historically, the main focus of the asset management industry has been governance, however, when it comes to ESG issues, the study shows that this is no longer the case. Thirty-nine per cent of US investors said they were most concerned about environmental issues, followed by 28% who expressed concern about social issues and 23% cited governance concerns.

The generation gap showed up in investors' awareness of, and interest in, the social investment space, with consequent effects on retirement planning. Eighty-six per cent of survey participants who were 39 and under said they were interested in sustainable investing, compared with 70% of those over the age of 50.

Asked whether they used a sustainable investing option in their retirement pension, 36% of respondents reported that their plans did not have such an option and 44% said they did not know whether or not they had a sustainable option in their pension.

The survey found that even in the 'forced-choice' environment of self-invested corporate or personal pensions, where investors have to do at least some research, only 20% were aware that they had a sustainable investing option. However, of those investors who recognised that they had such an option, 53% chose to use it — but with almost five times more millennials in that group than baby boomers choosing to do so.

Younger investors increasingly want to see their values, interests and concerns reflected in their investment decisions and the study highlights how millennials, who have a long investing horizon, are thinking about sustainable investing as it relates to retirement planning and also hints at the future of investing and how companies might better align themselves with the concerns of the next generation of investors.

UK black professional representation

'Despite black people making up more than 3% of the population in England and Wales, there has been little success over the past decade in addressing the lack of diverse representation in senior leadership roles', according to a recent report published by Business in the Community, the group founded by the Prince of Wales to support responsible business, and UK employers have been told to take 'urgent action' to support workers from ethnic minorities.

Published the day after a group of high-profile business leaders pledged to set diversity targets for candidate lists for every job vacancy in an attempt to boost ethnic representation, the Report comes ahead of a deadline set by the Parker review which is pushing FTSE 100 firms to appoint at least one non-white board-level director by the end of 2021.

The Report reveals that the number of black professionals in leadership roles has barely changed since 2014, black professionals holding just 1.5% of the 3.7m leadership positions across the UK's public and private sectors in 2019 (10.3% for BAME professionals) compared with 1.4% in 2014.

The Report also looked at representation across a wide range of sectors, including the police force, journalism, academia and the civil service and found that just 1% of the police force identified as Black African or Black Caribbean, that of 39 appeal court judges none was black; just 1% of journalists, senior civil servants and academics were black; public sector leadership remains static at 1%; and 62% of charity boards are all white.

Meanwhile, white professionals held about 89.6% of the UK's leadership positions across both the public and private sector, down about 1% since 2014 but higher than the white population across England and Wales which is around 86%.

The lack of diverse leadership has a direct impact on decision-making and businesses need to remove barriers to progression for BAME employees.

The Report calls for an end to inaction and disengagement and urges employers to review their internal culture, including how they help workers from black communities succeed in their organisations.

Feature

Raising the Bar

Cosette Reczek and **Hanif Barma** look at Identifying opportunities for evolution and improvement in risk oversight for financial services.

Principles-based guidance for board risk committees and risk functions in the UK financial services sector was published in December 2019 by the Risk Coalition. Formed in 2018, the Risk Coalition launched the Risk Guidance Initiative to meet the need for coherent, principles-based good practice guidance for board risk committees and risk functions within the UK financial services sector, filling a gap in the absence of such guidance. Titled *Raising the Bar*, the Risk Coalition has drawn on industry, academic and regulatory best practice and consulted widely including with the key UK financial regulators who are supportive of all work that raises risk standards across the industry. Part A of this principles-based guidance addresses board risk committee principles and guidance, with Part B sharing risk function principles and guidance.

Adoption of these principles and guidance can support organisations in their oversight of the management and execution of a diverse range of risk management requirements and activities. Using culture and conduct as one example, Principle A3 states that: 'The board risk committee should provide the board with advice on the continued appropriateness of the board-set risk strategy and risk appetite in light of the organisation's stated purpose, values, risk culture expectations, corporate strategy and strategic objectives'. Regulators now expect regulated firms to have a greater focus on organisational culture (for example, the FCA's March 2020 publication of 'Transforming culture in financial services – driving purposeful cultures' or the HKMA's May 2020 expressed views regarding banks' culture self-assessments). These expectations, together with requirements of the UK's Senior Managers & Certification Regime that increase the focus on personal accountability, reinforce the need for boards to demonstrate objectively how well they perform in key areas that are on the regulators' radars. The Risk Coalition principles and guidance will aid firms by improving their objective setting processes and their assessments of achievement.

Another example is management of risk within the Three Lines of Defence framework (3LoD). A cornerstone of this is the first line's (ie the business') risk-taking activities and management of the risks associated with those activities. The second line (ie the risk function) must assure the appropriate balance of risk appetite, risk-taking within that appetite, and risk management of the resulting risks. This comes to life in Principle B1 – Independent risk oversight and challenge: 'The chief risk officer, supported by the risk function, is responsible for ensuring robust, independent oversight and challenge of risk-taking activities across the organisation'. Execution of this requires measurement and monitoring of risk within business and setting of objectives for business personnel. In addition, regulators expect independent oversight of these risks within the second line as part of the risk functions' everyday independent review and challenge. Also, the risk function will monitor and share their own observations and recommendations regarding risks with the business, formal risk committees, and the board, and will provide input about these into the staff remuneration process.

> 'Regulators now expect regulated firms to have a greater focus on organisational culture.'

The next step in the journey is to support UK financial services companies in assessing how they benchmark against the principles and guidance in Raising the Bar and in turn identify areas for evolution and improvement. To support this critical undertaking, the Risk Coalition has created GABI – their *Gap Analysis and Benchmarking Insights* service. This is accessed securely online and facilitates the anonymised gathering of views from board members, key executives and stakeholders about the organisation's current state of risk reporting and risk oversight practices. At the time of launch, in May 2020, GABI's initial focus was on benchmarking and assessment against board risk committee principles and guidance, to enable timely assessment ahead of the 2020 annual reporting season. GABI will shortly be expanding this service to include the risk function principles and guidance.

Having a structured approach to assess how your company stands against the guidance is an excellent starting point for prioritising of key risk reporting and governance activities. In addition, GABI enables the company to see how views vary across key stakeholders. GABI provides objective reporting output: charts and comments can be compiled into a report for the board risk committee, the board and regulators (PRA, FCA, etc) to demonstrate the effectiveness of the company's risk oversight. This can then be used as a basis for discussion and key action points can be agreed to continue the company's journey of improvement. At the tipping point of participation in this service later this year, the Risk Coalition will also provide a benchmarking service to enable financial services firms to see how they compare against peers – before they move on to a new phase of work, developing risk guidance for non-financial services organisations.

Cosette Reczek is the founder of Permuto Consulting Limited, providing interim management and advisory services to financial services companies regarding governance, culture & conduct and risk management. Hanif Barma is a co-founder of the Risk Coalition and founder of Board Alchemy; he brings extensive expertise of boards, risk and audit through his career as a governance consultant.

For further information about the Risk Coalition, Raising the Bar and GABI, see www.riskcoaltion.org.uk.

Feature

Governance 2020 Awards

A short introduction to The Chartered Governance Institute's new categories in their annual Awards.

Nominations are open for The Chartered Governance Institute's Awards, the highlight of the governance social calendar, and this year three new categories have been added to showcase the wonderful work that company secretaries and governance professionals are doing. While Covid-19 has put the kibosh on a physical event this year, achievements in the world of governance will still be celebrated, with winners due to be announced as planned in November.

The three new categories are Governance Champion of the Year, Diversity & Inclusion Initiative of the Year and ESG Initiative of the Year. The judges are looking for individuals, teams and initiatives that have made a significant and very positive impact in the governance arena in the last year.

Governance Champion

Governance Champion of the Year is an exciting new category as a champion can be many things. You might consider a champion to be a visionary; someone who opens doors and creates 'the new'; an evangelist, inspiring and challenging others; or a person who lobbies, drives and pushes for recognition – for others, and their profession.

The judges will be looking for evidence of why nominees are champions, and why, in particular, this is the year they should win an award. If you know someone who is a true ambassador for governance in everything they do – whether that be speaking out, nurturing fresh talent or simply embodying good governance, nominate them before 14 August and they could be crowned a winner when the Awards take place in November.

Diversity & Inclusion

The *Diversity & Inclusion Initiative of the Year* will recognise an innovative project that has changed how an organisation addresses D&I. Really moving the dial on diversity is a significant piece of work and this award recognises those initiatives which are designed to boost D&I around the entire organisation, including interactions with customers, investors and other stakeholders. Individuals or teams in any sector can nominate their initiative.

ESG

The *ESG Initiative of the Year* celebrates those initiatives which are designed to address ESG issues head on, such as a commitment to sustainability and the use of ESG data in decision-making and reporting. ESG is at the top of many a governance agenda and the judges will be looking to see that there is an ongoing commitment to ESG issues that sits at the heart of an organisation's work – from closer alignment of ESG concerns with strategy to efforts to address problems with supply chains, human trafficking and exploitation or efforts to minimise carbon footprint. As with the previous category, individuals or teams in any sector can nominate their initiative.

The remaining categories are:

- *Company Secretary of the Year*, which celebrates those senior company secretaries who have made a demonstrable difference. The judges are particularly interested in individuals who have undertaken initiatives that have reshaped best practice and driven significant and lasting change, including leading their team through a challenging period, delivering a particularly complex piece of work or delivering results beyond the expectations of their role.
- *Governance Professional of the Year*, which is open to anyone in a governance role who is not a company secretary. The award acknowledges someone who has made a positive and sustained contribution to an organisation or to the profession as a whole, going above and beyond to encourage, support or even lead the adoption of effective governance.
- *The One to Watch*, which recognises a rising star in governance, someone early in their career who is making a significant contribution to the profession, embracing challenges and showing the kind of spirit that will take them to the top.
- *Team of the Year*, which credits a company secretarial and governance team that has demonstrated excellent collaboration, brought out the best in team members and developed effective and innovative ways of working.
- *Service Provider of the Year*, which recognises those individuals or companies that have made a valuable and creative contribution to a client's business, providing practical and cost-effective solutions to the day-to-day and embracing the unknown, the exceptional.
- *Governance Project of the Year*, which celebrates those governance projects that are so significant in terms of their size, nature or the value created that they could be described as 'transformational'.

If you know someone, a team or a project that has made a significant and positive impact in the field of governance, nominate them at www.icsa.org.uk/awards before the 14 August deadline and help recognise the very best that the profession has to offer.

Feature

Disciplined experimentation

David Lewis considers why businesses need both emotional and strategic resilience as they tackle the challenges of the Covid-19 crisis?

In conversations with senior executives and board members, grappling with the challenges of the pandemic, what is striking is the extent to which people are experimenting with new ways of working, developing new products and services and thinking and planning in a very different way. It is amazing how quickly some have moved from laying down the recovery anchors – safeguarding cash, looking after key stakeholders – to exploring the opportunities presented by the disruption.

Ideas that previously would've taken months, if not years to work their way through the internal bureaucracy, are being put into prototypes, minimal viable products, in a matter of weeks. It seems that the challenge presented by Covid-19, has confronted us with what is in fact an ever present need, even in so called normal times, and that is to experiment, if our business plans are to be resilient in the long term.

The conventional approach to business planning is based on variance analysis – an extrapolation of what has gone before, with a variance of plus or minus a small percentage. Little more than a prediction, an educated guess and sometimes simply wishful thinking about what will happen in the future. In benign times, such an approach may well deliver the result that we are looking for.

Unfortunately, there are two problems with this approach. First, the effort to avoid underachievement also negates the possibility of overachievement, and secondly, we do not live in benign times. The KPIs, cost control measures and investment prioritisation processes that we put in place to support our business plans, are designed to do everything possible to ensure performance remains within the predicted boundaries. But what if, as well as the threats, there are opportunities out there that meant the upside could be 30%, or 50%, or more?

Even though many of us have long since realised the shortcomings of the variance analysis approach, the associated assumptions, processes and behaviour continue to dominate management and leadership practice. In our attempts to maintain performance, when faced with threat, we instinctively cut costs, delay investment, work harder and increase controls. When faced with a great opportunity, that means we're going to have to change the way we work, the way we organise, and more, we become cautious and risk averse – 'if it aint broke, don't fix it'.

What the pandemic has brought to life, is the necessity to look again at what we do and why we do it, to question what we could do differently, how we can create more value and reduce costs. Most organisations only begin to fundamentally challenge assumptions or conventions when they are in dire straits, when they have peaked, when market share and margins are declining. The point at which they see a threat so large that without fundamental change their very existence is in question is too late.

The point at which we should question what we are doing, is all the time. When we're starting out, when we're scaling up, when our market share and profits are increasing and when they are declining. To question does not mean that what we're currently doing is wrong, but it does mean that if there's a better way, we stand a chance of discovering it before it's too late. The corporate graveyard is full of those organisations that waited until the ship was sinking before they asked the question, what could we do differently?

So if you want to build resilience into your business planning you should regularly question what you're doing and how you are doing it. But how?

> 'The vast majority of organisations in our study were dominated by behaviours that undermine experimentation and resilience.'

You can't question everything, and if you do question something, how do you know that a different answer will give you a better result? Karl Popper, the Austrian-British philosopher argued that you can never prove anything, you can only, through practice, find out whether what you believe, and consequently what you are doing, still works better than any alternative. Popper was a proponent of critical rationalism – learning through trial and error – experimentation. 'All life is problem-solving', as he put it. He confronts us with the reality that in our fast changing world, there are so many assumptions that need to be made, assumptions about existing knowledge and conditions, that sooner or later, the complexity, uncertainty and volatility we face means our assumptions will turn out to be false. If we apply this thinking to business planning we realise that the variance analysis approach falls short. It is closer to theorising – making assumptions and following hunches – than experimenting.

Resilient business planning is not a process of theorising it's a process of experimenting. The resilient organisation is not the one with the best business plan, but the one with the best ability to constantly generate and test ideas and adjust the plan accordingly – to learn continuously.

Feature

Again the corporate graveyard is a good indicator of how many organisations struggle to learn. To understand why they struggle, we need to understand what happens to organisations as they evolve and become successful.

Most organisations start small with a handful of like-minded people – people who join together with a shared sense of purpose and great enthusiasm to do something wonderful. Those endeavours that are successful take on more people, they set up specialist functions and departments – departments for marketing, sales, engineering, manufacturing, IT, HR, finance – and as the organisation grows each function in turn gets bigger.

‘Resilient business planning is not a process of theorising it’s a process of experimenting.’

Naturally, in order to coordinate and align activity across large numbers of people, with different specialisms, formal processes and job descriptions are needed, hierarchical structures emerge and decision authority matrices are created to make it clear who can decide on what. All this is put in place with the positive intention of securing continued growth and success. And it works, up to a point.

But as the rulebook expands, and procedures and processes become more complex, and management layers increase, things start to change. What was once a group of people ‘in it together’ rolling up their sleeves, doing what it takes to get the job done, flexing their approach, making best use of limited resources, encouraging each other, learning through experimenting, becomes a complex and rigid set of interconnected silos. Where once good ideas were shared, tested and put into practice with speed, it now takes several months and a 50-page report, before an idea is even considered. Just recently, I remember sharing in the frustration of a participant on one of our programmes. For two years he had been trying to get permission to do a small experiment to enhance customer experience, only to be thwarted by the bureaucracy of the internal approval procedures.

We see the impact of bureaucracy and siloed behaviour in a study we’ve been conducting with 2000 individuals from more than 100 organisations. Eighty-five per cent of people report that the dominant behaviours in their environment are hierarchical, controlling, directive, cautious, resistant and conforming; they describe the dominant emotions as feelings of fatigue, defensiveness and constraint. Only 15% report working in an environment dominated by flexible, encouraging, curious and resourceful behaviours and feelings of empowerment, appreciation and optimism. The 15% describe their organisational capability as dynamic; the 85% describe their organisation as bureaucratic.

If we want people to learn, to share their learning and be open to change, to create an organisational learning capability – a dynamic organisation – we cannot expect them to do so if we interact with them in a hierarchical and controlling manner, surrounding them with bureaucratic red tape. We need to invest in the way we interact. We need to be curious, to encourage others, to be flexible, to be resourceful, if we are to develop our organisational learning capability, our ability to experiment and learn – to be resilient.

Resilient business planning and execution depends on regular questioning about what we do and how we do it. It depends on experimentation and collaboration between people who bring new and different perspectives to the questions asked. Experimentation is not random improvisation. It’s a disciplined approach to testing hypotheses within defined risks, in line with strategic goals, to discover better ways of doing things. It is to see if there is 30%, 50% or more potential to grow the business, as well as to protect ourselves from potential significant threats.

Behaviour counts when it comes to organisational resilience. It is not that there is no need for control, or to set direction, or that hierarchy should be eliminated – it cannot be. But it is the case that if the dominant behaviours are not those that encourage and support disciplined experimentation, then sooner or later a once winning business formula becomes a hiding to nothing. The vast majority of organisations in our study were dominated by behaviours that undermine experimentation and resilience.

Human beings are resilient, they seek to flourish. Aristotle described human flourishing as the drive to find purpose, to do the right thing, to grow our talents and exercise our agency. Organisations too often are not resilient, but those organisations that find a way to channel human flourishing through disciplined experimentation, can be.

David Lewis is Programme Director for Executive Education at London Business School and co-author of ‘What Philosophy Can Teach You About Being a Better Leader’, published by Kogan Page, priced £14.99. https://bit.ly/3ho3Clo

Latest Update for Boards
GOVERNANCE
Join Patrick Dunne, author of ‘*Boards*’ book and Alison Gill, behavioural psychologist and CEO of Bvalco, to discuss this live on
Friday 11 September, 12-1 pm

Feature

Governance in China

Lindsey Zhang looks at what we can learn about Chinese corporate governance from the Luckin Coffee and TAL Education Group experiences.

Corporate governance development is a long journey in every country, and each journey twists and turns under the influence of the history, culture, public policy and economic development of a particular country. Historically, significant corporate failures and scandals act as catalysts upon a country's corporate governance development. In the UK, the Maxwell pension fund abuse accelerated the Cadbury Code of 1992, the first comply or explain governance code in the world. In the US, Enron and Arthur Andersen's accounting scandals prompted the Sarbanes-Oxley Act of 2002, and the 2008 financial crisis brought about the Dodd-Frank Wall Street Reform and the Consumer Protection Act of 2010. Luckin Coffee (Luckin) and TAL Education Group's (TAL) recent financial frauds could spur similar progress for Chinese companies' corporate governance, if Chinese regulators are willing to take a closer look.

Luckin opened its first store in January 2018, joined Nasdaq in May 2019 with 2,370 stores and then crashed in April 2020 with 6,500 stores before the scandal was revealed. Upon admitting sales fraud of $310m (42% of its 2019 revenue), Luckin established a special committee to investigate. In May 2020, Luckin's CEO and COO's contracts were terminated, and in June, the Chair was accused of instructing employees by email to commit sales fraud and will face criminal charges in China. Consequently Nasdaq suspended Luckin stock trading on June 29, with delisting procedures to follow.

TAL is an online education platform started in 2003 that offers award-winning tutoring services. TAL offers over 150 education programs for students ranging from kindergarten to post-graduation across various fields. Since their NYSE IPO in October 2010 at $10 per share, TAL revenue grew 25 times and their stock price increased to $50 before the scandal. TAL admitted inflated revenue from its online product 'Light Class' and suspended the employee accused of wrongdoing in April 2020. The research group Muddy Waters estimated that TAL net profits from 2016 to 2018 were overstated by 43.6%.

Both Luckin and TAL have shaken global investors' faith in Chinese companies and have raised important questions regarding how Chinese companies are governed. As Thomas Clarke argues in 'International Corporate Governance, A Comparative Approach', 'Weaknesses in financial controls are related to weaknesses in corporate governance.' This begs the question: What was it about the nature of Luckin and TAL's corporate governance that allowed and nurtured these scandals?

Luckin and TAL's governance structures: warning signs

According to Bob Tricker's authoritative 'Corporate Governance', corporate boards should have four basic functions – strategy formulation, policymaking, supervising executive activities and accountability, together with three key committees – audit committee, compensation committee and a nomination and corporate governance committee. Board directors must be competent, have demonstrable business and industry experience and independent directors must remain independent. How do Luckin and TAL measure up to these standards?

Here's a snapshot of Luckin's board: Luckin's board had nine members, including three executive directors, three non-executive directors and three independent non-executive directors. All audit committee members were independent directors; chairman Charles Lu chaired the nomination and corporate governance committee that was responsible for the board directors' compensation, although this should be a compensation committee function according to Nasdaq rules. CEO Jenny Qian chaired the compensation committee that was responsible for company executives' compensation and management succession planning. Before jointly founding Luckin, Qian was COO of another public company founded by Lu. Chairman and CEO held 30.53% and 19.68% of company shares, with voting rights of 36.86% and 23.7% respectively.

Now, let's take a look at TAL: TAL's board has five members, including two executive directors and three independent non-executive directors. The audit committee, compensation committee and nomination committees are all chaired by independent directors. However, nomination and corporate governance committee chairperson Professor Kaifu Zhang is an assistant professor of marketing with no other practical business experience. Chairman Yunfeng Bai and CEO Banxin Zhang are both alumni of Peking University and hold 1.0% and 29.7% of company shares, with voting rights of 2.5% and 71.8% respectively. COO Yachao Liu holds 4.5% of company shares with 10.2% voting power.

In four key areas, both Luckin and TAL lack the checks and balances that make strong boards and help prevent corporate fraud:

- *Independence and objectivity:* Nasdaq requires all compensation committee members to be independent directors, but Luckin's Chair was also Chair of the nomination committee that conducts the compensation committee's function of reviewing and approving board directors' compensation; and Luckin's CEO was Chair of the compensation committee that is responsible for executive compensation and succession planning. This structure technically allowed the Chair and CEO to arrange their own compensation structure and the CEO to establish her own succession plan, thereby compromising the independence and objectivity of the compensation committee.

Feature

- *Competency:* At TAL, the fact that an inexperienced non-executive director Chairs for the nomination and corporate governance committee that is responsible for annual board self-evaluation and management succession planning should raise competency concerns. With TAL's small board, board directors wear multiple hats to perform board functions on different committees. The directors' competency for cross-board functions should also be questioned.
- *Internal control:* Both Luckin and TAL are inside-controlling founder firms where checks and balances in business decision-making and operation processes are essential to protect minority shareholders' interests. A high number of sales frauds result from flawed internal control systems. The lack of independence in Luckin's governance structure and serious questions regarding TAL's directors' competency are red flags that call for careful consideration by investors and scrutiny by regulators.
- *Insider stock pledges:* Luckin founders pledged 49% of their company shares as loan collateral. 'From the perspective of the outside shareholder, share pledging by insider executives could be disastrous to a firm', according to Siqi Wei, Assistant Professor of Finance at David Nazarian College of Business and Economics at California State University. 'The pledging of firms' stocks may have a detrimental impact on shareholders if the stock's beneficial owner is forced to sell the shares to meet a margin call. The forced sale of significant company stock could negatively impact the company's stock price.' This is exactly what happened to Luckin: When the lender group had to sell the Luckin founder's pledged share when the Chair defaulted the loan, Luckin stock price declined further. The founder's share pledge is a signal of risk to investors.

Board practice that mitigates fraud risk

Luckin and TAL's fraudulent practices may stand out, but the flaws in their corporate governance that permitted misconduct and negligence are common to Chinese companies. Their examples reveal some specific actions Chinese companies can take to improve their board practices, strengthen their corporate governance and prevent future fraud.

- *Encourage honesty and transparency in corporate culture.* Most Chinese companies operate with an inherent paternalism. Most decisions are made by top managers with opaque processes. Since employees can be afraid to share their honest opinions because they are trying to please their superiors, such paternalistic corporate cultures tend to nourish and sustain fraud. While a whistleblower programme is considered the most effective anti-fraud solution, this may not work for Chinese companies because it conflicts with Confucian philosophy, which emphasises compromise and tolerance. However, it is important that Chinese companies foster an honest and transparent corporate culture, which can create checks and balances and lift morale for the entire organisation.
- *Raise the bar for business ethics.* Should a business' ethical conduct be limited to avoiding detection by regulators or not breaking the law, or should it make an effort to look after the interests of all stakeholders? Both Luckin and TAL had written ethical policies as required and even Luckin's founder's share pledge did not break any law. However, good corporate governance practice means these policies do not remain written procedure, but have real, practical implications for board leaders' understanding of board functions and fiduciary duties. Companies that push ethical boundaries inevitably put outside shareholders' interests at significant risk, eventually harming the business itself. Conversely, raising the bar for ethical behaviour will make board members more professional, which is the key to building trustworthy relationships with regulators and investors.
- *Appoint and train competent independent directors.* According to Xin Tang, professor at Tsinghua University School of Law and former member of the China Securities Regulatory Commission, 40% of independent directors of Chinese-listed companies are university professors. While academic expertise might help someone like Professor Zhang on TAL's board better understand corporate governance regulations, his lack of practical business experience limits his ability to perform board functions and guide the company's business practices. Moreover, since it's common for companies to treat independent directors as outside consultants or outsiders who should not be trusted with critical business information, it's even more important for them to be competent business professionals. And to help independent directors play their roles effectively, company boards need to better understand independent directors' purpose and responsibilities, help them to learn the business and to keep up with corporate governance regulations by providing and supporting continuing education and training.
- *Understand the consequences of misconduct.* Overseas-listed companies are required to comply with the listing country's security laws and corporate governance code. The company board is responsible for helping board directors understand their fiduciary duties, responsibilities, exposure for misconduct and legal consequences of violations by encouraging continuous professional education and emphasising effective annual self-evaluation. This is all the more important when we consider the differences between China's and many Western countries' approaches to law enforcement. While China enacts severe penalties for misconduct, Western countries tend to enforce regulations more softly but that approach can be more effective for better governance.

Keeping pace with growth

China's rapid economic growth has made it the second largest economy in the world, but its regulatory development

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has lagged far behind. With limited regulatory guidance and restrictions, Chinese companies are experimenting with innovative governance models. Some of these creative models have slowly gained recognition from the global business community, with leading companies like Lenovo, Alibaba and Tencent demonstrating their advantages and reaping steady success. However, basic board functions, professionalism and ethical duties are fundamental and universal. Chinese companies can improve their corporate governance by maintaining high standards in each of these areas.

Financial fraud is not just the result of individual misconduct or negligence; it has systemic roots. It needs fertile soil to develop, and that soil is the culture in which companies are governed. Instances of fraud expose the flaws in a company's governance model and ethical commitments. Both Luckin and TAL's stories should be a serious wake-up call for Chinese companies to refine their governance structure so they, and those they serve, can experience the success that comes with more effective board governance.

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