# Redirecting the focus of corporate governance

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The term "corporate governance" can associate to how it is actually performed in companies but also to what could be called "the corporate governance movement" – including sets of international corporate government activists, legislators, regulatory bodies, code developers etc – making up almost an entire "industry" of its own. I see a growing tension in recent years between the latter and proposed regulations on the one hand and what is considered good governance and how corporate governance is actually practiced in Sweden on the other.

Swedish corporate governance – often referred to as "ägarstyrning", governance by owners – is based on a strong tradition of actively involved, leading and long term committed owners nominating and electing the board of a company. The board is accountable to the AGM (Annual General Meeting) and the CEO reports to the board.

The corporate governance movement originates in the USA and the UK in particular where it was initiated in the 1980s and took off in the 1990s. A major driving force behind the movement was the lack of owner/shareholder influence. Executive management, closely integrated with the boards of companies, has been in control. Repeated abuses of shareholder rights, spectacular frauds and mismanagement have turned corporate governance into a hot political issue in the United States as well as in Europe. As a consequence, politicians and regulators have applied their usual tool, legislation and an extension of the regulatory framework to remedy the situation. Within EU there has also been an ambition to introduce common rules for all the member states.

I have noticed two types of reactions to this development. One is a deep concern in Sweden that EU regulatory initiatives threaten the traditional Swedish model of corporate governance. The other is a general resentment of what is perceived as too much and too detailed regulation, taking away precious time from the boards to work on the business agenda of the companies.

This is in contrast to the Swedish Code of Corporate Governance which has been well received and applied by the companies.

To put the international development in perspective let us go back to how corporate governance was viewed by the committees that were set up in the UK in the 1990s.

*The Hampel Report*

When I started to focus on corporate governance in earnest in the 1990s inspiration and ideas could be found in the UK. With the British penchant for self-regulation some industry initiated commissions produced reports that got a lot of influence internationally. We have all heard about the Cadbury Report published in 1992 for instance.[1)] Less well-known, maybe, is the third commission and its Hampel Report.[2)] It had a significant impact based on that it summed up the recommendations of the earlier reports and provided the substantial input for the Combined Code, which was adopted by the London Stock Exchange.

The Hampel report on corporate governance stated – already in its first sentence: "The importance of corporate governance lies in its contribution both to business prosperity and to accountability".[3)] So, corporate governance has a dual mission; it should look after how well a company creates value/serves its business prosperity purpose, and how well it meets its accountability requirements.

1) The commission was led by Sir Adrian Cadbury, former chairman of Cadbury Schweppes.
2) It was led by Sir Ronnie Hampel, retired chairman of ICI.
3) Committee on Corporate Governance. Final Report, London, January 1998.

**Figure 1 The dual mission of corporate governance**

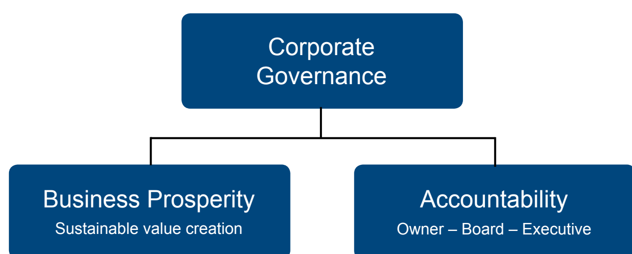
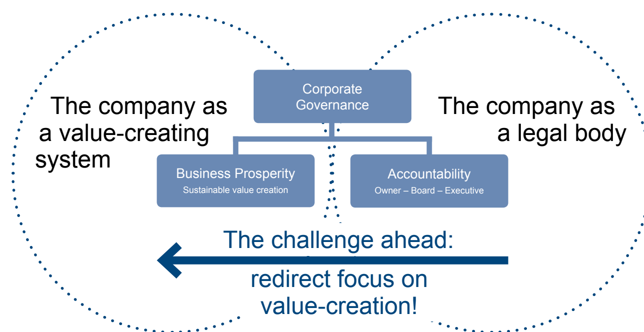



**Figure 2 Redirect focus on value-creation**




How can we include also the other side of the coin – the sustainable value creation – in the corporate governance debate?

Let us make a reality check at this point: how many of those concerned with corporate governance issues fully appreciate both criteria above? Far from everyone, most people seem to associate corporate governance only with accountability. Already the Hampel Committee made that observation saying that corporate governance activities and focus had been too much concerned about accountability at the expense of the prosperity/value creation aspects.

Obviously, this imbalance has not improved by developments since then.

### Get more balanced – redirect focus on the value creation mission

The result is that the frame of reference dominating the corporate governance movement is rather lop-sided. Accountability and formal aspects are in the foreground. Legislators and regulatory bodies do not seem to fully appreciate the value creation aspects and the realities of companies.

So, for legislators and regulatory bodies, in particular, there is an urgent need to make corporate governance more balanced by applying a wider frame of reference and to redirect focus on what needs to be done to promote the value creation mission.[4)]

Figure 2 below help explain my point.

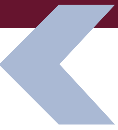
The dual mission of corporate governance could be viewed as related to two different perspectives of a company, like two sides of a coin. Making such a distinction will facilitate an analysis of the two aspects. The accountability mission would correspond to seeing the company primarily as a legal body. Analogously, the value creation mission would correspond to the company being viewed as a system for value creation.

This is not the place for a thorough analysis of the two sides of the coin. However, before outlining some key elements of an alternative frame of reference – badly needed to make corporate governance truly effective – I would like to point out two crucial mementos regarding governance by regulation.

### Prerequisites and limitations of effective regulation

To avoid any misunderstanding – I think good institutions and the rule of law are much desired necessities for a well-functioning free market – as well as for freedom overall. However, to introduce new laws is a demanding undertaking which must be exercised with utmost professional care, diligence, and clarity of purpose.

[4)] From early on I have seen this as my particular mission in the corporate governance discussion – referring to it as strategic corporate governance. As in the title of my book: Ownership & Value Creation; strategic corporate governance in the new economy, Wiley 2001.



*Law effectiveness*

In order for a new law or regulation of some kind to be effective, it must also meet the following criteria

- To a large extent it should be a codification of what is already the best practice of the social body it is addressing. Attempts to impose new practice by means of regulation are bound to fail or would require very powerful means of implementation and harsh sanctions. That would also turn out to be counterproductive considering value creation aspects. Companies thrive on risk taking and innovativeness, i.e. they are highly dependent on freedom of action which is not the same as acting irresponsibly.
- An effective law must be in consonance with the values already embodied in society or values those concerned would like to see supported. Shared values emerge over time and as a result of shared experience, particularly of proven success, courageous acts, inspiration by role models, but also by overcoming difficulties and severe crises.

A good example in this context is the Swedish Company Act (SCA). It clearly defines the differentiated roles of the three key bodies in the governance of a company: the owners, the board and the CEO. It puts the owners on top – "in the driver´s seat" – and gives the AGM clear constitutional supremacy. It was based on best practice to a large extent, not least on the role model of Marcus Wallenberg Sr (MW Sr; 1864-1943), son of the dynasty founder, and the one who developed the industrial sector of the Wallenberg sphere. Not only did he play the role of an engaged and committed owner, he was also keen and never spared any effort to find the best man to be the CEO as well as to surround himself, often as chairman of the board, with competent board members of high integrity (he did not like "yes men"). In addition, a triggering factor for the SCA and a reason why it acquired such a distinguished quality was the ensuing trauma of the Kreuger scam and financial disaster in the early 1930s.[5)]

[5)] For more information about Ivar Kreuger, please see Wikipedia!

*The limits of governance by regulation*

The theoretical advances made some sixty years ago by the science of systems analysis and cybernetics are good to keep in mind, e.g. on analyzing and designing control and regulatory systems. One of its fundamental postulates is called the law of requisite variety, outlining the prerequisites of control.[6)] In ordinary language: if you want to control something, someone or a subordinate system you must be smarter than the object of your control. A frequent metaphor to drive home the case in point is the relation between a cat and a caught mouse. Whatever the mouse tries to get away with, the cat has superior means to stop it. The cat has requisite variety in relation to the mouse.

Should one lack requisite variety – what are the options? Basically, there are two:

- The option once applied by the Communist regimes: using sheer and brute force to impose, e.g. a preconceived economic plan with little regard for changing environments, what the citizens really want and without much individual adaptation, a "one-size-fits-all" dogma.
- The alternative option is self regulation, decentralizing power as much as possible and relying on a minimum of regulation to safeguard certain principles of an open market, competition, entrepreneurial freedom, ownership rights etc. In a wealth creating society, the costs of regulation should also be weighed against the benefits it brings. There are of course certain unalienable rights justifying the costs it takes to uphold them, but a cost-benefit analysis should accompany any new regulatory propositions.

Of course, the latter is the only option in a civilized society. This should also make it obvious that we need to focus on "first things first" – that companies are the vehicles for societal wealth creation by pursuing their endeavors of sustainable value creation.

[6)] Ashby, W. Ross (1956) Introduction to Cybernetics; Chapman & Hall, London.

### An alternative and wider frame of reference: Putting the horse before the carriage – the mission of sustainable value creation

Sustainable value creation must be the primary concern of corporate governance because that is what a company is all about, because it generates the wealth of the society, and because it is so complex and demanding that we must see to it that companies are supported by the best prerequisites we can muster.

*The amazing phenomenon of the modern company – a valuable and indispensable societal asset*

Companies are extremely valuable societal assets – precious, yet vulnerable human and social creations. They are the vehicles for wealth creation for the economy and the society at large, given that they succeed in creating sustainable value. It follows that in pursuing the process of sustainable value the companies must play a plus-sum game with all its stakeholders, i.e. all other parties a company interacts with. Just remember that the future is not predictable. You never know what other company, potential customer or partner you will come across around the corner. You need to deserve the trust of all around you. In a plus-sum-game everybody wins – and the economy as a whole grows.

In addition to creating wealth by supplying consumers and the society at large with goods and services, companies have become indispensible social institutions. They provide employment, career opportunities, and social community to large parts of the population. Furthermore, they are social innovators, developing organizational solutions for how to coordinate and make productive a variety of resources – people, machines, input materials, equity as well as, and not least, knowledge.

The rest of the society has also benefitted from the social innovation achievements of the companies. Government agencies, non-profit organizations, hospitals and other institutions owe a lot of their management practices, personnel policies, organizational solutions etc to what the dynamic companies have come up with, driven both by intense competition and freedom to try new ways.

However, all the benefits created by companies cannot be taken for granted. Some companies succeed, but many fail at some point. So, let us take a look at what is required to succeed in the creation of a company as well as what it takes to achieve sustainable value creation.

*A company starts and ends with an owner, with "real ownership"*

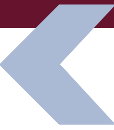
Creating sustainable value starts with an owner – and if the value creation process fails, "the buck will stop" with the owner. Without an initial entrepreneur/founder/owner – often the same person – there won´t be any sustainable value created at all. It is also that person who embodies the unique idea of how and with what to create and serve a new customer. The personal embodiment means that there are existential driving forces involved such as perseverance, a strong will to overcome upcoming difficulties and to see the process through to lasting results. Business success cases are rare, particularly the ones that have the potential to eventually become big corporations like IKEA, founded by Mr. Ingvar Kamprad and Tetra Pak (now Tetra Laval), started and developed by Dr. Ruben Rausing followed by his two sons, Hans and Gad.

So, the scarcest resource to be recognized by corporate governance is the committed, dedicated, competent, idea embodying owner and the long term committed equity capital that follows the owner. I like to call this type of ownership "real ownership".

While people, including "real owners", are deadly, companies can live forever. So, the transfer of ownership in due course becomes critical, not only the financial ownership, but everything the former, "real owner" stands for.

*The different worlds of fundamental value creation and the stock market*

"Real ownership" is very different from what one usually finds going in and out of the stock market – short term speculators, index chasers, and day traders. At best they contribute by mobilizing the overall supply of equity capital. Of course, corporate governance should see to it



that their rights are not abused, but their role and importance for the fundamental processes of value creation cannot be compared with that of the long term committed owners.

While an invest/divest decision can be done by the blink of an eye in the stock market, the investments in fixed assets, organization and people to produce products and services are for the long term. To accommodate the vast gap between the two worlds we badly need the long term committed owners.

*The purpose and goal of a company*

Sustainable value for shareholders is often referred to as the goal of a company. However, you will only know in retrospect if that will be the outcome. For Swedish success stories like IKEA and Tetra Pak, it took around twenty years before they had achieved their full commercial breakthroughs. So, companies cannot be governed by shareholder value (Wall Street & co may disagree).

The most influential thinker on management of our time, Peter F. Drucker, suggests that the role of a company is to "create a customer".[7] The statement contains two messages: the role of a company is to serve customers but it should also make a difference by creating a customer that did not exist before. So, it is up to each and every company to define its own, unique idea of what new customers it should create – as did Mr. Kamprad for IKEA and Dr. Rausing for Tetra Pak etc. Sometimes such an idea is clear in the head of the founder/entrepreneur from the beginning – as in the case of Dr. Rausing.[8] In other cases the unique idea follows as the outcome of a learning process – as in the case of Mr. Kamprad.[9]

If a company offers products and services highly valued by its customers and manages to produce and deliver efficiently profitability will follow. The value of such a company will grow. So, sustainable value creation – hopefully and eventually – becomes the validation of a good company.

*The challenges of eternal company life*

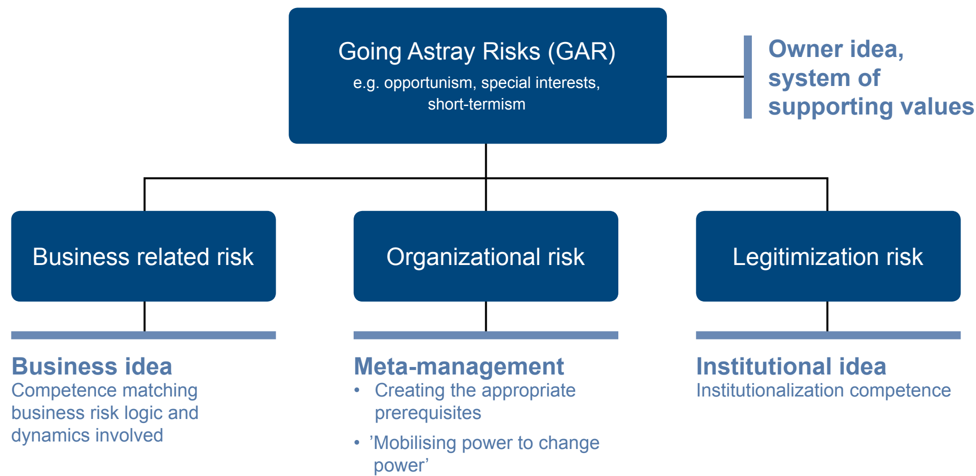
It is one thing to get a company started and to transfer ownership to a new dedicated owner. But what is required to keep the company going day in and day out in an environment characterized by *the process of creative destruction*?[10]

*The intriguing interplay of taking risks and reducing/eliminating risks*

Running a business is about taking risks, but it is also a matter of reducing and/or eliminating risk, the whole panorama of risk and the dynamics of risk. Based on my research and experience I have found it fruitful to distinguish four major categories of risk, one of which is different from the rest and the most fundamental. Figure 3 below will give an overview of the four types and the corresponding competence required to deal with each category. This intriguing and demanding topic should deserve a whole book. In this context, I can only try to give some hints about what is involved.

[7] Drucker (1909-2005) in his book The Practice of Management, New York 1954.
[8] Dr. Rausing was clear from the outset that he wanted to offer the type of milk packaging that eventually was achieved.
[9] Mr. Kamprad started his entrepreneurial activities selling a variety of products, e.g. seeds, pens, matches and similar, until he spotted the opportunity to take advantage of economies of scale in getting wooden furniture produced in Poland and selling them at low prices. He built IKEA from that and changed the entire furniture industry.
[10] Schumpeter, J. A.(1942) Capitalism, Socialism, and Democracy; New York: Harper & Row.

**Figure 3 Reducing / eliminating risk – what competence?**

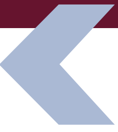



*GAR – Going Astray Risk – the most dangerous*
GAR is the most dangerous because it threatens the very basis of the company, the owner idea. To eliminate this risk the owner idea and all the values to support it must be thoroughly infused into the organization of the company – from bottom up and through management, the board and the current owner(s).

*The three other categories of risk*
Business-related, organizational and legitimization risks have a cognitive character. It is a matter of identifying emerging new risks, of understanding the particular situation and position of the company. To see what needs to be done one must assess whether or not the identified risks threaten the business idea – the way the company has achieved its business success so far – or its institutional idea – the way the company has gained its legitimacy in the past. So, this is a demanding task, involving executive management as well as the board and the committed owner, the whole value creation hierarchy. The required board competence is multidimensional, in addition to a thorough understanding of the company, it should include an extensive experience, a wide frame of reference, conceptual skills, creativity, and a constructively critical mind to build upon input from executive management and contributions from fellow board members while adding individually independent views and judgments.

*Risk elimination – a matter of meta-management by the value creation hierarchy*
In relation to executive management, the board should have a stronger risk orientation – based on its longer and richer experience. Executive management should be driving and eager to extend the business while the board should make sure that executive management identifies all risks – both of new initiatives and, not least, of not taking initiatives to counter new competition, acquiring new skills and technologies etc.

Most importantly, the board should closely monitor the learning capability of the executive management and the entire organization. If *organizational learning* falters and the board finds that the cause of it goes all the way to the top, the CEO must be replaced.[11)] Together with the new CEO, very often even more drastic changes are needed. Such intervention by the board means that it



exercises *meta-management*.[12] The board should not micro-manage the organization. It should only intervene when the prerequisites for executive management to carry out its delegated responsibility needs to be changed. Meta-management is thus a prerequisite for delegation. In particular, meta-management will be called for when emerging risks are threatening the very foundation of the company – its business idea and institutional idea respectively – when the really difficult decisions are facing the board!

At the top of the value creation hierarchy, the committed and competent owner must exercise meta-management in relation to the board.

*Summing up the challenges of the corporate governance mission of value creation*

I hope this paper has been able to convey some aspects of the crucial mission of governing our companies so as to boost sustainable value creation and the societal wealth that follows. I have only been able to scrap on the surface of the complexities of that demanding task, but hopefully I have provided some food for thought and some hints about how much more there is to know to understand and fully appreciate the amazing world of companies as vehicles for value and wealth creation.

## Redirecting the corporate governance focus – the tall order ahead

Sweden should take the lead in an assembled effort to redirect the focus of corporate governance to the mission of sustainable value creation. We have a lot to be proud of regarding both sustainable value creation and the Swedish corporate governance model, but also a lot to lose if EU should succeed in imposing much additional regulation.

However, I must leave it to others and another context to discuss and suggest how to tackle this urgent and challenging issue. Just remember: when we defend the Swedish model, we fight for more than a Swedish special interest. Our cause will also serve to remedy a fundamental flaw of most corporate governance systems – the dearth of "real ownership".

[11] The concept of organizational learning was pioneered by SIAR (Scandinavian Institutes for Administrative Research) under the leadership of Eric Rhenman (1932-93) in the late 1960s as part of SIARs´ research program The problems of large organizations in a structurally changing environment. The concept refers to the capability of organizations to learn, to acquire new capabilities so as to adapt to and be able to cope with changing competitive environments. The concept is explained in Carlsson, Rolf H (red.) Strategier för att tjäna pengar; om affärsidén och andra SIAR-koncept. Ekerlids Stockholm 2000.

[12] See figure 3 and the "competence box" for a mini-definition of meta-management to cope with organizational risk.