

A Note On Ten Principles of Sound Governance

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Preamble

It is popular at present in addressing means for solving numerous social, economic and political problems for those recommending to call for “better governance”². The term once reserved largely for dealing with quite narrowly specified processes for decisionmaking in commercial enterprises has become a favourite amongst politicians, their eminent person advisory cadres and the media.

The earnest manner of remonstrating delivery about the need to apply “principles of governance” has not, unfortunately been accompanied by such care in definition or explanation of concept as might make use of the advice helpful.

The term has become a vacuous catch cry³.

This note seeks to advance from that position by explaining what is entailed in the effective application of the ten principles I perceive to make up the core of high quality governance.

Approach

This treatment of the principles of governance uses a generic approach to the issue. The two reasons for this are that:

1. Principles of Governance are applicable in so many situations that the broadest possible approach is needed to cover as many contexts as is possible; and,
2. Application often involves the use of judgment and discretion such that a clear understanding of the generic principle is required to achieve a satisfactory outcome in a specific situation.

The clutter of detail should not be allowed to obscure the generic principle at issue if effective outcomes are to be achieved.

The terms in the following principles are used in carefully defined ways. These definitions are important because frequent imprecise treatment in business writings has meant that precision is often missing.

When are the Principles of Governance Applicable?

¹ Executive Chair, The Boardroom Practice Limited. I am indebted to numerous colleagues for their suggestions, especially Janine Smith and Ron Hamilton of The Boardroom Practice. Errors and omissions remain the author’s responsibility.

² The Wharton Centre for Leadership for example held a conference devoted entirely to governance and the global financial crisis in September 2010 (<http://gfc.wharton.upenn.edu>) while local government reform in Auckland N.Z. was overseen by a “Governance Committee” <http://www.johnkey.co.nz/archives/702-Gerry-Brownlee-Auckland-governance-committee.html>

³ A search for definition of governance by Google results in 22.8 million referring entries as at the date of this writing.

Most generally the principles of governance are applicable in any situation where the interests of one group of individuals (the principals) are placed in the hands of another group (the agents)⁴.

In the majority of settings (both commercial and non-commercial) it is the making of decisions by the agents on behalf of the principals which is the critical function and therefore the function to which the principles of governance apply most pertinently.

In What Circumstances Does the Need for Governance Arise?

There are numerous details, contexts and situations in which a need for Governance arises or is said to arise. Ultimately these boil down to:

1. Circumstances in which diminished responsibility prevails for one, some or all of the principals. Examples include decisionmaking on behalf of the infirm, the insane or children⁵.
2. Situations where an agent has a comparative advantage in making decisions over agents for one or several reasons typically by virtue of the agent's greater skill, experience, information or knowledge. An example would be industry expert directors on company boards.
3. Circumstances in which efficiencies that benefit principals can be achieved through the use of agents such as Boards of Directors. For example where an investor has too many investments or is otherwise occupied such that he or she cannot manage the affairs of each investment held⁶.

It is not uncommon for all or various combinations of these three circumstances to result in a need for governance.

Ten Principles

The ten principles of sound governance form a set of normative statements prescribing the requirements for sound governance. Good governance may be defined, shorn of grandiose embellishment, as the making of high quality decisions for principals on a sustained basis.

High quality decisions in turn, are decisions which best advance the total welfare of principals having regard to risk.

The ten principles of sound governance embody the following concepts.

1. Accountability

This term makes little useful sense without specification of what is meant. If accountability is to be achieved it is necessary to:

- a. identify who (singular or plural) exactly is to be accountable,

⁴ The seminal paper in the economic context which alerted wider audiences to principal agent frameworks is Jensen, M., and Meckling, W. 1976. Theory of the firm: Managerial behavior, agency costs, and ownership structure. *Journal of Financial Economics*, 3: 305-360. The main alternative "stewardship" view is discussed in Davis, J.H., Schoorman, D and Donaldson, L. "Towards a Stewardship Theory of Management", *The Academy of Management Review*, Vol. 22, No. 1, Jan., 1997.

⁵ See for example Scottish Law Commission. Discussion Paper on Insanity and Diminished Responsibility. Discussion Paper No 122. (2003).

⁶ See Jensen and Meckling op. cit.

- b. identify to whom (singular or plural) they are to be accountable,
- c. what exactly they are to be accountable for,
- d. what timeframe they are supposed to be accountable over, and,
- e. how such accountability is to be evidenced and measured.

Typically accountability is ineffective if its exercise is not accompanied by sanctions and remedies. Effective sanctions might include peer pressure, moral suasion and other forces which may be intangible yet effective⁷.

Unless these items are specified in one or another form - and that form may well be implicit (but at least understood) or intangible (but identifiable) - it is likely unreasonable and unhelpful to demand accountability.

2. Specification and Execution of Roles

Effective delivery of outcomes for principals is difficult if roles in organisations are not specified clearly so that those with the requisite skills and experience are able to apply their resource directly and unhindered to their assigned tasks in delivering outcomes.

A fundamental distinction is to be drawn between management in implementing policy and undertaking the problem solving required to deliver, and governing the organisation through development of the strategy and accompanying policy which enables management to deliver.

As a general rule, directors should not interfere in the management of organisations. Interference by directors - frequently with the best of intentions - is notorious for leading to ineffective results, lowered morale, unnecessary tension, inappropriate risk taking and ultimately erosion of value⁸.

3. Appointment of Agents Based Solely on Ability and Capacity to Enhance the Total Welfare of Principals

Appointments should be made purely and exclusively on the basis of demonstrable competence, skills and experience of direct relevance to enhancing owners' welfare and managing risk to that welfare⁹.

The explicit or implicit use of criteria such as gender, ethnicity, and interest group affiliation where such criteria do not relate directly to principals' welfare should be eschewed. In particular appointment on the basis of social or political favour and connection are to be avoided¹⁰.

Appointment processes should be supplemented by routine systematic evaluation (both individual and collective) of performance coupled with explicit rotation policies appropriate to owners requirements' and welfare.

⁷ Discussed in various contexts in "Sanctions, Accountability and Governance in a Globalised World" Edited by: Jeremy Farrall, Asia-Pacific College of Diplomacy, Australian National University. Edited by: Kim Rubenstein, Australian National University, Canberra 2009.

⁸ See KJ Hopt and others. (eds), *Comparative Corporate Governance: The State of the Art and Emerging Research* (Clarendon 1998) for typical discussions.

⁹ See Wheeler, P.B. "Selection Criteria for SOE Directors", Report to Crown Company Monitoring Unit, 2001, update 2002, Wellington, New Zealand.

¹⁰ See "Political Connections, Governance and Managerial Behavior", Luc Goupil, Master Thesis, Paris School of Economics, 2008 as an example of research in this area.

4. Capacity to procure independent views

Development of strategies which enhance principals' wealth (however measured) while managing their risk exposures requires that a diversity of views is captured so that the fullest breadth of information is brought to bear.

Typically though not exclusively, this is most readily achieved by the appointment of one or more independent parties to the governing body (usually a board). Independent generally means having no beneficial interest in the ownership of the entity¹¹.

The appropriate stance for such independents is that of the "constructive sceptic" - one who is not unduly negative or behaves in a manner which is deleterious to morale but who is objective and searching in questioning efficacy while offering superior alternatives where existing practice or thought is found to be unjustifiably wanting.

5. Identification and management of conflicts of interest

Conflicts of interest arise where the interests of agents diverge from those of principals to the extent that principals' wealth is or could be eroded materially. Several situations might give rise to such outcomes¹².

Rules should be applied to ensure disclosure of such potential is mandatory. It may be both appropriate and possible to modify processes (for example the right to vote on decisions) so as to manage conflicts or it may be necessary to prohibit involvement of the agent with conflicting interests in given cases.

Procedure and rules should be spelt out explicitly and formally as matters of procedural policy.

6. Marshalling of resources to discharge tasks effectively

Regardless of the size or scope of governance duties being undertaken it is virtually impossible to maximise the welfare of principals without marshalling relevant resources both financial and non-financial through arrangements (and these might take numerous forms) which result in the solving of problems and execution of tasks to the standard required for advancing principals' welfare.

The single most significant element of this principle is that governing bodies are responsible for the hiring, mentoring and monitoring of the individual performing the chief executive function (whatever that might be labelled in different organisations and however it might be performed). This a prime role which governing bodies should embrace and deliver¹³.

7. Transparency of process

Closely linked to accountability, good faith discharge of obligations and managing conflicts of interest, transparency of process demands explicit disclosure of actions and their motivation

¹¹ See for example, Report of New York Stock Exchange Commission on Corporate Governance, 2009, summarised at <http://corporategovernanceoup.wordpress.com/2010/12/06/is-director-independence-so-important>.

¹² See for example Davis, Michael; Andrew Stark (2001). Conflict of interest in the professions. Oxford: Oxford University Press.

¹³ Discussed in the following typical article <http://www.heidrick.com/board>.

amongst all affected parties so that treatment of principals' interests by agents is visible at all material times¹⁴.

Further, transparency requires that the harbouring and pursuit of opaque collateral interests and motives be proscribed in all aspects of the principal agent relationship and actions associated with that relationship.

Principals' interests are best served through agents observing openness as a fundamental.

8. Adherence to rules of natural justice

Procedures adopted by agents should adhere to concepts of natural justice such as the right to advance warning (of decisions and actions), the right for those affected to be heard and to question and the need to incorporate relevant matters in decisions while taking account of extenuating circumstances and excluding irrelevancies¹⁵.

A number of the ten principles espoused above buttress and explicitly address concepts incorporated in rules of natural justice, for example, the management of conflicts of interest (avoiding personal interests in decisions) and procuring independent views (taking account of the relevant while excluding the irrelevant).

To the extent that agents are often called upon to develop and govern their own procedure, remaining faithful to the rules of natural justice becomes a vital principle to be followed.

9. Discharge of obligations in good faith

A closely related concept is the notion that decisions and actions of agents should reflect and actively incorporate sincere, honest intention and belief regardless of expected outcomes.

Many commonly used instruments of commerce and other activity (for example the execution of contracts and fair dealing in trade of goods and services) depend for their effectiveness and therefore their capacity to deliver benefit for principals, on agents performing tasks and discharging duties in good faith¹⁶.

10. Sustained development, application and monitoring of strategy

Strategy is the set of decisions which creates and defines the fundamental direction taken to ensure that principals' welfare is maintained and increased. While its development and implementation is not the exclusive preserve of the governing body, responsibility for development and monitoring strategy is.

Responsibility for strategy is a long run obligation and a central concern of agents. Following the imperative to sift through detail and distraction to apply consistent, hard-nosed strategic perspectives is a prime principle of governance¹⁷.

¹⁴ Discussed in Lord, K. M. (2006). *The Perils and Promise of Global Transparency*. State University of New York Press.

¹⁵ See Lane, W.B. and Young, S. *Administrative Law in Australia*, 2008. Thomson Lawbook Co, Sydney.

¹⁶ For a common form of definition see <http://dictionary.law.com/Default.aspx?selected=819&bold=>

¹⁷ See *The Halo Effect: ... and the Eight Other Business Delusions That Deceive Managers*, Rosenzweig, P. Free Press 2007.

Beyond Preaching to Practice

It would be remiss to discuss the principles of governance without stressing that their value is inextricably tied to practice, that is to the effectiveness with which agents, typically directors and governing bodies, operationalise principles through practice.

Thorough examination of the issues is beyond the scope of this note. What is worthwhile noting are the three factors which research and evidence to date reveal as being critical to effective practice which facilitates exploitation of the value of the principles.

Constructive, Functional Relationships

Implementing sound principles of governance is likely to be difficult unless a positive functional relationship exists amongst agents in a governing body. In the vernacular it is helpful to have “good chemistry” amongst agents. Best outcomes for principals are therefore most likely where strong, positive relationships exist, are maintained and are nurtured.

Observation, while recorded in a less systematic fashion than might be desirable in the literature and having a strong anecdotal character seems to suggest clearly that where relationships are or become dysfunctional, value is eroded and principals’ welfare diminished¹⁸.

Governance Management Relationships

Pivotal amongst relationships is that between groups of agents such as boards of directors and leaders of the executive, typically chief executives. The conduit for passing information and recommendations for welfare enhancing actions “upward” to the governing level is the chief executive or equivalent. The conduit for passing policy down and having it executed is the chief executive or equivalent.

The key prerequisite for these flows to operate effectively is a functional relationship between board and management. Development and espousal of sound principles of governance is likely to be of little or no avail in improving and guarding principals’ welfare without such relationships. As with internal relationships in governing bodies the evidence, again though less systematic than may be desirable seems clear that dysfunctional relationships are synonymous with value being destroyed for principals.

The Chair as Driver

Recent research has clarified the long asserted importance of the chair or equivalent leader of groups of agents such as boards of directors. Smith¹⁹ in particular examined assessments of factors accounting for board effectiveness made by a range of directors in private and publically owned companies. The analysis confirmed the pivotal role of the chair.

In implementing principles of effective governance the chair role acts as a point of focus, a call to action through leadership and most critically brokers, maintains and operates the relationship between management and the governing body.

¹⁸ Examples of unfortunate outcomes resulting from corrosive relationships amongst directors (as agents) are plentiful.

¹⁹ Smith, J.L. Directors’ insights from inside the boardroom: A New Zealand perspective, Master’s thesis, Auckland University of Technology, Auckland 2010.

Conclusions

Agent principal relationships are ubiquitous in human societies. Value adding management of those relationships through sound governance is thus of central importance in advancing and protecting the welfare of principals. Such is the case in commercial and non-commercial situations, in public and in private life and in the public and private sector.

Better governance is well served through striving for at least a modicum of precision in establishing what governance is and how the principles which underpin it should be understood and applied. The ten principles espoused above provide a framework from which governance structures and processes which perform well can be fashioned so as to meet the requirements of particular agents and principals.

Coupled with effective practice which incorporates well-functioning relationships amongst agents in the governing body and between that body and the executive function of entities, the prospects for improved safe guarding of principals total welfare is likely to be enhanced.

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