

# UK Corporate Governance: Enron to VW - It's Not About The Car

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# Scope of Presentation

- Introduction
- Enron
- Background to UK Corporate Governance
- UK Corporate Governance Code and changes introduced in 2014
- VW's Corporate Governance
- Future for UK Corporate Governance
- Conclusion

# The Infamous VW 'Defeat Devices'

Ingenieur Volkswagen vindt nieuwe job



# What is it About Then?

“We have broken the most important part in our vehicles: your trust”

“Now, our number one priority is winning back that trust”

Volkswagen statement – The Times 10.10.15

# The Brown and Messy Stuff Hitting The Fan..



# Your Starter for 10 Mr Horn

- "You are the Lance Armstrong of the industry"
- "How do you sleep at night when you know you knowingly poisoned the planet?"
- Allegations of a "massive cover up at VW"
- Peter Welch to Michael Horn – Senate Committee Hearing, Washington – October 2015

# Speaking of Lance...



# It's Not About The Bike

- “My opinion is slightly different. It feels like a historical artefact now, that it has a certain value even if it doesn't contain the entire truth within it. ”
- “It's still a fantastic book. At the time it was an extraordinary story and the story is at least as much about a cancer survivor as it is about a successful cyclist. As a piece of writing, it certainly stands the test of time.”
- Matt Phillips, editorial director at Yellow Jersey Press



# Seven Deadly Sins

- “I know that when I’m on my deathbed and somebody asks: did you ever do anything as a journalist you were proud of, I would say only one thing: ‘Lance Armstrong’”

David Walsh – Seven Deadly Sins: My Pursuit of Lance Armstrong

# Remember Enron?

- The VW scandal is on the scale of Enron, according to the committee
- Enron was formed in 1985 by Kenneth Lay
- Merging Houston Natural Gas and InterNorth
- Several years later Lay recruited Jeffrey Skilling
- Enron used accounting loopholes, special purpose entities, and poor financial reporting.
- Were able to hide billions of dollars in debt from failed deals and projects

# Remember Enron?

- CFO Andrew Fastow and other executives misled Enron's board of directors and audit committee on high-risk accounting practices
- Pressured Arthur Anderson to ignore the issues
- Arthur Andersen was found guilty in a United States District Court of illegally destroying documents relevant to the SEC investigation which voided its licence to audit public companies
- Led to dissolution of Arthur Anderson

# Remember Enron?

- Executives at Enron were indicted for a variety of charges and some were later sentenced to prison
- Employees and shareholders received limited returns in lawsuits, despite losing billions in pensions and stock prices

# Remember Enron?

- New regulations and legislation were enacted
- Sarbanes – Oxley Act 2002
- Increased penalties for destroying, altering, or fabricating records in federal investigations or for attempting to defraud shareholders
- The Act also increased the accountability of auditing firms to remain unbiased and independent of their clients

# What is Corporate Governance?

- There is no single, accepted definition of what the expression 'corporate governance' means
- *“Corporate governance is the system by which businesses are directed and controlled”*

# Background to Corporate Governance Code

- Origins of the current Code stem from the report of the Committee on the Financial Aspects of Corporate Governance –
- Cadbury Report (1992)

# Greenbury

- Greenbury Committee
- Culminating in the Directors' Remuneration – Report of a Study Group chaired by Sir Richard Greenbury
- Greenbury Report (1995) with its recommendations on executive pay and a Code of Best Practice



# Hampel

- Aim for a single code
- Hampel Report (1998)
- Combined Code on Corporate Governance
- Number of provisions relating to internal control

# Combined Code

- Hampel report criticised as it gave little guidance on internal controls' scope and extent
- Higgs Review in 2003 also suggested amendments to the Combined Code
- Financial Reporting Council (FRC) asked a group chaired by Sir Robert Smith to issue Combined Code guidance for audit committees
- In July 2003 the revised Combined Code, taking account of both the Higgs Review and the guidance for audit committees was published, and took effect for reporting periods beginning on or after 1 November 2003

# Back To The Future

- The latest revisions in September 2014 took effect for reporting periods beginning on or after 1 October 2014
- Code begins with the words *“The purpose of corporate governance is to facilitate effective, entrepreneurial and prudent management that can deliver the long-term success of the company.”*

# Back To The Future

- *“Corporate governance is therefore about what the board of a company does and how it sets the values of the company”*
- *“It is to be distinguished from the day-to-day operational management of the company by full-time executives.”*

# Purpose of The Code

- All the UK reports and codes have taken the '*comply or explain*' approach
- Listed Companies
- Only quoted companies (those with a premium listing on the London Stock Exchange, whether they are incorporated in the UK or elsewhere) are obliged to report how they apply the Code principles and whether they comply with the Code provisions

# Purpose of The Code

- Where they do not comply with Code explain their departures from them
- For a quoted company reporting on its application of the Code is one of its continuing obligations under the Listing Rules published by the UK Listing Authority (UKLA)
- If quoted companies ignore the Code, then there will be penalties under the Listing Rules

# Purpose of The Code

- The Code is divided into main principles, supporting principles and provisions
- For both main principles and supporting principles a company has to state how it applies those principles

# Purpose of Code

- In relation to the Code provisions a company has to state in a report –
- whether they comply with the provisions or
- Where they do not – give an explanation



# Main Principles

- For many non-quoted companies and other organisations the main principles of the Code form a useful starting point for reviewing their governance structures and processes
- What are the main principles of the Corporate Governance Code 2014 ('the Code')?

# A. Leadership

## **The role of the board**

- Every company should be headed by an effective board which is collectively responsible for the long-term success of the company

## **Division of responsibilities**

- Clear division of responsibilities at the head of the company between the running of the board and the executive responsibility for the running of the company's business.
- No one individual should have unfettered powers of decision

# A. Leadership

## **The chairman**

- The chairman is responsible for leadership of the board and ensuring its effectiveness on all aspects of its role

## **Non-executive directors**

- As part of their role as members of a unitary board, non-executive directors should constructively challenge and help develop proposals on strategy

# B. Effectiveness

## **The composition of the board**

- The board and its committees should have the appropriate balance of skills, experience, independence and knowledge of the company to enable them to discharge their respective duties and responsibilities effectively

## **Appointments to the board**

- Formal, rigorous and transparent procedure for the appointment of new directors to the board

# B. Effectiveness

## **Commitment**

- All directors should be able to allocate sufficient time to the company to discharge their responsibilities effectively

## **Development**

- All directors should receive induction on joining the board and should regularly update and refresh their skills and knowledge

# B. Effectiveness

## **Information and support**

- Board should be supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties

## **Evaluation**

- Board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors

## **Re-election**

- All directors should be submitted for re-election at regular intervals, subject to continued satisfactory performance

# C. Accountability

## **Financial and business reporting**

- Board should present a fair, balanced and understandable assessment of the company's position and prospects

## **Risk management and internal control**

- Board is responsible for determining the nature and extent of the principal risks it is willing to take in achieving its strategic objectives. The board should maintain sound risk management and internal control systems

## **Audit committee and auditors**

- Board should establish formal and transparent arrangements for considering how they should apply the corporate reporting and risk management and internal control principles and for maintaining an appropriate relationship with the company's auditors

# D. Remuneration

## **The level and components of remuneration**

- Executive directors' remuneration should be designed to promote the long-term success of the company
- Performance-related elements should be transparent, stretching and rigorously applied

## **Procedure**

- Formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors
- No director should be involved in deciding his or her own remuneration



# E. Relations with Shareholders

## **Dialogue with shareholders**

- There should be a dialogue with shareholders based on the mutual understanding of objectives
- Board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place

## **Constructive use of general meetings**

- Board should use general meetings to communicate with investors and to encourage their participation

# IOD Principles

- Unlisted Companies
- Good governance
- Framework and procedures “add value”
- Protection of minority shareholders
- Attraction to external finance

# IOD Principles

- IOD Principles and Guidance
- Voluntary; potentially applicable to all unlisted companies
- Step by step
- 2 phases

# IOD Principles- Phase 1

1. Appropriate constitutional framework and governance structure
2. Strive to establish an effective board, collectively responsible for long term success and setting objectives
3. Board size and composition to reflect scale and complexity of company's activities
4. Board to meet regularly, with timely supply of appropriate information

# IOD Principles – Phase 1

5. Remuneration to attract and motivate executives and non – executives of the quality required
6. Board responsible for oversight of risk and maintenance of sound internal controls
7. Dialogue with shareholders, based on mutual understanding of objectives. Board responsible for this – also for treating all shareholders equally

# IOD Principles – Phase 1

8. All directors to receive induction and “refreshment”
9. Family controlled companies to establish mechanisms for co –ordination and mutual understanding, and relationship between family and corporate governance

# IOD Principles – Phase 2

1. Clear division at head of company between running the board and running the business - No one individual to have “unfettered powers of decision making”
2. Board to have mix of competencies and experience. No one to dominate
3. Board committees to be established
4. Board to appraise itself periodically, and each director

# IOD Principles – Phase 2

5. Board to present balanced and understandable assessment of company's position and prospects for stakeholders and establish programme of stakeholder engagement



# Legal Framework

- Companies Act 2006
- Directors' duties (ss171 to 177 of the Companies Act 2006)
- Promoting success of the company (s172 CA 2006)
- Company's Articles a procedure for declaring and authorising directors' conflicts
- Namely, that if directors comply with the procedure in the Articles, they cannot be in breach of any of their duties (s.180(4))
- The Act creates a 'safe harbour' for directors – s463 CA 2006

# Changes to The Code in 2014

- October 2014
- Of particular interest-
- Remuneration policies that were linked to the long-term success of the company
- Encourage companies to predict, beyond a year, whether they believe they will remain solvent
- Relations with shareholders

# Changes to Code in 2014

- (1) Remuneration
- Greater emphasis be placed on ensuring that remuneration policies are designed with the long-term success of the company in mind; and
- Lead responsibility for doing so rests with the remuneration committee

# Changes to The Code in 2014

- Remuneration Committees should put in place arrangements that will enable them –
- Recover ('Clawback') or withhold variable pay when appropriate to do so
- Remuneration Committee 'should consider' appropriate vesting and holding periods for deferred remuneration
- Amended Schedule A to Code

# Changes to The Code in 2014

- In the FRC's consultation document:
- Two key provisions it proposes to include in the next revised version of the Code stated:
- A formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors
- No director should be involved in deciding his or her own remuneration

# Changes to The Code in 2014

## (2) Going Concern Basis

- Companies should state in their financial statements whether they consider it appropriate to adopt the going concern basis of accounting
- And identify any material uncertainties to their ability to continue to do so
- Companies should robustly assess their principal risks and explain how they are being managed and mitigated

# Changes to The Code in 2014

- Companies should state whether they believe they will be able to continue in operation and meet their liabilities taking account of their current position and principal risks
- Specify the period covered by this statement and why they consider it appropriate

# Changes to The Code 2014

- It is expected that the period assessed will be significantly longer than 12 months
- Companies should monitor their risk management and internal controls systems and, at least annually, carry out a review of their effectiveness and report on that in their annual report



# Changes to The Code in 2014

## (3) Relations with shareholders

- When significant number of votes cast against a resolution at any general meeting, the Code now requires that the company should explain what action it will take – to understand reasons for results
- Explanation should be provided when results are announced

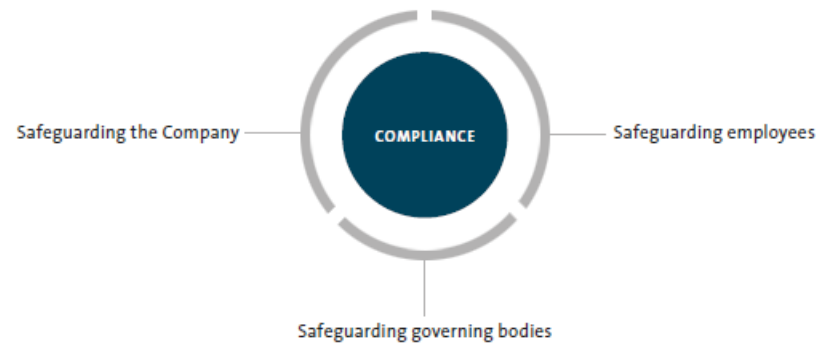
# Changes to The Code in 2014

- Determination of what constitutes a 'significant proportion' is for the board of directors to decide.

# VW – What did Corporate Governance Look Like Before Scandal?

THE VOLKSWAGEN GROUP'S PREVENTIVE APPROACH TO COMPLIANCE

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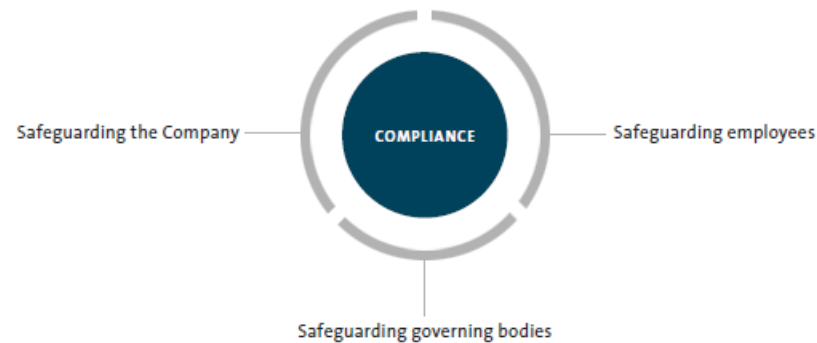
# VW – What did Corporate Governance Look Like Before Scandal?

- “How successful we are at continually increasing our Company’s value is crucial for the future of the Volkswagen Group”
- “The trust of our customers and investors is a fundamental requirement”
- “We foster this trust through transparent and responsible corporate governance, which takes the highest priority in our daily work”

# VW – What did Corporate Governance Look Like After Scandal?

THE VOLKSWAGEN GROUP'S PREVENTIVE APPROACH TO COMPLIANCE

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# VW – What did Corporate Governance Look Like After Scandal?

- “Under my leadership, Volkswagen will do everything it can to develop and implement the most stringent compliance and governance standards in our industry”
- Matthias Mueller – VW Chief Executive – September 2015

# VW: Writing On The Wall

- Position with VW –
- Management Board – led by CEO
- Supervisory Board – to which CEO reports
- Did Supervisory Board adequately control CEO?
- Was CEO, Martin Wintekorn a titan or a tyrant?
- “There was a distance, a fear and respect...if he would come and visit or you had to go to him, your pulse would go up” (VW Executive)

# VW: Writing on The Wall

- Frankfurt Motor show 2011 –
- YouTube video – Hyundai i30
- “It doesn’t clank, BMW can’t do it, we can’t do it, but they can”



# VW: Writing On The Wall

- VW's corporate governance score was already on 28<sup>th</sup> percentile before scandal broke meaning it was lower than 72 per cent of companies globally
- VW's corporate governance score had been falling since 2014 due to "management and board turmoil"
- "We had concerns about VW for some time"  
Howard Sherman of MSCI

# VW: Writing On The Wall

- Public arguments between chairman Ferdinand Piech and chief executive Martin Winterkorn culminated in Piech's resignation in April 2015
- Winterkorn resigns in September 2015 after scandal revealed (and share price drops 30 per cent)
- Winterkorn replaced by Matthias Mueller

# VW: Writing On The Wall

- “Allegations of corruption over the past decade” at VW according to Vigeo
- “Volkswagen had a trustworthy public image coupled with flattering financial ratings that did not necessarily conform to their social responsibility ratings”

# VW: Writing On The Wall

- However, (not everyone agreed)
- VW chosen as the industry group leader for the Dow Jones Sustainability index in early September 2015 based on 'strong scores on economic, environmental and social dimensions'

# VW: Writing On The Wall

- Emissions scandal serves as a “clear example of the importance of integrating environmental, social and governance (ESG) factors in the investment process”
- Jeroen Bos – NN Investment Partners

# VW: Writing On The Wall

- Huge share price decline - £22 billion
- Immediate Euros 6.5 billion provision
- Some analysts predict cost will be Euros 78 billion
- ESG factors – material impact on share price, near-term financials but also on its longer term reputation and business success

# The Future Fallout For VW

- Recall of 11 million diesel vehicles – January 2016
- Shareholder claim against VW in Germany and elsewhere
- Claim in Germany estimate to top Euros 4 billion or £2.9 billion
- Could be “the most significant securities action that has ever been filed in Germany”
- Potential significant claim in UK

# The Future For Corporate Governance in UK

- Regardless of what actions government or regulators take, the power remains vested in shareholders
- Shareholders, as owners of these companies, hold boards to account
- Executive pay and other issues such as board appointments



# The Future For Corporate Governance in UK

- FRC encouraging companies to abide by the principles in the Sharman Report 2012 (going concern and liquidity risks)
- Lessons learnt from financial crisis of 2008
- Consider solvency and liquidity over the cycle –prudent view
- Inextricable link between risk assessment, corporate governance and financial stability and reporting
- Continue to manifest itself in corporate governance best practice in UK
- Risk assessment to fall squarely on shoulders of the directors

# The Future For Corporate Governance in UK

- VW lessons?
- The days of one issue, one jurisdiction appear to be over
- A single issue can morph and evolve very quickly with potentially catastrophic consequences
- VW has to deal with different regulations and different enforcement agencies on a global basis

# The Future For Corporate Governance in UK

- The Code is to emphasise the responsibility of directors not only to anticipate risks to business; and
- Also to work out the interplay between identified risks and mitigation required to ensure that a crisis does not prove fatal to company
- Consultation paper
- Further revisions to Code in 2016?

# The Future For Corporate Governance in UK

- EU Audit Regulation and Directive (ARD)
- Aims?
- Auditors should not treat standards as a rule book
- Rather should be an assessment of what behaviours are appropriate
- ARD standard covers how independence of auditor might be judged

# The Future For Corporate Governance in UK

- Role of audit firm in ensuring ethical conduct
- Prohibitions and limit on non –audit services in line with ARD requirements
- 10 year tenure of auditors for FTSE 350 companies
- Proposed changes to the Code and the revised Ethical and Auditing Standards to apply to financial periods on or after 17.6.16 (implementation date of ARD)

# Conclusion

“Risk comes from not knowing what you are doing” – Warren Buffett

# Addendum

This presentation contains general advice and comments only and therefore specific legal advice should be taken before reliance is placed upon it in any particular circumstances.

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