MINDFUL, OUTCOMES-BASED CORPORATE GOVERNANCE BASED ON INTEGRATED THINKING

Milan

9 October 2019

Presented by Prof Mervyn King SC

17TH - 19TH CENTURIES

- 17th and 18th century unincorporated entities
- With unlimited liability
- Deterred wealthy families from investing
- Political leaders wanted job creation
- Consequence less risk capital was being made available
- Create an artificial person with limited liability?
- Debate 19th century

ACADEMIC OPPOSITION

Negative reaction by society to a person not being a creature of the Almighty

An individual with immortality lacks a soul to be punished by the Almighty

Lacks a body

Is a person without a conscience

"No soul to be damned and no body to be kicked." Lord Thurlow 1844

The company with limited liability act was passed in the UK in the middle of the 19th century

INCAPACITATED PERSON

- Young healthy individual, soul and heart in the body
- Incapacitated of mind
- Artificial person no heart, mind, soul or conscience
- Directors become the heart, mind, soul and conscience
- Context to a director's duties of good faith, care, skill and diligence

"OWNERSHIP" – A SOCIAL CONSEQUENCE

- Wealthy families provided the equity capital
- Members of the families directors
- Seen as "owners" of the company
- Primacy of the shareholder developed
- Public discourse of shareholders' "ownership"
- Short term profit for shareholders even at a cost to society and the environment
- Focus on financial capital

THE PRIMACY OF SHAREHOLDERS REINFORCED

- The Dodge Brothers vs Henry Ford 1919 – minority shareholder
- Ford wanted to use profits to pay better wages and improve plant
- Court ordered Ford to discharge its primary duty to shareholders and pay a special dividend
- So thinking was directors had to act in the best interests of the shareholders - primacy
- Corporate success was equated with increased profit, share price and dividends
- There was a focus on financial reporting

OWNERSHIP?

Shareholders are “the owners of the business” and the responsibility of the corporate executive is to “conduct the business in accordance with their designs, which generally will be to make as much money as possible while conforming to the basic rules of society . . . . There is one and only one responsibility of business – to use its resources and engage in activities designed to increase its profits as long as it stays within the rules of the game . . . .” Friedman, 1970s

- Tacit – company not part of society
- Principal (shareholders) agent (directors and managers) – puppet directors

OWNERSHIP

- Entitles one to consume, waste, donate or destroy a thing
- Shareholders have shares – not even hard copy today
- They own incorporeal rights
- Important incorporeal rights – purpose, vote, appoint, dismiss and receive dividends
- They do not own the company
- The company, a sovereign but incapacitated person

TRANSIENT SHAREHOLDERS

- IPOers
- Secondary market traders
- Transient shareholders
- Have a claim to a future stream of income if company can pay its debts on due date and/or has readily realisable assets to pay its debts
- On bankruptcy shareholders stand at the back of the queue
- Shareholders self-protection - can disperse investment by investing in the equities of other companies
- Stakeholders such as employees or managers cannot disperse these risks in other companies
- London S E – 6 months average holding

OWNERSHIP MYTH DEBUNKED

- Shareholders no rights:

  To possess the company's assets

  To use the company's assets

  To manage the business of the company

  To the income of the company
- Shareholders have no duty or responsibility to the company
- Representative shareholder duty to their ultimate beneficiaries

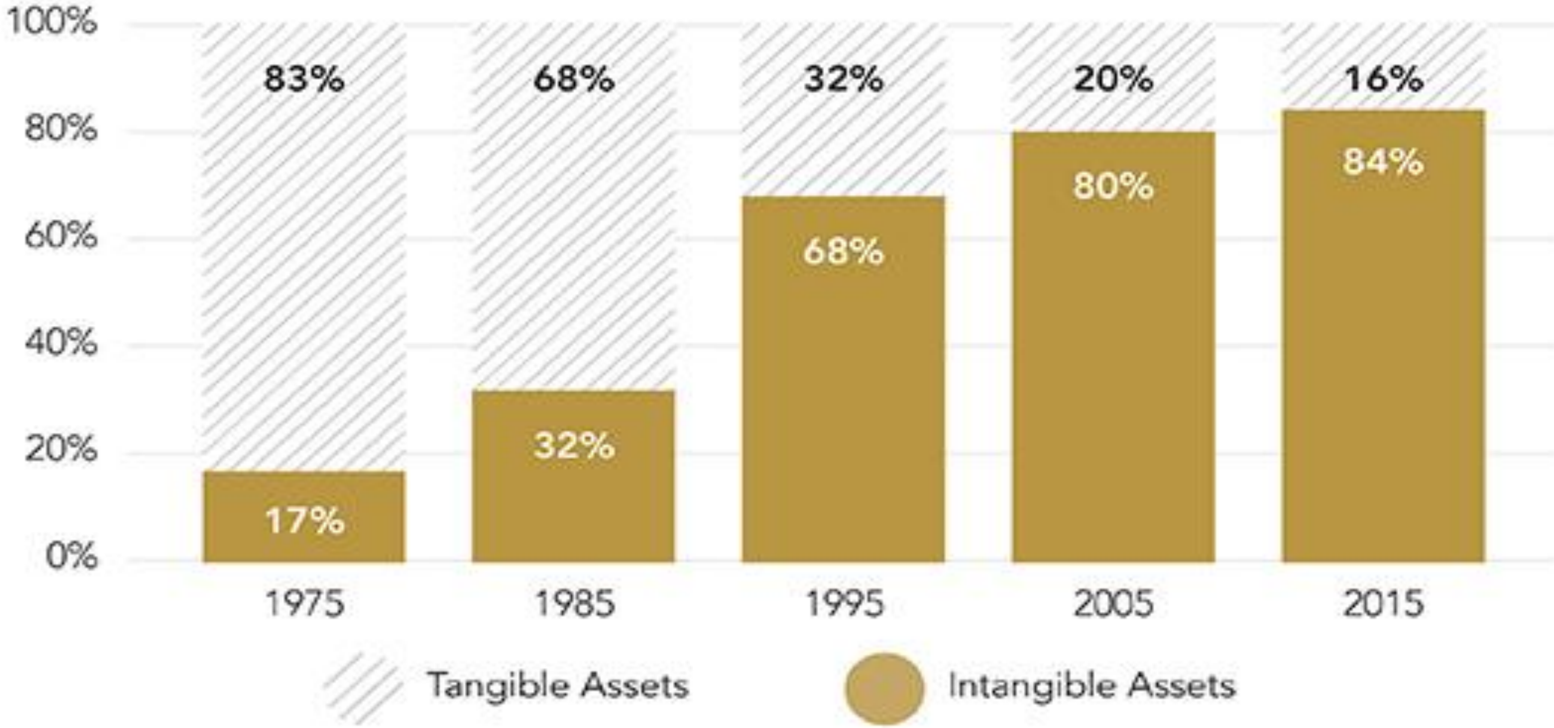
THE ERROR OF CORPORATE LEADERS

- Directors' duties owed to the company not shareholders
- Agency theory requires directors to obey
- Independence of mind fettered
- A company's long term health not its shareholder's wealth
- Time has come to challenge maximising shareholder value at any cost and regulations focusing on shareholders
- Distracts boards from building the company's long term health
- Professors Stout (Cornell) and Paine (Harvard)

UNTIL THE END OF THE 20TH CENTURY

- Company and its activities seen through a financial lens – reporting financial and historic
- In automotive terms a car with rear view mirrors and no windscreen
- Shareholder centric governance model
- 20th century one of unsustainable development
- 1995 ecological overshoot
- 1997 GRI founded

COMPONENTS *of* S&P 500 MARKET VALUE



SOURCE: INTANGIBLE ASSET MARKET VALUE STUDY, 2017

INTANGIBLE ASSETS

- Ecological overshoot and population explosion
- Strategy – long term value creation
- Reputation – perceptions of stakeholders
- Supply chain – legitimacy of operations
- Human rights – child labour
- Stakeholder relationships – civil society
- How does the company make its money?
- Positive and negative impacts on triple context
- The quality of governance of the organisation

INNOVATIONS IN CORPORATE REPORTING AT BEGINNING OF 21ST CENTURY

- Enhanced business reporting
- Balanced score cards
- Triple bottom line – theory - context
- Operating and Financial Review in Australia
- Each trying to communicate value creation
- Sustainability reporting
- Integrated reporting framework 2013

BEYOND FINANCIAL REPORTING

- Reporting in monetary terms
- FR critical but not sufficient
- SR critical but not sufficient
- The two in silos divorced from reality
- Triple context – dimensions integrated – SDG's 2015

DRIVERS OF CHANGE (1)

- Global financial crises
- Climate change crisis
- Ecological overshoot
- Radical transparency
- Greater expectations from stakeholders
- Stranded assets

DRIVERS OF CHANGE (2)

- Responsible investment
- Population growth
- Digital and net generation era - fourth Industrial revolution
- Cannot carry on business as usual
- Have to learn to make more but with less

FROM PROFIT TO VALUE

- From Friedman's "free" economy profits
- 21st century value creation by a company
- Historically book value – the difference between total assets and total liabilities
- Book value greater or less than the market value
- Value of money – the present value of discounted future cash flows
- All through a financial lens

VALUE TODAY

- Does the company make its money in a sustainable manner?
- The positive and negative impacts on the triple aspects of the company's business model and outputs – financial, social and environmental
- Enhancing the positives, eradicating or ameliorating the negatives - strategy
- Embedding sustainability issues into the business model
- As the conservation of water is critical to the beverage manufacturer
- Now value is seen through a sustainable lens in a resource constrained world
- Integrated thinking and reporting

THE SIX CAPITALS

Financial

Manufactured

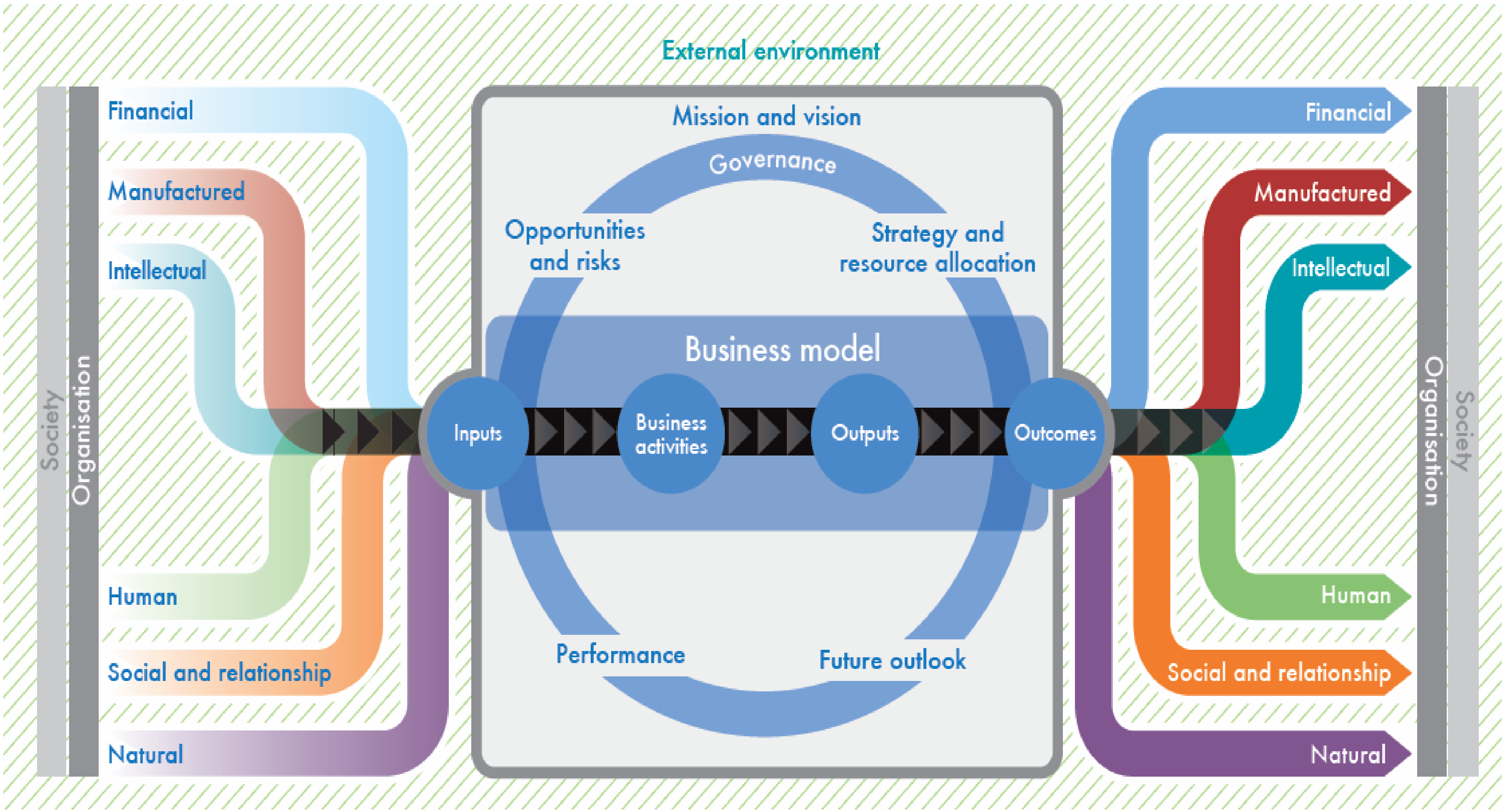
Human

Intellectual

Natural

Social

AN ORGANISATION'S VALUE CREATION PROCESS



INTEGRATED REPORTING <IR>

MEK Corporate Legal Advisers

At Coca-Cola, we believe active lifestyles lead to happier lives. That's why we are committed to creating awareness around choice and movement, to help people make the most informed decisions for themselves and their families. Coca-Cola commits to:

1. Offer low- or no-calorie beverage options in every market.
2. Provide transparent nutrition information, featuring calories on the front of all of our packages.
3. Help get people moving by supporting physical activity programs in every country where we do business.
4. Market responsibly, including no advertising to children under 12 anywhere in the world.

NEW INTEGRATED THINKING

- Every company dependent on relationships and sources of value creation
- Mindset change at board & senior management level
- Symphony of resources and relationships
- Knowledge of stakeholders' legitimate NIE's
- Greater stakeholder expectations – informed oversight
- Agenda items: Inputs to outcomes
  Stakeholder relationships

SHARE VALUE TO VALUE CREATION

- Board decides how, impacts, inputs to outcomes
- To generate the long term health of the company
- For the economy, society and the environment
- Success depends on internal and external outcomes:
- internal financial return
- external social, environmental and economic

THE REPORT

To be accountable you have to be understandable

"If I had more time…"

BLACKROCK

- At the beginning of February 2016, Larry Fink, CEO of BlackRock, the world's largest investor with $6 trillion in assets under management, sent a letter to the CEOs of the S&P 500 and a number of large European companies. In his letter Mr. Fink urges CEOs to "lay out for shareholders each year a strategic framework for long-term value creation"
- October, ESG in investment decisions and metrics in next five years
- Investors driving new thinking
- UNPRI, CRISA, SDG's
- Business Rountable

STRATEGY

- Strategy no longer stops at output
- Board needs to be informed of stakeholder relationships, sources of value creation and how the company makes its money
- Board needs an informed oversight
- Hence agenda items of inputs to outcomes and stakeholder relationships
- "CFO" working with C-suite on an integrated strategy – guardian of values - CVO

NEW CHALLENGES

- Mindset changes
- Capitals and stakeholder relationships
- Population growth and diminishing natural assets
- Greater stakeholder expectations
- Responsible investment –UNPRI
- Financial capitalism to inclusive capitalism
- Short term capital to sustainable capital
- Outcomes based approach to governance

"Yes, the planet got destroyed. But for a beautiful moment in time we created a lot of value for shareholders."

NEW THINKING

- Inclusive company centric model
- Basic good governance principles
- To achieve four outcomes
- Regimen of apply basic principles and explain practices
- Equal consideration to the sources of value creation and stakeholder relationships in the decision making process in the best interests of the company

FOUR OUTCOMES

- Ethical culture and effective leadership
- Value creation in a sustainable manner
- Adequate and effective controls/informed oversight
- Trust and confidence of community and legitimacy of operations

QUALITY VS QUANTITY

- Quality governance needs to be mindful
- Quality governance needs to be a value add
- Needs to achieve the four outcomes
- If basic principles are practised and the four outcomes are achieved, a company has practised good governance

CORPORATE GOVERNANCE ARCHITECTURE

Company an integral part of society

Stakeholder inclusivity

Integrated thinking

Corporate citizenship

Sustainable development

Annual integrated report

HELEN KELLER

- “The only thing worse than being blind is having sight and no vision”

NEW CHALLENGES

- The vision must be to have a company centric governance model which moves away from yesterday's primacy of the shareholder. It needs to be implemented mindfully to achieve the four outcomes of effective leadership, value creation in a sustainable manner, adequate controls and legitimacy of operations
- We don't have to grope in the dark
- We have the light – the IIRC Framework of December 2013 and mindful outcomes based governance

COMPANY

- No mind of its own
- Sovereign
- Immortal
- No owner of company
- Company owner of assets and its own liabilities
- Tangible and intangible assets

THANK YOU

Prof Mervyn King SC