The Impact of Evolving I.T. on Corporate Governance - Information and Corporate Governance

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Abstract

This is the first draft of a working paper that seeks to explore two related issues.

First, this paper explores the extent to which I.T. is modifying corporate governance, and may do so in the future. This part of the paper starts with a conceptual critique of the current information disclosure requirements inherent in best practice corporate governance before moving on to discuss the likely future role of I.T. in this.

Secondly, the paper posits that best practice corporate governance must apply to I.T. governance, if I.T. is to play a leading future role in the corporate governance of public interest entities.

The paper is intentionally visionary in nature and, as such, very contestable. It is also very preliminary and incomplete. Comments would be gratefully received by the author at ProfADC@aol.com.

INFORMATION DISCLOSURE REQUIREMENTS

Transparency

About a hundred years ago a judge opined that sunlight is the best disinfectant. 'Transparency' features in all of the many lists of criteria on what constitutes good corporate governance. Where there is a responsibility there should also be an accountability obligation – to account for how the responsibility is being discharged: this applies at the levels of governments, boards and also internally within organizations.

Power, responsibility and authority

While authority may be, and usually should be, delegated, undiminished responsibility remains with the delegator. It is true that those to whom authority is delegated acquire their own responsibilities to deliver on their delegated tasks and to account for that delivery to those from whom authority was delegated. But delegation should not mean abdication. While it may be a partial explanation, it should not be an effective defence by those at a more senior level that defective performance occurred not at their level but further down the chain.

Those who direct entities have excessive power unless they are required to account for their performance. Power tends to corrupt. One of the several theories postulated by academics as contributing to our understanding of corporate governance is agency theory. This suggests that management are the agents for the shareholders. Both management and the shareholders endeavour to maximise their own returns from the venture. There is a need to align the incentives of both parties, avoiding perverse incentives. The board should ‘hold the ring’

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3 John Emerich Edward Dalberg Acton, first Baron Acton (1834–1902) in a letter to Bishop Mandell Creighton in 1887: ‘Power tends to corrupt, and absolute power corrupts absolutely. Great men are almost always bad men.’.
between these parties but there is a
perception that boards are often more
closely aligned with management than
with shareholders. Management often
efforts to control the flow of
information through to the board, and
its content. Board themselves may be
selective and slanted in the information
they provide to shareholders. Even
when shareholders are well and reliably
informed, shareholders may have
insufficient powers to exercise effective
control over their investment.4

Who are the stakeholders?

An important question that arises is
whether the shareholders are the only
stakeholders to whom a duty of
transparency is owed. In addition there
are business partners in the supply
chain, staff, the local community,
creditors and debtors, central
government and the state, the global
community – and so on.

Another academic theory, stakeholder
theory, seeks to address this. When a
company’s shares are traded publicly
there is a requirement for public
reporting, including public provision of
annual and possibly quarterly financial
statements – though standards of
disclosure vary across the world. Yet
there is a public interest in the conduct
and performance of many entities that
are not public companies, for whom
standards of public disclosure may be
much poorer. Examples include large
private companies, mutuals, charities,
large professional partnerships, inter-
governmental and government agencies
and sovereign wealth funds. ADIA, the
world’s largest sovereign wealth fund
publishes no annual report and financial
statements.5 There are much reduced
disclosure requirements for companies
controlled by private equity investors,
which for many is one of their
attractions. Taking a company private
trends to conceal the company’s conduct
from the public view.

Corporate domination of the world
economy

Of the one hundred largest economies in
the world, about half are multinational
enterprises and half are nation states.
Year 2000 data had it as 51/49, 2004
was 53/47.6,7 It follows that the proper
governance of companies is as crucial to
the world economies as the proper
governing of countries.
The Company Law Directive of the
European Union requires that all
publicly quoted entities are defined as
‘public interest entities’ while allowing
individual member states to broaden the
definition to includes other categories of
entity. The UK has not broadened the
definition, so the enhanced standards of
disclosure that are required of public

5 Established in 1976, the Abu Dhabi
Investment Authority is a globally diversified
investment institution wholly owned by the
Government of the Emirate of Abu Dhabi.
6 http://www.corporations.org/system/top100.htm,
accessed on 02Apr13.
7 Chambers, A.D. (2012) Chambers Corporate
ISBN 978 1 84766 878 3, April, 912 pps., see
C1.10 on p.355.
interest entities apply only to public UK companies.

**Reliability of corporate disclosures**

More may be less. Regulations require banks to disclose vast amount of information, to the extent that their filings/annual reports are largely unintelligible. Furthermore, unreliable disclosures will misinform investors to the extent that they may be a poor basis for shareholders to exercise external control. When lack of confidence in the reliability of disclosures catches on, capital flows elsewhere, the cost of capital increases, and 'bottom line' company performance is therefore damaged:

‘Corporate governance lies at the heart of prospects for growth and development, and will be a key determinant of a country’s success. It’s very simple, if you think someone is dishonest and not telling the truth, you don’t give them the money. It’s not a question of people, it’s a question of intelligence. If you think someone is being honest, and is giving you a fair shake, a fair return, you do business with them.’

and:

‘If a country does not have a reputation for strong corporate governance practices, capital will flow elsewhere. If investors are not confident with the level of disclosure, capital will flow elsewhere. If a country opts for lax accounting and reporting standards, capital will flow elsewhere. All enterprises in that country – regardless of how steadfast

a particular company’s practices may be – suffer the consequences.

‘Markets must now honour what they perhaps, too often, have failed to recognise. Markets exist by the grace of investors. And it is today’s more empowered investors who will determine which companies and which markets will stand the test of time and endure the weight of greater competition. It serves us well to remember that no market has a divine right to investors’ capital.’

UK listing rules require quoted companies with a premium listing to explain in sufficient detail how they apply the main principles in the UK Corporate Governance Code. It is the

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8 President of the World Bank, 2002 or 2003.


10 The UK Corporate Governance Code now applies to overseas companies in the Premium tier. UK-incorporated listed companies can now opt out of the Premium tier and into the Standard tier which would then mean the Corporate Governance Code (and other things) would not apply to them. The 'Standard' tier equates to the minimum EU requirements for listed companies. The hope is that few UK companies will opt out of the 'Premium' tier as the intention is that they would then not appear in any of the FTSE UK Indices, even though they would remain listed. The UK Listing Authority’s listing rules 9.8.5 and 9.8.6 require a company with a premium listing to include in their annual report: ‘(5) a statement of how the listed company has applied the Main Principles set out in the UK Corporate Governance Code, in a manner that would enable shareholders to evaluate how the principles have been applied;’ and ‘(6) a statement as to whether the listed company has: (a) complied throughout the accounting period with all relevant provisions set out in the UK Corporate Governance Code;
requirement for assurance about the disclosures made in public filings/annual reports that has led to the requirement for an audit so that shareholders can be more confident that the information they receive is a reliable basis for the control decisions they make:

'Without audit, no accountability; without accountability, no control; and if there is no control, where is the seat of power? ... great issues often come to light only because of scrupulous verification of detail.' 11

A limitation of audit is its scope. With minor exceptions it is limited to the audit of financial statements which provide an account of past financial performance. There is a wide but misguided expectation that audit does much more than that.12 Shareholders or (b) not complied throughout the accounting period with all relevant provisions set out in the UK Corporate Governance Code and if so, setting out: (i) those provisions, if any it has not complied with; (ii) in the case of provisions whose requirements are of a continuing nature, the period within which, if any, it did not comply with some or all of those provisions; and (iii) the company's reasons for non-compliance;

11 Professor Mackenzie, an eminent economist at Manchester University, coined these words as far back as 1966 in his Foreword to E.L. Normanton (1966) The Accountability and Audit of Governments, Manchester University Press and Frederick A. Praeger, New York, Library of Congress 66-12160 [based on Normanton’s MPhil thesis which Mackenzie had supervised].

12 Liggio (1974) coined the phrase ‘expectations gap’ in relation to external auditing (Liggio, C.D. (1974) The expectation gap: the accountant’s legal waterloo, Journal of Contemporary Business, 3(3), pp.27 -44]. This was elaborated upon by Porter (1990) who described it as an ‘audit expectation-performance gap’, thus having two major components: (a) a gap between what society expects auditors to achieve and what they can reasonably be expected to accomplish (designated the ‘reasonableness gap’); (b) a gap between what society can reasonably expect auditors to accomplish and what they are perceived to achieve (designated the ‘performance gap’.) This may be further subdivided into: (i) a gap between what can reasonably be expected of auditors and auditors’ existing duties, as defined by the law and professional promulgations (‘deficient standards’); and (ii) a gap between auditors’ existing duties and auditors’ performance, as perceived by society (‘deficient performance’).’ [Porter, Brenda A (1990) ‘The Audit Expectation-Performance Gap and the Role of External Auditors in Society’, PhD Thesis, Massey University, New Zealand, p.13].

**Responsible investors**

Our discussion of corporate information disclosure would be incomplete without more reference to those to whom the information is addressed and in particular investors. Many investors have little interest in, or little potential to exercise effective control of the companies they are invested in. They may be shareholders only in the short term. They may hold a class of shares with voting rights that are inadequate to influence boards. Shareholder rights and powers may in themselves be...
inadequate in the best of circumstances. The shareholder body may be so fragmented that concerted action by a significant proportion of shareholders is in practice impossible. Even institutional investors are not all what might be termed active or responsible investors.

It has been observed that the corporate governance of some institutional investors has not always been up to the standard that they demand of the companies they invest in.

FUTURE ROLE OF I.T. IN CORPORATE INFORMATION DISCLOSURE

Already it is fairly general practice for companies to place their annual reports and accounts on their corporate websites. Regulators across the world are content for additional corporate information to be made available by companies on their websites only, not also being provided to shareholders in hard copy form.13 These developments enhance communication with shareholders and other stakeholders in terms of wider and extended access to more corporate information.

Openness

13 For instance Provision B.2.1 of the 2012 UK Corporate Governance Code allows that the requirement for the nomination committee of a UK listed company to make available its terms of reference, explaining its role and the authority delegated to it by the board, is met by including the information on a website that is maintained by or on behalf of the company (http://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-September-2012.aspx).

In the UK public sector, the Nolan principle of Openness14 has resulted in many board meetings being held in public and for plans, agendas, minutes and reports to be placed on the organizations’ websites to varying extents. The rationale being that the

14 The Nolan Committee set out 'Seven Principles of Public Life' which it believes should apply to all in the public service. These are:

Selflessness
Holders of public office should act solely in terms of the public interest. They should not do so in order to gain financial or other benefits for themselves, their family or their friends.

Integrity
Holders of public office should not place themselves under any financial or other obligation to outside individuals or organisations that might seek to influence them in the performance of their official duties.

Objectivity
In carrying out public business, including making public appointments, awarding contracts, or recommending individuals for rewards and benefits, holders of public office should make choices on merit.

Accountability
Holders of public office are accountable for their decisions and actions to the public and must submit themselves to whatever scrutiny is appropriate to their office.

Openness
Holders of public office should be as open as possible about all the decisions and actions that they take. They should give reasons for their decisions and restrict information only when the wider public interest clearly demands.

Honesty
Holders of public office have a duty to declare any private interests relating to their public duties and to take steps to resolve any conflicts arising in a way that protects the public interest.

Leadership
Holders of public office should promote and support these principles by leadership and example.
stakeholders of public entities, that is the public themselves, have a right and a need to be well informed. Even public bodies need to keep some information secret, and the need for confidentiality of information is likely to be greater in ‘for profit’ entities for competitive reasons. However, we have discussed earlier that there is a legitimate public interest in ‘for profit’ private companies and other types of non-public entity.

**Impermanence of website information**

Some of the challenges still to be faced relate to the permanence of company website information. Companies have the freedom to add, amend and delete at will. Reliance upon ‘soft’ information on corporate websites is risky as due to its impermanence and changeability. There is a need for an independent depository which automatically captures and archives securely company corporate governance and financial reporting website information, including all amended versions.

**Electronic standardisation of reported data**

There is scope to extend the electronic standardisation of financial reporting data to the standardisation of other data relating to corporate governance, such as the elements of the board’s published corporate governance report. This would be an extension of XBRL, allowing quicker and more reliable comparisons of corporate governance practices between companies. eXtensible Business Reporting Language (XBRL) is an existing language for the electronic communication of business information, providing major benefits in the preparation, analysis and communication of business information. It offers cost savings, greater efficiency and improved accuracy and reliability to all those involved in supplying or using business information. Many companies report their financial results in XBRL format. In the UK, tax authorities require companies to submit financial account information to them in XBRL format.  

**Real-time reporting to align market expectations**

The higher the quality of information available to investors, the greater is investor confidence. Uncertainty trends to depress market capitalisation. Executive rewards are usually related to share price. Whereas once companies reported only annually, many are now required to report quarterly. Beyond that, retailers for instance report their Christmas sales volumes promptly – as the market expects them to. If a company is performing below expectations it issues a profit warning, or if above expectations a ‘trading update’: the intention is that the board must keep market expectations aligned to business fundamentals. It may be regarded as best practice, and indeed a stock exchange requirement, to realign market expectations with a profit warning or a trading update when it is expected that results will differ by more than 10% from market expectations. To remove uncertainty, real-time reporting by companies of their financial results and of other matters such as

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15 All CT600 submissions must now include iXBRL Accounts and iXBRL Computations.
changes of board membership should now be feasible, thanks to I.T. and the internet. Companies reporting in real-time should become the favoured stocks of investors, so long as the real-time reporting is reliable. Real-time reporting on a company's website would require significant re-design of a company's in-house accounting and financial reporting systems, and the systematization of other elements currently managed manually such as changes in board composition.

Real-time reporting would require a changed approach to the external audit which would become more concerned with attesting to the reliability of the real-time financial information being updated continuously. The external audit could also be extended to providing assurance of the robustness of non-financial corporate governance information which the company was updating continuously. It might still be appropriate for the year-end financial statements (and half-yearly and quarterly financial statements where there is an existing legal or regulatory requirement for their publication) to be given extended external audit attention.

Independent generation of reported information

We need to explore the potential for extending the degree of independence underpinning the generation and reporting of corporate and financial information. At the moment, some but not all of this is subject to independent attestation by independent auditors. It is however the company's information. It is likely that in today's interconnected world there may be potential to make innovative use of I.T. to enhance the generation, collection and communication of primary and secondary corporate information that is reported publicly.

An area which needs to be explored is the extent to which company information which is reported could be compiled independently of the company in order to enhance its perceived or actual reliability. Perceived reliability is just as important as actual reliability: reliability is in the eye of the beholder.

It would be feasible for I.T. to independently compute market expectations, especially if there were extended reporting using XBRL-type of coded data, and to flag up situations where it had become necessary for boards to re-align market expectations.

There are clear opportunities for independent correlation of company performance with the vexed issue of executive rewards, making use of published information – especially if extended use of XBRL were to be applied. Independent reporting of the voting record of shareholders might also be feasible.

By analogy, many banks are now endeavouring to maximise the extent to which information being reported internally to their boards is generated independently of management with operational responsibility for the activities being reported. Databases and new software are the key to independent generation of information to be sued internally and by the board. Boards are endeavouring to minimise their 'assurance vacuum': they need a
high degree of assurance that their policies are being implemented by management and that there are no banana skins round the corner, known or not to management, about which the board is being kept in the dark.

**BEST PRACTICE GOVERNANCE OF I.T.**

Earlier in this paper we observed that the corporate governance of institutional investors (pension funds, investment trusts, life assurance companies, etc.), who themselves are one of the gatekeepers for the corporate governance of the companies in which they are invested, has not always been up to a high standard. We have also pointed out that, due to the ubiquitous nature of companies, the proper governance of companies is as important as the proper governance of countries.

Similarly, if I.T. is to assume a greater role in the corporate governance of public interest entities, then I.T. governance needs to be of a high standard. In part this refers to the need for quality I.T. governance within companies. In part it refers to the corporate governance of the I.T. service providers to companies. Finally, in part it refers to corporate governance of the I.T. services which are likely to step up to the plate in order to provide the web-based quasi-independent corporate governance analysis, archiving and other services we sketched out in the previous section of this paper.

**I.T. governance within companies**

Today I.T. drives corporate strategy. Arguably there are opportunities for all entities to gain a strategic advantage through the innovative use of I.T.. It is surprising that the executive who heads up I.T. still rarely has a seat on the board alongside other executives directors – such as the director of finance, marketing or H.R.. In part this is a consequence of the other members of the board being poorly informed about I.T. and reluctant to expose their ignorance.

There are three legs to the effective governance of I.T.. Like a three legged stool which is stable on an uneven floor, it requires effective risk management and internal control over and within these three components:

1. Each individual I.T. application and associated databases (each application requires effective controls to be built in)
2. The I.T. development process (I.T. projects must be developed in a well-controlled way)
3. The I.T. infrastructure (effective controls of the entity’s internal I.T. installation and of the I.T. of service providers that the entity is dependent upon)

Whenever an entity outsources to a service provider, part of the entity’s internal control is within the service provider’s business. Too much of that control, as it relates to the systems within I.T. service providers, is taken for granted.

Figure 1 indicates the generally accepted relationship between governance, risk management and internal control. Risk management is an important part of governance. In turn, internal control is an important part of risk management.
I.T. governance within the I.T. service providers of companies

The degree of transparency to their clients of I.T. service providers is important but often largely lacking. Companies should not need to take on trust the quality of governance, risk management and internal control within their service providers’ businesses. An adequate audit oversight, with audit reports being shared with users of the service, should be an essential part of the assurance process.

I.T. governance of entities contributing to the corporate governance oversight of companies

We have pointed out that institutional investors have often not been the beacons of light in corporate governance terms which they expect the companies they are invested in to be. If leading I.T. companies are to move into providing web-based quasi-independent corporate governance analysis, archiving and other services, the spotlight will be shone on their own corporate governance standards. Just as banks have been pilloried for conflicts of interest, excessive risk taking and excessive charging, so might be leading I.T. companies be exposed to similar censure unless they can demonstrate high standards of corporate governance.

The regulatory process is likely to be extended beyond the role of information/data protection commissioners which we have at present, and the reach of I.T. regulation will need to be global, not national.