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Governance: Form or Substance?

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There is little dispute that good corporate governance is good business. Yet it is disconcerting that behind boardroom doors, there continue to be murmurings about implementing corporate governance processes in areas such as risk management and internal controls. There lingers the impression that these processes are implemented only because of the requirements for corporate reporting and compliance. This leads to the "form" of corporate governance practices prevailing over the true "substance" of good governance practices within an organisation.

The current high costs of doing business and the issue of low productivity faced by many companies further impede boards and management in closely examining the state of corporate governance in their organisations, and taking it a step further to create real value for the business.

Director's independence

How valid is this sentiment of the form taking precedence over the substance of governance? An examination of corporate governance reports provides some examples.

One example is the "nine-year rule" of the Code of Corporate Governance. Under this rule, a director's independence should be subject to "rigorous review" if he has served on the board beyond nine years from the date of his first appointment. According to the SID-ISCA Singapore Directorship Report 2014, 560 directors are still deemed to be independent despite having served on their boards for more than nine years, 71 of whom have served for 20 years or more.

Many of the corporate governance statements making this disclosure merely state that after a review of the director's independence, it was concluded that the director is independent. There is no information on the substance of that review such as the specific factors or criteria being evaluated by the board and the manner in which a substantive (or cursory) review was undertaken to support the view that the director continues to be independent despite his long service.

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The Code also recommends that a director be deemed not independent when a director is related by family or financially to the company and its officers. In several cases where the relationships are not within the proscribed limits (for example, parents or children) but could be close enough to an external observer as to raise the question of independence (for example, a chief executive who may be a son-in-law or daughter-in-law of the chairman), the disclosure of such relationships is not made, let alone deemed to affect the director's independence.

The risk of sticking only to the letter rather than the spirit of the rules is that this could lead to failures in governance, abuse and severe consequences for the firm. The classic example would be Enron and the special purpose vehicles it created to finance large projects. These special purpose vehicles were set up in such a way as to legitimately (under the accounting rules then) avoid full disclosure of the billions of dollars in debts from failed deals and projects. Enron's board of directors and audit committee failed to fully appreciate the high-risk nature of these practices and when things started going wrong, Enron collapsed.

Compliance purposes

Form and substance are both important and go hand-in-glove. Reporting for compliance purposes has its value, if the underlying activities and procedures that are being reported are important, are relevant, and have substance.

For example, an organisation that has implemented risk management processes to identify and prioritise its risks, and merely uses this information for reporting to the board, audit committee and the authorities – and stops at that – would simply be demonstrating form rather than substance. However, if such risk management processes and their outcomes are integrated with operations, then there is much more relevance, meaning and purpose in the effort, thereby creating substance.

It is a pity when resources invested in compiling information such as risk impact, or changes and mitigation measures for the board or audit committee on a periodic basis often do not translate into improved business outcomes through risk-mitigated or, better still, risk-enabled performance management.

This integration of risk assessment and analysis with business strategy offers the board and management greater insight into each business decision or proposal by better predicting its outcome. This is when reporting then moves from form to substance by virtue of the purpose it serves and the value it creates for the business.

Putting in place the underlying processes that are relevant and essential to business operations and reporting them will assist the organisation and its stakeholders in achieving a higher level of confidence in meeting their business goals as well as ensuring proper compliance with rules and regulations. All this will contribute directly and significantly to the organisation's business reputation and continuity.

To that end, the question is not whether governance should be more of form or substance, as both ought not to be distinct constituents. Rather, governance should reflect both form and substance – holistic and integrated.

The writer is a member of the Corporate Governance Guides Committee of the Singapore Institute of Directors. This article first appeared in BTInvest, <http://www.btinvest.com.sg/specials/boardroom/governance-form-or-substance/>