

Agency Governance

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A new era in governance has been ushered in across the world, in all sectors and industries, in the past decade, spearheaded by:

- Britain's Cadbury Report, which defines governance as "the system by which organizations are directed and controlled", and calls on "boards of directors to take responsibility for the governance of their firms"¹
- Canada's Dey Report, "Where Were The Directors?", calling on boards to "explicitly assume responsibility for governance" including "leadership, stewardship, risk management and information"²
- The U.S. Sarbanes-Oxley Act, which requires boards and three core committees (Audit, Governance, Compensation) to take direct responsibility for critical elements of oversight and control³

This new era is actually a return to the way corporations (organizations) were originally governed, and, according to Agency theory, ought to be governed.

Agency theory was articulated in the 1700's by Adam Smith.⁴ Essentially what he said is that the members of every social organization (from hunter gatherer tribes to corporations to nations) rapidly specialize into different groups, depending on their competencies and expertise:

- Principals (owners) are people with a knack for accumulating capital (wealth, resources)
- Agents (management) are people with a surplus of ideas to effectively use that capital (and get things done, i.e. create more value)

Economics is all about how we allocate these scarce resources (from the principals) to their most effective uses (by the agents.) The "agency problem" is that agents often have ideas to use capital that lies outside the intent (purpose) of the principals. This can apply to a single (financial) or triple (economic, social, environmental) bottom line: principals have a purpose in mind for their resources, and agents aim to accomplish those.

Governance exists to address this agency problem. Governors act as an intermediary (boards in corporations), as the principals' representative (steward, trustee, fiduciary) with the agents, ensuring capital is directed to the right purpose. The governors also act as the voice of the agents to the principals, articulating their ideas for uses of capital and making an accounting of the use of capital back to the principals.

¹ *Report on the Financial Aspects of Corporate Governance*, "The Cadbury Committee", London 1992

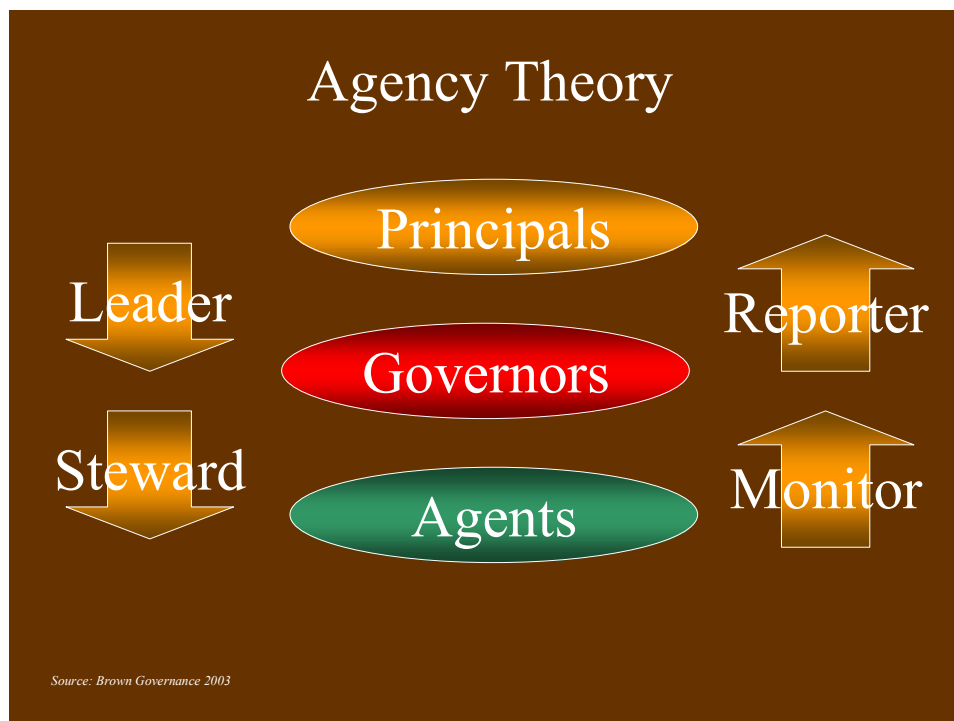
² *Corporate Governance Guidelines*, Toronto Stock Exchange, Toronto 1994

³ Sarbanes-Oxley Act is an amendment to the U.S. federal law (Criminal Code) passed by the U.S. Congress and signed by President Bush in July 2002. Its provisions have been adopted by the Securities and Exchange Commission (SEC), New York Stock Exchange (NYSE), NASDAQ and securities regulators worldwide.

⁴ *An Inquiry into the Wealth of Nations*, Adam Smith, Boston and Chicago 1776.

The governors (intermediary entity or board) therefore have these 4 core responsibilities, which comprise “governance” [see graphic below]:

1. Leadership: set the strategic direction of the organization (purpose, mission) and put in place the leadership (CEO selection, board renewal) to accomplish that direction
2. Stewardship: shepherd resources belonging to others (trustee, fiduciary), i.e. risk management, allocation of duties/roles/responsibilities, delineation of authority
3. Monitoring: receive and review measures of performance, and hold management (CEO) accountable for success (achieving the purpose, creating “value”)
4. Reporting: account to the principals (owners, investors, stakeholders) on the results of using their capital (resources, labour, etc.)



The principals and agents have specific core responsibilities as well: good governance is not about an adversarial or confrontational relationship among the 3 players, but each identifying and fulfilling their own unique competencies:

Principals have three core responsibilities in agency governance:

1. Select and put in place (elect; appoint) the governors (board of directors, trustees)
2. Select and put in place (elect; appoint) the auditors (external, independent body that tests and reports on the integrity of financial reporting and controls)
3. Ensure there is an effective governance system in place

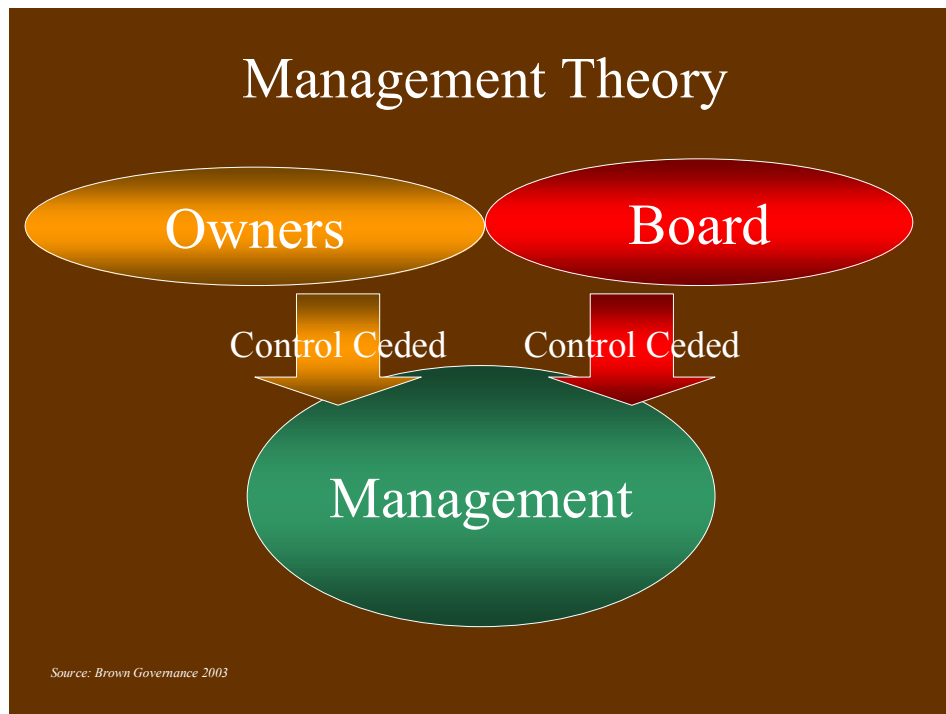
If we use the illustration of an organization being a ship:

- the principals are the ones who cause the ship to be built, who pay for it, and who have in mind an initial destination or mission;
- the governors are the rudder of the ship, setting its direction, and using “controls” (diagnostic measures and course changes) to ensure that direction;
- the agents are responsible for every other duty on the ship: from the bridge to the boiler room, the lookouts, decks, holds, etc. – the operations and activities throughout the organization.

Competing Governance Theories

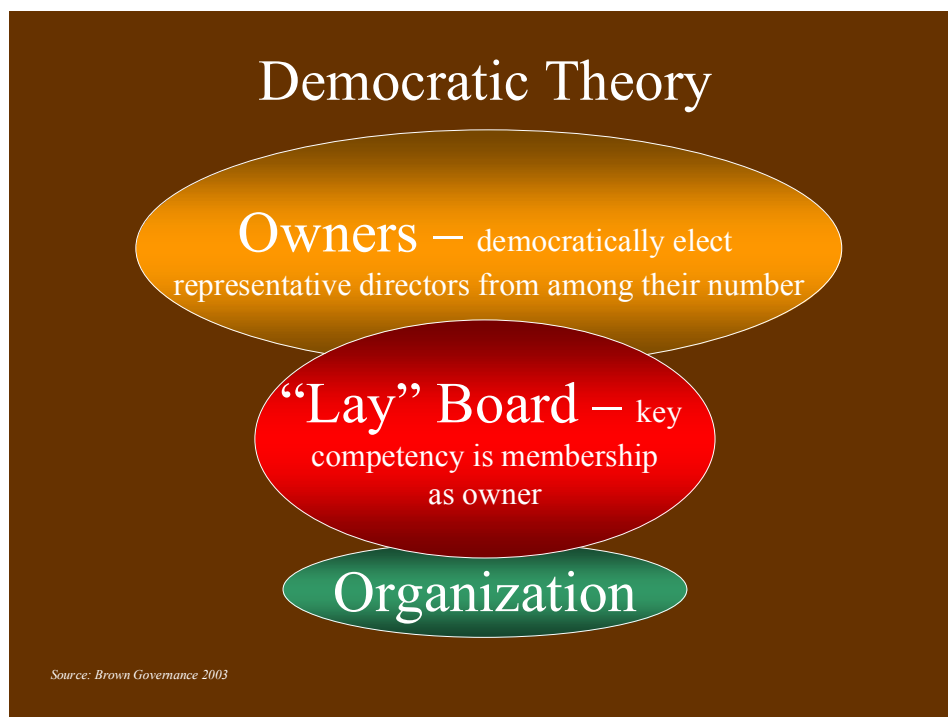
For a time in the 20th century, governance levers swung away from governing bodies (including boards) towards either management (often in the private sector) or owners (often in the public sector). In both cases, there results a breakdown in accountability, as the correct separation of powers (division of duties) fails to occur:

The private sector, particularly in industrialized countries, was dominated by a swing to Management Theory (1920’s through 1990’s). Management theory says that agency theory was perhaps workable for the simpler, smaller corporations of Adam Smith’s day, but in today’s world, corporations are complex, large, multi-faceted entities that are very challenging to direct and control. Only a sophisticated, experienced, professional management team can effectively direct and control a modern complex corporation. We should admit that direction and control have been ceded by owners and boards (principals and governors) to these managers:



Management theory is what the new era in governance calls into question. Cadbury, Dey and Sarbanes-Oxley do not deny that modern corporations are complex, but their main point is that management cannot be given all the levers over *both* governance (direction and control) and management (everything else) – to do so would create a circularity or tautology in accountability. In fact, Adam Smith’s reasoning is that the more complex social organizations get, the more people need to specialize, to divide their labours: Boards (governors) are not given responsibility for governance because they understand the corporation any better than managers, but precisely because they are NOT the managers. Many today argue that one of the reasons Japan has failed to recover from its economic troubles of the early 1990’s is because of its continued adherence to management theory.

The public sector and co-operative sector have experienced a different dominating governance theory: Democratic Theory. Under this theory, the levers of power for direction and control belong neither to the board or management, but to the owners of the organization:

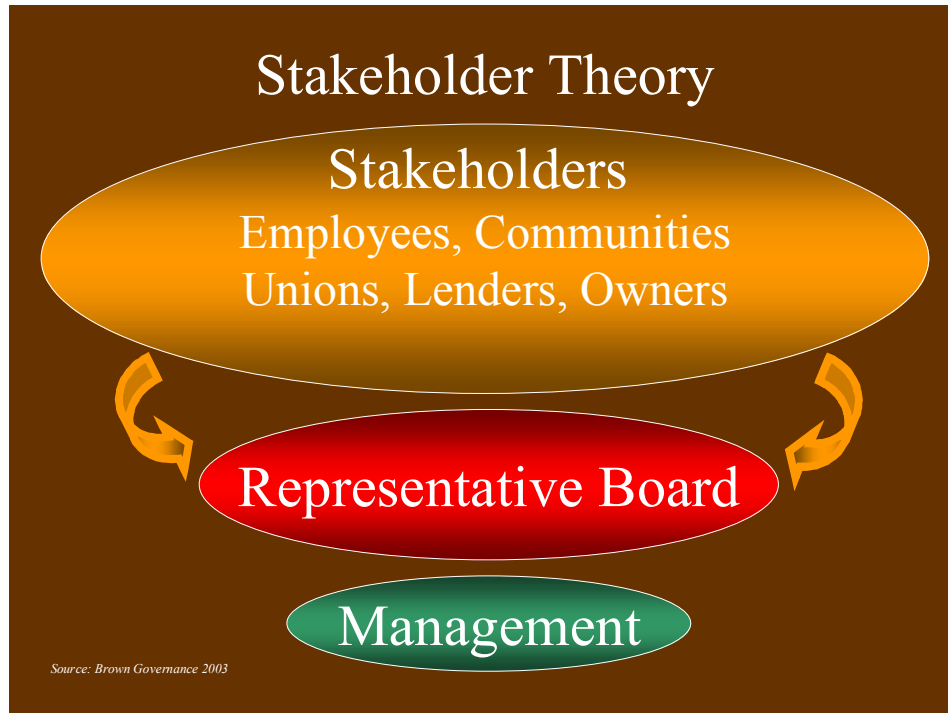


Under democratic theory, the board is selected based only on their ability to represent the interests of the owners. This is what we usually mean by a “lay” board – they have no specific experience or expertise in the business or in governance. They are meant to sit around the boardroom table and ask themselves: “what would the owners want us to do?” Clearly there are at least two major weaknesses to democratic theory:

- the board lack the clout to actually govern the organization; governance is usually divided in an ad hoc way between the owners (who may approve the Strategic Plan and budget, and select, compensate and evaluate the CEO directly, at least this is commonplace in the public sector) and the management (who often set the strategic direction and priorities, design and use the performance measurement system) – and in turn, accountability once again fails due to circularity (how can the CEO hold him/herself accountable for failure?) and distance (how can the owners effectively hold management accountable?)
- this theory runs counter to the law. In all British common law jurisdictions (the U.K., Canada and the U.S. among them), the corporation is treated as a person under the law, with a birth (chartering; incorporation) and death (no corporation is expected to last forever) and a lifetime fulfilling a unique purpose. It is the board of directors that is the “directing mind” of this “body corporate”. The board is expected to “act in the best interests of the corporation” at all times, not in the interests of the owners. (This is always the case for public sector and Crown corporations, although often the government as sole shareholder ignores this in practice. Under Co-operative law, the board must act in the best interests of the co-operative, but is entitled to take into account the interests of its members while it does so. Under U.S. corporate law, states have constitutional authority to enact the board’s duties, and practice does differ from state to state. In Canada, however, all federal and provincial corporate law makes it clear that directors must act in the best interests of the corporation. Recent hearings on amending the Canada Business Corporations Act rejected suggestions to incorporate shareholder or stakeholder wording into directors’ duties.)

There are other competing governance theories, one of which we will mention here: Stakeholder Theory.

Stakeholder theory holds that every corporation or organization was created to serve more than just its shareholders, but instead to serve a diverse range of people who have a legitimate stake in the organization’s outcomes and performance, and indeed to serve a broad societal purpose:



Because of this, the board is selected to be as broadly representative of these stakeholders as possible. Employees, unions, lenders, even communities and minority shareholders, are given seats on the board in addition to major shareholders. The result?

- Benefits: inclusion; diverse legitimate points of view and expectations have a direct voice around the boardroom table and influence the strategic direction and priorities of the corporation. Corporations and management are more sensitive and responsive to broader social and environmental interests.
- Disadvantages: the decision-making process is very slow. Inclusion of diverse voices necessarily means longer board meetings. Further, decisions are more often revisited: even when a strategic direction is approved, there is little board discipline in unifying behind it. Board members tend to act in their constituent's best interests, at times at the cost of the corporation's best interests. And so much time is taken up in direction that the board rarely pays sufficient attention to the other half of governance: control. Management and second tier boards often take on this responsibility in stakeholder governance (which leads once more to circularity of accountability and therefore a continuance of ineffective management.)

Stakeholder theory is best known in continental Europe where it has roots: Germany, France, the Nordic and Low countries. Some business writers argue that continental European economic performance tends to lag British common law (U.S., U.K., Ireland, Australia, etc.) economic performance because its stakeholder boards are slow to act and react to a rapidly changing competitive global environment.

In North America, stakeholder theory is fairly common in the not-for-profit sector. In order to build strong relationships with donors and campaign leaders, charities develop large representative boards. While there are clearly advantages to this approach, effective governance is not one of them: many volunteer and not-for-profit boards give only a passing glance to direction and control and focus their energies on other areas.

The different theories of governance can be arranged on a spectrum representing the degree of engagement of the governing body (e.g. board) with the organization’s agents (management/staff):

Management Theory	Passive, “rubber stamp”, advisory board
⇓	⇓
Stewardship Theory	Collaborative, non-oversight board
⇓	⇓
Agency Theory	Board actively engaged in direction and control
⇓	⇓
Democratic Theory	Board acts in owners’ interests, not organization’s; board often active in management; owners and management have large roles in governance
⇓	⇓
Stakeholder Theory	Board often more active in management than oversight and control; “micro managing”

To achieve the most effective governance, organizations need to determine their right position on this spectrum. While Agency Theory is supported by guidelines, law and research, there is room for some movement along this spectrum based on the organization’s current situation and needs. Among these:

- The number or owners (principals; shareholders): a small number of shareholders will often put in place a shareholders’ agreement that effectively unempowers the governors (board.) The board is required to be more passive in governance as the shareholder exercise these levers of power.
- The number and relative importance of key stakeholders: single owner organizations with a narrow range of other stakeholder interests can position themselves further up the spectrum (governance/board more passive.) This has been the practice in much of the public sector in the past generation or two; however, authoritative sources call this into question, and point out that effective governance must be more broadly-based.
- The competence and effectiveness of the agents (management): to the extent that an experienced and successful management team is achieving or exceeding results in a mature, stable industry, the organization can also position itself further up the spectrum (more passive board/governance.)
- A few, diverse stakeholders that hold significant power and divergent interests or views: in this case, one could argue for moving further down the spectrum, creating a strong representative board that more actively directs the activities of the organization. However, there is a risk of moving too far down the spectrum, to the point that direction is deadlocked

by an inability to reach consensus, and management is left to make critical decisions essentially in a vacuum.

There is a second, parallel spectrum that also affects the eventual choice of governance model, where the entity lies in terms of its “arms-length” from government:

Line Department in Government	Direct, hierarchical chain of command (authority and accountability lines): Minister – Deputy – ADM – DG – etc.
⇓	⇓
Special Operating Agency	Management or Administrative Board with limited authority and accountability; primary governance is still Minister – SOA Management directly
⇓	⇓
Agency, Board, Tribunal, Commission	Board is primarily involved in management (adjudicating, hearings, appeals), secondarily (often perfunctorily) in governance
⇓	⇓
Fully funded / Heritage Crown Corporation	Board is legally responsible for governance (direction and control), but government (shareholder) retains most levers of power in practice: hiring/firing CEO, approving capital and operating budgets, borrowing, major financial and strategic items, strategic direction/plan
⇓	⇓
Commercial Crown Corporation	Board takes on more practical as well as legal governance: strategic direction/plan, capital and/or operating budgets, hiring/firing CEO, borrowing/capital
⇓	⇓
Mixed / hybrid Governance Arrangement	Non-government stakeholders play an active role in selecting the board, although government is initial owner and funder; mixed/hybrid board then governs in organization’s interest (e.g. Canadian Wheat Board, CIHI, CPP Investment Board)
⇓	⇓
P3 (Public-Private Partnership) or ASD (alternative service delivery)	Ownership itself is shared between the government and industry; board is selected by both; governance models vary but can be pure Agency Theory (depends on shareholders’ agreement)
⇓	⇓
Joint Venture / Partnership	A limited number of owners who come together for a specific purpose, each contributing something different; similar governance issues as P3s (depends on partners’ agreement)
⇓	⇓
Private, Family or Controlled Private Sector Corporation	Incorporated as a business corporation, with one or more large shareholders (and perhaps many smaller); the board’s role in governance will depend on the large shareholder’s preferences and can vary across all governance models
⇓	⇓
Widely-held publicly traded Corporation	Management often exerts major influence on governance; owners are relatively small and disaggregated; recent governance regulations are aimed at correcting this imbalance by requiring boards and auditors to exert direct control over governance

There are constant tensions between flexibility and consistency, between control and diversity, between public/social policy and commercial/financial objectives, between mandated standards and risk-taking innovation ... the right choice of entity and governance model will depend on where and how the principals seek to balance these competing dynamics.

Having said all this, Agency Theory is meant to apply, not just to private sector firms of the 1700's, but to any social organization (including but not limited to corporations), in any sector of any country. Public sector and Crown corporations, co-operatives, hybrid and mixed governance models and entities can all benefit from the basic principles and lines of authority and accountability expressed in Agency Theory.