IoD CENTRE FOR CORPORATE GOVERNANCE PAPER

Are boards losing control?

August 2023

Introduction

One of the aims of the IoD Centre for Corporate Governance is to ensure that boards have the tools and support they need to lead their companies effectively.

This involves looking at how companies govern themselves and the effect that differences in governance practice can have, but also at the impact of public policy — an area where there is considerable activity at present.

While there is always an understandable tendency to prioritise the most immediate issues, it is also important to look ahead. The decisions taken now by boards and policymakers can either help or hinder companies in the future.

For that reason we asked the members of the Centre's Advisory Board and a selection of other commentators what they considered to be the biggest challenges facing companies over the next five to ten years, and what actions should be taken to address them. We are very grateful to all contributors for sharing their thoughts, which were invaluable in informing this report.

The comments we received primarily related to the challenges faced by the boards of listed and large private companies and that is reflected in this report. However some observations may be relevant to companies of all sizes.

The main conclusions of the report are:

1. **Companies face risks that are probably more complex than before and the idea that they operate within a business environment that is essentially benign and quite predictable is no longer valid;**

2. **The cumulative impact of the challenges they face has put many boards on the back foot, reacting to events rather than setting their own direction;**

3. **Combined with an increase in the pressure — and in some cases prescription — from policymakers, investors and other stakeholders, this has left some board members feeling that they are no longer in control of the company;**

4. **Now that governance is increasingly viewed as part of the broader ESG agenda, debate has become noticeably more politicised and views more polarised. This is not helpful to companies, but they have to find ways to deal with it;**

5. **Boards need to step up, re-establish their leadership role and engage more effectively with stakeholders and systemic issues. But there also needs to be a debate on how the policy framework for governance operates, with the aim of having a clearer delineation of responsibility for decision-taking between boards, regulators, investors and others.**

What challenges do boards face?

The operating environment for companies is challenging and will be for the foreseeable future. It will continue to evolve and become more complex, not necessarily in ways we can anticipate. Our commentators identified a number of different challenges that companies will face in the next five to ten years. Many are ones which companies are already having to deal with and which are predicted to persist, and in some cases increase.

Boards need to be equipped to steer a course through these challenges, taking account of a broader range of factors when developing their strategy and business plan and managing their risks. They need the right skills, information and governance structures in order to do so, but they also need a supportive policy framework.

The individual challenges are not discussed in detail in this report, which is concerned more with their cumulative impact. Most of them are already well recognised, and boards need to make sure they are taking them into account in their strategy and risk management systems and, where they are material, in the composition of the board and governance structures and processes.

Many of the challenges that were identified by our commentators can be grouped under three broad headings: the impact of the external environment on boards' decision-making and companies' ability to operate; the responsibilities of boards to shareholders and other stakeholders; and the impact of technology, in particular AI.

The external environment

Commentators identified a multitude of different issues under this broad heading, some specifically related to the current circumstances and others of a longer-term nature, which cumulatively make this a particularly challenging time for UK business. All of these issues potentially generate strategic, operational and reputational risks for companies.

Geopolitical issues such as the war in Ukraine and Brexit continue to have an impact on supply chains and international trade. For example, the most recent survey of IoD members found that 59% of members trading with the EU are finding the relationship challenging[1].

Addressing climate change continues to be a priority, albeit one on which public debate is becoming increasingly politicised. More attention is also being paid to other environmental issues such as biodiversity and waste. Listed and large private companies are subject to an ever-increasing level of regulation and standards relating to these issues, as well as greater pressure from investors and other stakeholders.

Many of the challenges affect the company's workforce both indirectly as employees and directly as consumers, such as the cost of living and the supply and cost of energy and other utilities. This in turn has contributed to an increase in industrial action and highlighted issues of social inequality in the UK, and both boards and investors are now paying more attention to workforce issues.

Running alongside this are longer-term issues such as the impact of changing demographics, an increased sense of division in society — 65% of UK respondents to the 2023 Edelman Trust Barometer survey considered that the country is more divided than previously[2] — and a lack of trust in institutions, including business. The same survey found that while the level of trust in business was higher than for government and the media it still stood at only 50%.

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[1] IoD press release: Challenges of EU trade see no let up | IoD (July 2023)
[2] Edelman Trust Barometer | Edelman

The shareholder vs stakeholder debate

The debate about the extent to which boards should be required to take account of the interests other stakeholders as well as shareholders, and longer-term as well as short-term financial considerations, is not a new one.

This issue has become arguably even more important in light of some of the environmental and social challenges referred to above. Regardless of the formal legal position, boards find themselves dealing with expectations that they will not only address matters specific to the company's own stakeholders but also contribute to tackling systemic issues such as climate change.

Most of the commentators who contributed to this report considered that the old, narrow 'shareholder primacy' interpretation of the board's responsibilities was not appropriate any longer, although there is plenty of evidence that it still exists in some quarters. However, there was less agreement about what should take its place. Simply transferring the notion of primacy from shareholders to stakeholders would create problems of its own.

In IoD's view, the board's primary consideration should be the interests of the company itself rather than those of its owners or other stakeholders. For that reason the IoD supports the Better Business Act campaign proposing changes to the Companies Act 2006 to create a duty for directors to act in a manner that will advance the purpose of the company[3].

The impact of technology

Developments in technology, and in particular AI, will affect all aspects of business activity. Potentially it may have a transformative effect on individual companies and on the economy as a whole, stimulating innovation and growth.

But as well as opportunities, technological change brings with it major challenges for many companies. Some will need to fundamentally rethink their strategy and business model and their products, services and ways of working if they are to reap the potential benefits rather than succumb to the threats.

The ethical implications of AI and other technologies and their impact on stakeholders, in particular the workforce, and on the board's decision-making process are also significant. Boards of all companies will need to ensure they have effective oversight[4].

It is not just companies that face the challenge of developing an approach that harnesses the benefits of technology while effectively addressing the potential risks. Policymakers do as well, as has been highlighted in the Government's recent policy paper on AI regulation[5].

[3] More details of the Better Business Act campaign can be found at https://betterbusinessact.org/

[4] Guidance for boards can be found in AI in the Boardroom: The essential questions for your next board meeting | Blogs | IoD, published by IoD's Science, Innovation and Technology Expert Advisory Group in March 2023

[5] A pro-innovation approach to AI regulation - GOV.UK (www.gov.uk); March 2023

Are boards still in control?

Some of the commentators we spoke to were concerned that boards were no longer fully in control of setting their company's direction and strategy.

Some felt that the extent and pace of the challenges described above had caught many boards on the back foot and they were stuck in a reactive mode. Others felt that many boards had failed to grasp the implications of systemic challenges for the long-term future of their company and were not providing the required leadership.

If true, this leaves a vacuum at the top of companies which some commentators believed was being filled by regulators, investors and other influencers whose priorities may not always be aligned with those of the company. Their requirements and expectations are becoming increasingly prescriptive and arguably encroaching into areas of responsibility that rightly belong to the board, blurring lines of decision-making.

In law, directors are ultimately responsible for their companies. This is appropriate, as they should be better placed than other stakeholders to take decisions the best interests of the company. But if too much directors' discretion is lost — either because the board has ceded control or had it taken away — then the outcomes may not be in the best long-term interests of the company.

This was exacerbated by what some commentators view as the increased 'politicisation' of governance and ESG more widely. Many of the issues provoke strong and polarising views, as ESG's conscription to the 'war on woke' demonstrates. Companies can find themselves caught in the middle, where a purely reactive approach may be of limited use.

Are these concerns justified? To some extent, we believe that they are.

Lack of strategic leadership
It is undoubtedly the case that the series of crises in recent years, starting with the Covid-19 pandemic, has meant that the boards of many companies have of necessity largely been in reactive mode. Responsiveness is a positive attribute, as the ability to react to events may be crucial to the company's survival, but it is not sufficient.

Boards need to be able to anticipate trends and developments that may impact on the business, as well as react them. Understandably this is something that many boards struggle with. According to a recent survey of global business leaders, 50% believed their companies were not well prepared to anticipate and react to external shocks[6]. Robust governance can help boards improve their ability to do so, particularly if allied to a clear sense of purpose and direction which can enable them to identify which systemic issues are most material to their business.

Some of the environmental and social challenges facing boards are slightly longer-term in nature, albeit they are ones on which companies need to be taking action now. While many boards are integrating the ESG issues most material to the company fully into their strategic thinking, it appears that some boards still view them primarily as compliance or stakeholder management issues.

For example, a survey of audit committee chairs commissioned by the Financial Reporting Council[7] noted that "some saw ESG as a 'tick box exercise' focused on fulfilling reporting requirements" while others commented that "if current shareholders have an interest in ESG it tends to influence the business' attitude."

It is questionable whether this is an adequate approach to addressing systemic issues that impact on the company; that may depend on the company's sector, size and availability of resources. But where there is an absence of strategic consideration of these matters at board level, it leaves a gap that is waiting to be filled by regulators, investors and others.

[6] The State of Organizations in 2023 | McKinsey (April 2023)
[7] Audit Committee Chairs' views on, and approach to (ESG) June 2023 (frc.org.uk)

The impact of regulation

There is no shortage of regulatory activity on ESG related issues, mainly affecting listed and large private companies. On top of existing rules and standards, 2023 sees the introduction of new Sustainability Disclosure Requirements[8] and an updated UK Corporate Governance Code[9].

In July the Government published draft regulations, due to take effect in 2025, which will require companies to publish a resilience statement and an audit and assurance policy covering, amongst other things, governance and climate transition planning[10].

Many of these newer requirements will apply to companies that are classified as Public Interest Entities[11] regardless of whether or not they are listed, with the consequence that the reporting burden associated with being a listed company is now to some extent spreading to private companies as well.

There are differences of opinion about the extent to which the existing and impending regulatory framework actually restricts the ability of boards to run their companies and set their strategies in a way that the board considers to be the company's best interests, as opposed to setting minimum standards and ensuring accountability.

Some commentators identified specific requirements that they considered had a restrictive effect, including some covered by the Financial Conduct Authority's proposed amendments to the UK Listing Rules[12]. There was also a view that ESG-related reporting requirements had in some cases led boards to focus their attention on issues that may not be very material to the company, potentially neglecting others that were.

A more widely held view was that the sheer volume of regulation has meant that many boards are overly focused on compliance at the expense of strategy, innovation and other matters crucial to the company's performance, and tended to be risk averse as a result.

Some commentators considered that it was not just the volume of regulation that had changed but the nature of that regulation, with some of it being more overtly 'political'.

Separately, the Centre has argued that there is a need for regulation to be developed in a way that takes greater account of the impact on innovation[13].

Investor and stakeholder expectations

There are many aspects of corporate governance in particular and ESG more broadly on which regulations and standards are not prescriptive or completely silent. However, this does not mean that companies have a free hand. The market will often set its own standards and expectations, as will individual institutional investors.

As with regulation, the view of most commentators was that this source of pressure on boards has increased notably in recent years. Some consider that one effect of combined regulatory and market scrutiny has been to increase delistings and reduce IPOs.

Some commentators were critical of what they saw as attempts by investors and the proxy advisors whose services they use to micro-manage companies' governance arrangements.

Research commissioned by the Financial Reporting Council[14] found examples of companies that had dropped or changed governance proposals because they were concerned that proxy advisors might recommend a vote against. However, the same research found that the influence of such recommendations on voting results appears to be less significant than is often claimed.

[8] Chancellor sets new standards for environmental reporting to weed out greenwashing and support transition to a greener financial system - GOV.UK (www.gov.uk)
[9] Consultations | Financial Reporting Council (frc.org.uk)
[10] New transparency over resilience and assurance for big business - GOV.UK (www.gov.uk) (July 2023)
[11] Public Interest Entities are defined as companies which have both 750 or more employees and an annual turnover of at least £750 million.
[12] CP23/10: Primary Markets Effectiveness Review: Feedback to DP22/2 and proposed equity listing rule reforms (fca.org.uk) (May 2023)
[13] Governance and innovation – what we have learned — IoD Centre for Corporate Governance (iod-cfcg.com); November 2022
[14] https://www.frc.org.uk/news/june-2023/frc-publishes-research-on-impact-of-proxy-advisers (June 2023)

It is unquestionably the case that investors are applying more pressure on companies to address environmental and social issues than was the case even just a few years ago. While this largely reflects the expectations of the clients and beneficiaries to whom they owe their fiduciary duty, it is also the case that at least in some markets — the European Union and to an extent the UK — investors are themselves under regulatory pressure to use their influence to address climate and other systemic issues.

As already noted, views on these systemic issues can be very polarising, with the result that investors are finding themselves caught in the middle alongside companies, particularly in the US where a growing number of states are passing laws to restrict the use of ESG factors in making investment and business decisions.

Greater politicisation
There has always been a political element about the way in which the regulatory framework for corporate governance has developed, for example on executive remuneration. But as views become more polarised, and as governance is increasingly seen as a part of a broader ESG agenda, the extent of politicisation does appear to have increased.

This is true of the policy-making process, engagement between companies and investors, and the expectation that companies should pay more attention to their stakeholders and to public opinion (what one commentator called the 'Citizen Regulator').

This is not necessarily helpful to board members who are just trying to run a business, but it is not something they can afford to ignore as greater politicisation and higher expectations increase the potential reputational risks that companies might face. The best defence is for directors to exercise their duties diligently and lead their companies responsibly.

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What actions are needed?

Reverting to the question of whether boards are still in charge of setting their company's direction, it is difficult to give a clear answer. What some might consider a loss of control others will view as greater accountability.

Where boards feel 'forced' to take decisions based on the views and expectations of others this could indicate that they are open and responsive. But it could also indicate that they are too timid to stand up for what they consider to be right for the company, or that they lack a strategic view of their own.

What is clear is that the complex network of relationships involving boards, investors, regulators and policymakers, stakeholders and public opinion can make it very difficult to determine exactly where the lines of responsibility are drawn.

Most decisions about a company's strategic direction and governance arrangements should rightly be taken by the board. Their understanding of the company and its purpose mean that they are best placed to do so.

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Policymakers, the market, stakeholders and society at large all play a part in establishing the framework of requirements and legitimate expectations within which companies operate (the 'rules of the game'). But within that framework, there should be plenty of scope for directors to exercise discretion and judgement in the company's long-term interest. This is key to enabling the innovation needed to stimulate growth and meet some of the challenges discussed in this paper.

However, these external pressures are not going to go away, and neither are the systemic challenges that are the source of some of those pressures. Business has an important role to play in addressing them, and it needs to step up rather than retreat into the boardroom.

While boards need to be allowed to lead, they should not be unaccountable or completely insulated from external pressure. So the onus is on boards to demonstrate that they are capable of exercising judgement wisely and are deserving of the trust that they are asking for, by managing their companies in a responsible way that avoids provoking interventions from regulators and wider society.

Specific actions for boards

Boards should be more proactive in addressing systemic issues and demonstrating that they capable of doing so without it being imposed upon them. The starting point for doing so is understanding which specific systemic issues are most material to the company's purpose and long-term viability. These may not necessarily be those are being pushed by policymakers and others; if so, companies need to be able to explain coherently why that is the case.

Companies should also consider how they can engage more effectively with stakeholders on material systemic issues. This might be by participating in collective initiatives as well as direct engagement through advisory panels and other methods.

In view of the politicisation of governance and broader issues impacting on companies, boards should consider adding political awareness to their skills profile. Companies should also consider whether the skills, resources and remit of their corporate affairs function are adequate. They should also be willing to take an active role in public debate where they believe the impact on business, and its ability to contribute to solutions, are not well understood.

Boards should be willing to be more robust in defence of their governance arrangements and make better use of the regulatory flexibility that does exist. As noted, the consequences in terms of voting for listed companies of not complying with the UK Corporate Governance Code or standards set by investors and proxy advisors may not be as severe as is sometimes believed. However, there may still be broader reputational risks, so companies will need to explain coherently why they believe the approach they have taken is best for the company.

Specific actions for policymakers

There is a need to clarify that directors' primary duty is to act in the long-term interests of the company in accordance with its purpose. While this will not on its own resolve where the lines of responsibility between the board, regulators and others should be drawn, it will set out clearly the basis on which boards should exercise those responsibilities that do fall to them.

This can only be done effectively through legislation, which is why IoD supports the Better Business Act campaign to reform the Companies Act 2006[15].

There is a need to ensure that regulations and regulatory processes do not inappropriately reduce the ability of boards to take decisions that they consider to be in the best interests of the company. This might involve reviewing some existing regulations and standards to permit greater flexibility where appropriate, but without reducing accountability to shareholders and other stakeholders. Wherever possible, future regulation should be principle-based rather than prescriptive.

It should also involve reviewing policy-making processes to ensure that they do not deter innovation and responsible risk-taking. The Centre supports the recommendations of the Regulatory Horizons Council[16] and would encourage the Government and regulators to adopt them as soon as practicable.

[15] The arguments for legislative change are set out in Amending UK Company Law for a Regenerative Economy — IoD Centre for Corporate Governance (iod-cfcg.com) (May 2021)
[16] Closing the gap: getting from principles to practice for innovation friendly regulation - GOV.UK (www.gov.uk); Regulatory Horizons Council; June 2022

The Institute of Directors is a non-party political organisation, founded in 1903, with approximately 20,000 members. Membership includes directors from right across the business spectrum, from media to manufacturing, professional services to the public and voluntary sectors. Members include CEOs of large corporations as well as entrepreneurial directors of start-up companies. The IoD was granted a Royal Charter in 1906, instructing it to “represent the interests of members and of the business community to government and in the public arena, and to encourage and foster a climate favourable to entrepreneurial activity and wealth creation.” The Charter also tasks the Institute with promoting “for the public benefit high levels of skill, knowledge, professional competence and integrity on the part of directors”, which the IoD seeks to achieve through its training courses and publications on corporate governance.

The IoD is an accredited Good Business Charter organisation.

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The IoD Centre for Corporate Governance exists to explore current issues in corporate governance, company stewardship and ESG - for the benefit of the business community, IoD members and wider society. The Centre arises from the IoD’s Royal Charter obligation to “promote the study, research and development of the law and practice of corporate governance”. The Centre functions as an independent, not-for-profit centre of excellence under the umbrella of the IoD. Please note that views expressed in Centre publications do not necessarily reflect the position of the IoD or the Centre Advisory Board, and are solely the responsibility of the authors.

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