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TOWARDS CORPORATE GOVERNANCE IN THE NHS

One Volume

FRANK THOMAS HARSENT

PhD Thesis

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University of Durham

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2002

TOWARDS CORPORATE GOVERNANCE IN THE NHS

Frank Thomas Harsent

PhD 2002

ABSTRACT

Corporate governance in the context of the UK's National Health Service is not well defined or understood. The theoretical basis for how the service operates is unclear and there is little guidance on what practitioners should really focus.

This thesis takes the corporate governance failure of the Wessex Regional Health Authority and explores the causes to generate key concepts. Literature is reviewed for evidence that the generated concepts have been recognised by other writers and commentators. The identification of a theoretical basis of corporate governance in the NHS examines agency theory, then investigates what stakeholder theory can offer on stakeholders, and results in discussing the main NHS stakeholders within an agency environment. A developed conceptual framework is used to analyse three further cases of recognised corporate governance failure from the NHS, local government and the private sector. The four significant corporate governance initiatives of the 1990s, Cadbury, Greenbury, Hampel and Nolan, and the NHS response to corporate governance, are examined to see whether the generated concepts have been identified and thereby test their consistency.

The outcome has four distinct products. Firstly, a definition of corporate governance in the NHS. Secondly, the acknowledgement of theory around the relationship of agent and principal. Thirdly, the identification of the key elements of corporate governance in the NHS; accountability, directors and management control, audit committees, and conflict of interests. Finally, practical advice for practitioners in the NHS on how to put the key elements into operation

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DECLARATION

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GLOSSARY

Abbey Business Consultants (ABC) – private sector consultancy firm

Area Health Authority (AHA) – pre-1974 NHS organisation covering a county or significant part of a metropolitan area

Arthur Andersen – international management consultancy firm

Bank Arabe et Internationale d' Investissement (BAII) – investment bank based in Paris

Bank of America – international bank which was an investor in BCCI in the early years

Bank of Credit and Commerce International (BCCI) – international bank

Bank of England – UK central bank responsible for monetary policy

Cipfa Services Limited (CSL) – consultancy arm of professional accountancy body

College of Supervisors – group of financial regulators from Luxembourg, UK, Switzerland, Spain, Hong Kong, Cayman Islands, UAE and France who aimed to monitor the activities of BCCI

Community Health Council (CHC) – independent patient watchdog for an area

Credit and Commerce American Holdings (CCAHL) – secret BCCI subsidiary

Credit and Commerce American Investment (CCAI) - secret BCCI subsidiary

Deloitte, Haskins and Sells (DHS) – private sector consultancy

Department of Environment (DOE) – UK Government department for regulating Local Authorities

Department of Health (DoH) – UK Government department responsible for health from the late 1980s onwards

Department of Health and Social Security (DHSS) – UK Government department responsible for health and social security until the late 1980s

Department of Trade and Industry (DTI) – UK Government department responsible for regulating business

District Auditor – external auditor appointed, by the Audit Commission on behalf of the UK Government, to scrutinise the work of Local Government. In the case of Westminster it was the major audit firm Deloitte Touche

District Health Authority (DHA) – NHS organisation responsible for services in a given area post 1984

District Management Team (DMT) – NHS management team responsible for services in a given location and accountable to their host AHA

Family Practitioner Committee (FPC) – NHS organisation responsible for administering payment to GPs, dentists, pharmacists and opticians between 1974 and 1991

Federal Reserve Bank (Fed) – US central bank responsible for monetary policy

Finance Directorate Letter (FDL) – NHS written mechanism for issuing instructions to finance departments

Financial General Bankshares (FGB) – American bank

General Practitioner (GP) – UK self-employed doctor providing primary care

Gulf Group – major customer of BCCI throughout its existence. Run by the Gokal brothers debts of \$2 billion were amassed over 18 years

Health Advisory Service (HAS) – NHS organisation responsible for offering advice and spreading good practice to elderly care, mental health and learning disabilities services

Health Service Circular (HSC) – NHS mechanism for issuing instructions to NHS bodies

Health Service Guidance (HSG) – NHS mechanism for issuing advice to NHS bodies

Hospital Information System (HIS) – integrated hospital computer system which incorporates all the key functions and departments

Hospital Management Committee (HMC) – NHS body responsible for the management of a hospital or group of hospitals between 1948 and 1974

Inland Revenue Service (IRS) – US tax authority

International Credit and Investment Company Holdings (ICIC) – the BCCI bank within the bank based in the Cayman Islands

International Monetary Fund (IMF) – international organisation offering help and support to countries with struggling economies

Luxembourg Monetary Institute (LMI) – the financial regulator of Luxembourg

Management Services Division (MSD) – supplied internal business consultancy to the NHS in the West Midlands and was part of West Midlands Regional Health Authority

National Bank of Georgia (NBG) – US bank in the state of Georgia

National Health Service (NHS) – UK publicly funded healthcare system

National Health Service Trust (NHS Trust) – NHS organisation responsible for the delivery of a range of services to a given area

Non-Departmental Public Body (NDPB) – UK Government controlled organisations which can carry out executive, advisory or judicial functions

Office of the Controller of the Currency (OCC) – US financial regulator

PA Cambridge Economic Consultants (PA CEC) – private sector consultancy firm

Price Waterhouse – audit firm who became sole external auditor for BCCI from 1987

Primary Care Group (PCG) – NHS organisation responsible for primary care and community services for a locality, as a sub-division of a health authority

Primary Care Trust (PCT) – NHS statutory organisation responsible for primary care and community services for a locality

Public Accounts Committee (PAC) - select committee of UK House of Commons and responsible for scrutinising expenditure of public funds

Quality Assured Business Services (QaBS) – management buyout organisation of the Management Services Division of West Midlands Regional Health Authority

Securities and Exchange Commission (SEC) – US regulator for share trading and stock exchanges

Regional Health Authority (RHA) – NHS organisation, established in 1974, responsible for overseeing the running of the NHS for a large geographical area for 3-6m people

Regional Hospital Board (RHB) – created in 1948 these NHS organisations were the forerunner to RHAs

Regional Information Group (RIG) – a user group of chief officers from NHS organisations in the Wessex region to agree priorities and policies for RISP

Regional Information Systems Plan (RISP) – the Wessex Regional Health Authority project for connecting up, through information technology, all NHS organisations in the Wessex region

Regionally Managed Services (RMS) – part of West Midlands Regional Health Authority responsible for providing non-clinical services to NHS organisations in the West Midlands region

Regional Supplies Division (RSD) – an arm of RMS with the role of procurement and provision of supplies to NHS organisations in the region

United Research Group (URG) – US management consultancy firm

Wessex Integrated Systems Limited (WIS) – company set up by CSL to provide Wessex Regional Health Authority with computing and information services

Wessex Regional Health Authority (WRHA) – RHA for Wiltshire, Dorset, Hampshire and the Isle of Wight

West Midlands Regional Health Authority (WMRHA) – RHA for Herefordshire, Shropshire, Staffordshire, Warwickshire and Worcestershire

Chapter 1.

A PATHOLOGY OF CORPORATE GOVERNANCE FAILURE: WESSEX REGIONAL HEALTH AUTHORITY – REGIONAL INFORMATION SYSTEMS PLAN

The reason behind the existence of this thesis has its roots in my appointment to my first chief executive appointment in 1995. On the commencement of my new responsibilities I was faced with a variety of corporate governance initiatives which required understanding and action on a personal basis. Whilst I was aware vaguely of two major corporate governance failures in the National Health Service (NHS), my knowledge and comprehension of the underlying concept was non-existent, and the ability to turn corporate governance into a meaningful, practical reality within a NHS organisation had not been developed. The undertaking of a thesis was aimed at the examination of the pathology of corporate governance so that a coherent concept could be developed, and, as a practitioner, useful actions could be identified to assist managers in the NHS in the delivery of corporate governance in the workplace.

The beginning of this thesis is the examination of a recognised corporate governance failure within the United Kingdom (UK) public sector, but in particular, the NHS. The story of Wessex Regional Health Authority allows the research question to be defined and provides the setting for the subsequent three sections. The first develops the conceptual framework; the second takes the framework and uses it to understand three further cases of significant, recognised corporate governance failure; the third section investigates the public responses from the private sector, Government and the NHS, that have taken place as a reaction to corporate governance failure.

As a practitioner of many years my perspective of organisational behaviour is grounded in significant experience. When options for the methodology of research to be employed for this thesis were considered, acknowledgement had to be made that no practitioner can examine the subject of corporate governance in a

value free environment. The orthodox approach of devising a hypothesis which is then tested would not work for this thesis as the reality of the practitioner world cannot be ignored and therefore an alternative methodology has been chosen.

My research began with specific goals in mind; to define corporate governance in the context of the NHS, to examine the underpinning theoretical context of corporate governance and to identify the position which it occupies within the field of organisational theory, to identify the key elements of corporate governance in the NHS, and to offer practical advice for use by practitioners so that corporate governance can be realised in organisational settings.

This practitioner needed to begin his research by the exploration of theory which flows from a practical problem. The starting point is the journey of a study of Wessex which is a well documented case that came to the attention of the Public Accounts Committee (PAC) (1993a) of the House of Commons and resulted in the publication of a comprehensive report. In addition the scandal attracted the media so that as well as the numerous written articles, there is a complete *Panorama* television programme on this subject. From this case the reasons for what took place are analysed to identify the main characteristics which could be examined in academic literature. The outcome is the development of a possible conceptual framework but further theoretical exploration is required.

This chapter introduces a common approach to the four case studies within the thesis. The rationale is twofold. Firstly to allow comparability between four different scenarios which span three organisational cultural backgrounds. Secondly to facilitate analysis of the underlying causes of corporate governance failure and thereby allow the identification, if any, of similar issues.

The aim of the Wessex case is to investigate what took place and to determine a set of elements which may serve as a basis for further conceptual, theoretical and empirical investigations. The context is important and to appreciate how a corporate governance failure of significant magnitude occurred it is necessary to understand, in broad terms, the historical development of the NHS. From that

point Wessex can be examined in detail as the basis for a broad investigation of corporate governance.

1.1. History of the National Health Service

The Wessex scandal took place in the NHS and part of its causation was due to the evolution of the public sector healthcare system of the United Kingdom (UK). The establishment of the NHS on 5th July 1948 was regarded by the population as a symbol of a new dawn following the tragedies of World War II. Until that time health care was delivered in a fragmented way through a variety of means. Hospitals were run by Local Authorities or voluntary agencies on the basis of charging whilst General Practitioners (GPs) operated usually on the small shopkeeper principle of working single-handed. The common view that emerged following the end of the Second World War was that change was required which coincided with the election of a Labour Government. Klein (1995 p.1) comments:

at the time of its creation it was a unique example of the collectivist provision of health care in a market society.

The NHS Act saw the establishment of Regional Hospital Boards (RHB) with chairmen and members appointed by the Minister. Within a Region there were a number of Hospital Management Committees (HMC) with their membership appointed by the RHB, however teaching hospitals were given Boards of Governors appointed by the Minister and with a funding stream direct from the Ministry. In addition GPs remained as independent practitioners, though Executive Councils were established to administer payments to GPs, dentists, pharmacists and opticians (Watkin 1978). Again Klein (p.29) offers an interesting observation:

the depoliticisation of the NHS after 1948 can thus be seen simply as the re-emergence of organisational routines anchored in the British tradition of government; in particular the emphasis on resolving disagreement by the incorporation of interest groups in the process of decision-making.

There were two key issues in the early years. Firstly the creation of a single national health service required a massive administrative effort and secondly the required level of funding began to escalate as citizens took advantage of the new, free service. The result was the establishment of the Guillabaud Committee in May 1953 which was asked to review the financing of the NHS. The Report was published in 1956 and concluded no drastic action was required, though better financial management was needed. This led to the introduction of departmental costing and the creation of a career structure and training for hospital administrators.

The service reached its tenth birthday and onwards for another ten years with little deviation from the culture that had been set. Whilst the Minister was accountable to Parliament for the NHS, great latitude was given to the various RHA, HMC and Boards of Governors on policy interpretation, however on detail of buildings instructions could be prescriptive. There is no evidence at all during the first twenty years of its existence that the NHS had any significant debate or interest in the area of corporate governance and this changed only marginally following the Ely Hospital scandal.

In 1967 allegations were made in the *News of the World* newspaper by a member of staff about the conditions at Ely Hospital, a mental health institution in Cardiff. The subsequent Committee of Inquiry published its findings in 1969 and was critical of conditions at the hospital and poor standards of treatment. Watkin (p.78) comments that the Report criticised members of staff, the HMC, the Welsh Hospital Board and the lack of supervision and inspection of such facilities. The Inquiry and Report was the first occasion on which the NHS was held to account publicly for its actions. The response from the Government was to establish the

Health Advisory Service (HAS) as an independent body from the Department of Health and Social Security (DHSS) with the remit to visit chronic hospitals and offer constructive advice and spread good practice. It was stressed that HAS was not an inspectorate however in reality that is how the NHS viewed this organisation.

Ely brought little change in NHS culture towards corporate governance issues such as public accountability, openness and transparency. At the end of 1968 there was a police investigation at Farleigh Hospital near Bristol where ill treatment of mentally handicapped patients led to criminal proceedings. Two years later, a further inquiry was needed into problems at Whittingham Hospital in Lancashire. The Payne Report found administration by labyrinth. Other problems at Coldharbour Hospital in Dorset and Napsbury Hospital near St. Alban's followed.

The first twenty five years of the NHS saw significant advances in medicine. New drugs helped control diseases such as tuberculosis and new technologies, e.g. renal dialysis in 1963, allowed new treatments to save lives. However organisational culture did not make the same progress. Before 1948 the key figure in Local Authority hospitals was the medical superintendent who was in charge and to whom the matron and administrator reported. In voluntary hospitals the person at the top was the chief administrator, however he derived much of his influence because he played a major role in fund raising. The creation of the NHS saw an amalgamation of the two cultures but in reality the prominence of the medical profession remained. Klein (p.75) summarises the position:

while central government controlled the budget, doctors controlled what happened within that budget. Financial power was concentrated at the centre, clinical power was concentrated at the periphery.

Also nothing had changed in the original set-up of the NHS whereby hospital, general practitioner and local authority health services remained separate. The

outcome of twenty five years experience demonstrated these factors combined so that central government seemed unable to implement its policies uniformly across the whole of the country and rational planning was hampered by the fragmented administrative system. The first major reorganisation of the NHS was announced in 1974.

The government decided that it needed a new body to achieve effective management of policy implementation and rational planning. England saw the creation of a new tier of administration through 90 Area Health Authorities (AHA) which were designed to be coterminous with Local Authority boundaries. The link with the DHSS would be through 15 Regional Health Authorities (RHA). Below AHAs there would be District Management Teams (DMT) who would operate local services on the basis of consensus management. In addition AHAs would manage the new Family Practitioner Committees (FPC) who would administer the payment systems for GPs. Finally the government introduced Community Health Councils (CHC), one each for the 200 districts. CHCs were to represent the views of the public and were not accountable to AHAs.

This new system was very bureaucratic and led to a proliferation of committees. In addition the consensus management approach required by the DMT meant that the doctor and nurse representative had the power of veto. Two years later the DHSS unveiled a new planning system which meant health authorities were required to produce strategic plans in line with Priorities for Health and Personal Social Services in England.

The 1970s were extremely difficult years for the UK economy with high inflation, high public sector borrowing, very high interest rates and severe industrial relations problems. Allsop (1984 p.37) argues that there was a post-war consensus in health policy for the first thirty years of the NHS existence. This had given a lack of political conflict unlike education and “the principles on which the NHS was based..... were not seriously challenged and commanded widespread respect and affection”.

The year of the thirtieth birthday of the NHS saw yet another report of a major scandal. The publication of the Committee of Inquiry into Normansfield Hospital in 1978 illustrated mismanagement of a mental handicapped facility. The Report criticised different levels of organisation, DHSS, RHA and AHA and various senior officers of the AHA, because the problems had been well known of for a number of years and despite CHC complaints, no action had been taken. In a scathing commentary in the British Medical Journal in December 1978, Klein (1978) voices the view:

.....a breakdown in the NHS's system of management. The vocabulary of management - with its emphasis on monitoring and accountability - is shown to have been empty, incantatory rhetoric devoid of substance.

At the same time field research by Bevan and colleagues (1980 p.235) for the Royal Commission found "...the NHS is so backward in developing finance and other management disciplines" and

.....as regards fallback sanctions for avoidable and unjustified overspending.....we ourselves have encountered no case that went so far as to involve dismissal or other heavy penalties.

Around the same time Elcock and Haywood (1979 p.105) completed some research which concludes "...Health Authorities have demonstrated that they can resist and even thwart central instructions which they find unwelcome or unacceptable".

1979 saw the election of a new government that quickly realised changes were required and published Patients First (DHSS 1979) which was a consultative document on reorganisation. It argued for decisions to be made at a local level, with effective local management and minimal interference from central government or region.

1982 saw the second major reorganisation of the NHS with an emphasis on making decisions as close to the point of delivery of services as possible. The 90 AHAs were abolished and the DMTs were enhanced to become District Health Authorities (DHAs). FPCs had in fact remained relatively independent of AHAs since 1974 and therefore in 1982 they became separate from DHAs with linkage direct to the regional level. In general the reorganisation was welcomed for stripping away a needless tier of bureaucracy and for the move to local autonomy, however the conflict with central accountability remained.

The economic situation in the early 1980s was a major concern for the government. In particular there was a need to control public expenditure at a time when NHS spending was escalating. Efficiency was seen as the key to produce more health care for less money. The result was a number of initiatives.

Firstly, in 1982 the DHSS introduced the Annual Performance Review between Ministers and regions which were accountability meetings to review progress towards targets. These reviews were to occur further down the management hierarchy between RHA and DHAs and DHAs and operational units. Secondly, in 1983 under the Financial Management Initiative there was the mass publication of Performance Indicators (PIs) for the public sector. The aim was to introduce a means of accountability to Ministers for a hospital's performance. Thirdly in 1983 there was the publication of the Griffiths Report.

Over only six months of 1983, the Managing Director of Sainsbury's, Roy Griffiths, was brought in to lead the NHS Management Inquiry. He concluded that the NHS was suffering from institutional stagnation and he used a phrase that was repeated many times in the media, "if Florence Nightingale was carrying her lamp through the corridors of the NHS today she would almost certainly be searching for the people in charge". His recommendations were for the implementation of a general management structure from top to bottom. The Secretary of State was to chair a Supervisory Board to set direction and monitor performance. Within the DHSS a Chief Executive would implement policy, provide leadership and control performance and he would have a Management

Board to assist him. Finally there would be general managers at regional, district and unit level. Consensus management was dead as decisions had to be made as general management was expected to deliver.

On a practical level the new appointments did not take place for most posts until 1985 and in reality the majority of jobs were filled from existing administrator ranks with a smattering of high profile external appointments from Industry and the Armed Forces. For many NHS individuals the new managerialism was uncomfortable and in some cases abhorrent. The traditional administrator was a diplomat who exercised influencing skills over long time spans rather than the more direct active manager. The result was that as the end of the 1980s approached progress was slow (Pollitt et al 1991).

The NHS passed its fortieth birthday having undergone some change but it is arguable how much the fundamental culture had altered. The dominant feature of this time was the primacy of the medical profession with central government having limited influence on effecting change. The administrators of the service did not see that their role was to challenge the status quo or else the various scandals would not have occurred. Review of literature for this forty years shows no real interest in the issues of corporate governance as we know them today. Accountability arrived in a real sense with the Griffiths Report which as we shall see was slow to deliver true embedded change.

1.2. Regional Information Systems Plan – The Story

In the early 1980s Wessex Regional Health Authority (WRHA) covered a population of three million people in an area of southern England which encompassed Dorset, Hampshire, Wiltshire and the Isle of Wight. The revenue budget for which WRHA was responsible, was some £500m. The Public Accounts Committee Report (1993a) identifies in great detail what occurred in Wessex.

The Regional General Manager (RGM), John Hoare of WRHA had the view that there was a need to take advantage of developments in Information Technology (IT) and thereby link every hospital and GP surgery within the region into an integrated network. This network would have five core systems of accountancy, manpower, hospital information, estates and community. The aim was to provide good quality information to assist staff to discharge the tasks of the NHS. In October 1982 the WRHA considered a report to pursue an integrated approach to IT within the region. The report was approved and the Regional Information Systems Plan (RISP) was born.

The following 18 months was taken up with the identification of information needs of hospital and community services from which flowed the development of data models showing how the information needs could be met. The work on the former involved WRHA and two of the DHAs and led to the publication of the Regional Information Requirement in June, 1983. From then on the consultants Arthur Andersen became involved and undertook the data modelling work.

In May 1984 RISP was adopted by the WRHA and proposed:

- the development of five main systems, operating to common standards and operational in every district of the Region;
- development to be completed within five years;
- a transitional strategy to make the most use of existing systems proved they worked well and could be integrated with RISP in due course;
- any interim systems to make use of proven software and systems and packages elsewhere;
- the devolution of responsibility for the operational management of systems from region to district.

The five year capital cost of the RISP was £26m at 1984\5 prices with revenue costs of £17.5m. It was recognised that 500 programming years of input was required over and above the efforts of 38 in-house staff who would work on the Project, which meant that the use of external consultants would be very high.

Commitment from DHAs to RISP was crucial and therefore a Regional Information Group (RIG) of District representatives at Chief Officer level was established to agree priorities and policies. The overall Project was the responsibility of the Regional Information Systems Manager (RISM) under the direction of the RGM with advice from the WRHA's Information Committee and the RIG.

In June 1984 Arthur Andersen presented its development proposals to take RISP forward and identified the potential risks of cost control, time slippage, maintenance of relevance to users and achievement of a demanding implementation plan. Two months later WRHA signed its first contract with Abbey Business Consultants (ABC) for five staff.

The turn of the new year saw the publication of Regional Information Service Planning and Control Procedures which set out the roles of region and districts. In May the WRHA Information Group (IG), which comprised of Members of the Authority, met and as did RIG. August 1985 saw the issue of Invitations to Tender (ITT) for the provision of the hospital information, personnel and accountancy core systems. Multi-disciplinary teams were established to evaluate submitted tenders.

The IG considered the issue of single or mixed hardware solutions and decided on the former in February 1986. The hardware supplier DEC (now known as Digital) was chosen and in a letter of 27th February 1986, the unsuccessful suppliers (Arthur Andersen, ICL, IBM and McDonald Douglas) were informed of the decision but also told that it did not mean that they had been excluded from the tendering process. WRHA made a public announcement at Easter that DEC had won a contract worth £21m to supply the three core systems. During April, separate approaches were made to the Chairman and RGM of WRHA lobbying on behalf of the unsuccessful Arthur Andersen\IBM consortium.

Detailed negotiations with DEC took place from May - August and included a visit to the USA to identify a suitable Hospital Information System (HIS),

together with searches in the UK. During these trips and at the debriefings Arthur Andersen representatives accompanied the WRHA team as advisors. On 29th September 1986 the IG were told that negotiations with DEC had failed and that the evaluation group unanimously recommended a contract with the Arthur Andersen\IBM consortium. The contract was signed on November 14th.

At the beginning of 1987 Robin Little was appointed as Regional Treasurer from which he resigned only nine months later in October to take up a post with Cipfa Services Limited (CSL) as a consultant. The following month CSL were appointed by WRHA to review a number of regional services including Information Services; the lead consultant was Robin Little. During the time of the review it became clear to the RISM that there were serious shortfalls in the funding of RISP.

CSL's report was made in February 1988 and detailed problems with implementation of the Project. Mr. Little suggested that to overcome the staffing difficulties and to provide an alternative source of funding for RISP that CSL and WRHA should form a partnership. The following month CSL were given the task of developing the strategy, policies and plans to act as a specification for the tendering process. On 6th April, eight firms were sent the Invitation to Tender and four firms responded.

Evaluation took place during which time WRHA had a new Chairman, Robin Buchanan, take up post. In September a contract was signed with Wessex Integrated Systems Limited (WIS) to provide computing and information services; WIS was an external company formed by CSL. In October 1988 WRHA signed two subsidiary agreements with WIS for the provision of strategic management advice and the provision of IT staff.

By January 1989 alarm bells were ringing at the Department of Health following a ministerial review of RISP. Of concern was the rising cost and the slow progress. A costed plan was requested from the RGM by 22nd February but was never produced. At the same time following the resignation of the RISM, Dr. Roger

Chaddock in December 1988, Robin Little was seconded to WRHA to act as the RISM. In February he produced a three year Regional Development Plan for the full implementation of RISP. The plan was agreed by WRHA in February 1989.

In March 1989 without the knowledge of the IG, WRHA or the Chairman, an order worth £3.3m was placed with IBM for a mainframe computer. This month saw the appointment of Harry Tuffill as RISM on a secondment from IBM though the terms of his placement did not allow his involvement in IT acquisition. The Chairman did not become aware of the computer purchase for some months. In August he engaged consultants DeLoitte, Haskins and Sells (DHS) to report on WRHA's computing requirements, and IBM to undertake a capacity planning exercise for hardware needs. Around the same time, Robin Buchanan also met the RGM and made it clear that he could not continue in post. John Hoare resigned on 15th September.

October saw the presentation of two reports from DHS; one on computer hardware and accommodation, and one on WRHA's contractual position with WIS. In particular the latter was critical of uncompetitive terms to which WRHA were exposed. From the very start of RISP commitment from the DHAs was crucial. By this time only three of the nine DHAs were still committed to HIS alongside Winchester DHA which had been selected a few years earlier to be one of the national pilot sites for the Government's Resource Management Initiative.

January 1990 brought Ken Jarrold into post as the new RGM. By April he recommended to WRHA, and it was agreed, that RISP should be abandoned. Two months later the new RGM called in the District Auditor to investigate RISP and the WIS contracts. The District Auditor's detailed reports became available in July 1992. On 10th February 1993 the Public Accounts Committee became aware of the issue and asked for information which the Comptroller and the Auditor General submitted in a memorandum dated 27th April 1993. The Committee met on a number of occasions over the next 6 months and interviewed the Chairman and RGM of WRHA and the Chief Executive of the

NHS. The findings of the Committee were issued as the 63rd Report on 3rd November, 1993.

1.3. The Failings of RISP

The previous narrative identified the outline of what took place but to comprehend the magnitude of the corporate governance failure an understanding of detailed actions is necessary. The failings include control of contractors, tendering process, conflict of interest, and poor management control.

1.3.1. Control of Contractors

The first major problem was the confusion of roles between advisor to WRHA and bidder to provide goods and services. The former was the role for Arthur Andersen consultants in 1983 and 1984, however in 1985 the company teamed up with IBM to bid for the three core system tender. At this stage Andersen should have ceased to fulfil the advisor role but in visits to the USA in July 1985 and on return in the UK, the WRHA negotiation group were accompanied by Andersen's representatives despite being in direct competition with DEC for the contract. Their involvement continued at debriefing meetings following the visits.

Separately, ABC had undertaken some consultancy projects for WRHA previously and in 1985 they were commissioned with the development of a proposal for a statistical information system. No specification or implementation plan was agreed with WRHA neither was a formal contract signed. The system evolved into a general management information system which the DHAs amended to meet their needs. ABC took on this extra work and charged WRHA the cost. There was no separation of cost between RHA and DHAs which should have occurred. The total cost charged by ABC was £1.08m with a further £1.3m charged by Istel who acquired ABC. In 1989 Istel were themselves taken over by AT&T. Following the District Auditor's detailed examination two former RHA

managers, the former owner of ABC and a consultant were arrested for conspiracy to defraud WRHA.

In August 1984 WRHA signed its first contract with ABC for the recruitment of five staff to support the STAMP project. The agreement gave the WRHA access to skilled staff and artificially reduced manpower figures in accordance with Government targets. The costs of this contract were:

- staff salaries and bonuses of up to 1\3rd of Whitley Council rates;
- 40% overhead and management cost;
- VAT;
- payment quarterly in advance.

15 months later an additional eight staff were included and the management fee was reduced to 35%. Whilst WRHA achieved its objectives it was at a highly questionable cost and not Value for Money.

One of the subsidiary agreements to the WIS contract was for the provision of strategic management advice to WRHA. Under this heading WIS charged the WRHA for work which was nothing to do with the NHS but the formation of the company. In addition WIS was guaranteed a 15% profit above incurred expenses irrespective of performance. Other significant issues were that originally it was planned by WRHA to use man day rates for charging and two WRHA Members were to be unpaid Non-Executive Directors of the Company. The former was changed to a “cost plus” formula and the latter was abandoned. Also the contract was prepared by WIS and not the WRHA.

After the contract was signed WRHA officers attempted to implement controls through requirements for a Plan progress reporting, quality assurance and budgeting compliance. These attempts were thwarted by Robin Little, a director of WIS who saw the procedures as unnecessary bureaucracy. He proposed to the new RISM, IBM seconded Harry Tuffill, that sample checking of invoices would be adequate and that the RISM should control the contract against an overall

budget and leave detailed budgeting responsibility with Mr. Little. This proposal was agreed, which along with the specifics of the contract referred to above, meant that WRHA had no control over WIS on performance or charging.

In the mid 1980s WRHA had a budgeted establishment of 104 staff for the IT Department. In reality due to a shortage of skilled staff which was exacerbated by higher private sector salaries, a number of posts were vacant and consultants were used to bridge the gap. The second subsidiary agreement to the main contract for WIS placed a number of responsibilities on the company. These included a requirement to offer jobs to existing WRHA staff and to recruit additional staff to deliver plans agreed between WRHA and WIS. On the latter issue WRHA was to write to WIS and identify the vacant posts to be filled.

Not long after the establishment of this agreement in October 1988 the RISM post was occupied by three different individuals over a period of four months. The third person Harry Tuffill decided on his third day in post that he did not wish to review every WIS vacancy. He wrote to the company and stated that the establishment of the department transferred to WIS was 104 staff and therefore the company could recruit up to that level. At that point WRHA was assured a legal responsibility to pay WIS for the costs of 104 staff. The new RISM failed to understand before making this commitment that the duties of only 86 staff transferred to WIS whilst the other duties stayed at WRHA or ceased to be necessary. In fact at the time of the creation of WIS only 60 staff transferred but two months after the RISM's commitment WIS had employed another 60 staff which gave then a complement of 105 operational staff. Eight weeks later in August 1988 the Department of Health raised a number of concerns with the RISM and included a criticism of the imprecise nature of the WIS contract.

External consultants DHS were asked to review the contract in September. In light of their report the WRHA Chairman decided to renegotiate with the company which was now called CFM Healthsystems and it is at this stage that the WRHA's solicitors Blake Lapthorpe were brought into play for the first time. Both the Chairman and solicitors believed that 104 former WRHA staff had

transferred to the company. The agreement went through various drafts but the final document included the phrase “the currently mutually agreed level of 104 permanent staff”. Whilst the wording falls short of a guarantee the actual budget allowed for the costs of this staffing level. The budget was proposed by company employees and effectively guaranteed a set level of income for an unspecified service. The agreement was signed in February 1990 even though with effective management control it could be seen that WRHA did not need the services of 104 IT staff; the cost to the taxpayer was £3,150,000 per annum.

The WRHA\WIS staffing fiasco had another quite separate strand which requires comment. One of the major plans of the original contract was the avoidance of redundancy payments and therefore no provision was made for this purpose. However when WRHA began the renegotiation of the contract in the autumn of 1989 CFM raised the issue of redundancy liability. Their argument was that the original three year contract would allow the company to develop sufficient external business to protect transferred staff from redundancy. However, as other RHAs were moving to five year contracts it was unlikely that staff would move without the support of redundancy if necessary. In December the RISM agreed that WRHA would underwrite redundancy payments to a level of £100,000 for any redundancy on the date of the termination of the contract. This decision is quite extraordinary as staff transferred to CFM and were subject to the company’s terms and conditions. No liability remained with WRHA and this point had been advised by the WRHA Legal Officer. The District Auditor formed the view that the payment could only be a subsidy to former employees and as such WRHA were acting ultra vires.

The original WIS contract was flawed in that it had no clear performance criteria against which the contract could be judged. This issue was pressed by both the Department of Health (DoH) and the external auditors. Assurances were given by WRHA that the renegotiated contract would address the problem. However in November 1989 Blake Lapthorne wrote to the WRHA Chairman with the first draft of the contract. The letter made it clear that the solicitors had followed the now knighted Sir Robin Buchanan’s instructions so that there were no specific

penalty clauses for poor performance but some general clauses regarding the standard of work. Later when challenged as to the reasoning behind this action the WRHA Chairman argued that he aimed to give the former WRHA employees a “soft landing” for three years after which time a proper commercial contract would be signed and be enforced. The result was that the taxpayer effectively subsidised the operation of a private commercial organisation which meant that CFM was protected from the normal pressures of the market place.

The WIS contract had one other related but separate failing which flourished because of poor control by WRHA. In addition the DoH had raised concerns at the over-reliance of WIS on work from WRHA. At a meeting on 4th October 1989 between DoH and WRHA it was stated that WRHA aimed to move from 100% guaranteed business to nil over three years for WIS. In reality within a couple of weeks following discussions with CSL, Blake Lapthorne were instructed to include in the draft contract a sliding scale of dependence for WRHA work which would move from 90% to 75% to 50% over three years. By the time the contract was signed the reduction in reliance had dropped to 10% per year. These changes were approved by WRHA Chairman. This failing is another example of poor control of external consultants by WRHA.

In March 1989 a decision was taken by senior officers of WRHA to buy a IBM 3090 mainframe computer at a cost of £3.3m. It was argued that the machine was needed to underpin the delivery of RISP. A sizing exercise had been completed by WIS who based the work on the Regional Development Plan adopted by WRHA in February 1989. This Plan was by this time already showing signs of being unrealistic. In April the manpower system was abandoned, followed in July by a re-estimation of HIS costs from £12m to £30m and a growing disenchantment from DHAs to sign any commitment. Yet WIS did not inform WRHA of these problems and therefore query the need for the IBM 3090.

When the purchase of the computer became known WRHA commissioned consultants DHS to confirm whether the computer was required and then asked IBM to undertake another sizing exercise. The key issue at this time was for

WRHA to form a view before the option to cancel the purchase expired at the end of September. DHS advised that WRHA should seek an immediate upgrade from the IBM 3090\200E to model 3090\3005. Significantly DHS based this conclusion on the capacity planning exercises of WIS in April and the IBM assessment in September. Both of these reports used the Regional Development Plan which by September could be seen to be unrealistic. The IBM report argued for the upgrade of the computer based on every DHA implementing the Plan but the RISM knew that at least half of the DHAs were very sceptical of RISP and therefore unlikely to commit themselves. Also both external consultants used information provided by the RISM, Harry Tuffill, who was seconded from IBM in April of the same year. The outcome was that the IG were given the flawed reports and decided not to re-negotiate the IBM contract. By the time the computer was commissioned 18 months had passed since it had been ordered and it declined in value by £2.3m.

1.3.2. Tendering Process

The public sector has clearly defined tendering procedures for the purchase of services or items of significant value so as to ensure that the taxpayer receives best value for money and that no particular supplier can influence the outcome of the tendering process to their advantage. The RISP case is littered with examples of major breaches of process which should have resulted in action being taken against individuals and organisations.

The original process for the tendering of the three core systems for RISP followed an expected pattern. However significant errors began to occur once the evaluation stage was concluded and the contract awarded to DEC. It is not uncommon with a large contract for negotiations to continue after the award has been made as the supplier may have offered a number of options on parts of its bid which require further discussion. In DEC's case it would appear that whilst WRHA wanted DEC's hardware there was some choices around the best software. Visits by the WRHA team to view differing packages would be expected but the error by WRHA was to continue to use Andersen as their

advisers when Andersen had submitted a bid for the RISP contract as a partner with IBM. The error was compounded by the involvement of Andersen consultants in the post visit debriefings. This allowed Andersen access to privileged competitor information and as Andersen had been told that all bidders were still not excluded from the bidding process the consultants should not have been involved as this situation compounded the magnitude of the next error.

Before the assessment of submitted tenders can begin an agreed evaluation process has to be established. This allows bids to be scored against key criteria which are necessary for the delivery of a service or preference of a piece of equipment. In a complex tender such as the three core systems for RISP there will also be a weighting between different elements of the requirement. 40% of the weighting in this tender was for the patient administration system.

DEC won the contract and prepared its own software for accounting and manpower but McDonnell Douglas software for the hospital information system. Though McDonnell Douglas had the highest evaluated score there were concerns with the technical feasibility which is how WRHA came to explore other HIS options in the USA and UK. The last such visit occurred to a McDonnell Douglas site on 26th September 1986 when at least two members of the WRHA Group expressed enthusiasm for the product but the RISM persuaded the Group that it was not a viable option. Three days later the IG was informed that negotiations with DEC had failed and Andersen\IBM should be given the contract. The IG was never given the report of the evaluation group nor the HIS group, but it was given the criteria against which bidders had been scored. The criteria had changed significantly in that there was no weightings between the attributes of the three different systems but subjective assessment was used. The outcome was that Andersen jumped from a ranking of 4th out of 5, to 1st.

A separate but disturbing issue arose during the period when WRHA was negotiating with DEC in the summer of 1986. The RGM was approached by a Member of WRHA to reconsider the decision to award the contract to DEC. The impropriety was twofold. Firstly, the decision to award the contract was made by

WRHA and therefore if there were good grounds to reconsider the decision a case should have been made to the Authority and not its senior executive. However, more worrying is the second aspect in that the Member was John Foster who also was the Director of Corporate Services at IBM. In addition the Chairman of WRHA at that time Sir Brian Thwaites received a telephone call from Patrick Jenkins, former Secretary of State at the DHSS, who was acting on behalf of Andersen and argued that the award of the contract to DEC was a bad decision. Either of the two approaches could be interpreted as an attempt to influence the outcome of a tendering process and should have led to disqualification of Andersen from any further involvement.

Standing orders and standing financial instructions of WRHA throughout the period 1984-1990 clearly state that competitive tendering is required for the supply of goods and services and that the directives of the European Community (EC) on the awarding of contracts were to be followed. In March 1989 without reference to the IG or WRHA, officers decided to purchase an additional IBM mainframe computer at a cost of £3.3m. Clearly this is a major breach of Standing Orders as no tendering process was undertaken. Also the potential size of the contract meant that an advert should have been placed in the European Journal so as to inform computer supplies in the EC of the business opportunity; EC law was therefore broken exposing WRHA to the possibility of a large fine and public censure. In addition standing orders stated that the award of contracts over £100,000 in value should be reported to the Authority, but it was many months before Members were informed.

1.3.3. Conflict of Interest

The RISP case study is littered with conflicts of interests which are worthy of explicit identification.

- Arthur Andersen

This firm was originally employed as consultants at the start of RISP. Then they were invited to become a bidder for the three core system contract. Whilst their bid was still on the table as WRHA sought to complete negotiations with its identified preferred provider, Andersen acted as advisers to the Authority which appears to have given them inside information on a competitor and influence on the final award of the contract. Finally the company became a bidder again as the DEC negotiations failed and the Andersen\IBM consortium was awarded the contract.

- John Foster

This individual was both a senior employee of IBM and a Member of WRHA. The normal practice when the organisation who employs you is bidding for NHS work, is for the Member to declare a potential conflict of interest and to ensure that he\she has no involvement in the decision making process of the Authority. Mr. Foster ignored this protocol and deliberately sought to influence the most senior officer of WRHA with a view to furthering his company's position.

- Patrick Jenkins

This politician was a former Secretary of State for Health who had been retained by Arthur Andersen to act as an adviser. In a note to the PAC he admitted that he knew the Chairman of WRHA both as a Health Authority Chairman in Brent and had selected him to be the Regional Chairman in Wessex; in addition they had worked together at Westfield College, London University. His telephone conversation with Brian Thwaites was an attempted use of the old boys network to influence a major decision of a public body which as the former senior politician for the NHS, he should have known was unethical.

- CSL

The first problem with this organisation occurred in 1987 when only the month after the Regional Treasurer, Robin Little, resigned he returned to lead a team from CSL which had been asked to review a number of services. This contract was awarded on a non-competitive basis and the wisdom of allowing a very recent senior officer back into the organisation as a contractor must be regarded as a doubtful decision. Whilst this work was in hand the funding problems of RISP became apparent. Mr. Little suggested the idea of partnership between WRHA and CSL and when agreed, was asked to prepare the policies and plans to underpin the tendering process. Up to this point there was no real conflict of interest. However CSL were allowed to bid for the contract despite detailed inside information and were awarded the contract.

For the period of two months at the start of 1989 Robin Little was seconded from CSL to act as the RISM. This meant he had the responsibility of overseeing the WIS contract and the most appropriate analogy is that a poacher is asked to act as the game-keeper. The issue of the second agreement and the level of staffing enshrined in the contract has been covered in detail. This is yet another example where CSL in the form of WIS confused their own and their client's interests. As advisors to WRHA, WIS should have raised the unrealistic nature of the Development Plan, however the company put its own profits ahead of the needs of WRHA.

- IBM

IBM allowed the secondment of Harry Tuffill to the post of RISM at a time when it was a significant provider of services to WRHA. Again this meant that the duties of the RISM were severely compromised as Mr. Tuffill should have been monitoring the performance of IBM and taking action for any deficiencies. Whilst the terms of his secondment precluded his direct involvement in the purchase of equipment, it was documents made available by him which external consultants used to confirm the need to purchase the IBM computer.

- ABC

The conflict of interest was so great that the Police successfully prosecuted four individuals for fraud. Two people were former IT staff of the Authority and should have been controlling the work and payment of ABC. Unfortunately one of the others was the former owner of ABC which meant that a conspiracy rather than a proper commercial contractual relationship existed.

1.3.4. Poor Management Control

Two of the fundamental roles of Members of health authorities were to monitor the performance of officers and to ensure that systems were in place to protect the public purse. Levels of authority are key to any organisation, yet with RISP there are examples of major decisions being made by individuals when they did not have the authority to do so. The most striking example is the purchase of a £3.3m computer which was authorised by the RGM and Regional Treasurer without recourse to WRHA.

Next, decision making committees can be empowered to act on behalf of the corporate body within defined terms of reference, membership and the attendance of members which constitutes a quorum. The IG was such a committee empowered by WRHA. Unfortunately the key decision to replace DEC with IBM\Andersen was taken when the IG was inquorate and therefore the decision was invalid.

Availability of information is vital for Members to discharge their function, RISP had many examples of information being withheld. Firstly the reports of the evaluation group and HIS group were not made available to WRHA or the IG to demonstrate why the contract was moved to IBM\Andersen. Secondly the District Auditor's investigation uncovered the fact that the cost of RISP was not £29m as told to WRHA but £80m. Thirdly because good information was not made available to the Regional Chairman at the time of the contract renegotiation with WIS at the end of 1989, the fiasco of the staffing level ensued.

These issues could have been avoided if before embarking on this visionary project, the Authority had insisted on a detailed project plan which was based on a tried and tested project management methodology. This would have laid down the key decisions that would have been necessary, who was to make them, monitoring of implementation and cost control to name but a few key components.

The final failing under poor management control is the lack of use of Internal Audit. Even with hindsight it would have been reasonable to assume that around 1986-87 that Internal Audit should have examined the progress of RISP particularly when it represented such a large cost and volume of effort. Sadly the PAC Report states:

throughout the history of the RISP, Internal Audit failed to provide management with an adequate level of independent assurance as to the propriety of expenditure on the plan.

1.4. Wessex Man

In 1993 in the aftermath of the RISP fiasco the BBC's premier current affairs programme, *Panorama*, pointed its spotlight at RISP. Interviews with the key players involved in the Project shed valuable insight into what transpired. It is clear from the comments of John Hoare that he believed Wessex RHA was right at the front of the Information Technology revolution and he talked of creating "a living network of data".

Robert Sheldon MP, who chaired the Public Accounts Committee investigation into RISP, identified the three issues of fraud, probity and standards as at the heart of the matter. He stated that the activities of John Foster were a "division of loyalties.....muddying of differences between his two roles". Tony Rees, who was a Member of the RHA from 1976-90, stated " the public sector is not terribly geared to taking strolls in the jungle" which he argued was one lesson, whilst

another was “big projects are dangerous”. It was during his tenure as chairman of the RHA’s IG that the inquorate meeting awarded the first major contract to IBM\Andersen. John Hoare’s response to any suggestion of any maladministration brought forward the following quote:

I think that the Authority, Members of the Authority, Chairman and indeed myself, behaved with total integrity.....and would not have thought otherwise. Any mistakes were of ignorance and certainly not underhand about any part of the project.

In 1987 when an elected representative, David Martin MP for Portsmouth, sought answers from the RGM and Chairman of the RHA, he was treated as “a naughty schoolboy”. When he went to the Government, the Minister Tony Newton implied that the Department was monitoring the situation and therefore Mr Martin should not become involved. Hoare’s justification of the deliberate underestimate of RISP by some £61m was dismissed by the statement:

when you are doing something totally new, which no-one has done before, estimates of cost are difficult, you can put all the expertise you like into it.

At the PAC hearings the second RHA Chairman, Sir Robin Buchanan, was challenged as to why he had sought a secondment from IBM to the key role of RISM. He responded “he was the only hope I had to provide the grip that the then Minister of Health was requiring me to provide”.

The *Panorama* programme finished with two key segments of interviews. Firstly in conversation with the senior manager who had the task of clearing up the RISP mess, Ken Jarrold. He made 3 summary quotes:

what we discovered was that the public sector really has to be well informed and rigorous in its management procedures if it is to avoid being taken advantage of.

there is no question that being a public servant in the new world is particularly challenging because on the one hand as public servants we have to learn new disciplines of commercial relationships and competitive tendering and so on, and at the same time we have to remember the very important traditional public service values, and that is not an easy combination.

I think it is very important that whilst we seek to apply the private sector disciplines, we never forget we constantly revisit public sector values.

The final word went to the PAC Chairman who said “standards are higher in the public sector than in private, we must ensure that transferred services have standards transferred as well”.

1.5. Summary

It has been said that we cannot forget our history and with RISP this comment is apt. The first 20 years of the NHS saw a concentration on the establishment of a national service and its development. The strong middle class value of public service pervaded the Service and no-one found the need to discuss corporate governance as it exists in 2002. The early 1980s saw a fundamental change in British society. The election of Margaret Thatcher in 1979 led to the defeat of the Trades Union and the rise of the entrepreneur. Perceived needless red tape was stripped away and businessmen were encouraged to be innovative to revitalise the British economy after the hyperinflation years of the 1970s.

Within the NHS at this time the culture was one of consensus and of long term relationships built on a diplomatic, civil service approach. Along came Griffiths who effectively threw a bomb under this method of operation. However the majority of the senior personnel who were expected to act in general management mode, were the same individuals that were inculcated in the old ways of

operating. Such a fundamental culture shift in an organisation as large and widespread, required a number of years to pass before significant changes could be achieved.

In the same period came the start of the Information Technology revolution. For the first time it was possible to give individuals desk top computers such as the Apple II. The attraction to the labour intensive and information hungry environment of the NHS, was immediate. Unfortunately the development of entrepreneurship, managerialism in the NHS and the IT revolution happened at different speeds with the NHS evolving the slowest.

Until this time any significant development in the NHS had been under the control of the Service as invariably they were clinical in nature. A former Chief Medical Officer at the DHSS, Sir George Godber, wrote in 1975 (p.45):

look at the last twenty-five years. The greatest priority tends to have been given to areas of greatest scientific interest. New developments like kidney transplantation, cardiac surgery, super-voltage radiotherapy and intermittent haemodialysis.

Now for the first time there was an exciting new world but it was so specialised that the NHS required significant external assistance to understand and use the new technology. The problem for all organisations in this situation is that you don't know what you don't know, The result was that the NHS was not in a position to recognise when it received poor advice from its advisors. Neither did the Service heed lessons that were already around. In a Social Policy Paper published in 1985 Ellie Scrivens points out that the PAC had published a Report in the previous year titled "Management and Control of the Development of Administrative Computing in Government Departments" which had been highly critical of the DHSS and its track record.

If culture is the first major cause of the RISP failure then the second is Big Idea Blindness. There is no doubt that even at the start of the 21st century the vision behind RISP is still valid today. Within the NHS at the present time each health

authority is working with its local hospitals and general practices to create an area wide network which will allow all health organisations to communicate electronically with each other. This goal is still exciting and has real patient benefits if achieved. RISP led to the generation of excitement about new technology, the wish to be at the leading edge of the revolution, and the desire to put Wessex on the national if not international map. These drivers compelled senior public servants to allow actions and processes which at a more reflective and objective time would have been recognised as unsound and against public service standards of conduct. The result was a breakdown in the various components of the Triangle of Dependences which Sauer (1993) defines as the structure needed to deliver a successful information systems project. The Project Organisation innovates the System which serves the Supporters who support the Project Organisation. RISP is littered with numerous examples of failings between different parts of the triangle.

The failure of RISP lay with these two fundamental drivers from which issues such as poor process were derived. Because there was no culture of overt corporate governance for over 40 years of the life of the NHS, as the Service expanded and became infinitely more complex there was a very strong likelihood that a fiasco would have occurred somewhere. Sadly for Wessex it happened to them.

The Wessex study identifies the fundamental issue of accountability which will require examination, whilst the emerging elements appear to be directors and management control, audit committees, and conflict of interest.

1.6. Conclusion

Examination of Wessex allowed a possible conceptual framework to emerge. However further elaboration is required, in particular, the organisational theoretical underpinning for the framework. Academic literature identifies agency theory as the predominant approach. The strengths and weaknesses of the theory

are explored for the light that they shine on corporate governance. In addition, the growing importance within the NHS of stakeholders means that they must be examined within the agency environment

At this stage my exploration of corporate governance was to generate a possible theoretical view of the subject. The Wessex case threw up the concept of accountability and indicated a number of significant themes which are important; directors and management control, audit committees, and conflict of interest. The focus of the thesis switches from development of theory to the testing of those generated ideas with the aim to find supporting evidence to corroborate the conceptual framework.

Three further acknowledged case studies of corporate governance failure are scrutinised. Different contexts are chosen to allow common subjects, if any, to emerge. It will be seen that Wessex was primarily an issue of managerial ineptness. The second NHS case has been selected to have a different underlying theme. The West Midlands Regional Health Authority was founded on bad intentions. A third case has been chosen from the wider public sector, local government. Investigation of the Westminster City Council “Votes for Homes” debacle allows a further testing of common threads but against a different culture than that of the NHS. Finally a fourth case has been picked from the private sector so as to complete a range of examples of corporate governance failure from various organisational perspectives and environments.

The sources of information for all the cases are from well researched, authoritative reviews. In two studies the core information is derived from formal reports of the Public Accounts Committee. The third case uses the published, multi-volume District Audit report whilst the fourth utilises two non-fiction books dedicated to that particular scandal and cross-references between the books to check for the validity of the descriptions of events. Each case study chapter has the purpose of identifying what took place and why.

The second part of the testing process is to comprehend the range of national initiatives which occurred in the United Kingdom (UK) in the 1990s, Cadbury, Hampel, Greenbury and Nolan, and understand whether there is any commonality with the provisional framework postulated by this research. At the same time the NHS produced numerous documents and instructions on corporate governance, a review of these publications will allow a similar exercise to take place.

Finally from the development of the theoretical framework and its testing, this thesis will offer a conclusion and an epilogue of a reflective practitioner's thoughts, which together creates the four products identified earlier in the introduction.

Section A

Development of a Conceptual Framework of Corporate Governance

Chapter 2.

DEVELOPMENT OF THE CORPORATE ENTITY

At the start of the 21st century the term corporate governance is now in common use, both in the academic world and also in the everyday media. However only as recently as 10-15 years ago this was not the case, even in academic literature. To understand the arrival of the term, corporate governance, it is necessary to comprehend the origins of the most common corporate body, the company and, the parallel evolution of two factors: the changes in society that inevitably had an impact on the way people behaved and the regulatory and legal framework that developed as a consequence of social progress. This chapter will examine the “corporate” element of corporate governance whilst the subsequent chapter will address “governance”.

From Roman to Medieval times the economy of the country of England was based on agriculture and sheep (Tevelyan 1944). Society had a small number of very powerful, rich landowners whose primary assets were worked by their peasants. Also there existed a number of ancillary trades, such as pottery and forges, which supported this work. Any trade that was present was based in the towns.

The 12th and 13th centuries saw the consolidation of the French influence on the country following William the Conqueror’s victory at Hastings in the 11th century. One of the results was increased traffic between England and the Continent, and the consequent increase in trade both nationally and internationally. English wool was in great demand and was exported in large quantities to the Flemish society which was regarded as one of the premier trading communities in Europe. An organised structure to trade started to evolve through craft guilds.

Producers and traders worked together under the auspices of a particular guild, e.g. fishmongers, grocers, saddlers, tailors and goldsmiths, but these organisations did not trade in their own right. Trevelyan (p.35) argues that these

arrangements were “the beginnings of the capitalist as organiser of industry”. A guild’s fundamental purpose was to regulate and control local markets. It:

- enforced collective monopoly;
- ensured standards of workmanship;
- ensured product quality;
- regulated entry to the guild e.g. long apprenticeships;
- enforced a fair share of the market to each member so that one trader could not grow at another’s expense.

This theme of self-regulation remained unaltered for hundreds of years. Every now and then a new group of like minded individuals would be recognised by the Crown and be allowed incorporation. For example the Company of Merchant Adventurers was chartered which meant that they controlled the import and export of goods. Similar to guilds this Company was a regulatory structure to protect members’ interests rather than a corporate body seeking to make a profit. In fact the great merchant Companies became very powerful such that during the War of the Roses in the 15th century they governed London and effectively ensured peace through neutrality (Trevelyan). In Europe the position was different as corporate organisations had developed where their aim was to generate profit and growth, in particular, impressive mercantile and financial concerns developed in Italy and Germany. England did not follow this route as the national culture had been greatly influenced by Magna Carta in 1215. It enshrined the rights of the individual and the principle of personal ownership of property with power based on such ownership. This meant that in England self-regulation based on the individual was the approach whereas on the Continent the Roman influence means that the State had a bigger part to play.

The 16th and 17th centuries saw major changes to English and European society. Science began to have a major influence as Gallileo proved that ships would not fall off the edge of the world if they set out on voyages of exploration. The influence of the Church underwent a dramatic shift as in England Henry VIII broke with the Roman Catholic faith and established the Church of England. The

New World was discovered and sailors of the calibre of Drake and Raleigh uncovered new trade routes that were waiting to be developed. Even in the newly competitive expansionist environment the collegiate, self-regulatory and protective form of company survived (Tricker 1984). New organisations continued to be chartered. In 1540 the Company of Barber-Surgeons was created and the Apothecaries became a City Company in 1606.

The growth in opportunities did not bring about the establishment of a culture of corporate organisations. Joint ventures were common but existed for a defined, relatively short period of time as partners shared investment, profit and debts for specific voyages. However some businesses did pursue a corporate approach with profits and losses divided amongst shareholders. They were created by the Crown and continued through the appointment of Chartered companies to pursue trade in far away lands. One of the most famous was the East India Company which was still in existence in the 19th century. The Crown appointed the boards of these companies and exercised its authority through this mechanism.

Some 500 years after Magna Carta trade and commerce in England was run mainly by individual proprietors. However the early 1700 saw an ever increasing set of business opportunities, e.g. the expansion in North America, which required new capital. The outcome was the development of unincorporated companies that were co-partnerships where some members ran the venture whilst others only contributed finance. As the number of new organisations grew, so did the possibilities for dubious entrepreneurs to persuade individuals to invest in companies where the outlook for a return was poor. It would appear that self-regulation had now failed and the result was the first piece of legislation to be introduced to control business. The Bubble Act of 1720 was a criminal statute aimed to protect investors through the prevention of the establishment of a large stock of easily transferable shares in these new bodies. The end of the 1700s saw a growing wish to limit the liability of company members for debts. At that time such limitation required incorporation under a charter from the Crown or by a specific Parliamentary Act, and therefore the aspirations of companies remained unfulfilled. Whilst there were some further small changes to commercial law, the

end of the 18th century did not see any major alteration to the process of trade and commerce.

The 19th century was the era that saw significant change in the framework for business creation and governance. In 1825 the Bubble Act was repealed as it proved to be easy to sidestep. In the same year the Crown passed responsibility to the Board of Trade for chartering companies through the issue of Letters Patent. This alteration meant that companies could sue and be sued, however liability was still not limited. In 1844 a significant piece of legislation was introduced which over time encouraged a key change in the configuration of business. Before the enactment of the Joint-Stock Companies Act business had not moved on from single proprietors and unincorporated companies. The statute was introduced to protect investors and was a move away from self-regulation to Government intervention. The law required the registration and regulation of all unincorporated companies and specifically called for:

- directors to manage the company;
- the appointment of a secretary, clerks and servants;
- periodic meetings of members of the company;
- the appointment of a chairman;
- accounts to be kept;
- balance sheet to be produced for shareholders;
- the appointment of auditors;
- registration of the company with the Registrar of Joint-Stock Companies;
- the maintenance of a register of shareholders.

From public knowledge of business in 2002 it can be seen that the 1844 Act laid the groundwork for the establishment and governance of companies that is in existence some 160 years later. The outcome was that approximately 1000 companies were obliged to register and within 15 years the number had doubled. In the age of the British Empire, many companies were in shipping and insurance as overseas trade flourished. Within the United Kingdom much advantage was

taken of modern science to develop gas, water and railway companies. Already in the first half of the century technology had had an impact on the nature of business. Hannah (1976) uses the cotton textile industry to illustrate this point. Up until the end of the 1700's it was a home based, craft industry. By 1830 there were large new mills which employed large numbers of staff and utilised new machinery and power equipment to gain large economies of scale. By 1871 over half the working population worked in factories.

Further important change on the issue of limited liability followed relatively soon after the 1844 Act. There was much debate in the business and political communities which could not fail to be influenced by factors such as the failure between 1846 and 1857 of nearly 100 banks with liabilities approaching £50m (Trevelyan). A Royal Commission examined limited liability. The eventual outcome of all the discussion was to pass an Act in 1855 that limited liability for any company whose capital divided into shares of a nominal value of not less than £10. There followed two amending acts that led to a Consolidation Act in 1862. This statute laid down the process for the establishment of a company and included:

- 7 or more people were required to subscribe to the Memorandum of Association;
- if liability was limited the company name must have the word "Limited" at the end;
- the Memorandum must state the address of the Registered Office, the Objectives of the Company, and the amount of Capital which was to be Registered.

This framework for incorporation exists still today. In addition the Act required:

- register of all members;
- the production of an annual list of members to be sent to the Registrar of Joint- Stock Companies;

- register of mortgages and charges;
- register of managers and directors;
- an Annual General Meeting to be held every year;
- the Board of Trade to appoint inspectors to investigate the conduct of a company if requested by at least 20% of the members.

The liberalisation of the business culture through the introduction of limited liability led to a major increase in the number of companies. Despite the governance measures that had been introduced, there were company collapses and fraudulent promotion. Tricker (p.32) argues :

within less than a decade English company law had moved from an essentially regulatory, interventionist stance to become the most permissive in Europe.

The fourth quarter of the 19th century not only saw the growth in businesses but there were two significant social changes. The development of the North American prairies with its cheap methods of mass production, was the main cause in the fall of English agriculture (Trevelyan), whilst at the same time industrialisation continued at a pace. One of the results of these combined influences was the growth of companies. The expansion of Limited Liability Companies brought about the introduction of salaried managers who were needed to take advantage of new technologies and to ensure efficiency. Trevelyn (p.572) argues that it was these changes which “brought a step away from individual initiative towards collectivism, and municipal and State-managed business”.

One of the outcomes of the 1855 Act was the development of companies which did not seek public capital. They used proprietor’s funds and profits from the business to grow the enterprise; these organisations tended to be family businesses. It can be argued that their development was the start of the private company whose existence was recognised by the 1907 Companies Act. This legislation stated that private companies must not have more than 50 members

and not seek public capital but they were exempt from most disclosure obligations of public companies.

The end of the 19th and the start of the 20th century saw the merger and acquisition of businesses to create large public companies. “Between 1888 and 1914 an average of at least 67 firms disappeared in mergers each year” (Hannah p.23). In the beginning it was the business that was absorbed into the larger organisation but as time went by these large companies began to buy holdings in companies that continued to trade and operate as corporate entities. As these relationships became more complex society saw the birth of what is now recognised as holding companies. The years before the First World War saw the establishment of many major firms which still exist today, e.g. Imperial Tobacco, GKN and Vickers (Hannah).

Government intervention continued with a Companies Act in 1929 that eventually led to a Consolidating Act in 1948. This piece of law was the main plank of business regulation for the next 25-30 years and according to Charkham (1994 p.261) “the 1948 Act was regarded at the time as a milestone”. One of the interesting effects of the legislation was that the value of firms became more transparent and therefore allowed takeover bids to be put directly to shareholders. The consequence was that the vulnerability of quoted companies to merge, was increased and between 1948-63 no less than 20% of companies quoted on the London Stock Exchange were acquired by other quoted companies (Hannah).

The 1948 statute was supported by five amending Acts that introduced small but significant legal changes. The exempt private company was abolished in the 1967 statute that also required publication of :

- information on subsidiary companies;
- directors’ emoluments and the salaries of high paid workers;
- profitability and turnover of different divisions of business;
- the number and wages of employees;
- political and charitable donations.

The amending Act of 1976 laid down a number of detailed requirements for company accounts, such as, contents of accounting records. A further Act in 1980 introduced the public company as a formal type of organisation and stated that if a company wished to seek public capital, it had to be registered and to add the words “Public Limited Company” or PLC to their name. As with the Acts of 1967 and 1976, the 1980 legislation also covered further detailed regulation, in particular, it prohibited loans to directors and made Insider Dealing a criminal offence.

The fourth Act became law in the following year. It covered very detailed requirements on the form and contents of company accounts and their accompanying notes. The 1981 Act also covered issues such as allowing companies to buy their own shares and various aspects on registration, investigation and disclosure.

The overall outcome of organisational evolution is that by the early 21st century the corporate entity is firmly established and whilst this chapter has chartered the rise of private sector organisations, the public sector to varying degrees has adapted private sector governance mechanisms. At the same time scandals began to emerge such as the Bank of Credit and Commerce International and Maxwell. By the early 1990s the names of Polly Peck and Blue arrow were added to the list of perceived corporate governance failures. They were joined by some high profile public sector cases which were also exposed; Wessex Regional Health Authority, West Midlands Regional Health Authority, and Westminster City Council.

This chapter has focused on the development of the corporate entity so that its evolution can be appreciated before the concept of governance is explored in general and in particular, its application to the corporate entity.

Chapter 3.

EMERGING CONCEPTS IN CORPORATE GOVERNANCE

The aim of the Wessex study was to understand how a significant corporate governance failure occurred. The preceding text explored the development of the corporate organisation whereas this chapter will analysis the elements and concepts that exist in “governance”. Academic literature was examined to explore what has come to the attention of researchers and commentators, and test the outcome for its robustness for more general application outside the specific case of RISP. The approach was to search electronic databases e.g. BIDS and HELMIS and generate lists of possible abstracts. These were downloaded, selection of appropriate material was made with copies of the source information obtained and entered on an electronic reference database.

The purpose of this chapter is to examine whether some or any of the issues identified in the Wessex case have attracted academic interest previously and allow judgements to be made as to their possible inclusion in a theoretical framework. A wide range of academic disciplines, e.g. law, organisational behaviour and finance, and a variety of countries, e.g. America, Australia and Canada, have been used to obtain a broad perspective. For each theme a specific examination of the field of healthcare is included.

The first issue is to obtain an understanding of the fundamental concept of corporate governance. Secondly, the notion of accountability which appears to be a corner-stone of corporate governance, is discussed. Thirdly, Wessex highlighted the issue of management control and the importance of directors, so these two matters will be examined together. Fourthly, the lack of an effective audit committee was important in Wessex and therefore the principles of audit committees will be studied. Fifthly, there were numerous conflicts of interest within the Wessex case which means that this concept merits discussion. Finally a conclusion is drawn about the findings which will indicate whether the development of a theoretical framework is possible.

3.1. Corporate Governance

Examination of literature shows that the term corporate governance appears only relatively recently in the written observations and discussions of how organisations do and should work. In particular over the past twenty years, as communities in the developed world have taken a closer interest in both public and private organisations, the term corporate governance has moved from the academic environment to common place use in the media.

To understand the concept there are three questions that need consideration. Firstly what is the definition of corporate governance ? Secondly what is its purpose ? Thirdly who are the implementers of corporate governance ? Following clarity on these issues a final question is does corporate governance apply equally to the public sector, in particular the NHS, as private companies ?

3.1.1. The Definition of Corporate Governance

From the 1920s to the early 1970s increased government regulation, rapidly diffusing ownership structures and escalating public pressure moved the centre of gravity of corporate governance from the Boardroom into the public domain. Until World War I corporate governance was easy as it was essentially performance accountability. From 1918 onwards society began to be concerned with how organisations operated e.g. the use of sweatshop labour (Demb and Neubauer 1992).

Hodges et al (1996) argue that there is no authoritative definition of corporate governance, but there appears to be a degree of agreement that it is concerned with the procedures associated with the decision-making, performance and control of organisations, with the provision of structures to give overall direction to the organisation and to satisfy reasonable expectations of accountability to external stakeholders.

Jackson and Carter (1995) approach the subject from a different tack. They argue that it is not possible to examine and monitor all aspects of corporate practice. Therefore corporate governance is a form of organisational chiaroscuro as light is shone on some elements of corporate workings but not all and subsequently it is not universal. The analogy that is drawn is Rembrandt's famous *The Night Watch* which uses light to draw attention to some sections within the total painting.

Tremblay (1996 p.670) on the other hand has a clear definition of corporate governance:

the total accountability of all organisational activity. In that regard governance is defined through control, containment, power and authority.

Hodges and Starkey (1995) have a different view of the concept and argue that it embraces strategic issues which gives direction to the organisation and helps satisfy the legitimate expectations of those outside the organisation. A practitioner's opinion was expressed by MacDonald (1996), who as New Zealand's Auditor-General, stated that corporate governance is about the concepts of steering, direction, control, authority and stewardship. Banaga et al (1995) argue that corporate governance is often expressed too narrowly as conformance with a set of regulations. As fundamentally organisations exist to perform their set role, corporate governance must be about both conformance and performance.

Gray (2001) has explored governance and brings another perspective on the subject. He concludes that the concept contains a number of elements such as authority, function and rights. However he argues:

we may elucidate an initial working definition of governance as the relationships of authority and function through which policies and practices are effected and rights and obligations established and regulated.

3.1.2. The Purpose of Corporate Governance

A review of the literature shows that there are two broad schools of thought on this issue. Mitchell (1993) argues that the answer to the question “what is the nature and purpose of the Corporation ?” depends critically upon whether the modern company is essentially a matter of public or of private concern; the response defines to which school the individual belongs. The American Law Institute has struggled with this issue. At first it argued that the purpose of the corporation was quite narrow i.e. to maximise stockholder wealth. However it can also be inferred that the corporation can pursue ethical and responsible conduct even if contrary to stockholders’ interests. Clearly this in turn would mean a broader perspective for the role of the company. Mitchell defines the debate as enhanced efficiency for stockholders opposed by more explicit public-directed purpose.

Arthur (1987) puts forward the argument that the legal doctrine governing the corporation is based upon the idea like any other organisation where people associate together to undertake some common action. Individual rights have to be limited to some degree and this leads to the establishment of the corporation as a legal entity separate from its shareholders. In United States (US) law historically the notion has been that only people can be subject to rights and duties. To treat a company as a person presents problems and therefore Arthur explores two theories.

Fiction theory states that the company is a legal person as a matter of convenience. Effectively the rights of persons are aggregated and looked upon as a single person. Therefore using this theory it has been argued that the duty of the board is to protect the interests of shareholders, and the way that the aggregated person exercises any power is through the board. This artificial person imposes duties on directors such as a return on investment, management of the enterprise in the interests of this fictional person, observance of the law and philanthropic contributions should be reasonable. Fiction theory holds to the accepted norms of corporate governance with regard to the function of a board. However to operate

properly there needs to be some independence from management so that the board is not dominated by management. In practice it has been that management should be in the minority of board membership.

Difficulties exist with fiction theory because of the pre-eminence given to shareholders who may be quite transitory and short term, exercising no responsibilities of ownership. Arthur argues that other constituencies e.g. customers, suppliers, the public and government should be considered as stakeholders. To focus purely on profit is not borne out in practice by the best corporations in the Fortune List in the US. With these organisations issues such as quality or consumer service come first. Arthur further puts forward the view that on a societal level a focus on profits leads to legal challenge and calls for regulation. The generation of financial wealth should not be at the expense of public gain. In the 1980s in the US there was a moratorium on take-overs in the oil industry. This resulted from the artificial wealth creation caused by take-overs where the share price would rise but was not supported by any increase in the asset base or productivity to account for the valuation increase.

The second theory is an alternative view of the company. Organic theory states that the company is a real and not an artificial person. It exists separate from the aggregate rights of its members. The company has rights and duties of its own and is responsible for its own actions. The basis of the theory is that the existence of a distinctive informed will and a capacity to act reasonably, constitutes the foundation of rights and duties. Therefore if a group of people come together for a common purpose to achieve a definite goal, they have a distinctive will and act on their own, they are in fact a corporate person. Globally successful companies such as Hewlett Packard and J&J are often quoted in this context as corporate culture is key to their success and underpinning this culture there are guiding beliefs. These are statements about what the company stands for, its identity, its vision and ethos. Culture is key for corporate governance as it allows the organisation to exercise its responsibilities clearly. Bain and Bend (1996 p.173) support this general approach:

...we hold the view that Corporate Governance is very much about adding value. Companies and other enterprises with a professional and positive attitude to Governance are stronger and have a greater record of achievement.

Demb and Neubauer (p.14) argue that the legalistic definition of corporate governance is too narrow for the complexities of the late 20th century. The scale of resources controlled by individual companies has brought them into an explicit contract that defines accountability more broadly. Their model is that the various stakeholders define a 'lifespace' in which the company must conduct its business and where the parameters are defined by stakeholders' expectations.

Mintzberg (1984 p.90) is even more forthright in his view on which school of thought he belongs:

the strategic direction of large organisations inevitably involve social, as well as economic consequences that are inextricably intertwined.....there is no such thing as pure economic decisions in big business. Only a conceptual ostrich, with its head deeply buried in the abstractions of economic theory, could possibly use the distinction between economic and social goals to dismiss social responsibilities.

Argenti (1993) has a diametrically opposing view to the previous discussion. He is of the definite opinion that shareholders are the sole beneficiaries of the efforts of the company and therefore corporate governance exists to protect their interests. Stakeholders should be seen as interest groups whose concerns should be examined and needs met not as a right but as largesse. This view is supported by Lord Wedderburn (1985) who argues that Britain has remained closer to the pure doctrine that the company exists to meet the interests of shareholders.

Jackson and Carter (p.884) are of the clear opinion that corporate governance is for the protection of ownership against its agents i.e. management. Whittingham

(1994) entered the debate on who is corporate governance for, through an example from the pensions industry. Pension fund managers have to make decisions on where to invest large sums of money on behalf of their clients. Should they choose to dump a company's stock because they disagree with the product or philosophy of the company thereby potentially depriving the pension fund clients from accessing what may be excellent returns, and in the medium to long term, undermining the company so that it is destroyed ? The emotive example that comes to mind is tobacco.

3.1.3. The Implementers of Corporate Governance

Many scholars in this field have taken Berle and Means (1932) as the starting point for discussion of corporate governance. Their basic premise was that there is separation of ownership and control in the modern corporation. Because of the dispersed nature of ownership of companies, stockholders do not control corporate management effectively and subsequently managers often act in their own rather than owners' interests. Bainbridge (1995 p.674) points out that:

insofar as statutory corporate law is concerned, separation of ownership and control is in fact an inherent feature of the Corporate Governance system.

However he notes that the vast majority of corporate decisions are made by boards of directors as shareholders have no power to initiate corporate action.

Butler and Ribstein (1995) take this position on further. They argue that the presence of rationally ignorant shareholders presents managers with opportunities to engage in activities that are not necessarily in the shareholders' best interests. This is a dilemma for owners who have to endure agency costs i.e. payment by the company to individuals to manage the organisation. Agency theory, which will be examined in detail in chapter 4, suggests that costs are minimised by competitive forces that align managers with shareholders' interests. Flowing

from this point Butler and Ribstein put forward two broad theories of how an organisation can be controlled.

Firstly there is contractual theory which has three fundamental concepts:

- no-one has to use the corporate form of organisation;
- market forces are ubiquitous in publicly traded companies because efficient capital markets are constantly evaluating the impact of corporate governance arrangements;
- it is important to trade off costs of delegating power to agents against the benefits of doing so

Despite the first point, the modern corporation has been adopted widely and survives as a primary vehicle of capitalism. Contractual theory is a set of contracts among the participants in the business including shareholders, managers, creditors, employees and others. Regulatory theory states that corporate arrangements are different from ordinary contracts such that they should be subject to additional regulation by the State. Butler and Ribstein favour contractual theory as they believe that its basis presents a powerful case for investors and entrepreneurs to be left to their own devices in fashioning the governance arrangements that best suit their needs.

Jackson and Carter argue that the self regulation approach to corporate governance is capitalism protecting itself as legislation would make fundamental change which companies would dislike. Much of what a company does is discretionary and whilst legally binding disclosure exists, management has the decision over what is and is not seen by the wider world. Demb and Neubauer (p. 34-35) agree with this view and point out that the responsibility for choosing which stakeholders receive priority attention is at the core of corporate governance and beyond legal necessities there remains enormous discretion for management. These two commentators have a definite opinion over the role of boards:

although they play an integral role boards are no longer the primary mechanism for corporate governance. No group of 8, 12 or 20 individuals can sensibly carry the full responsibility for assuring corporate accountability to its stakeholders. Rather boards are one among a set of elements used by societies to make corporations responsive and accountable.

Blair (1995) points out that the 1980s saw shareholders attempt to assert more control through hostile take-overs, leveraged buyouts and boardroom coups. In most cases shareholders' interests were seen as to increase the value of the company's stock. Shareholders' rights advocates believe that share value and control are an extension of the benefits of private property. Legal scholars Easterbrook and Fischel (1991) argue that shareholders have the moral and legal standing to be treated as 'owners' of the corporation and thereby given control rights. The outcome is that the social role played by the company, the interests served and who has control rights is derived from who receives the economic residual generated by the company and therefore who bears the economic risk. Blair (p.14) believes this model does not fit most companies:

any time there are parties other than shareholders who make investments specific to a given corporation - employees with specialised knowledge or skills to cite perhaps the most prominent example - shareholders are no longer the only residual claimants in that corporation.

Wherever firm-specific investments exist the employees share of the rents can always be increased at the expense of the shareholders and vice versa.

Nations use various mechanisms to keep business activity and societal objectives congruent argue Demb and Neubauer. Firstly, there is the use of regulations, both governmental and non-governmental. Secondly, through the definition of ownership patterns for public and private sectors. Thirdly, the use of societal habits to apply direct pressure on corporations e.g. the judicial system and a free

press. Finally, there is the corporate board. They conducted some research into the final mechanism across different countries. They concluded that irrespective of structure and legal framework the board has a consistent list of tasks:

- strategic direction;
- securing top management succession;
- controlling\monitoring\supervising management;
- caring for shareholders;
- allocating resources.

Demb and Neubauer (p.39) state that it is the board's role to take a comprehensive view of organisational activity with responsibility for understanding social, economic and stakeholder demands for performance accountability. The dilemma is, though legally the board has the ultimate responsibility, in practice management has the expertise, infrastructure and time to run and control the company.

As a highly successful businessman O'Reilly (1998) who is both Chairman and Chief Executive of the major multinational company Heinz which has a turn-over of \$10 billion, is in a good position to offer a view on corporate governance. He argues that there is no magic formula which fits all sizes and types of company. O'Reilly states:

the best protection for shareholders remains in complete reporting each year. It tells you all you ever wanted to know about your company, its directors, its officers, their pay, and perquisites, their future pensions, any material contracts they have with the company, their stock options and the number of shares they own beneficially or in trust. Short of their sex life you can learn almost everything that you need to know about the company's directors and officers from the annual report. And as if this is not enough, then the combined statutory filings will further inform your fireside reading. Now that is what I call corporate governance and

that is why we should continue to insist on shareholder value as the primary test of good corporate governance.

Johnson et al (1996) note that many companies are under management control because they have taken charge of the proxy machinery. Most shareholders do not attend annual general meetings and instead they sign proxy cards granting management the right to cast their votes. This mechanism is of key importance to major corporate decision making e.g. the election of directors.

Walsh (1998) records a practical example of this power. A significant proportion of the shareholders of Granada, a large leisure industry based company, expressed their discontent at the annual general meeting. They were unhappy with regard to the large financial payouts to directors that had been made as compensation for reduced service contracts. Despite 19% of shareholders opposing the reappointment of a particular non-executive director who sat on the Remuneration Committee, and 12% of shareholders abstaining, the proxy votes given to the management carried the day and the director was reappointed.

3.1.4. Relevance to the NHS

Before examination of the NHS there is first a need to focus on health care organisations, both public and private organisations.

In the US Pointer (1995) defines the core responsibility of a hospital board as:

- to assume responsibility for the affairs of the organisation;
- represent owners i.e. stakeholders and shareholders;
- ensure those at interest e.g. management or medical staff, deliver the mission and goals of the organisation.

This list is not dissimilar from what many commentators have described corporate governance to be when applied to pure businesses. He argues that responsibilities

are the 'what' aspects of governance while roles are the 'how'. Together they define the work of the board. There are five responsibilities:

- ends - define mission, vision, goals and development of appropriate strategies;
- management performance - predominantly focused on recruitment, selection, objective setting, appraisal, remuneration and termination of the chief executive;
- quality of patient care - ensure systems are in place to deliver and monitor;
- finance health - establish financial objectives and monitor performance;
- itself - examine board effectiveness and efficiency.

With regard to roles Pointer suggests:

- policy formulation - encompass statements of board responsibility, policy and operating policy;
- decision making - must be based on policy;
- oversight - closes the loop and entails monitoring, assessment and feedback.

Umbdenstock et al (1990) articulated five critical areas for corporate governance for not-for-profit hospitals in the US:

- common working definition of governance;
- clearly defined mission with specific goals and objectives;
- well planned decision making process;
- board structure tailored to the priorities at hand;
- information, reporting and communication system that keeps the priorities in focus.

In the UK Ferlie et al (1995) identified that the scandals which hit the private sector, such as Maxwell, BCCI and Polly Peck, were mirrored with similarities in the public sector and in the NHS. The Wessex and West Midlands Regional Health Authority debacles meant that corporate governance became a key agenda item for the Government. In particular as the structure of the NHS under the Working for Patients (1989) reforms meant that business like structures and processes were adopted. Therefore it followed that the principles of corporate governance should apply also. With the publication of the Cadbury Report in 1992 which proposed changes to the corporate governance mechanisms of the private sector, the Government decided that a similar approach was appropriate for the public sector. In the NHS the result was the publication of a Code of Conduct and Accountability for NHS Boards of Directors (Department of Health 1994). It articulates six key functions:

- i) to set strategic direction of the organisation within the overall policies and priorities of the Government and the NHS, define its annual and longer term objectives and agree plans to achieve them;
- ii) to oversee the delivery of planned results by monitoring performance against objectives and ensuring corrective action is taken when necessary;
- iii) to ensure effective financial stewardship through value for money, financial control and financial planning and strategy;
- iv) to ensure high standards of corporate governance and personal behaviour are maintained in the conduct of the business of the whole organisation;
- v) to appoint, appraise and remunerate senior executives;
- vi) to ensure that there is effective dialogue between the organisation and the local community on its plans and performance and that these are responsive to the community's needs.

3.2. Accountability

Writings on corporate governance invariably use the term accountability somewhere in the discussion. The writers quoted as references in the preceding section are no exception. From a historical perspective the common view is that many notions of democracy and its associated concepts such as accountability stem from the Athenian State. Here individuals from the society were given responsibility for undertaking leadership tasks on behalf of their fellow citizens who had the right to ask such individuals to account for their actions.

Day and Klein (1987 p.5) define accountability as:

to account is to answer for the discharge of a duty or for conduct. It is to provide a reckoning. It is to give a satisfactory reason for or to explain. It is to acknowledge responsibility for one's actions.

Gray and Jenkins (1993 p.55) use a definition which has a similar basis:

accountability is the obligation to present an account of and answer for the execution of responsibilities. On this obligation depends the allocation of praise and blame, reward and sanction so often seen as the hallmarks of accountability in action'.

Both sets of writers agree that the heart of the concept is about stewardship which historically stems from the management of an estate. The owner of the estate, the principal or accountee, would often be absent so entrusted responsibility for running the estate to a steward or accounter. Many commentators stop at this point in their definition of stewardship but Gray and Jenkins believe that there is an important third component, the code or codes which govern the establishment, execution and adjudication of the stewardship. They (p.55) state:

a code of accountability is thus a system of signals, meanings and customs which binds the Principal and Steward in the establishment, execution and adjudication of their relationship.

In the modern world codes have evolved into two types. External codes are established for general categories of relationship as in professional ethics. Whereas internal codes have been devised to deal with specific relationships and therefore are made explicit. The theme of principal and agent is explored in greater detail in the next chapter as it forms the basis of one of the organisational theories that are explored in this thesis.

In Australia Mulgan (1997 p.26) believes that to understand the concept of accountability, the broader concept of responsibility should be used as a reference and states:

responsibility has a number of connotations, including freedom to act, liability for praise or blame, and proper behaviour on the part of the person responsible. It may also, but need not, imply a relationship between two persons (or groups) where one has entrusted the other with the performance of certain duties or 'responsibilities'.....this aspect of relational responsibility, the responsibility of one person to another, is also referred to as accountability.

Tricker (1984) argues that accountability is more than simply reporting what has been done. It requires an explanation of why particular actions have been undertaken and then acceptance of any consequences that may follow. Furthermore he states that accountability means that an individual has to participate in the process and recognise the existence of power that can demand compliance. The result is that accountability is not discretionary and involves rights and duties not interests and options.

Accountability expressed as stewardship is developed by Block (1993 p.5) who states:

stewardship is the willingness to be accountable for the well-being of the larger organisation by operating in service, rather than in control, of those around us.

He believes that stewardship is a set of principles and practices which have the potential to make dramatic changes in the governance system. It is concerned with creating a way of governing ourselves that creates a strong sense of ownership and responsibility for actions at the bottom of the organisation. Block has a clear view that stewardship is the choice for service which is best served through partnership rather than patriarchy. He believes that dependency is the antithesis of stewardship and so empowerment becomes essential.

Hoskin (1996) argues that responsibility implies stewardship whereas accountability is in its operation and scope more total and insistent with most issues specified in advance. Therefore it goes further than responsibility.

Day and Klein (p. 9) have the opinion that:

the ability to call people to account defines the locus of authority in any given society. The notion of authority involves the “right” to call people to account but must involve the notion of power as the “ability” to call people to account.

They put forward the view that in the second half of the 20th century there is a growing perception of inadequacies in the existing system of accountability. The result, they argue, is that there has been a move away from seeing accountability in terms of being answerable to the people towards being accountable for proper conduct which is defined not by “demos”, nor by political processes but by unalterable laws.

Accountability is real as Boyd recounts the tragedies of the London Underground Kings' Cross Fire (1992a) and the Zeebrugge Car Ferry Disaster (1992b). In the former it was shown that management had failed in its responsibilities and the result was the dismissal or resignation of a number of senior executives. The latter saw an explicit criticism of the board with the result that some directors faced criminal charges and although they were thrown out by the Courts, accountability as an issue had been brought into sharp focus for all managers in the UK.

Paul (1991 p.2) defines accountability in general terms as holding individuals and organisations responsible for performance measured as objectively as possible. However with regard to public accountability he broadens the definition:

a spectrum of approaches, mechanisms and practices used by governments to ensure that their activities and outputs meet the intended goals and standards.

He sees that the stakeholders who include the public, political leaders, civil servants and service providers, will influence the effectiveness of accountability dependent on whether their concerns and needs are reflected in the monitoring and incentive systems of service providers.

Day and Klein (1987) suggest that financial accountability is quite different from political accountability. The former is a neutral, technical exercise whereas the latter involves judgements where there is a difference of opinion over subjective issues e.g. success criteria for a given policy. The State Auditor subsequently evolved separately and apolitically e.g. in the UK Gladstone's Exchequer and Audit Department Act 1866 created the office of Comptroller and Auditor-General.

Harman (1994) in Australia is of the view that public accountability requires autonomous accountability. This means that an external trigger mechanism on an automatic timer is established so that specific requirements such as annual

reports are produced. She states that few of us justify our actions unless we are asked to, particularly if our performance has been flawed. Without built-in timers accountability remains ad hoc and imperfect, and reliant on aggrieved parties, the media, opposition politicians etc to pursue public service officials and agencies. She also supports the views of Gray and Jenkins that codes are important such that Harman believes autonomous accountability can be achieved by nurturing codes of ethics and practice.

A similar view of accountability is taken by Medawar (1982 p.156) who says that it can be perceived in a negative light:

accountability is something learned in childhood and it is probably closely related to the childhood experience of being found out.

The viewpoint has merit in that when accountability is seen in action it is often an uncomfortable experience for an individual or organisation. Expressions such as the day of judgement or reckoning engender a feeling that accountability is an ordeal rather than a positive process. This impression is reinforced further when terms such as whistleblower are used. Rather than applaud the action of the individual in highlighting the failure of accountability the term has connotations of disloyalty by the individual to the employing organisation.

Stone (1994) takes an opposing tack to Harman in that he has argued for autonomous public sector accountability which is achieved through satisfaction of a number of objectives and public tests of good performance.

Longley (1993) has examined accountability as it applies specifically to the public sector. She states (p.6):

accountabilities within the public arena have always been perplexing, often comprising a complex, heterogeneous mix of fiscal, managerial, professional and public forms.

In Australia in the State of Victoria, Sinclair (1995) undertook some research amongst public sector chief executives and found five forms of accountability which is not that dissimilar from Longley. He classified political, public, managerial, professional and personal accountabilities.

A different approach is taken by Romzek and Dubnick (1987 p.228) who define public administration accountability as

the means by which public agencies and their workers manage the diverse expectations generated within and outside the organisation.

Day and Klein argue that managerial accountability is about making those with delegated authority answerable for carrying out agreed tasks according to agreed criteria of performance. They split this form of accountability into three dimensions:

- fiscal/regularity – concerned with the proper use of money within the rules, legal accountability is a counterpart to ensure procedures and rules are used;
- process/efficiency – assurance that action has been taken and value for money obtained;
- programme/effectiveness – assurance that action or investment has achieved its intended result.

These dimensions can be summarised as input, output and outcome.

Loughlin (1992) puts forward the concept of administrative accountability. He states that citizens, consumers, elected representatives have expectations that decisions are properly made through a fair and equitable system, and that the decision makers are fully accountable for the implications of their decisions. Efficiency and propriety rather than policy are seen as the forms of administrative accountability which is achieved through three routes.

Firstly there is financial probity which comes from the historical basis of stewardship and reflects an economic ethic. Compliance is checked through audit. Secondly there is accountability of public bodies to the courts for the process of decision making rather than the merits of the decision. This administrative propriety has a legal ethic at its heart and is a form of natural justice. It is overseen by judicial supervision. Administrative rationality is the third route and involves efficiency which is reflected through the promotion of professionalism. It is based on a professional ethic and uses inspection as its monitoring vehicle.

Longley supports Loughlin's view in that she believes that effectiveness and efficiency are closely linked to the question of accountability. However she argues (p.13) that:

traditional processes of accountability are often inadequate to meet the needs of public management because they were designed long before complex issues as quality, effectiveness and efficiency developed as legitimate concerns of modern public organisations.

This point is endorsed fully by Day and Klein (1987) who more simply put the view that our ideas of accountability were developed in relatively simple societies whereas the 21st century is a far more complex environment. Plummer (1994) undertook research into the accountability of public bodies in the UK. He found great variety of accountability requirements between different types of organisations. For example directors of Training and Enterprise Councils (TECs) carry personal fiduciary liability whereas NHS Trust directors do not. TEC members are appointed by the Company but Trust non-executive directors are appointed by the Secretary of State for Health. TECs are controlled through the contract mechanism however Trusts operate under statutory control. Plummer (p.10) concluded:

the research has clearly shown that the current arrangements for accountability are so confused and contradictory as to be probably unsustainable.

Despite this pessimism Weeks (1995a) indicated that recognition of the need for accountability was not constrained to obvious public sector organisations or large businesses. Universities, which traditionally regard themselves as part of the public sector, have begun to look at mechanisms for better accountability. A committee of university chairmen published a Guide for members of governing bodies of universities and colleges in June 1995 following the scandal at Huddersfield University.

Within healthcare there was an explosion in the number of people employed in the public sector through the creation of the Welfare State which included the establishment of the NHS. However accountability was complicated by parallel establishment of the Professional State. Experts derive their authority from their knowledge and experience and not from delegation from the community. Core to the concept of professionalism is that the individual is accountable to his\her peers, e.g. Medicine. The dilemma is that professional accountability is not integrated into the system of political or managerial accountability. These difficulties with existing systems has meant that the Athenian concept of answering to the people for your actions has been replaced by answering to the people for proper conduct which until recently has remained an unwritten set of values.

At the beginning of the 1990s of all the major public services such as Education, Social Services, and Police, Day and Klein highlight the fact that only the NHS had a hierarchy of accountability running from the delivery of individual patient care to Parliament. From the birth of the NHS through to the reorganisation of the NHS in 1982, it was emphasised in many government documents that DHA and RHA members were agents of the Minister. The Permanent Secretary at the DHSS, Sir Patrick Nairne stated to the PAC (1981):

the DHAs are formally accountable for the exercise of their responsibilities through the RHAs to the Department and to the Secretary of State; in short they are accountable upwards.

Interestingly an occasional paper by Rees (1990) sets the context of the NHS in the 1980s. The post 1974 NHS reorganisation was the era of consensus management and despite the reorganisation of 1982 and the introduction of general management in the following year, his research found “health authorities were unaltered in the shake-up”. Haywood and Ramade (1985) carried out research into the work of DHA members which is equally applicable to other NHS bodies (p.99):

our evidence suggests that members are influential only through the commitment and support of chairmen and/or chief officers who believed strongly in the legitimacy of member involvement and design mechanisms to ensure that it occurs.

The publication of the Cadbury Report (1992) had a profound effect on the issue of corporate governance in the private sector and was picked up by the Government as applicable to the public sector. The Code of Accountability for NHS Boards is an example of how the clarification of accountability has been tackled in the NHS in the 1990s. Ryle (1994) indicated that the wider public sector was involved as well with the publication by the Treasury of a Code of Best Practice for Board Members of Public Bodies. This Code encompasses some 350 bodies from a wide field of operation which included housing associations, museums, ACAS, the Audit Commission and the Commission for Racial Equality.

The final word on accountability is left to Gamm (1996) who though writing about not-for-profit health care in the US, seems to encapsulate the current mood of accountability in the NHS in the UK. He notes (p.75):

whilst responsiveness to organisational superiors and to society at large are central elements of accountability, the notion of ‘moral obligation’ to the public is frequently cited.

He argues that there are four dimensions of accountability:

- political which establishes the boundaries of legitimate structure and behaviour through government regulation and standards;
- commercial which participates in outcome assessment, demonstrates value for money and collaborates with other providers;
- clinical/patient which is concerned with intrinsic value (such as appropriateness, accessibility and quality) of service and extrinsic value based judgements by service recipients;
- community which is concerned with the relationship with the local community.

Gamm’s views strike a remarkable chord with the contents of the NHS White Paper (Department of Health 1997) which talks about accountability in exactly these terms.

3.3. Directors and Management Control

Much has been written about directors regarding the make-up of the board between insiders and outsiders, and about their function. Jemison and Oakley (1983) reviewed corporate governance arrangements in the mutual insurance industry in the US. They found that there had been a significant move towards a majority of outsiders on the board. Of 1839 board directors in the participating companies 1352 (74%) were from outside the company.

Zahra and Pearce (1989) reviewed the existing research findings of the time and proposed an integrated model on board roles which is underpinned by four attributes – composition, characteristics, structure and process. These attributes

have a direct effect on company performance but interestingly their literature review found mixed results on the matter of board composition.

In Canada Brown (1994) writes about the responsibilities of directors and points out that the director of the 1990s has a much broader burden of responsibilities than in the 1980s. This encompasses the numerous stakeholders in addition to shareholders and the need for a sharper emphasis on business ethics. He uses Italy to illustrate the point that corporate ethics is more than doing what everybody else is doing. Italy used to be a country where companies kept two sets of books and where bribery of politicians and officials was regarded as a normal part of business life. This culture changed dramatically when the Government cracked down. Three well known CEOs committed suicide and hundreds of senior executives are either in jail or facing charges, or have had their careers destroyed even if they avoided criminal proceedings. Directors exist to prevent such scenarios and to inculcate a corporate culture which is open and honest. Brown states therefore directors should be regarded as watchdogs rather than bloodhounds.

A key responsibility of directors is to appoint the chief executive of the organisation. Borokhovich et al (1996) undertook research to examine whether there is a relationship between the make-up of directors, i.e. the balance of the insider and outsider appointees, and the appointment of the chief executive from inside or outside the company. The research examined nearly 1000 appointments made over 18 years at just under 600 large businesses. The conclusion was that there is evidence of a positive relation between the proportion of outsider directors and the likelihood of an outside candidate being appointed as chief executive. In addition when the sitting CEO is forced out, the Market responds more favourably to an external rather than an internal appointment as it is viewed as more beneficial to shareholders. The study also showed that over the time period of the research the percentage of outsider directors on boards increased.

Zajac and Westphal (1996) completed research into the issue of the politics of director appointments dependent on whether the organisation was board or CEO-

controlled. They examined 491 director appointments and found some robust conclusions. In general where a director had been involved in changes at a company that led to increased board control over executives, the individual director was attractive to companies with high board control. Similarly the findings confirmed that the opposite was true as well. Chief Executives who wished for passive directors, looked to CEO-controlled companies for recruitment.

Beasley (1996) approached his research into board composition from a different angle. He looked at the variation in the proportion of insider to outsider directors and the occurrence of financial statement fraud. He examined 75 firms where no fraud existed and compared them with 75 firms where fraud had been discovered. The empirical results confirm that the proportion of external directors of the board is lower in the firms which experienced financial statement fraud compared to no-fraud companies. Also Beasley argues that the research indicates that it is board composition rather than audit committee presence, that is more important for reducing the likelihood of financial statement fraud.

Fiduciary responsibility is a major accountability issue for directors to shareholders. The courts evaluate directors' fiduciary responsibility on the basis of the business judgement rule (Johnson et al 1996). This rule identifies directors' obligations to the company but offers protection from liability when directors have made decisions on an informed basis, in good faith, with the best interests of the company in mind, and have acted in a disinterested and independent manner. Two specific elements are used in applying the business judgement rule. Firstly, the directors must exercise a duty of care that an ordinarily prudent person would exercise in the same scenario. The second is that of loyalty which effectively means that there must be no conflict of interest between the director and company. This can be a problem in a take-over situation where directors reject a beneficial bid for shareholders to maintain their own employment.

In health care Gautam (1996) studied 335 hospitals in California during the mid 1980s with a view to examining the proportion of insider and outsider directors, and the issue of strategic change. The particular time period was chosen because new legislation came into effect in 1982. The findings concluded that boards who had high proportion of outsider directors from a business background and insider directors with specific health care expertise, made more strategic changes in response to the legislative reform. In the UK the publication of Working for Patients (Department of Health 1989) came to a similar conclusion with regard to board composition. This White Paper introduced corporate style boards to the NHS for the very first time. Ferlie et al (1996) examined their impact through a formal study between 1990-1993. They found that around two-thirds of all outsider directors or non-executive directors as they are known in the UK, were from the private sector but less than half were involved in voluntary service work which had been the dominant background before the White Paper. Also as the immature boards of directors began to operate, the non-executive directors became more and more involved in strategic decision making as opposed to rubber stamping decisions of executives.

Academic investigation of NHS boards proved to be a busy preoccupation in the early 1990s. Ashburner and Cairncross (1992) reported on the findings of a Warwick University study into the first year of Trust boards. The role of non-executive directors was perceived as firstly selecting, rewarding and if necessary, replacing the chief executive. Secondly ensuring ethical and legal conduct, and thirdly providing expertise and advise to senior managers.

The Audit Commission followed with its own research into the role of non-executive directors and published a report *Taken On Board* (1995). It summarised the role of boards as steering, monitoring performance and accountability. Nicklen (1996) records that following the Report external auditors went into all NHS Trusts to examine current practice. The results were that a wide variation existed in the involvement of non-executive directors in the decision-making process. The spectrum ran from rubber stamping of executives' decisions through to genuine involvement in the development of policy and

strategy. Clearly this conclusion conflicts with the early work of Ferlie and implies that development of boards had not been as fast as first thought.

The attitudes of NHS board directors were examined by Sheaff and West (1997) around the same time as the other studies. Their findings showed that probity was seen to be the key issue. This involved a requirement for transparency, accountability and avoidance of illicit self-enrichment in decision-making. This view has additional support when the issues of honesty, conflicts of interest, financial honesty, and interactions with suppliers were taken together as they accounted for nearly 50 % of mentions in the survey.

Tremblay (1996) points out that the board is about final accountability and therefore to mix governance and management causes confusion for senior executives who sit on the governing body. He argues that to separate managerial and board responsibilities puts unnecessary pressure on executives and reduces the effectiveness of non-executive directors. The dilemma is to prevent the board concentrating on operational issues but on the matter of governance. Tremblay indicates that in the private sector some organisations exclude executives from discussions and use the chief executive as the conduit for their involvement. This approach addresses the issue of board focus but hinders the non-executive directors from evaluating the performance of senior executives, and the absence of involvement from these individuals can lead to a lack of ownership of key organisational decisions.

In the private sector the chief executive has always been a member of the board of the organisation. Until 1991 in the NHS the position was the exact opposite in that the senior executive was answerable to the governing body but not a member. Dixon (1993) argues passionately that the move to mirror the private sector is wrong for the NHS. She believes that for executives to be members of the board causes confusion of accountability and relationships. She goes further (p. 23) and states:

all the important checks and balances, both within and between the corporate governance system and the management hierarchy, are suppressed.

Williamson (1995) writes as a commentator on the NHS and as a non-executive director about her role at a Trust board. She argues that there are three fundamental roles. Contribution of ideas, knowledge, skills, contacts and experience is the first. Evaluation and analysis of executives' plans, proposals and ideas, and of the organisation's performance is the second. Monitoring against agreed objectives and criteria of executives' and the organisation's performance is the third role.

A similar understanding of roles is provided by Deffenbaugh (1996) who lists the provision of independent judgement and critical detachment, and the undertaking of specific functions such as a functional interest like finance, as his three roles. He argues that it is the approach to the third role which requires thought. If non-executive directors play to their strengths then it is likely that someone from a financial background will shadow the director of finance. Deffenbaugh questions whether this enhances independent judgement and critical detachment or does it turn an area of interest into a sphere of influence.

3.4. Audit Committee

Williams (1977), as the incumbent Chairman of the Securities and Exchange Commission (SEC), the US financial regulator, argued that audit committees were a fact of life in the US for the publicly owned company, however there was no clear definition of their duties and responsibilities. He stated (p.72-73):

the audit committee can delineate the corporation's financial and accounting controls, its financial reporting requirements, alternative accounting principles that could be applied and the quality and effectiveness of services provided by the independent auditors. Provided with this in-depth review, the directors are then far better able to meet their responsibility to maintain and preserve the propriety of the company's financial policies.

Birkett (1986) supports the view that the SEC was a major influence in the development of audit committees.

Eichenseher and Shields (1985) suggest that, in general, external audit firms have an incentive to encourage the formation of an audit committee as it enhances the independence of the auditor from management and protects the auditor from allegations of fraud. Their view (p.14) of audit committees is to:

provide a convenient means of documenting board compliance with regulations and demonstrating the exercise of due care in discharging its duties.

In the US Pincus et al (1989) undertook research into why some companies voluntarily formed audit committees while others did not. They used data from a random sample of 100 NASDAQ (National Association of Securities Dealers Automated Quotation System) over-the-counter firms. Their findings were that where voluntarily formation of audit committees existed there was:

- lower managerial ownership of the company; the incentives for formation of the Committee increases with agency cost of equity;
- larger firm size;
- higher proportion of outside Directors;
- a Big Eight external auditor was employed.

Research by DeFond and Jiambalvo (1991) examined the incidence and circumstances of accounting errors revealed by prior period adjustments for forty-one companies in comparison with a control group of another forty-one firms. The adjustments were for overstatement errors. The findings suggest that companies with this type of error have diffuse ownership and are less likely to have audit committees.

Menon and Williams (1994) took a different approach and studied the issue of the formation of audit committees in companies where their existence was not mandatory but recommended by the National Commission on Fraudulent Financial Reporting (Treadway Commission). Their Report (1987 p.40-41) recommended that all public companies be required to have audit committees and to maintain them as the primary vehicle to ensure integrity of financial reporting and the audit process. At that time some Exchanges required audit committees e.g. New York Stock Exchange, whereas others such as the American Stock Exchange did not. Menon and Williams outline their view of the responsibilities of the audit committee which include selecting the independent auditor, overseeing the audit process and ensuring the integrity of financial reporting. This can be achieved because the audit committee has delegated responsibility from the board of the company, and because there are two potential monitoring advantages. Firstly, independence, because insider directors are not members of the committee as their performance may be examined by auditors. Secondly, the audit committee aids board efficiency as it is not possible to carry out the detailed work that is required in the main board meeting. Both Jemison and Oakley (1983) and Zahra and Pearce (1989) argue that audit committees are an important mechanism by which the board exercises its oversight responsibilities.

These two writers go on to point out that the formation of an audit committee does not mean that the board uses it to undertake the role as outlined. They suggest that indicators of whether a company is serious about its audit committee, are the frequency of meetings and its composition. A study was conducted of 200 randomly selected companies for which data on audit committees existed in 1986-87. They chose over-the-counter firms as they were not required to form

audit committees. The researchers concluded that whilst most companies had voluntarily formed committees, many did not appear to rely on them (p.137). 57 committees did not meet at all or only once in the year, and 19 were comprised of insider directors. Menon and Williams support Bradbury's (1990) opinion that audit committees are often used as window dressing rather than for any real purpose. The study demonstrates that board composition is important in the effective use of audit committees. The greater the number of outside directors, the more likely that insiders will not be on the committee and the audit committee meets more frequently. Also as McMullen points out the expertise of audit committee members is crucial. A survey by the US Government Accounting Office in 1991 found that 35% of banks surveyed, had no accounting experience on their audit committees. This resulted in new regulations which insisted that at least two members of audit committees must have financial or banking experience

McMullen (1996) pursued research into the issue of audit committees. She states (p.88):

as part of their oversight function, audit committees ask questions of both auditors and management and this may reduce the risk of material errors in the financial statements by providing an information flow among the board of directors, external auditors, internal auditors and company management.

She undertook a study which examined if the presence of an audit committee is associated with financial reporting reliability. Five potential consequences of audit committees are identified and involve the occurrence of errors, irregularities and illegal acts. The study uses five variables as measures of these consequences; shareholder litigation alleging management fraud, quarterly earning restatements, regulator actions, illegal actions, and auditor turn-over involving an accounting disagreement. The findings of the study of 219 companies indicate that audit committees are associated with fewer incidences of the five variables. The results

suggest that companies with errors, irregularities and other indicators of unreliable financial reporting are less likely to have audit committees.

In New Zealand Bradbury (1990) agrees with McMullen that audit committees establish a formal communication mechanism between key players. He articulates the purpose of the committee as firstly to increase the credibility of annual audited financial statements. Secondly to assist directors in meeting their responsibilities, and thirdly to enhance audit independence. He used an agency theory framework to study the incentives for voluntary formation of audit committees. Bradbury examined 135 companies listed on the New Zealand Stock Exchange and found that both the number of directors on the board and intercorporate ownership were the more important determinants of voluntary audit committee formation.

Despite the obvious benefits of an audit committee for an organisation it cannot be seen as the panacea for financial probity. MacErlean (1993) records the large increase in company fraud. Maxwell, Polly Peck and the Bank of Credit and Commerce International (BCCI) have been the global headline grabbing examples. However the article notes the results of the Society of Practitioners of Insolvency research into company failures. They found that five percent had fraud as a principal factor. The outcome of the rise in company fraud has been the development of specialist fraud accountants, particularly in the major audit firms. MacErlean (p.9) quotes David Sherwin of Ernst and Young who said “often you go in and you uncover a catalogue of disasters which have been going on for a long time”. This suggests that audit committees should only be seen as one, albeit very important, part of the control machinery of corporate governance.

Vanasco (1994) studied audit committees from an international perspective. He concluded that there was a consensus among researchers and various national and international organisations that audit committees provide significant benefit to the company, public, investors and regulators. He states (p.38) that the most cited functions of the audit committee are:

- strengthening the internal and external audit functions;
- co-ordinating the work of the external and internal auditors;
- strengthening the position of non-executive directors;
- assisting the board of directors to fulfil their legal responsibilities.

3.5. Conflict of Interest

Atkinson and Mancuso (1991) examined the differences between Britain and the United States with regard to conflict of interest for politicians. They state that a conflict of interest arises when considerations of personal gain influence or appear to influence the exercise of public duties (p.471). They suggest that conflicts of interest often present themselves as problems of discretion.

In the US Roberts and Doss (1992) believe that there has been a proliferation of rules, regulations and other controls by both State and Federal authorities on the issue of conflict of interest for public officials. Official-act rules are common and are designed to prevent public servants from receiving anything of value for or because of their public function. In addition there are supplementation-of-salary prohibitions which are aimed specifically at the prevention of extra salary from non-public sources for the performance of a public service. The third type of control is the interested-source prohibition. This requires public officials to inquire into whether the source of a gift has an interest in actions taken by the official or their agency. Roberts and Doss argue that this myriad of external restraints has become the dominant feature of ethics in public service; yet public confidence has not risen with the new controls. The writers question the value of even further external rules and regulations particularly when they seem to reinforce the perception that the normal democratic systems cannot be relied upon.

O' Connor (1993) points out that in the US there are a variety of State statutes on the issue of conflict of interest. However as case law interpreting these laws is sparse, confusion can exist on whether a transaction between a director and their

company is valid. O' Connor believes that the American Law Institute's (ALI) *Principles of Corporate Governance: Analysis and Recommendations*, brings clarification to the area of director conflict of interest and fiduciary obligation (p.955). ALI leans towards the business judgement rule to review conflict of interest transactions by disinterested directors. The shareholder has the burden of proof to show that the director could not reasonably have concluded that the transaction was fair to the corporation at the time of the agreement. O' Connor goes on to argue that fiduciary law has a socialising role to promote ethical behaviour and that the language used around the subject of conflict of interest is important. She points out that "fiduciary" is derived from the Latin word *fiducia* meaning trust. Therefore the word fiduciary is associated with the morality of the duty of loyalty.

In 1994 Carson wrote an extensive article on conflict of interest which takes a broader view of the issue. Firstly he argued that all too often conflict of interest is defined too narrowly and uses the following example (p.388):

a conflict of interest exists in any situation in which and individual (*I*) has difficulty discharging the official (fiduciary) duties attaching to a position or office she holds because either: (i) there is (or *I* believes that there is) an actual or potential conflict between her own personal interests and the interests of the party (*P*) to whom she owes those duties (her employer, client or organisation), or (ii) there is (or *I* believes that there is) an actual or potential conflict between the interests of her friends, family, or other clients and the interests of the party to whom she owes these duties.

He is of the opinion that conflict of interest do not have to involve a conflict between *I*'s own self interest and *P*. Carson uses the example of hiring a man who once saved his father's life. Under the definition it does not count as a conflict of interest but Carson believes that it is. Therefore he proposes this definition (p.388):

a conflict of interest exists in any situation which an individual (*I*) has difficulty discharging the official (conventional/fiduciary) duties attaching to a position or office she holds because either: (i) there is (or *I* believes that there is) an actual or potential conflict between her own personal interests and the interests of the party (*P*) to whom she owes those duties, or (ii) *I* has a desire to promote (or thwart) the interests of (*X*) (where *X* is an entity which has interests) and there is (or *I* believes that there is) an actual or potential conflict between promoting (or thwarting) *X*'s interests and the interests of *P*.

Carson argues that there is a pervasiveness of conflict of interest. The interests of employees are routinely opposed to those of their employers. He cites bureaucracies as examples of self-interest in growth and self perpetuation, irrespective of organisational need. With regard to hiring staff he suggests that sometimes people are hired so that the individual doing the hiring, looks good by comparison but the organisation wants the best people for the job. Similarly Carson accuses the self-regulation of professions as a rich environment for conflict of interest when peer review, promotion and rewards are at stake. He also suggests that when payment is involved between a professional and a client, there is a possibility of conflict of interest because the professional can supply more services than is really required because of the incentive of income generation. Carson goes on to give example under the headings of technological change and intangible interests to further support his view.

Margolis (1979) appears to have similar views to Carson but stresses the importance of not confusing conflict of interest with conflicting interests. The latter occurs when two legitimate stances are at odds, for example trying to reconcile the conflicting interests of peace and security in the Middle East. He states that a conflict of interest is where one of the interests is not legitimate. He suggests (p.362):

in a conflict of interest it is.....the relationship of the putative interests that is essential; in conflicting interests the conflict is a mere contingency arising to relate independently legitimate interests.

Kay (1994) reviewed director conflict of interest in the US and started by quoting from Black's Law Dictionary (p.208):

corporate director conflicts of interest arise when directors' personal or financial interests conflict with their fiduciary responsibilities to the corporation and shareholders.

He notes that there are three common director conflict of interest. Firstly, direct or indirect ownership of property leased to the company. Secondly, sales to or purchases from organisations in which the director has an interest. Thirdly, ownership of a portion of the minority equity in a subsidiary.

Historically in the US the law governing conflict of interest has developed from an approach based on common law at the turn of the 20th century to that of a statutory approach. The American Bar Association decided that updated statute was needed and introduced subchapter F to the Model Business Corporation Act which encompasses definitions of conflicts of interest, preclusions of judicial review, director transaction approval provisions and shareholder approval provisions. Once the presence of a transaction is established the statute places possible conflicts of interest into one of two categories dependent on the director's involvement in the transaction.

Firstly, there is a conflict of interest if the director knows that he\she or a "related person" is a party to the transaction or has such a significant "beneficial financial interest" in or so closely linked to the transaction that it would influence the director in an approval vote. Secondly, if a transaction of significance which normally comes to the board, and the director knows that he\she has a relationship with the other party or would have a significant beneficial financial

interest in or linked to the transaction that it would influence a vote, then a conflict of interest exists.

The statute defines “related persons”. Whilst parents or siblings of the director are classed as related, grandparents and children of siblings are not. The spouse, his\her parents, and children of the director are related as are the spouse’s siblings but not their spouse or children.

3.6. Conclusion

Whilst there is no agreed definition of the term corporate governance it does appear that there is general agreement that the concept is principally about the decision-making processes of the organisation at its higher levels.

Similarly the majority of commentators now have strong arguments that in a complex world, the narrow view that companies exist purely for the benefit of shareholders is incorrect. On balance corporate behaviour seems to indicate that stakeholders are recognised, albeit with a graded response dependent on the perceived significance of any particular entity.

The views of who should undertake corporate governance are more mixed but the comment of Demb and Neubauer, which questions the ability of any group to be in complete control, does intuitively ring true. However it would appear that the board of directors fulfil the significant role in the pursuit of corporate governance.

The relevance of corporate governance to the NHS does seem clear. The similarity between the NHS Code of Conduct and Accountability for NHS Boards and the myriad references from writers on the private sector, is striking. The obvious difference is that the public sector does not have shareholders in the sense of the private sector but if it is accepted that government act as a form of

shareholders, the difference is immaterial and therefore corporate governance is very relevant to the NHS.

It can be seen that there are many opinions of accountability, most of which encompass the notion of stewardship. Whether it is public, financial, managerial or general accountability, the concept involves a person or persons giving account to an individual or group for the performance of a set of responsibilities and justifying their actions.

With regard to directors and management control, publications are clear that directors are fundamental to good management control. It is also evident that better control is exercised when the board has a significant input of external or non-executive directors.

The literature shows that the use of audit committees has grown over the past twenty-five years. It is now recognised that audit committees are a key component of corporate governance but require active support and usage by the board

Conflict of interest articles indicate that there is general agreement on the nature of the concept. Margolis and, in particular, Carson argue that conflict of interest covers a much broader range of activity. The examples that he quotes are in a pure sense conflicts of interest however they are also the every day organisational politics which are part of the fabric of organisations. As such Carson may have an exact concept but it has no practical application in daily life.

In summary the issues that were extracted from the Wessex case appear to be well supported by academic literature as important issues which, if addressed, should prevent organisations from following Wessex's path, particularly in the public sector. The Australian Public Service Commissioner, Peter Shergold (1997 p.119) reminds us of the different nature of public service:

the public service is held to an ethical standard not demanded of others. It must recognise the distinctive nature of its contribution to the public good and meet a demanding accountability regime.

The elements of governance extracted from RISP do appear to have a resonance on a wider scale but are they just random issues or is there a theoretical connection. The next chapter will allow this question to be answered.

Chapter 4.

AGENCY THEORY : ? A THEORETICAL BASIS FOR CORPORATE GOVERNANCE IN THE NHS

During the previous chapter the concept of accountability was discussed and through writers such as Gray and Jenkins, Day and Klein, Tricker, and Block the idea of principals and agents was introduced in different ways. This chapter investigates further the main theory in which principals and agents appear. It will be through this exploration that the question, posed at the end of chapter 3, can be answered. Agency theory will be discussed by reference to its academic supporters and opponents. This theory gained credibility over the past twenty-five years and is probably the most widely quoted theoretical explanation of medium-large organisations' behaviour. The aim of the chapter is to examine this theory which might explain organisational behaviour for corporate governance in the NHS, and provide the theoretical basis of a conceptual framework. In addition the issue of stakeholders within a principal-agent environment will be examined.

This approach is discussed in four parts. Firstly, by a discussion of agency theory. Secondly, by an examination of agency theory in the NHS environment of 2003. Thirdly, an investigation of stakeholder theory to see what can be offered with regard to stakeholders, and finally a broad identification of NHS stakeholders and the challenges that they bring to an agency theory background.

4.1. Agency Theory

Most academic literature over the past twenty years has given credit to Jensen and Meckling (1976), Fama and Jensen(1980) and Jensen (1983) as the principal agency theorists who explained agency theory. Jensen and Meckling wrote (p.308):

we define an agency relationship as a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent'

Davis et al (1977) explain that agency theory assumes that in modern companies agents and principals are motivated by opportunities for personal gain. Both parties seek to receive maximum utility with the least expenditure and therefore the rational principal or agent will select the option that increases his/her individual utility. Agency costs are incurred because of this possible divergence of interests. It is difficult to know *ex ante* whether an agent will pursue individual utility maximisation, the result is that principals aim to impose internal controls to restrict agency costs and to focus an agent's behaviour to align with the interests of the principal. The two main internal mechanisms are executive compensation and governance structures. Failure of this approach will lead normally to more expensive external control mechanisms such as acquisitions, divestitures and changes in ownership.

Jensen and Meckling point out that there are three components of agency costs. Firstly, there is the expenditure incurred by the principal in monitoring the agent and includes remuneration policies, operating rules and budget restrictions. Secondly, there are "Bonding Costs" which occur when the agent expends resources to guarantee that he will not take actions which harm the principal or to ensure that the principal receives compensation if he does so. Thirdly, there is "Residual Loss" which is the money equivalent of the reduction in welfare experienced by the principal due to the divergence of interests. Clearly the level of agency costs will vary between companies but will depend upon:

- the cost of measuring and evaluating the agent's performance;
- the cost of devising and applying an index for compensating the agent which correlates with the principal's welfare;

- the cost of devising and enforcing specific behavioural rules and policies.

In addition the employment market for agents will have an influence as well as the company's position in the capital market. With regard to the latter, the principal can choose to divest himself of the company if he believes that the value of the company is higher to others than himself. The existence of agency costs suggests that the preferable model of ownership for companies is that of owner-manager and thereby avoid divergence of principal - agent interests and the subsequent need for agency costs. Jensen and Meckling explain that the modern use of Limited Liability has meant that shareholders are not exposed to the full impact of debt. Shareholders incur lower costs of monitoring their agents than they would do if liability was unlimited. If an owner-manager attempted to purchase a company through debt and, possibly, personal wealth, Limited Liability would inhibit potential creditors. They would be unwilling to lend substantial sums of money to an owner-manager who has a small personal investment but may take large risks with the company's money. Failure would leave most of the liability with the creditors whilst success would see the majority of the gain captured by the owner-manager. Even if there were willing creditors available, such bondholders would be likely to impose constraints on the owner-manager's behaviour through the prescription of provisions which would incur costs in monitoring and thereby reduce profits. Also bondholders would be aware that in the situation of a bankruptcy, debt does not have primacy over the assets of the company with the result that they would see a reduction in payoffs because of the existence of other claimants. The outcome of these scenarios is that at the start of the 21st century, the most common form of organisation separates ownership and management which creates a principal-agent relationship.

This fundamental point is picked up by Fama and Jensen (1983) who state (p.301):

we contend that separation of decision and risk bearing functions survives in these organisations in part because of the benefits of specialisation of management and risk bearing but also because of an effective common approach to controlling the agency problem caused by separation of decision and risk bearing functions.

They proceed to illustrate that contracts will specify the decision process for agents, and suggest four steps. Firstly, there is “initiation” when proposals are created for consideration for resource allocation. Secondly, “ratification” when specific choices are made for action. Step 3 is “implementation” when decisions are executed whilst Step 4 involves “monitoring” when measurement of performance and implementation of reward\sanction takes place. The first and third steps are decision management functions undertaken by agents, whereas steps 2 and 4 are decision control tasks taken by principals.

Eisenhardt (1988) picks up the importance of the contract and states (p.58):

the focus of the theory is on determining the most efficient contract governing the principal-agent relationship given assumptions about people (e.g. self-interest, bounded rationality, risk aversion), organisations (e.g., goal conflict among members) and information (e.g., information is a commodity which can be purchased). Specifically the question becomes, “is a behaviour orientated contract (e.g., salaries, hierarchical governance) more efficient than an outcome-oriented contract (e.g., commissions, stock options, transfer of property rights, market governance) ?”.

She explores the two main strands of agency theory in attempting to answer this question. Positivism has concentrated on governance mechanisms in large public companies to solve the agency problem and is achieved by two approaches. Firstly, the use of outcome based contracts. Agents will usually have better

information than principals so it is argued that principals should concentrate on the outcome that they desire which align with their aspirations. A number of different measures are used, examples include specific rise in the share price or market growth. The second approach is the installation of information systems which allow principals to verify agents behaviour. The existence of such information is likely to influence the agent to behave in the interest of the principal.

The principal-agent stream focus on determining the optimal contract under various variables, e.g. risk aversion and, information and outcome uncertainty. The theory suggests that the use of information systems are positively related to behaviour based contracts and negatively related to outcome based contracts. Over time the principal has clear insight into the working of the agent and therefore can more accurately predict behaviour. This explains why outcome-uncertainty is positively related to behaviour based contracts and negatively related to outcome based contracts. Similarly, the length of the agency relationship is linked to whether an outcome or behaviour based contract is used with the latter supporting longer principal-agent working.

To enact an effective contractual arrangement there are two impediments to overcome (Nilakant and Rao 1994). The first is moral hazard which is defined by Holmstrom (1979 p.14) as:

.....when individuals engage in risk sharing under conditions such that privately taken actions affect the probability distribution of the outcome.

Eisenhardt (p.61) defines moral hazard more succinctly as “the lack of effort on the part of the agent, i.e. shirking”. The second impediment is adverse selection or misrepresentation of ability by the agent. Both issues require the principal to configure the contract to ensure that expectations are clear to ensure his/her

interests are met. Kren and Kerr (1993) explain the dilemma faced by the principal. An agent cannot diversify employment risk as easily as the principal can diversify investment risk. This means that as a significant proportion of the agent's compensation is based on performance the agent bears a greater risk and therefore expects a higher total compensation as a risk premium. Because the nature of information asymmetry places the principal at a disadvantage, he/she bears the problem that the agent will avoid the compensation risk to the disbenefit of the principal. Kren and Kerr undertook a study that involved 150 managers employed in various Fortune 500 manufacturing companies. They found that a clear negative relationship existed between behaviour monitoring and the use of performance related pay. In organisations that used little monitoring and focused on outcomes, higher levels of uncertainty were associated with increased use of performance related pay. The opposite was also found in firms with high monitoring, decreased use of performance related pay was associated with large amounts of turbulence.

Weir (1997) illustrates the point that agency theory is not only about the possible non alignment of agents. His research demonstrates that boards with non-executive directors in a clear majority, but of a poor quality and with combined chairmen\chief executive posts were more likely to be acquired as their companies are poor performers. In these circumstances the principals are in a position to put in place effective checks and balances but failed to do so.

Other researchers have demonstrated the validity of agency theory as a concept. Gomez-Mejia et al (1987) studied 71 large manufacturers. They found that in companies with dominant shareholders, chief executive compensation was geared to performance rather than the scale of the operation. These principals were focused on aligning their agents' output with their goal which was to generate a return on investment. The opposite held true in companies with no dominant shareholders where compensation was based on scale of operation and not performance. Abrahamson and Park (1994) examined 1,000 different company

annual reports. They found concealment of negative organisational outcomes. They argue that agency theory was being enacted in their study. Independent agents, i.e. with no personal gain involved, such as outside directors, major institutional investors and accountants, limited the concealment. However, small institutional investors and outside directors who were shareholders encouraged concealment. Also low rates of disclosure of poor performance were associated with subsequent selling of stock by top executives and outside directors.

In the same year Tosi and Gomez-Mejia (1987) studied monitoring and incentive alignment of chief executive compensation. They found that it was greater in owner controlled companies than management controlled firms. In the former there was more influence over chief executive pay by major shareholders and boards of directors whereas in the latter organisations this was not the case.

In a separate piece of research Stroh et al (1996) found further support for agency theory. They studied middle managers across eight industries. They found that when organisations experienced increased uncertainty in their business environment, the proportion of compensation linked to performance increased. Also it was seen that companies who used forms of performance related pay routinely, had a negatively associated long term relationship with their managers. Similarly when there was a greater reliance on behaviour based pay, longer term relationships resulted.

Frey (1993) agrees that monitoring does increase work effort as indicated by agency theory. However, he argues that when there is a personal relationship between principal and agent, monitoring is perceived as distrust and can lead to a reduction in work effort.

However there are critics of the theory. Davis et al (p.24) argue:

the limits and boundaries of agency theory are determined by its model of man. Where individualistic self-serving executive motivation is assumed, shareholders desirous of minimising the risks associated with perceived non alignment of principal-agent utility functions should implement agency prescriptions.... Additional theory is needed to explain other types of human behaviour.

They suggest that stewardship theory is a more appropriate concept when an individual is in tune with organisational values and goals and operates in a cooperative manner. This view is supported by Donaldson and Davis (1994) and Donaldson and Hilmer (1998) who endorse the view that not every human being is self serving and therefore agency theory has its limitations. The choice it is suggested is between extrinsic and intrinsic motivation. Extrinsic rewards are tangible, exchangeable commodities that have a measurable market value. Intrinsic rewards include opportunities for growth, achievement, affiliation and self actualisation.

Perrow (1986) undertook an analysis of agency theory and is quite scathing as a result. He believes that the principal-agent relationship has numerous problems which include cheating, limited information and bounded rationality. His writing argues that there are other models which view human behaviour as more complex, and have greater validity. However Perrow does view agency theory as useful because it does indicate that self-serving behaviour does occur in organisations but, he argues, what is more important is to understand the circumstances under which individuals will maximise their personal utility irrespective of others. He concludes (p. 235) :

we are all agency theorists far more than we think ! Stated abstractly the theory sounds heartless, simplistic, and even pointless, as it assumes that organised social life is nothing more than a series of contracts between people with the resources to pick or choose the contracts they like. But if we reflect on our daily justifications for our actions, we can see that we use agency theory daily to appropriate the gains, and overlook the losses, that attend our efforts.

Hanney (2000) recounts a practical example of personal gain at work in the real world of business. Greg Hutchings was a highly successful businessman who underwent his apprenticeship at the industrial conglomerate Hanson which at the time was one of the most successful UK companies. Hutchings left in 1983 and acquired a small engineering business, FH Tompkins, which specialised in the manufacture of buckles and fasteners. Over the next 10 years he acquired many other businesses including Rank Hovis McDougal (RHM) in 1992 for £958m. Many critics in The City believed that this particular acquisition was a poor deal. It was believed that Hutchings wanted to beat his former boss, Lord Hanson, who was also bidding for RHM. In addition the purchase had to be funded through a £600m rights issue which caused problems with institutional investors who were of the view that a tight rein should be kept on cash resources due to the less than favourable economic environment. This non-alignment of agent and principals' goals finally came to a conclusion when Hutchings was forced to resign as chief executive because of a myriad allegations of corporate excesses. Hanney reports that these included the inclusion of both his wife and housekeeper on the company payroll, as well as concerns over the use of the four company jets and the two flats.

It is clear that agency theory does have a sound basis. It must be seen as a general approach that can be used in various circumstances but is not suitable on all occasions. Eisenhardt (p.64\65) summarises the position of the theory:

agency theory makes two specific contributions to organisational thinking. The first is the treatment of information. In agency theory, information is regarded as a commodity: it has a cost and can be purchased. This gives an important role to formal information systems such as budgeting, MBO, and Boards of Directors and informal ones such as managerial supervision..... A second contribution of agency theory is its risk implications..... The ramifications of outcome uncertainty to their implications for creating risk..... The implication is that outcome uncertainty, coupled with differences in willingness to accept risk should influence contracts between principal and agent.

This leaves the question, is agency theory of any relevance to the public sector in the UK. Shavell (1997, p.55) believes that the principal-agent relationship is relevant to many different organisational settings. In addition to shareholders and management he gives examples as diverse as professional and client, insurer and insured and society and a polluting firm. When thought of in this wider framework principal-agent relationships do exist in the public sector in general and in the NHS specifically. Mayston (1993 p.93) has given the issue some thought and states:

greater credence can be given to the notion that the reforms are attempting to increase accountability to consumers of public services as the new principals for whom the devolved bodies should be acting as agents. However many difficulties remain..... .

4.2 The NHS in 2003

The preceding discussion suggests that agency theory is applicable to the NHS so this section will explore further whether the theory exists within the NHS in

2003. Hoggett (1991) argues:

the centre of the government retains control over key strategic questions such as the allocation of resources to operational units and the framework of financial and personnel rules and performance targets within which devolution over operational matters is allowed to occur.

The legal framework in which the NHS operates is set by the government. The organisational forms that exist have been created via statute at different times. NHS trusts were established in 1991 by the Thatcher administration, and primary care trusts (PCT) in 2000 and strategic health authorities (SHA) in 2002 by the present government. In all cases, statutes were required and defined the responsibilities and powers each organisation were to be given. Clear accountability lines were defined and always led to the DoH and central government. At the time of writing a new piece of legislation, the Health and Social Care Act, is making progress through parliament and will introduce a new organisational form, the foundation hospital.

The use of statutes is much wider and is used for a variety of purposes when the government wishes to enact a policy change but legislation is required to change a relationship between a public body and other organisations, or may effect the rights of individual citizens. An example of the former is that the proposed new act will allow NHS organisations to bill local social services departments when they do not transfer out of hospital someone fit for discharge but not fit to return to their own home. For the latter there has been the creation of the National Institute of Clinical Excellence (NICE). This agency decides which new drugs and treatment should be adopted by the NHS and has, on a number of occasions, excluded drugs and treatments which has denied them to individual patients via the free NHS.

The government has tax raising powers and decides how the gathered monies are to be distributed amongst government departments which in turn have the key responsibility of allocating these resources to various services. The DoH issues annual allocations to the NHS but has always held back monies which government tend to use for various initiatives. The result is that the financial resource, for both revenue and capital, of NHS trusts and PCTs is closely controlled by the government.

Direction of the NHS has been exercised by all governments since the creation of the NHS in 1948 but over the past 20 years the direction has become more detailed and prescriptive. Working for Patients (Department of Health 1989) is an example of this process but has been surpassed by The New NHS, Modern – Dependable (Department of Health 1997) which introduced a new plan for the NHS and spawned many documents on direction so that the NHS is presently attempting to deliver some 400 different targets. Government has the ability to implement fundamental philosophical change as was seen by the 1989 and 1997 documents. The Thatcher reforms introduced competition and an internal market to the NHS. The Blair administration scrapped these arrangements and emphasised cooperation and collaboration. Six years on this government is bringing back competition under the heading of patient choice, and is introducing plurality of provision of delivery of services which include the private sector but still under the NHS.

As governments have made these major changes there has been a growth in monitoring. One of the recognised mechanisms of agency theory that can be used by the principal is to implement detailed performance management systems so as to attempt to align agents with the goals of the principal. Hoggett (1991) argues that performance management systems which include scrutiny, comparative tables of performance indicators including league tables, chartermarks, customer surveys, organisational performance reviews, and performance related pay contradict the notion that the public sector is moving to a more ‘hands off’ form

of organisational control. The reality in the NHS is of monthly, and sometimes weekly, returns to the DoH in great detail. Most NHS organisations undergo numerous inspections every year by agencies empowered by the government to scrutinise the NHS. The performance management burden on the NHS has never been as intensive as it exists in 2003 and confirms the direction of travel noted by Stewart (1992) who talked about ‘the growing burden of central accountability’.

It can be seen that the government controls the legal, financial, direction and monitoring levers of the NHS and is a command and control structure which fits with the principles of agency theory. Mayston (1993) is helpful in confirming who is the principal for the NHS ? He suggest three options.

Firstly, there is the national electorate which uses the formal democratic processes. However even a cursory examination shows that the electorate is not the principal. The Thatcher reforms of the early 1990s were not requested by the electorate and were opposed fiercely by wide sections of society. Currently, the electorate has not asked for foundation hospitals and if the media and opinion polls are correct, many citizens fear the start of the break-up of the NHS. In both cases the government, involving both major political parties, have introduced unpopular policies and used their parliamentary majorities and party political machineries to force through what they believe is right for the country.

Secondly, consumers of the NHS could be the principal. If this is true then the downgrading of Kidderminster Hospital would not have taken place as the local consumers objected strenuously to the proposals when they came forward. The government confirmed the decision with the result that at the 1997 general election the local consumers ousted the sitting member of parliament, who was of the party of the government, and elected an independent member who had campaigned solely on the hospital issue.

Thirdly, Mayston puts forward central government politicians who are in power, as the principal. Evidence from the current passage of the Health and Social Care Act through parliament confirms this suggestion. Opposition to the creation of foundation hospitals is quite strong and similar to the position in 1989 but ministers have used their parliamentary majority to force the proposed bill along the approval pathway and whilst there has been opposition from the government's own party, the government appears to be achieving its aims.

The only conclusion that can be drawn is that ministers are the principal. However at the same time the same ministers are exhorting the NHS to become more accountable to stakeholders. Hoggett (1996 p.17) suggest that there is a 'paradox of a public sector which has apparently been subject both to more centralisation and decentralisation.'. Despite this paradox the NHS has to respond to ministerial exhortations and stakeholders will now be considered.

4.3. Stakeholder Theory

To understand how to address stakeholders an examination of stakeholder theory has been made to see whether it has anything to offer. Examination of the research literature points to Freeman (1984) as the acknowledged initial promoter of stakeholder theory. He argues (p.46) that:

a stakeholder in an organisation is (by definition) any group or individual who can affect or is affected by the achievement of the organisation's objectives.

This definition was thought by some to be too broad and narrower views were published. Clarkson (1984: p.5) said:

voluntary stakeholders bear some form of risk as a result of having invested some form of capital, human or financial, something of value, in a firm. Involuntary stakeholders are placed at risk as a result of a firm's activities but without the element of risk there is no stake.

Rowley (1997) is of the view that whatever the differences of opinion over definition, there is a core which exists. Organisations are required to address a set of stakeholder expectations and therefore how management chooses to meet those expectations is a function of stakeholder influence. He suggests that this key factor can be analysed by examination of two variables. Firstly *density* which measures the number of ties in the network which link actors together. Low *density* is characterised by a bicycle wheel where the spokes, radiating out from the hub, have no direct linkage with each other. The result is that the various stakeholders, represented by each individual spoke, have limited influence as their efforts are not aggregated. High *density* would see direct linkage between many of the spokes without going through the hub. In this case stakeholders can share information and there is a diffusion of norms across the network. The ease of coalition formation leads to strong unified stakeholder pressure which often leads to organisational conformity. Management is forced to be attentive to the needs and actions of stakeholders. The second variable is *centrality* which refers to an individual\organisation's position in the network relative to others. It can be thought of as a proxy measure of power and\or status. The number of ties to other players defines the degree of *centrality*. Rowley suggests that this variable can have two components. *Closeness* defines an actor's ability to access independently all other members of the network. *Betweenness* measures the frequency on which an actor falls on the path between pairs of other players and is good for assessing control of information across networks. High *betweenness* indicates a broker or gatekeeper. From these variables Rowley (p.901) proposes a structural classification of stakeholder influences and the resulting organisational response to stakeholder influence.

Figure 1
A Structural Classification of Stakeholder Influences: Organisational Responses to Stakeholder Pressures

		Centrality of the Focal Organisation	
		High	Low
Density of Stakeholder Network	High	Compromiser	Subordinate
	Low	Commander	Solitarian

Source: Rowley 1977

High *density*\high *centrality* results in a stand-off between a stakeholder network which can easily coordinate its efforts and a company which can control information flows. Rowley (p.901) states the outcome is that:

according to both institutional and resource dependence theories, they assert that firms often engage in negotiations with their exchange partners to reduce uncertainty.

The organisation will appease stakeholder expectations and aim to achieve a predictable environment in which the organisation's actions are not opposed by stakeholders acting together; both parties will compromise. Low *density*\high *centrality* means that the organisation is in a strong position as stakeholders are fragmented and information flows are controlled by the organisation; it will command its environment. Rowley gives the Colombian drug cartel as an interesting illustration of this type of behaviour. High *density*\low *centrality* places the stakeholders in a powerful situation. The network will co-ordinate its activities but the focal organisation is unable to control information exchange. In this subordinate role the organisation has to acquiesce to stakeholder expectations. Finally low *density*\low *centrality* produces a position where

neither party is in control. Stakeholders are disjointed and the organisation masks its behaviour to the external environment. Rowley points out that organisations rarely stay in the solitary stance for long as resources are usually obtained from a variety of external players. He offers NASA in the late 1960s as an example of an organisation that was allowed to focus on its lunar work whilst its reporting duties were removed and thereby NASA was relieved from dealing with demanding stakeholders.

Mitchell et al (1997) developed an alternative method of interpreting the organisation\stakeholder interface. They suggested that defining stakeholder attributes would help in the understanding of relationships. The first attribute is *power* which has varying definitions but can be summarised as the ability to achieve the results that you want and is delivered by access to coercive, utilitarian or normative means. As such access is not a constant which means *power* is transitory and can be won and lost. The second attribute is *legitimacy* which broadly is a principle based on the actions of an individual or organisation that society regards as complying with accepted norms, values and beliefs. *Urgency* is the third attribute which Mitchell argues moves the organisation\stakeholder relationship from a static to dynamic posture. It only exists when two conditions apply. Firstly, when a relationship or claim is of a time-sensitive nature and, secondly, when that relationship or claim is important or critical to the stakeholder. *Urgency* is the degree to which stakeholders' claims require organisational attention. These three attributes are variable and not constant, and exist as a matter of multiple perceptions with the result that they are a constructed reality rather than an objective one. Also an individual or organisation may not realise that they possess an attribute or even if they are aware, may not choose to exploit their position. Managers are central to Mitchell's thinking because their perceptions of stakeholder attributes is vital to the managers' view of stakeholder salience. This suggests that managerial characteristics are a moderator of the relationships presented by Mitchell and his colleagues. The outcome is that they propose different stakeholder types based on different combinations of the three

attributes; the greater the cumulative number of attributes perceived by managers to exist, greater is stakeholder salience.

Latent stakeholders have only one attribute. Dormant stakeholders have *power* as the attribute but lack a legitimate relationship or an urgent claim. Examples include wealthy individuals or entities who have the power to commit large sums of money, or personalities who can influence the media. Managers have to be aware of this type of stakeholder as the acquisition of another attribute would change the position quickly. A good example is employees who are dormant but if fired or laid off, can acquire *urgency* and seek a variety of legal remedies for their claims. Discretionary stakeholders possess the attribute of *legitimacy* but have no power over the firm nor any urgent claim against it. Examples include most forms of corporate philanthropy. Demanding stakeholders have the attribute of *urgency*. With neither *power* nor *legitimacy*, these stakeholders can make a lot of noise but pose little threat to managers. Individual complainants are an example from this heading.

The second category Mitchell calls expectant stakeholders who have a stepped change view of how they should be perceived. They expect to influence the organisation because they possess two attributes, and therefore the tone of the relationship has moved from passive to active. For managers salience has risen from low to moderate. Dominant stakeholders have both *power* and *legitimacy*, and will require attention from the firm. This group includes non-executive directors, significant creditors and community leaders. The dependent heading covers the attributes of *urgency* and *legitimacy* which means that *power* has to be accessed through others. This can be in the form of advocacy or guardianship. When the Exxon Valdez spilt its huge cargo of oil in Alaska many stakeholders had both urgent and legitimate claims but no power over the giant petrochemical company. This was provided by the state government and the courts. The third group have *power* and *urgency* but no *legitimacy* and are labelled dangerous stakeholders by Mitchell. Individuals or groups in this category are likely to use

coercion to achieve their demands. Lightning strikes, employee sabotage, environmentalists occupying sites to prevent construction, and terrorism are examples where dangerous stakeholders have occurred.

Finally there are definitive stakeholders who have all three attributes. To managers there is high salience and will ensure that stakeholder needs are addressed ahead of both latent and expectant stakeholders. The most likely scenario will involve a dominant stakeholder moving to the definitive category. This could be a group of shareholders who see the value of their shares plummeting which generates an urgent claim. Their expectations will be to see the value of their investment reinstated or the managers will face the consequence of dismissal. Mitchell (p.878) highlights actual examples of this situation from the US in 1993. The boards of IBM, General Motors, Kodak, Westinghouse and American Express were all dismissed because managers did not respond adequately or appropriately to their definitive stakeholders. It is possible to acquire the missing attribute and become definitive even if you are lacking *power* or *legitimacy*. For the former the example is the citizens of Alaska who received support and therefore *power* from the state government after the Exxon Valdez disaster. For the latter the African National Congress gained legitimacy by winning free national political elections.

The “father” of stakeholder theory, Freeman (1984: p.62) developed the Stakeholder Grid to analyse the different influences on a company.

Figure 2
Stakeholder Grid

		Power		
		Formal(Voting)	Economic	Political
Stake	Equity	Shareholders Minority Interests		Dissident Shareholders
	Economic		Customers Unions Debt Holders	Foreign Government
	Influencers	Regulators Outside Directors		Government Trade Associations

Source: Freeman 1984

The idea behind the Grid was to allow managers to assess the types of stakeholders with whom they had to interact and the nature of their power.

4.4 Stakeholders and the NHS

In 2003 the government has told the NHS on a regular basis that it must take more notice of and become more accountable to its stakeholders. This section examines in turn eight specific stakeholders with whom all NHS organisations have a relationship whilst recognising that this list is not exhaustive.

4.4.1. Patients and the Public

The most common comment from government is that the NHS must become more accountable to patients and their local communities. These statements are made as if there is one collective group when in fact, there are two different groupings. The challenges of accountability to patients are to understand firstly the use of the word 'accountability', and secondly, how it can be applied to the hundreds of thousands of patients seen by the average district general hospital every year.

The former operates on two levels. For an individual patient the issue is the provision of high quality services which meet the specific needs of each individual patient. It can be argued that such an approach is no different from any service industry organisation. If the patient has good access times for services, has choice about date, time and, possibly, location of care/treatment, has good information about the options for care together with associated risks, and this takes place in good facilities with pleasant, professional staff, it is likely that the patient will be satisfied. At the collective level of patients the issue is about actively seeking out views of patients and then amending services to reflect their views. The context maybe the delivery of an ongoing service or the development of a new service.

The second challenge is how to accommodate the vast number of patients seen by the average hospital. The NHS has begun to understand the various tools which are used by other service organisations, and range from surveys to a representative sample of patients through to focused working groups on specific subjects such as cancer.

The public is not the same as patients as clearly it implies all individuals who live in the local community which is served by a particular NHS organisation.. For many people, particularly aged under 40 , they have had little or no usage of the

NHS as a patient. For others there maybe a significant involvement as a relative or carer of a relative or friend. The NHS needs to engage both groups as their perspective of the NHS will be different than patients.. The mechanisms that are used will be the same as described for patients.

It can be seen that the use of the word 'accountability' by politicians in the context of the NHS and patients and the public is incorrect. Generally what is meant is meaningful involvement so that both groupings recognise that they have an influence. A major difficulty arises when a service or facility maybe lost in order to comply with national guidelines/standards but both patients and the public object. The formal accountability within the NHS will expect compliance but in addition ministers want local involvement and hopefully agreement. This challenge is relevant in many areas of the NHS as managers and clinicians attempt to reconfigure services to meet the needs of the 21st century.

4.4.2 Community Health Councils/Patient Forums

At the time of writing the demise of community health councils (CHC) is imminent. These organisations have existed in every locality to act as the patients' watchdog and have comprised of local councillors, nominations from the voluntary sector and interested individuals. CHCs have had the power to visit NHS premises and produce reports with recommendations for action. Additionally CHCs have had the right to be consulted formally by the NHS on any proposed major service change, and a separate power to refer a change, to which the CHC objects, to ministers. The remit for monitoring the delivery of NHS services transfers to newly established patient forums at the end of 2003. The difference will be that there will be a forum to monitor each NHS organisation whereas CHCs have covered a geographical area. The challenge for NHS organisations is to develop a working relationship which is constructive. There is no formal accountability between CHC/patient forums and the NHS but the latter has responsibilities which it must discharge. These include access to

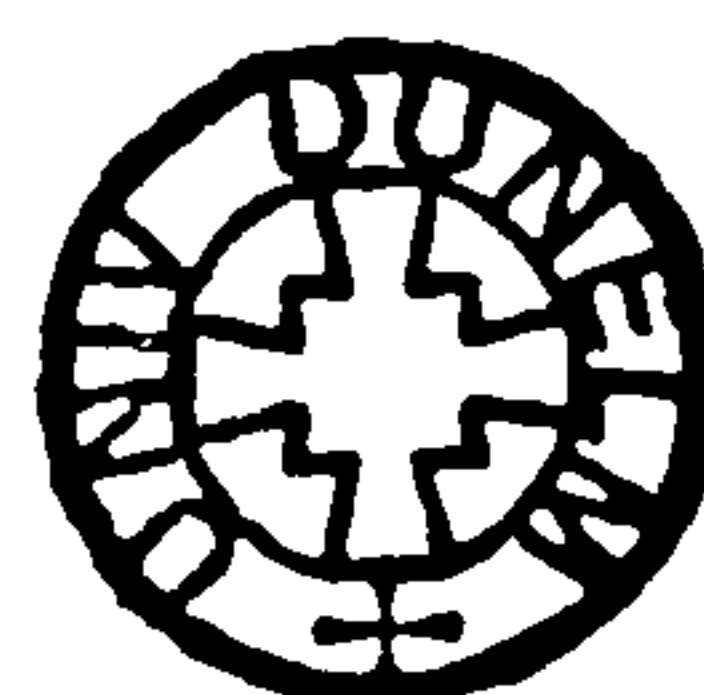
facilities and staff, the provision of information and the consideration of recommendations. If a forum believe that a NHS organisation is not responding appropriately it has mechanisms to engage the senior levels of the NHS and seek redress.

4.4.3 Interest Groups

Such groups come in two broad forms. Firstly, disease or condition based bodies which generally are driven by patients, former patients and carers. Examples include Diabetes UK, the British Heart Foundation, and the Alzheimers Society. Secondly, a response to a proposed closure of a facility or service, or to campaign for the creation locally of a service or facility which does not exist. The first group is relatively easy to engage and usually involves the relevant hospital service taking the lead, e.g. cardiology with the British Heart Foundation. The second group requires a more corporate approach as if common ground cannot be found the interest group will usually seek to involve politicians to support their cause.

4.4.4 Voluntary Sector

In most localities there is a busy voluntary sector where individuals give their time and effort to support the needy in the community. These welfare activities interact frequently with the NHS and therefore the voluntary sector is another stakeholder which seeks to influence the NHS. Usually there is an umbrella organisation locally which attempts to coordinate input to and from the voluntary sector into public services. The key issue for the NHS is to recognise that this stakeholder has a large membership of carers who are a key source of information on the delivery of services. The voluntary sector's common pleas are to be heard and to be involved.



4.4.5 Local Government

Health and social care are interdependent services which means that the NHS and social services need to work together. The challenge is to create a good working partnership when the cultures of the two types of organisation are very different. The NHS is managed by central government and has appointees on its boards whereas local government is locally controlled by individuals elected by local people through a democratic process. These differences can lead to non-alignment of objectives and priorities. An example has been the transfer of older people from hospitals to nursing homes. Whilst in hospital the costs fall to the NHS but once the individual is in a nursing home, apart from self-payers, the costs are a social services responsibility. This has caused friction over central versus local funding. Overall the issue is not one of accountability but of relationships between public bodies.

A new potential tension has been introduced with the demise of the CHCs. The power to review proposed significant service changes has been passed by central government to local government. Each county or metropolitan council has established an overview and scrutiny committee (OSC) to undertake this role. In addition each OSC can review any element of the NHS service in their area and call chief executives of local NHS organisations to appear before them. The government argues that this approach will bring some local democratic accountability to the NHS. OSCs can make recommendations to any NHS organisations and if not satisfied with their response, OSCs can refer issues to ministers. In pure accountability terms OSCs are a process for influence which has the fallback position of an appeal to the NHS principal if necessary.

4.4.6 Trades Union

The NHS is the largest employer in the UK and is an unionised environment. NHS organisations require harmonious relationships with trades union otherwise

unhelpful industrial unrest would impact on the delivery of services. In general NHS organisations are successful in the development of good relationships locally with unions. The difficulties arise when a national stance is adopted by a union which is at odds with government policy.. An example is the attitude of UNISON, the major public sector union, towards the government's private finance initiative (PFI). The opposition is because PFI allows the transfer of public sector workers into the private sector often with lower pay rates and worse terms and conditions than the NHS. In 2001 at Dudley Hospital the union's position led to industrial action over an extended period of time. When such positions occur the local NHS organisation, i.e. the agent, is directed normally by the DoH, the principal, as to what it can and cannot agree with the union.

4.4.7 Other NHS Organisations

The final core stakeholder is other NHS organisations. Within the service there are relationships between NHS organisations, NHS trusts and PCTs but in accountability terms no formal links exist. Both type of organisation are accountable upwards to SHAs but a PCT and its local hospital need to work together to deliver NHS services. In fact there is a co-dependency as the PCT is the main source of funding for the hospital which is the key provider of secondary care services to the PCT's populations. This relationship is increasingly reinforced through common performance indicators so that if one organisation fails on an issue so does the other.

4.3. Summary

The purpose of the first three chapters of this thesis was to establish a conceptual framework of corporate governance. Wessex identified some elements which might be valid in a wider context. Their robustness has been confirmed by an examination of the academic literature but chapter 3 questioned whether there

was a theoretical connection linked with the elements. The exploration of agency theory confirms that such a connection exists and is the underpinning theory for the command and control structure that exists in the NHS. The exploration of stakeholders show that none of them have a formal accountability function with NHS organisations but in every case they seek to have influence through participation. The key issue is that of working relationships which politicians inflate by talking of accountability.

In summary the conceptual framework comprises of the elements of directors and management control, audit committees and conflict of interest, and a theoretical backdrop of agency or theory which is represented by a relationship between different parties including stakeholders. The following cases in section B will be used to confirm or deny the soundness of these elements and relationship and thereby validate or reject the conceptual framework.

Section B

Using the Conceptual Framework to Understand Corporate Governance Failures

Chapter 5.

CORPORATE GOVERNANCE FAILURE IN THE NHS: WEST MIDLANDS REGIONAL HEALTH AUTHORITY

The aim of the second section of this thesis is to use the developed conceptual framework to explore more cases of corporate governance failure both within and outside the NHS. The purpose of stepping outside the NHS is to understand whether corporate governance is a generic concept with nuances that vary when applied to different situations, or does corporate governance in the NHS only apply within that specific environment and thereby mean that lessons cannot be learnt from the wider organisational spectrum. The second case study is another corporate governance failure from the NHS but in a different part of the country to Wessex. This study has been chosen as it appears to have at its heart a separate motivation by key players to that of Wessex and therefore allows a view to be taken as to whether causes of failure are similar or not. The purpose of this chapter is to describe what happened and analyse the causes. The two stage process outlined previously in Chapter 1 is used.

The history and failings of the Regionally Managed Services (RMS) are identified in great detail in the Public Accounts Committee Fifty-seventh Report (1993b) which was published on 27th October 1993. The story contains three separate strands. Firstly a major consultancy contract for the Supplies Branch of RMS, secondly the management buy-out of RMS and thirdly the development of an Electronic Trading System for the Supplies Service. These three issues ran in parallel at the same time and therefore in establishing the chronological order of events it will be necessary to switch between the three as appropriate.

5.1. The Story

The West Midlands Regional Health Authority (WMRHA) was responsible for the NHS at the heart of England. It encompassed the counties of Herefordshire,

Shropshire, Staffordshire, Warwickshire and Worcestershire, with a population of some 5.25m people. In 1994\95 the WMRHA had a revenue budget of approximately £2 billion. The story begins in 1983 when WMRHA established a Regional Supplies Council to improve effective procurement storage and distribution of supplies throughout the region.

April 1986 saw the creation of a Members Panel of WMRHA to oversee the future of a new organisation which would undertake certain functions such as supplies, management services (including computers), blood transfusion and ambulance services. In 1991\92 expenditure was approximately £40m. Chris Watney took up post as Director of RMS in June 1986 and in November of the following year the Supplies Council was wound up and replaced by the RMS Board which was chaired by Mr. Watney.

The mid 1980s was the time of the introduction of general management into the NHS and the need to become more business like. The establishment of RMS recognised that WMRHA operated a number of services which were not central to core activity, i.e. the delivery of patient care, and therefore should be put more at arms length to be run on commercial lines. The Director of Finance for the Regional Supplies Division (RSD) discussed the possible privatisation of the Division with the Regional Solicitor. Four months later Richard Armstrong produced a paper on the possible privatisation of RMS; he was a management consultant who had been brought in as a non-executive director on the RMS Board to coordinate RMS finances. The following month Mr. Armstrong wrote to Richard Branson (owner of the Virgin commercial empire) seeking investment as he stated that the RHA was actively planning to privatise the whole of RMS.

In 1989 the RSD separately began to explore the development of an Electronic Trading System. The aim was to connect all NHS customers, e.g. individual wards\departments within the region to their potential suppliers. This approach was in line with national thinking in the late 1980s and was taking place at the same time as Wessex RHA's RISP. Later that year Chris Watney began a series of meetings with United Research Group (URG) who were a large US

management consultancy. Their discussion was about a contract to establish RSD as an independent and commercially viable operation so that if privatisation occurred then the Division would be in good shape.

December 1989 saw the sale by WMRHA of its Management Services Division which was part of RMS. The deal was a management buy-out for £750,000 and the new organisation was called Quality Assured Business Services (QaBS). The following month Mr. Watney sought commercial advice from a firm of solicitors, Wragges. Their subsequent paper discussed the creation of a separate legal entity such as a public or private company.

URG were awarded a contract in April, 1990 and confirmed in a letter that the contract would cost £1.7m plus expenses and VAT. Four weeks later there was a dinner on 10th May between senior URG and WMRHA officials which included the WMRHA Chairman, Sir James Ackers. The purpose of the evening was to explain the project to the WMRHA Chairman.

Meanwhile the Electronic Trading System had progressed to the point that the Chief Executive of RSD, Mike Winslow, entered into an arrangement in April 1990 with a major computing company to undertake preparatory work on the system. Development started in May.

The autumn of 1990 saw a revolt from the DHAs within the region. As customers of RMS they should have been made aware of the URG contract but were kept in the dark and only discovered the nature and cost of the contract in September. Following representation from DHA Chairmen, the WMRHA Chairman appointed Mr. Carver, Chairman of Wolverhampton DHA, in February 1991 to lead a Review Group on the operation of RSD. On 11th March, 1991, Chris Watney was given an enhanced, new employment contract by WMRHA. Four days later the Carver Report was complete and reported serious failings in the management of the Supplies Service. On 25th March 1991, Sir James Ackers made Christ Watney redundant on the grounds of organisational change. Executive responsibility for supplies was given to the WMRHA Director of

Finance, Martin Davies. On 25th April, 1991, he approved a proposal from URG to provide ongoing assistance. The cost was an additional £44,000 plus expenses.

In September 1991, QaBS went into Receivership. The outcome was that many staff lost their jobs, a month's pay and several months expenses. The following month QaBS was acquired after negotiation by AT&T Istel. The total cost of the WMRHA involvement was £928,000. On 19th September, 1991 the WMRHA Board were informed of the Electronic Trading System Project but not that the scheme had been running for 15 months and had already cost £3.5m. The establishment of the national NHS Supplies Authority led to the halt of the project in January 1992 by which time the total cost was £7.3m.

December 1991 saw a negotiated settlement of URG's bills but the overall cost was some £2.5m and was followed in January 1992 by further expenditure for WMRHA which was not properly authorised, though it did not involve RMS; Martin Davies authorised a loan of £300,000 to Health Management Trust. The purpose was to help FIP Ltd which was owned by the Trust. FIP provided information services to WMRHA and was in financial difficulties. On 7th September 1992, Martin Davies resigned as Director of Finance. The District Auditor became involved in mid 1992 and on 27th October 1992 the Comptroller and Auditor General commented on the various issues in his report of the use of NHS funds for 1991\92. This led to a formal review of WMRHA RMS by the Public Accounts Committee.

5.2. Failings of West Midlands Regional Health Authority

As with the Wessex case the same broad themes emerged and therefore the same headings will be used.

5.2.1. Control of Contractors

The go ahead for URG was given on 4th April, 1990 by Chris Watney and Mike Winslow. On 15th May URG sent a letter to Chris Watney telling him how they would manage the project and what they would charge. The contractor identifies five key activity streams: executive vision development and organisation alignment, core business performance improvement, marketing and customer care development, information systems and best practices, and embedding and reinforcement. The letter went on to say that a joint project team was to be established and would involve four to six full time RSD staff, together with 10 URG consultants. It would be the role of this team to develop the project plan which would define milestones, resource requirements and what is to be delivered (deliverables). Finally the letter laid down the cost structure including the fact that in the first 34 of the 52 week contract URG planned to bill for £1.66m out of the total £1.7m. The letter illustrates a fundamental failure to control URG. Firstly, WMRHA should have been the organisation to write and confirm the details of the contract as the employing authority. Secondly, a significant part of the proposed work of the project team should have been done before the contract was signed as clearly the deliverables and milestones need to be agreed before any contractor can put together a costed proposal. Thirdly, WMRHA should not have agreed to pay money against a payment schedule which was not dependent on achievement of specific objectives. Finally, there was no performance monitoring arrangements agreed by which the employer could satisfy itself that work was progressing as agreed at the start and if not, what corrective action would take place.

The District Audit Service criticised the WMRHA Director of Finance for failing to satisfy himself that payments to URG were reasonable or proper. Over a year WMRHA paid £357,000 in expenses, often without seeing the accounts. The Auditors found a number of areas of concern:

- expenses claimed by consultants included VAT, WMRHA therefore paid VAT on VAT. The result was an overpayment of some £7,000;

- about £8,000 of expenses were not reasonable and included:
 - private charter of an aircraft (£1.138);
 - overstated travel claims (£5,000);
 - drinks at a farewell party (£195);
 - gratuity for waiters (£50);
 - leasing of computers and computer operators in London and kept in hotels in Birmingham;
 - leasing of houses in London for US Consultants and their wives in addition to hotels in Birmingham;
- URG could not provide evidence to support claims of £43,000 with regard to the employment of temporary staff;
- there was an overcharge of £2,100 in respect of professional fees.

Despite objections and queries from the RSD Director of Finance, Chris Watney gave express instructions for expense invoices to be paid. Finally when the contract was complete Martin Davies withheld the final settlement from URG as a number of queries had not been resolved. URG's response was to instruct their solicitors to demand payment. This they did on 9th December 1991 demanding £182,000. Martin Davies negotiated a 10% reduction and accepted the revised offer on 20th December. At no time did he seek legal advice because he thought it would be "fruitless".

The sale agreement of QaBS included a turnover agreement. The purpose of this arrangement was to provide a safety net if the DHAs did not use the computer bureau service as much as the stated amount. The turnover target was set at an unrealistically high level and the auditors believe that WMRHA officers knew that payments would be due to the tune of £1.9m. Also the high levels were set despite predictions in a letter of 21st June 1989 that DHA use of the computer bureau would decline from £3.61m in 1988\89 to £2.04m in 1991\92. The result was that when QaBS collapsed the guarantee payment mechanism had been triggered and cost WMRHA £0.6m. When QaBS went into Receivership in September 1991 the WMRHA faced a number of complications. Firstly, it needed to maintain certain services, e.g. the computer bureau. Secondly, most DHAs had

pre-paid for the bureau services and totalled £0.9m. Thirdly, QaBS still owed the final instalment of £0.15m of the original buy-out. Therefore the WMRHA became involved in the sale of QaBS even though it was primarily an issue for the Receiver and any potential buyers. The WMRHA wanted to protect the pre-payments and include a contract for services with the Authority. WMRHA agreed to a further turnover guarantee in order to sweeten the deal for any buyer. The result was that WMRHA underwrote the entire turnover target of £9.5m in the contract with the buyer, At&T Istel. By the end of October 1992 WMRHA had had to pay out £325,000 and if trends continued would have to pay out £1.5 - 2m for work which had not been carried out.

Development work on the electronic Trading System began in May 1990 based on the original business plan which specified an estimated cost of £4.3m and a delivery date of June, 1992. Sadly this plan was flawed as it was speculative and unrealistic. RSD supplied the contractor with information and the contractor prepared the business plan. In particular no market research was undertaken nor were suppliers consulted even though it was envisaged that 3,000 suppliers would be connected to the system. Potential customers similarly were not consulted and the royalty projection of £3.9m which was to offset the development cost of £5.3m was not supported by any evidence to sustain such a high level. In June 1990, just one month after the formal agreement with the contractor, the Chief Executive of RSD changed the original specification when he asked the contractor to deliver a system with reduced functionality by April 1991 and to carry out work on the Supplies Information System (SIS) which was not part of the original project. This cost in excess of £1m.

With the departure of Chris Watney in March 1991 executive responsibility for supplies was placed with Martin Davies, WMRHA Director of Finance. He signed the contract in August 1991, 15 months after work had begun. The business plan had not been updated despite the fact that it was known that only 11 suppliers had signed up to use the system. Also performance monitoring of the scheme was not possible, nor could the total cost of the system be calculated

because the contract was on a time and materials basis and the RSD kept changing its mind and failed to specify a final delivery date.

5.2.2. Tendering Process

Formal procedures of WMRHA laid down in Standing Orders and Standing Financial Instructions required specific actions to occur when the Authority was to let a contract:

- (i) firstly, before any contract is entered into a written estimate of the probable expenditure is obtained. With URG, work commenced in April before the terms of the contract were known;
- (ii) secondly, competitive tendering is required. Whilst four other consultancies were asked to make presentations the auditors do not consider that there was a serious attempt to compare them competitively;
- (iii) thirdly, if competitive tendering is not used because the proposed service is of a special nature than a formal record of the decision should be made. A limited file note was made in URGs case but it was not signed;
- (iv) fourthly, any contract over £5,000 should be set out in a formal document under the seal of the Authority. There was no formal document with URG but a letter from them setting out their conditions. If a document had been sealed then there would have been a better chance of the WMRHA knowing of the £2.5m contract.

The sale of the Management Services Division (MSD) of RMS was overseen by a WMRHA Negotiating Group which comprised of four WMRHA Directors and two DHA General Managers. They were assisted by Evershed and Tomkins (solicitors) and Peat Marwick McLintock (financial advisors). Their initial process was that WMRHA issued a press release in December 1988 announcing the intention to allow a management buy-out of MSD. A number of private sector companies stepped forward and declared an interest in buying MSD. The Negotiating Group agreed that all interested parties should be allowed to submit offers for MSD and therefore relevant information and a memorandum of sale

were issued. However, all private sector companies declined to make an offer. Peat Marwick McLintock identified two main areas of concern for these organisations. Firstly, the predicted use of the computer bureau was outlined in the received information however no turnover guarantee was on offer as it was to QaBS. Secondly, the liability of potential redundancy for transferred staff who were protected by TUPE. The result was a lack of a level playing field for all potential bidders. Whilst the TUPE issue was a matter of employment law the turnover guarantee was purely a WMRHA decision which the auditors believe to be ultra vires. On 12th July 1989 the WMRHA resolved to accept the offer for MSD subject to agreement on outstanding issues. The WMRHA established an Executive Sub-Committee of the Chairman and two Members to action this decision. No working papers or minutes of this Sub-Committee have been found.

Work commenced on the Electronic Trading System in April 1990. The anticipated spend in that year was £1.4m. There was no competitive tendering process for this project, nor for the additional work on SIS. No document was placed on record as to the reasons for single tender action nor was there a contract under the seal of the Authority at the start of the project. Fifteen months later on 16th August 1991 the WMRHA Director of Finance signed a contract by which time £3.5m had been paid to the contractor. In addition the contract was weighted against WMRHA. Royalties were to be a key component of the funding of the overall project however the contract provided for royalties to be paid on the sale and use of version 1.0 of the system. By August 1991 this version was obsolete. Despite concerns being expressed by officers of RSD to their Chief Executive and recommendations that legal advice be sought, no evidence could be found that these concerns were passed on to Martin Davies.

5.2.3. Conflict of Interest

The PAC Report comments on and notes a number of interesting relationships but stops short of stating that conflicts of interest exist. They have been placed under this heading as in its broadest definition no public servant should place themselves in a position where it may be perceived that a conflict of interest may exist.

The consultancy firm PM Vignoles Associates had a major involvement in the affairs of RSM:

- Philip Vignoles introduced Chris Watney to URG who had agreed to pay Mr. Vignoles an introductory fee if the meeting led to any business. As a consultancy contract resulted Mr. Vignoles was paid £78,380 by URG;
- Philip Vignoles provided the off pay-roll appointments of two members of staff for RSM, Peter Gibbs and Julia Berridge;
- through MMM Consultancy, Mr. Vignoles provided the pay-roll appointment of the RSD Chief Executive, Mike Winslow and another member of staff, Mike Hurt;
- Philip Vignoles assisted with the MSD buy-out which became QaBS
- Mr. Vignoles regularly visited all parts of RSM to discuss business opportunities. Staff felt obliged to see him as Chris Watney was encouraging them to see Vignoles.

It is clear that Chris Watney and Philip Vignoles had a business relationship outside the NHS. Of note:

- Chris Watney was a director of the firm Laureat Search. Philip and Lucy Vignoles were also directors;
- when Chris Watney left WMRHA there was a cocktail party at Birmingham Botanical Gardens. Laureat Search organised the event and paid the £500 bill;
- Chris Watney carried out consultancy work for the firm Whisstocks whilst employed by WMRHA. The Chairman of Whisstocks was Philip Vignoles who stated that the work was in respect of advice given on organisation, marketing and purchasing. He had been assured by Chris Watney that the WMRHA Chairman had given specific approval for him to undertake outside work; Sir James Ackers denies such approval was given. Mr. Watney was paid £200 a day for 20 days;

- Chris Watney spent one day per week in London and claimed to be conducting research on behalf of WMRHA;
- in February 1991 Mr. Watney travelled to Germany and France. It was believed that he was visiting firms with whom the RHA did business. It was established that this was not the case but Chris Watney claimed he was visiting new firms which could not be disclosed because of confidentiality.

5.2.4. Poor Management Control

The establishment of RMS was a recognition by WMRHA that there was a need to understand its core and non-core activities. The mood of the Thatcher Government was that the public sector should be more business like particularly in non-core areas. The appointment of Chris Watney was designed to pursue that agenda. However it was clear from an early stage that Chris Watney was actively exploring the privatisation of RMS even though there was no clear WMRHA policy to do so. The reality was that WMRHA wished to have stronger and more commercial management but with its own WMRHA Members Panel.

On 1st April 1987 the Regional Supplies Organisation moved from joint WMRHA\DHAs funding to a purely WMRHA managed service as money was withdrawn from the DHAs to establish the service. There was recurring funding of £6.1M but for the first three years of its existence there were growing deficits of £0.629M (1987\88), £1.219M (1988\89) and £2.078M (1989\90). These deficits had been supported by non-recurring funding in each year, contrary to WMRHA policy. During this time £1.1M savings from reductions in stock-holdings had been realised but not passed on to the customer DHAs which should have occurred under the RMS\DHA agreements. Also Chris Watney made £2.5M of funding available to RSD from other regional services. Whilst this allowed an overall balancing of RMS budget it implied that DHAs were being overcharged for other regional services, and occurred at a time of steeply rising charges in MSD. In addition Mr Watney levied £75,000 from DHAs to support his own organisation, this was in clear breach of the agreed principles of funding Mr

Watney's core organisation. These issues did not come to light until the Carver Report was submitted in early 1991, by which time the WMRHA Director of Finance had had to agree to loans totalling £3.7M to cover deficits in RSD for 1990\91 and 1991\92.

In November 1987 Mr Watney recommended that the Regional Supplies Council be abolished. In its place there should be a Regional Supplies Board which would be a mechanism similar to other parts of RMS. This proposal was agreed and Chris Watney became its Chairman. Its purpose was to establish supplies policy and to oversee the management of RSD. The Members Panel was left to keep an overview of the operation of WMRHA services. However the lack of any terms of reference meant that it could not function as the supervisory body between the WMRHA Board and the Director of RMS. This led to confusion whereby the WMRHA Board expected the Panel to control Chris Watney but the Panel thought it was a sounding board. Mr Watney did not report to the WMRHA Board but to the Regional General Manager, Ken Bales. The results were that Chris Watney ignored the Panel, the Panel was ineffective and the WMRHA Board was ignorant of what was happening in RSD.

In the pursuit of making RSD more commercially viable Chris Watney sought outside appointments for the chief executive and other senior staff in RSD. Between February 1989 and October 1990 the Director of RMS appointed three consultants on contract to fill NHS posts. Their salaries were £60,000 per year each, plus expenses against an equivalent salary for regional NHS staff of £40-45,000. It was agreed that high calibre staff were not available within the NHS. Whilst the use of consultants with scarce skills is not uncommon within the public sector, break or review points are normal to protect the employer. In this case the consultants had 12 month notice clauses in their contracts. It is clear that not all members of the RSD Board were aware that expensive consultants were occupying permanent NHS posts. Early in 1992 with the creation of the National Supplies Authority WMRHA terminated the contracts. By that time £410,000 had been paid out in fees and expenses to which a further £100,000 was added after a negotiated termination settlement.

The fiasco of the URG contract demonstrates poor management control. There was no clear WMRHA policy being followed by Chris Watney who appeared to do whatever he wished. On 31st January 1990 URG made a presentation setting out the scope of the project and possible cost to some members of the Supplies Board. Present were mainly executive directors with the exception of Malcolm Cooper, non-executive director and Frank Betteridge who was Chairman of the Members Panel. On 4th April a final presentation was made to a slightly different group with Mr Cooper being joined by fellow non-executive director Colin Jackson, and Dr Lloyd, Panel Member, joining Mr Betteridge. One hour after the meeting Chris Watney and Mike Winslow gave URG the go ahead despite the fact that the WMRHA Board knew nothing of the proposed £2.5M contract. On 10th May at a Dinner with URG Chris Watney and Frank Betteridge were joined by Sir James Ackers and Martin Davies. URG advised the auditors that the meeting was to meet the WMRHA Chairman, to outline the cost and seek assurances that Chris Watney had authority to proceed. Sir James Ackers recalled afterwards that he had not been advised that a firm agreement had been made. Martin Davies thought that only work on a scoping study had been done despite the fact that URG's invitation to dinner identified that a project had started with RSD. When the Director of Finance did become aware of the contract he voiced some concerns about some aspects but never reported his doubts to the WMRHA Board. The resultant contract was woolly and imprecise with no performance targets which left the WMRHA exposed and liable to large payments without recourse.

The employment of Chris Watney has an interesting history of its own. He was appointed on 2nd June 1986 with a salary of £27,421 and notice period of 12 weeks. After several national pay awards he reached a salary of £32,250 in February 1988 when he was offered a rolling 3 year term with a review every 12 months. The contract was performance related and pensionable but with no entitlement to pension enhancement. No external financial interests would be allowed and unsatisfactory performance would be grounds for action under the WMRHA disciplinary procedures. Mr Watney received national pay awards and performance related pay in both 1988 and 1989. However during the summer of

1989 he sought to increase his remuneration package to approximately £50,000 back dated to June 1989 and discussed the matter with Sir James Ackers and Frank Betteridge. In March 1990 Sir James offered a package of £41,069 to reflect Mr Watney's responsibilities. This did not meet Chris Watney's expectations and he arranged to see the WMRHA Chairman. Following advice from the Director of Personnel and a meeting with Mr Watney, Sir James informed Chris Watney on 6th June 1990 of three steps to bring his salary to £51,266 in September 1990. The first step was a new base salary on creation of the new RHA in July. Second a performance related pay increase on 1st September and third an increase of 8% for general managers' pay. The package was not backdated and Sir James asked for agreement or that Mr Watney should seek alternative employment; Mr Watney accepted. It is clear that these arrangements are inconsistent with the national scheme of employment which governed Chris Watney's terms and conditions of his contract, and therefore should not have been agreed.

In January 1991 Chris Watney enquired about pension arrangements and was told by the Director of Personnel, Mr Nock, that under the conditions of his fixed term contract, he was not entitled to enhancement of pension in the event of redundancy because it was balanced against the two years notice of his contract. On 12th February Mr Nock told Sir James Ackers that Chris Watney was looking for a redundancy\early retirement package, and raised the issue of no pension enhancement under the fixed term contract. Mr Nock also raised the question of lowering Chris Watney's performance rating, which was then the highest at Band 1. The outcome was that Mr Nock wished to explore with Sir James two points. Firstly the possibility of moving Chris Watney to a new contract which would allow pension enhancement and secondly reducing the performance rating to Band 2 or even Band 3. On 11th March 1991 Chris Watney signed a new contract which was permanent not fixed term. It had a notice period of six months and allowed pension enhancement if the individual was made redundant. This management action is incredible when it is remembered that the Carver Review into the RSD was underway at this time and in fact reported to Sir James Ackers only four days later on 15th March 1991. In addition for the Director of Personnel

to suggest downgrading a performance rating by two levels is an indication that all was not well. Also the Comptroller and Auditor General has discovered that there was no need to engineer a device to enhance Mr Watney's pension. Technically if Mr Watney was made redundant he had a statutory right to a pension irrespective of his contract. Therefore WMRHA did not in effect improve Chris Watney's position.

On 25th March 1991 the WMRHA Chairman saw Chris Watney and informed him that he was being made redundant on the grounds of organisational change. Based on figures supplied by the Industrial Relations Manager, Mr Aldworth, and the Payroll Manager, Miss Fox, Mr Watney accepted a severance package of:

- £19,962 - redundancy sum;
- £8,170 per annum - immediate pension;
- £24,510 - lump sum settlement.

Three days later Mr Aldworth and Miss Fox informed the Director of Personnel that significant errors had been made in the calculation. The proper sums were:

- £7,408;
- £6,458 per annum;
- 19,374.

The WMRHA Directors of Finance and Personnel decided to honour the original offer and though the Regional General Manager was made aware of their decision he chose not to overrule it. Mr Watney was advised orally of the revised package on 26th April 1991 and in writing on 2nd May 1991. The package had been adjusted because of the mistake but the overall effect reflected the original agreement. The final offer was:

- £6,462 per annum - immediate pension;
- £19,387 - lump sum;

- £20,142 - redundancy payment;
- £12,876 - payment in lieu of notice;
- £28,982 - special payment to compensate for the pension calculations.

This final payment is ultra vires as there is no provision within NHS regulations to make such a payment. Also the redundancy payment was incorrect. The outcome was an overpayment of £41,500. Both the Industrial Relations Manager and the Payroll Manager were severely reprimanded, and Mr Nock received a formal warning. No action was taken against any other person even though the WMRHA Chairman was not made aware of the mistake or the decision not to correct it, until much later. In the light of the concerns about the RSD following the Carver Report, it is amazing that disciplinary action was not taken against Chris Watney, instead he pocketed some £80,000 and a pension.

This review of the WMRHA RMS has illustrated a number of questionable decisions made by Martin Davies, Director of Finance. In particular the authorisation of loans and the signature of contracts for multi-million sums without the knowledge of the WMRHA Board. On 7th September 1992 Mr Davies resigned with an agreed package from the WMRHA. He received six months pay in lieu of notice and two months untaken leave as due to the exceptional workload Mr Davies had throughout his appointment, he had had to bring forward 29 days from four previous years. The RHA was willing to make full recognition of this untaken leave. In addition Mr Davies had been awarded £6,222 payable in equal monthly instalments though his settlement included the full 12 months. In total he was paid £42,924. Also as part of the deal Martin Davies was allowed to use his lease car for a maximum period of eight months from 1st September 1992, which cost the RHA some £3,000. There were two important non-financial aspects of the termination agreement. Firstly, it contained a “silence” clause, which limited any public announcement by either party. Effectively a short joint Davies\WMRHA statement was issued which stated that Mr Davies was leaving to pursue his professional interests after a significant contribution from him to the RHA. The aim of this clause was to curtail any

excessive comment on his departure. Secondly, the WMRHA agreed to help Mr Davies seek alternative employment, without guarantee, and to commend his candidacy for other NHS posts in the region. When the WMRHA was challenged by the NHS Executive over this package, it was argued that it was in everyone's best interest to secure Martin Davies' departure swiftly and on a voluntary basis, and thus avoid costly, contested disciplinary action. This is an incredible position to adopt when by September 1992 the URG, Electronic Trading System and QaBS chickens were all coming home to roost, and in all cases the Director of Finance had a major role.

Separate from the activities of the RMS in January 1992 the Director of Finance made a loan of £300,000 to the Health Management Trust (HMT) which was a registered charity. It owned the right to licence ex-crown copyright products. The loan was to assist a HMT company FIP Ltd which was in financial difficulties. This loan was made without the authority of the WMRHA Board and was beyond the powers of the Director of Finance.

The sale of MSD had a number of issues which fall into the category of poor management control. Firstly, the financial basis of the organisation was not known. In 1986\87 the trading result is shown as break even in the business plan but the Director of Finance shows a surplus of £1.132m with several other interpretations found in various documents. The same is true for 1987\88 and 1988\89. How can an organisation be sold unless you know its financial state? Similarly the figures were not complete as they did not include all the indirect costs that a commercial business occurs such as superannuation contributions and financing of working capital. These costs have been estimated at £1.41m. When added to the best interpretation of the trading results, MSD made a loss of over £0.25m in 1986\87 and over £0.85m in 1987\88. If pessimistic figures were used the losses over the three years were £1.41m, £1.5m and £0.76m. These figures together with the proposed turnover guarantee should have rang alarm bells that WMRHA was liable to large financial risk. In addition the Negotiating Team failed to undertake a critical analysis of the business plan. If they had done so the QaBS marketing strategy would have been exposed. It intended to generate 40%

of its income from non-NHS sources within five years. The rationale behind the strategy was very simplistic as it was based on the notion that the external market was huge and QaBS only needed a small proportion to be successful. Yet their pricing strategy was bizarre as they intended to charge existing customers an extra 10% in real terms and in future consultants would be charged out at £1,700 per week rather than the existing £650. All of this information was available but senior management failed to carry out a thorough analysis before jumping to a decision.

The Electronic Trading System failings have been mainly covered elsewhere but the overall poor management control can be summarised as:

- no WMRHA Board approval;
- improper letting of contracts;
- non-viable business plan;
- inadequate management control of the project.

5.3.5. Agency Theory

Examination of the WMRHA case using agency theory shows that a principal-agent relationship existed on two levels. The WMRHA was the agent and the DoH was the principal acting on behalf of the communities of the West Midlands. On the next level down the WMRHA board was the principal and its staff, including its non-board senior managers, were the agents. A clear failure to align the goals of principal and agent has been demonstrated at both levels, and the issue of moral hazard is seen at the second level as a number of key players appear to have no interest but their own. The literature in chapter 4 pointed out that poor board control leads to difficulties which was the case with WMRHA.

When the stakeholder perspective is taken it can be seen that there were significant stakeholders with an interest. In particular the various NHS organisations who were dependent on the delivery of services from RMS for which they paid inflated prices, and the staff who were transferred into the private sector. Applying Mitchell's (1997) classification, as explained in chapter

4, is helpful as these stakeholders are discretionary because they have the attribute of legitimacy. As problems developed they became dependent stakeholders through the acquisition of urgency. They had to exercise the power attribute through others but in the end they exerted a significant influence..

5.3.6. Summary of Failings

The District Auditors summarised the failings of the WMRHA as follows:

- Top Management

There was no clear strategy document and therefore it was difficult to monitor directors' activities against WMRHA objectives. Leaving the Director of RMS to his own devices was a major failing of responsibility. Throughout the PAC Report many individuals at the WMRHA are mentioned on numerous occasions however the Regional General Manager, Ken Bales, appears to be absent from any involvement in the whole RMS affair. As the senior executive he was responsible for the overall operation of the RHA but allowed the Board to be kept in the dark, did not control the actions of directors, and failed to see that Standing Orders and Standing Financial Instructions were followed. Whilst the Director of Finance was engaged in the various projects he failed to exercise the responsibilities expected of the senior finance professional of a public body. He and the other directors were all guilty of failing to report irregularities to the WMRHA Board.

- Management Controls

Many did not work such as the Members Panel and there was no delegated scheme of authority for officers to understand their boundaries. Projects were dependent on business plans which were poorly appraised. Standing Orders were largely ignored and NHS rules were contravened.

- Financial Control

This was below the standards expected of a public body. The RHA made internal loans of some £7m to RSD, which has now been taken over by the NHS Supplies Authority, and is unlikely to be recovered. WMRHA awarded major projects of more than £8m without competitive tendering, with more than £4m spent before formal contract arrangements were in place

- Communication

The external world lacked confidence in WMRHA to manage its affairs. Information was not shared with DHAs and led to the Carver Review at which time the costs of URG emerged. Internal communication was equally inadequate with concerns not being listened to and many individuals were in the dark as to the exact position with projects on which they should have been informed

5.4. Summary of the Case Study

The Wessex study in chapter 2 had at its heart the well meant intention of delivering innovation to the NHS. The West Midlands study, whilst another example of corporate governance failure from the NHS, has at its roots malfeasance and personal gain. Despite the very different underlying causes in the two substantial corporate governance failures the outcomes are similar with the elements of accountability, directors and management control, audit committees, and conflict of interest prominent as causal factors. For sometime the command and control system of the NHS failed to function and WMRHA as a principal did not control some of its agents. Agency theory have been found to be useful in understanding what took place with key theoretical components demonstrated in the WMRHA case study.

Chapter 6.

CORPORATE GOVERNANCE FAILURE IN LOCAL GOVERNMENT: WESTMINSTER CITY COUNCIL

To obtain an alternative perspective on corporate governance failure, the third case study remains within the UK Public Sector but uses the high profile local government scandal of Westminster City Council. The steward and principal perspective in this study is different than the NHS. Local Government is closest to the historical origins of stewardship with councillors elected as stewards by the local community which is the principal. Both the purpose of this chapter and the mechanism for its delivery, remain the same as for the two preceding NHS studies. The source of information for this case is not a select committee report but a large multi-volume public audit report published by the District Auditor who for Westminster City Council was Deloitte and Touche, one of the UK's major audit companies.

6.1. The Story of Westminster City Council

In the summer of 1984 a discussion paper was considered by the Majority Party (Conservative) group on the Housing Committee. The subject was the possibility of increasing sales to council tenants. The group decided not to pursue extension of the Designated Sales scheme which was a policy where a Council owned dwelling in designated blocks was not offered for reletting when it became vacant but was offered for sale to an approved applicant. The intention was that all dwellings in designated blocks would become owner occupied

The Local Government elections held on 8th May 1986 dramatically changed the political composition of the Council. Conservative seats fell from 43 to 32, Labour gained from 16 to 27 and 1 Independent remained; the overall majority reduced to four. Following these elections all Councillors were issued with a Members Manual dated 1986. It made clear that Council services and facilities

were available to support members in their official Council duties and not political activities.

Over the next couple of months the leadership of the Majority Party began to examine the social mix of certain electoral wards and how it might be possible to skew housing policy which would favour the Tory Party. For example at a working lunch on 30th June 1986 one of the topics was “Economic justification for Gerrymander on housing” (vol 4 para.23). On 4th July 1986 the Leader of the Council received briefing notes on Council House and Flat Sales, Purchase of Flats in the Private Sector and the Private Rented Sector. On 10th July 1986 a paper “Policy Coordination and Implementation” was presented to the Chairman’s Group and recorded the process for controlling policy. The Deputy Leader was to clear all reports going to committees and sub-committees at draft stage. He was to decide which items were to be referred to the Chairman’s Group who, in turn, would decide which items went to the Policy and Resources Committee.

The Director of Planning and Transportation invited four consultants on 11th July 1986 to bid to undertake a study of housing and economy in Westminster. Councillor Kirwan, Chairman of the Housing Committee wrote to the Leader on 18th July 1986 expressing major concern at the crisis of housing homeless families. Referrals and temporary accommodation costs had risen dramatically over the recent five years. More accommodation was vetoed by the Leader as was buying out tenants as they were more likely to be Tory supporters. Kirwan recorded that members must meet with officers so that they could receive advice on what legally was possible.

On 7th August 1986 Councillor Lady Porter wrote to the Secretary of State for the Environment and asked for a change in homelessness legislation. She cited the fact that 67% of available family lettings in Westminster Borough had gone to homeless families and therefore the Council’s ability to help many other more deserving families was now affected. Around the same time the four consultants submitted their proposals for the housing study. The following month PA

Cambridge Economic Consultants (PA CEC) were recommended for appointment after a report to the Planning and Development Committee.

On 6th September 1986 the Majority Party held a Saturday seminar at which the Housing Committee Chairman presented a paper. The recorded objective was (Vol 4 para.59):

to ensure that as far as possible, Westminster's housing policies achieve the type of social and economic residential mix that will enable us to retain control of the Council in 1990 and help us to retain the Conservative majority in the parliamentary seat of North Westminster.

The paper went on to indicate that there should be a change of emphasis with more concentration in the marginal wards.

On 24th September 1986 the Housing Committee was informed of the ongoing rise in the number of referrals made to the Homeless Persons Unit. The Committee resolved to request an additional allocation of £1.52m but also asked the Director of Housing to conduct a review of the home ownership policy with a view to expand the existing programme. PA CEC were appointed by the Council to undertake the economic and housing study on 24th September 1986.

A senior management conference for the top 70 Council officers was held on 25th November 1986. Councillor Kirwan announced that the Council was to adopt a policy of selling Council properties in marginal wards in order to boost the Conservative vote. In the last quarter of 1986 and the early part of 1987 the leading members of the Majority Party debated proposals drawn up by Councillor Segal with the aim to implement new approaches to housing to boost the Tory vote. At a Housing Committee meeting on 11th February 1987 a report drew attention to the rising demand from the homeless such that 512 homeless households were in temporary accommodation of which 312 were in hotels. Because of the backlog of cases the Director of Housing was given authority to

offer local housing against an agreed set of criteria.

The preliminary finds of PA CEC were given at a weekend conference on 14th\15th February 1987 at which the leading Tory Councillors and the Managing Director of the Council were present. On the following day the Policy and Resources Committee approved a “Quality of Life” initiative and allocated bids of £1.75m revenue and £3m capital for 1987\88. The aim was to launch a package of initiatives designed to improve the quality of life in the Borough. The same month new Housing Policy papers were written and identified opportunities in eight key wards, with a stated target of “more electors” to be included on the February 1990 electoral register.

On 18th March 1987 the Director of Housing wrote a briefing note for the Council Leader. It clearly identified that the Council had net 1066 property vacancies to be filled each year. If the proposed sale of all vacancies in the key marginal wards took place, then only 567 would be left. This figure would be insufficient to cover the Council’s obligations such as the Homeless Persons Act. He argued that a policy change would be required to mitigate the problem, e.g. reduction in assistance to non-statutory groups. Legal advice was sought which was explicit in the need to justify in full any policy change to be defensible under legal challenge.

At a Majority Party seminar on 21st March 1987 Councillor Kirwan tried to change the proposed new approach to housing policy in light of statutory duties and the lack of justification as the PA CEC study did not provide such support; she was ignored. A series of questions were sent by the Leader’s Office to the Director of Housing and the City Solicitor who in his evidence to the District Auditor stated that the questions caused him to “smell a rat” and to send a “forthright” reply (vol 4 para.90). He was asked about the conflict with statutory obligations, the legality of the proposed policy, the possibility of surcharging and whether any issue was ultra vires.

At the Housing Committee on 1st April 1987 a possible barter deal between the Council and a developer was discussed for the Walerton\Elgin ward. This area was not one of the key 8 wards and the Leader expressed concern at the proposed loss of 256 properties and the adverse impact on the Council. However as the scheme would not impinge on the gentrification project the barter deal was agreed. The same meeting called for a report from the Director of Housing to put forward proposals to increase designated sales from 10 to 250. Despite the reservations of the Housing Department a paper was prepared for the Chairman's Group in May and Counsel's advice sought on the legality of the proposed scheme of capital grants. One of the outcomes was that a revised higher figure than 250 was agreed to ensure that 250 sales per year in the key marginal wards were achieved without appearing to target these areas specifically.

On 13th May Councillor Lady Porter was re-elected as leader of the Majority Party despite the election being contested by Councillor Kirwan. At this time a group of senior officers met to consider the issue of homelessness in the Borough. They concluded that some 600-700 permanent homes were required for the homeless for the Council to meet its statutory duty. On 11th June 1987 the Leader of the Council appointed new Chairman, Councillor Hartley, and Vice Chairman, Councillor Dutt, to the Housing Committee.

Further Counsel's advice was taken in June on draft reports on designated sales and housing priorities which were due for presentation to the Housing Committee in July. These reports indicated that there would be no adverse impact on statutory obligations because of the proposed extension of the designated sales programme. Also the financial implications of the sales would be broadly neutral, the reports did not contain an option to increase sales by 500 per year, nor was there any proposal to make capital grants of £15,000 to tenants to encourage them to buy non-Council property.

Lady Porter held a Strategy Weekend on 13th\14th June with members but with some senior officers present. In a paper "Building Stable Communities" it was emphasised that certain marginal wards required special attention and in her

“Setting the Scene” paper the Leader pointed out that the electoral register for the 1990 election would be compiled in 2 years time. Several days later the draft report for the Housing Committee on home ownership was amended to include an option to increase designated sales to 500 per year which when examined by the City Treasurer indicated significant financial cost to the Council.

On 2nd July the local Housing Department wrote to the Department of the Environment with regard to homelessness. The Council requested permission to be allowed to start a major property acquisition programme outside the Borough for homeless people as the Council was to pursue a home ownership agenda within its boundaries. The Housing Committee on 8th July 1987 considered the reports and the Majority Party produced a list of properties proposed as candidates for designation for sale to achieve a level of 500 sales per year. After the debate the Committee divided along party lines with the Majority Party winning the vote 7 to 5. In addition to agreeing the expansion of the designated sales, the Director of Housing was authorised to select purchasers against a list of criteria, and a capital grant scheme of £15,000 to encourage tenants to purchase non-Council property was agreed. A separate agenda item authorised the Director of Housing to use a specific list of priorities for the allocation of properties. The following week the Director of Social Services responded to a draft report on placement of homeless people in accommodation outside the Borough. His view was explicit that temporary accommodation had a significant adverse effect on families with subsequent impact on various Council services.

At the end of July the Department of the Environment wrote to the Council and gave a cautionary comment on the legality of the capital grant scheme. Around this time the Chair of the Westminster Council Tenants and Residents Committee wrote to all Councillors to place on record their opposition to the sales programme which was being rushed through without proper consideration and with total disregard to statutory obligations. At a full Council meeting on 29th July the Minority Party attempted to overturn the Housing Committee decision but it was defeated in a vote. However Appointed Members Panels of the Housing Committee and, of the Policy and Resources Committee were asked to

examine the financial implications of the new housing policy; they met on 2nd September 1987. At this meeting officers reported that discussions with Department of the Environment were not encouraging on the issue of restrictions on resale prices. This would have allowed the Council to impose restrictions in resale prices of property originally sold under the designated sales programme thereby keeping prices at an affordable level for individuals who otherwise would not be able to buy in the Borough. The fear was that companies would buy up properties as transient accommodation or the properties might go as holiday homes, but officers confirmed that ministerial consent was not required for the Council to impose clauses in sale contracts for resident owner occupiers.

The papers of the meeting show that the anticipated cost of the new housing policy would be £1.2m (1987\88), £4.4m (1989\90) and an increase of £1.6m for each succeeding year. In addition officers recommended the purchase (up to £2.5m) or rent (£160,000 per year) of a building to become a Home Ownership Centre for the Council. At the same meeting the joint meeting received a report on temporary accommodation for the homeless. It highlighted the fact that more than 1500 homeless households were temporarily housed in the Borough by other Councils. Therefore it was argued that there was now a need to house some of Westminster's homeless outside the Borough. The report went on to point out that under the law permanent housing of the homeless must be deemed to be "suitable", this did not apply to temporary accommodation. Members were asked to approve recommendations in the report as a further report on permanent housing for the homeless would be forthcoming in the future. The Panels reconvened on 4th September 1987 when officers' recommendations were approved by a majority of two to one in both cases. On 21st September the Council received a response from the Department of the Environment which indicated that a large scale programme of home acquisition outside the Borough for the homeless would not be supported; each case would have to be considered on its own merits.

29th September saw the production of the first monitoring report of Building Stable Communities (BSC). Clearly, identified are the 8 marginal wards with

their monthly sales target, actual sales and cumulative sales. Further reports followed such as 3rd November. Later that month PA Cambridge Economic Consultants were appointed to advise and monitor the Council's initiative on BSC, and on 26th November 1987 a memo was written to a senior officer in the Housing Department and highlighted the urgent need for four-bedroom accommodation as 11 families were waiting at a cost of some £5,500 per week in bed and breakfast. At the same time the Borough had a number of voids in suitable accommodation but they had been designated for sale.

In December a report entitled Zoned Improvement Patrols (ZIP) Teams was produced by Councillor Davis. It proposed enforcement action teams to target specific problems in the implementation of BSC. The proposal was agreed. The following month, at an informal meeting of chairmen, it was agreed that production of the Council's Ratepayer Reporter should include supplements on two further marginal wards following the recent supplements on two other marginal wards.

The beginning of February saw receipt by the Housing Department of a letter from the Department of Environment who advised that restrictions on the resale of properties intended to keep the price at a reasonable level could not be supported.

A paper called "Keeping Westminster Conservative" was prepared in March for the Leader of the Council. The eight marginal areas were referred to as "key battle-zone wards". On 17th March 1998 the Council's Managing Director received a letter from the Leader of the Opposition. Councillor Dimoldberg accused officers of allocating resources to key wards when there was no apparent justification for their selection other than for a party political purpose of the Majority Party, a full explanation was sought. The response by Bill Phillips refuted the allegations completely, however the Leader of the Opposition rejected his answer and demanded facts not assurances.

April saw several meetings of different individuals to firm up the monitoring arrangements for Building Stable Communities and included detailed proposals with regard to the designated sales in the key marginal wards. The District Auditor (vol 4 para.585) notes that the targets for new residents in the eight wards were the same as the targets for more electors as considered at a political meeting of the Majority Party the previous month. Around the same time an Action Plan was established for the BSC project but the City Solicitor questioned on several occasions fundamental issues such as the existence of a strategy document and if so had it been approved by the Council. On 24th May 1998 the Policy and Resources Committee met and on the agenda was an officers' report and recommendation to approve a Corporate Policy Statement for Building Stable Communities which should then be taken into account by all Service Committees when directing their activities. The report made no mention of the targeting of eight key wards, the role or existence of a BSC Officers' Steering Group or of the BSC Members' Steering Group. A week later at a meeting between the Deputy Leader and officers on 31st May 1998 progress of the designated sales in five of the eight wards was reviewed. It was found that Little Venice and Victoria would achieve a projected surplus by 1990. The result was that priority was given to Cavendish, St. James's and West End as they had projected shortfalls. Correspondence had continued between the Council's Managing Director and the Leader of the Opposition over a period of some months. The former indicated that nothing improper had occurred whilst the latter continued to press for information on the designation of eight key wards.

In the middle of June a draft report was prepared for the Chairmen's Group by the BSC Officers' Steering Group. It stated that in addition to Victoria and Little Venice, Hamilton Terrace, Bayswater and Millbank were no longer a problem but there were still difficulties in the other three wards. On 21st June the Leader of the Opposition wrote again to the Managing Director and accused Council officers of serving the political purposes of the Majority Party. The same letter was sent to all chief officers. On 1st July Councillor Bradley (Minority Party) wrote to Bill Phillips to express his concern that the Millbank Ward insert to Ratepayer Reporter did not fulfill the objective of public service information but

had a political basis. He also observed that the four inserts prepared so far were Cavendish, St. James's, Hamilton Terrace and Millbank, four of the key wards. The City Solicitor reminded the Managing Director that a selective approach to the dissemination of information must have a rationale and not have a party political consideration. At the end of July the Director of Housing met with the Housing Committee Chairman and produced an action list which included "find defence of eight wards". Further political activity took place over the next month with the result that on 5th September the Director of Housing was asked by the City Solicitor to explain why the eight wards were chosen, by whom and why were they regarded as "key". At a meeting of the BSC Members Committee on 8th September there was a report entitled "Key BSC statistics for the Four Stress Wards" which referred to West End, Victoria, St. James' and Cavendish.

The Borough's Managing Director received a memo on 12th October from one of the Divisional Directors of Housing. It pointed out the ongoing issue of a lack of temporary accommodation for the homeless. At that time the Council was housing 350 families in hotels both within and outside Westminster. The memo went on to highlight the deteriorating situation as the Council reduced its stock of permanent accommodation through sales. Later that month the Director of Housing and the City Treasurer proposed to the Housing Committee an expansion of the sales and administrative capacity of the Council to promote the right to buy and flexible ownership. The report went to the Policy and Resources Committee on 17th October and extra spending was agreed; it amounted to £278,000 in 1988\89 and £882,000 in 1989\90. On 24th October the Director of Housing was reminded that he had not responded to the issues raised by the Leader of the Opposition. He replied that he had nothing further to add.

Monitoring of BSC continued and from notes of an informal meeting of Chairmen held on 20th December the Leader of the Council asked for congratulations to be given to those staff who were responsible for exceeding the right to buy target. It was noted that there was now scope to increase the target further to 1000, but designated sales was less satisfactory and voids needed to be filled. The start of 1989 saw Councillor Legg, Chairman of Finance Management

and Personnel Sub-Committee receive a note from the Assistant City Treasurer. It reported difficulties with the Housing Committee finances due to the designated sales policy. Rent losses were £646,000 in that year and £558,000 for 1989\90. In addition £20,000 per year would be lost for heating charges. Also the cost of securing properties for designated sales had increased from an estimate of £425,000 to £1,025,000 and would increase further to £1,046,000 for 1989\90. On 24th January the Chairman's Group considered the issue of homelessness. It was noted that whilst costs had been reduced by £2.3m over 2 years, they had been more than offset by other factors such as increased priority to medical cases. The Group agreed to de-designate family flats of 4 bedrooms or more and develop options to increase the provision of temporary accommodation. The latter decision was followed up on 14th February 1989 when an informal meeting of Chairmen approved direct leasing of properties and asked for more information on vacant sites inside and outside the Borough for portakabin schemes. The day before, 13th February, had seen the approval by the Policy and Resources Committee of a Code of Practice for Management by Officers and Members.

By May the informal meeting of Chairmen had considered a business plan for homelessness. It included the possibility of moving homeless families into short life property owned by the Peabody Housing Association in Victoria and Millbank wards. This offer was some three months old and the Opposition were challenging the reasons for not taking up a competitive proposal which would save £7,000 per homeless family. The Housing Chairman agreed to prepare an operational plan for use of the temporary accommodation. Contemporaneous notes indicate that the preference was to use housing association voids in "non key wards in WCC" and "our voids - outside marginal ward. Use them all ASAP".

On 10th May the Director of Housing wrote a personal and confidential memo to the Managing Director. It recorded the fact that there would be a recurring £1.8m shortfall in the budget due to the designated sales programme and the rising levels of homelessness. The latter had been estimated at 750 families for the first

6 months of the year, reality was 825. The memo advised that both the financial implications and the long term prospects of temporary accommodation were poor. It was suggested that the City Solicitor should be consulted as to whether Counsel's opinion should be sought. Written instructions were requested from the Managing Director on the matter of homelessness. The Housing Committee met on 5th July and should have considered "Supply Allocation of Rental Housing 1988\89" and "Homeless Persons Review" but ran out of time. The former report was referred to the Director of Housing for decision in consultation with the Committee Chairman whilst the latter report was deemed to be noted. However two days later Councillor Coleman wrote to the Chief Assistant (Housing and Social Services) with written representations about the two reports in accordance with the Council's Standing Orders. The basis of the representations was a failure to carry out Committee decisions, i.e. annual reviews of the designated sales programme, failure to draw attention to the serious financial implications of the rising levels of homelessness and failure to ensure that the Council met its statutory obligations. Councillor Coleman informed the Director of Housing that he would be objecting to the District Auditor that unlawful expenditure had been made from the Council's 1987\88 accounts. The formal objection was made on 17th July 1989. On 19th July Councillor Patricia Kirwan, former Chairman of the Housing Committee, took part in a *Panorama* television programme about Shirley Porter. In effect she agreed that the Conservative Party in Westminster was using the designated sales programme to maintain their position in power.

Counsel was given instructions on 21st July 1989 to advise on the Council's designated sales programme. He responded that the Director of Housing's intention to submit a report to the September meeting of the Housing Committee was advisable. The Committee was to be invited to review the programme and consider whether a policy change was required, having taken all circumstances into account. On 23rd August 1989 the District Auditor wrote to the Managing Director of Westminster City Council and requested the documents that had been referred to in the *Panorama* programme.

Between that time and the meeting of the Housing Committee on 28th September 1998 there were a number of consultations by the Chief Officers with Leading Counsel who declared that he was broadly happy with the draft report on Review of Home Ownership. At the meeting the Committee ran out of time and Standing Order 30 came into effect. The report on Review of Home Ownership was referred to the Director of Housing for decision after consultation with the Committee Chairman. However the Director of Housing decided that the matter should be resolved by members and did not approve the report. Further Counsel's opinion was sought and appended to the report which was represented to a special meeting of the Housing Committee on 30th October 1988. The Committee resolved to reduce the scale of the designated sales programme.

The result was that Councillor Coleman made further submissions to the District Auditor to support his Objections. The Managing Director responded to the allegations with letters dated 27th November 1989 and 1st May 1990. In all cases the Council rejected the allegations of unlawfulness. On 25th January 1990 Mr. Hilditch, one of the Objectors sought leave for Judicial Review but it was refused by the High Court on 12th February and at the Court of Appeal on 14th June 1990. The latter Court was of the view that an investigation by the District Auditor was more appropriate. Over the next six months the District Auditor reviewed the documentation held at City Hall and obtained preliminary legal advice. Over the next two years he carried out a range of interviews and pursued requests of the Council for further documents. The initial round of interviews involved 44 individuals and 56 meetings. The first quarter of 1993 saw a second round of interviews which involved 29 individuals seen over 47 meetings. From the information that was gathered the District Auditor's team searched a large number of Council offices and storerooms. John Magill records (vol 1 para.26) "significant new documentation, previously undisclosed was obtained in the course of this search for documents". Further interviews followed with the final tally reaching 135 and involved 50 individuals. The District Auditor notes that his investigation was hampered by a number of events:

- the shredding of documents by Mr. Phillips, Managing Director on leaving the Council at the end of 1990. Some of these documents were found in the offices of other senior Council officers;
- the inability of the Council to locate a number of documents;
- the disappearance of the working papers of two senior members of the Policy Unit;
- the disposal by the Leader of the Council after she ceased to be Leader, of papers which was relevant to the Inquiry;
- the delay by the Council in the provision of certain documents. In some cases not until 1993;
- difficulties in organising interviews which in some cases led to the use of the District Auditor's formal powers under the 1982 Local Government Finance Act which can require individuals to attend;
- the provision of inaccurate and sometimes misleading information by the Council and interviewees.

On 13th January 1994, the District Auditor issued formal Notices to 10 individuals. It informed each person that the Auditor was considering whether to surcharge the sum of £21.25m on the grounds of willful misconduct. The group of 10 included Shirley Porter, four other Councillors, the Managing Director, the Director of Housing and three other officers. At that stage the provisional view was that formal audit action was not required against 18 other individuals, and the overall aim was to allow those at risk to make representations to the District Auditor. An audit hearing sat on 32 days for the period 19th October 1994 to 7th February 1995. Written and oral representations and evidence was taken from the Objectors, the Respondents and from the Council. The District Auditor's findings were published in May 1996. He found six individuals guilty of willful misconduct and included Shirley Porter, two Councillors, the Managing Director, the Director of Housing and one other officer. The calculated loss to the Council was over £31.6m. The following year an appeal against the surcharge was heard at the Divisional Court with the result only Shirley Porter and David Weeks still faced the surcharge. They pursued a further appeal to the Court of Appeal which

decided in their favour in April 1999 by a majority of 2:1. Henderson (1999) reported that the sales policy was deemed lawful. The dissenting judge indicated that he would have reduced the surcharge to £7m. Because of the significance of the ruling, counsel for the District Auditor was given instant leave to appeal to the House of Lords. This will mean that the legal costs to the taxpayer at the end of the process will be some £10m and the saga will have dragged on for 12 years. Gibb (2001) reported that on 13th December 2001 the appeal was heard by five law lords and found in the favour of the District Auditor. The outcome was a reimposition of a surcharge of £26.5m on both Dame Shirley Porter and David Weeks. John Magill is quoted as stating:

I am, of course, delighted that the House of Lords has confirmed the decision of the High Court. Both courts unanimously concluded that the facts that I unearthed were the truth and that Dame Shirley Porter and David Weeks had lied to me in attempting to cover up their activities. The judgement also confirmed that their conduct in using council resources to achieve party political advantage was disgraceful and that they should be surcharged £26.5m

6.2. Failings of Westminster City Council

6.2.1. Conflict of Interest

This case is littered with examples of conflicts of interest of which a flavour is given below.

Council members are elected by their local communities to operate their local authority to provide a range of services to local people. This is supposed to be undertaken in an apolitical way in regard to the implementation of policy. The politics arise with regard to the policy on a particular issue. For example it is acceptable to have an Education Policy which involves selective schools such as

Grammar Schools, so long as the access to that service is not confined to certain parts of the community. In Westminster's case, the policy of selling Council properties to tenants was a reasonable political stance and had been enacted in many other Councils in England. However, the conflict of interest arose when implementation of the policy excluded large parts of the Borough and it was clear that the exclusion was for narrow sectional interests. During late summer of 1986 the Policy Unit of Westminster City Council produced a paper entitled "Homelessness\Gentrification" which defined gentrification (vol 4 para.43) as:

.....it is ensuring that the right people live in the right areas. The areas are relatively easy to define: target wards identified on the basis of electoral trends and results. Defining 'people' is much more difficult and is not strictly Council business.....

At a meeting of the Chairmen's Group on 27th January 1987 Councillor Segal presented his paper on "Home Ownership Proposals". It stated (vol 4 para.131):

the short term objective must be to target the marginal wards and, as a matter of utmost urgency, redress the imbalance by encouraging a pattern of tenure which is more likely to translate into Conservative votes.

The following month work was done within the Housing Directorate on extending the designated sales scheme to marginal wards. This piece of work originally identified nine such wards; Churchill, Victoria, St James', West End, Millbank, Cavendish, Little Venice, Bayswater and Maida Vale. This list was amended by the members of the Chairmen's Group in March. Churchill and Maida Vale were omitted from the final list and Hamilton Terrace was included (vol 4 para.153). At a senior management conference on 25th November 1986, held at the London City YMCA, the top 70 Council Officers were told by the then Chairman of the Housing Committee that the Council would have a policy of selling council properties in marginal wards so as to boost the Conservative vote. She later confirmed on a *Panorama* programme in July 1989 that the

designated sales programme had the political goal of maintaining the Conservative Party in power in Westminster.

The Chairmen's Group met on 16th November 1986 and received a report of the Committee of Inquiry into Conduct of Local Authority Business (the "Widdicombe Report"). The recommendations of the Widdicombe Report and a paper from the Council's Chief Executive entitled "Conventions Governing Relationships between Members and Officers". The Chief Executive reminded members that (vol 4 para.105):

Council stationery and photocopying, dispatch and postal facilities, wherever provided, are available to provide support to members of the Council. However, in making use of the facilities, members must take account of the distinction between their official duties as Councillors and their wider political role. These services are provided to assist members in the performance of their official Council duties and with constituents' casework. Party political activity and campaigning fall outside the scope of official duties and do not qualify for the use of Council facilities; nor is it appropriate for Council stationery or postal facilities to be used to indicate the party allegiance of any member or group on the Council.

This relationship was well understood by the Leader of the Council who in response to a question from an Opposition Councillor at a Council meeting on 10th June 1987 responded (vol 4 para.301) "as the member well knows, Council facilities must not be used for party political purposes".

Under the Housing Act 1985, the Council had a statutory duty to house homeless people. As early as 18th July 1986 the Chairman of the Housing Committee, Councillor Kirwan, wrote to the Leader of the Council and said on the subject of Homeless Families. "we are rapidly reaching crisis point". Despite such warnings, the Council pursued its right to buy scheme and set designated sales

targets. The following year, Councillor Kirwan was ousted from the Housing Committee after which no politician raised the issue of a conflict between a political policy and the statutory duty to the homeless. This was despite the fact that evidence continued to mount that the Council had a growing homeless problem. On 13th June 1989 the Director of Housing updated the Informal Meeting of Chairmen on the key housing issues (vol 4 para.745). “The number in temporary accommodation is 761, of which 328 are assessed and awaiting rehousing”. Two weeks later the same group were informed that by April of the following year, it was anticipated that there would be 600 families in temporary accommodation, assessed and awaiting rehousing. Despite further discussion in July, the notes of the meeting on 18th record under the heading of “Homelessness” that “home ownership policies remain unchanged” (vol 4 para.760).

Role confusion was a significant issue for senior officers of the Council. Their normal role is to advise Councillors on the options and consequences during policy development and to implement policy when approved through the formal governance process. They are analogous to Civil Servants and should be apolitical so that they can work with Councillors of any party. In the Westminster case there is clear evidence of some officers acting as political agents of the Conservative Party. For example at the meeting of the Chief Officers Board on 18th September 1986, amongst a number of items for discussion there were “Opposition Communications” and “4 Year Strategy”. On the former, the advice was not to give any information unless legally obliged to do so and if necessary use delaying tactics. On the latter, chief officers were told to “use Labour job adverts to see how the Opposition is thinking” (vol 4 para.71). Other examples are not hard to find. On a briefing note prepared by PA CEC, the Director of Housing wrote against households rehoused as homeless, “don’t want this kind of people - is this politically defensible.....” (vol 4 para 90). In January 1987 the Director of Housing wrote on a memo “? approx 2K voters” (vol 4 para.120) when referring to homeless families. In March, the same chief officer wrote to the Council’s Managing Director outlining a device whereby the Majority Party could raise designated sales as a topic at the Housing Committee without opening

the whole issue to debate by the Opposition. In fact he proposed a political tactic to the advantage of the Conservative Party and used the term “smokescreen” (vol 4 para.204). On 3rd August 1987 at a working lunch which included a number of papers, the City Solicitor made the following notes on his copy of the paper, “BSC targets” (vol 4 para.437):

this paper should not have been produced by an officer. Much more subtle approach required. This paper shows officers working for a Tory victory. I am troubled by the appearance of this paper.

A Chairmen’s strategy weekend was held in early May 1988. Clearly a political function, it was attended by a number of officers who also presented papers. The Director of Housing suggested the way forward for the right to buy, designated sales and assisted purchases. It included “designating other estates in key wards ?” (vol 4 para.603).

The Council produced a publication called the Ratepayer Reporter which was an apolitical vehicle for giving information on Council services to the local community. The Majority Party decided to place inserts into the Ratepayer Reporter and target the key eight marginal wards so as to promote the right to buy scheme. The Acting Head of Press and Public Relations wrote to the Council’s Managing Director on 9th December 1987 and pointed out that the Council’s City Solicitor had given clear advice. Firstly, all wards needed to be covered so as to avoid the possibility of political bias. Secondly, there should be a sound reason of the ward profiles as they would take time and money to produce. Thirdly, why Cavendish and St. James’ wards (two of the key eight) should be the starting point. The note goes on to point out that the Council’s services were not provided on a ward basis and therefore this approach would be new and cost £5,000 for each of the 23 wards. Despite these concerns the inserts proceeded and in January 1988 the Chairmen’s Group decided to target Millbank and Little Venice (two more of the key wards) for the next edition. It was recognised that profiles would have to be prepared for Opposition wards, but a Conservative Party newssheet would be circulated at the same time. At an Extra-Ordinary Council meeting on

2nd March 1998 in response to a question from the Opposition on which areas were to be included in the Ratepayer Reporter, Councillor Porter replied (vol 4 para.550) :

the special inserts in the last edition of the Ratepayer Reporter were aimed at wards where particular Quality of Life schemes are being undertaken. No decision has been taken yet about which wards will be dealt with in this way in the future.

Throughout the late 1980s, the Council took legal advice from Queen's Counsel (QC) on their Housing Policy. Mr. Sullivan QC made it clear at a consultation between himself and several officers on 5th May 1987 that electoral marginality of wards was not a proper basis for selecting properties for inclusion in the designated sales programme. Housing and planning grounds would be more appropriate and saleability would be acceptable. The Barrister was informed that justification of the new policy of increased designated sales could be found in the PA CEC report. However he was not told of the conclusion to a Housing Department paper which stated (vol 4 para.239):

the PA report suggests a need to supplement the rented supply. There is nothing in the PA report which at the moment would justify a designated sales programme.

Based on the information given, Mr. Sullivan advised that there may be a lawful basis for the increase in designated sales. In addition he advised that the Council set aside housing stock for the homeless so as to not breach statutory duties, but this did not mean that if homeless families were housed in temporary accommodation for longer periods before being rehoused permanently, statutory duties would be breached. Basically the impact on the homeless because of increased sales was a matter of judgement and he did not advise that statutory duties discharge could be balanced against the wish to increase home ownership. He advised officers to prepare a report which laid out all the pros and cons of any policy and which contained all relevant considerations. It was agreed that a draft

report would be submitted to Mr. Sullivan for review. Following various drafts, draft 4 was forwarded for Counsel review in early June 1987. In summary the reported stated:

- extension of the designated sales programme would have no impact on discharge of statutory duties to the homeless;
- the financial impact of sales in revenue terms would be broadly neutral;
- there was no option of an increase in designated sales by 500 per annum;
- 638 units of accommodation would be set aside for housing the homeless in 1987\88.

The report made no reference to any proposal to make grants of £15,000 to Council tenants to allow purchase of non-Council property. There were also other material difference between this draft report and the final version at the Housing Committee at 8th July 1987. Whilst Mr. Sullivan received new instructions on 3rd July 1987, they did not include approval or advise on the final report, nor did they draw attention to the differences between draft four and the final version. A consultation took place on 6th July 1988 which also involved Mr. Wilkie QC who acted as Junior Counsel. It appears the consultation was in a rush over the lunch period and no formal note of the conference can be produced by the Council. On 22nd July 1987 Councillor Killick, a member of the Majority Party, spoke with the City Solicitor on whether a target of 500 sales per year would compromise delivery of statutory duties. She was told that Counsel's opinion was that they were alright. Clearly Mr. Sullivan was unaware of the 500 target and could not have given this advice. Councillor Kirwan was also concerned and asked the Chief Executive on 23rd July 1987 about the legality of the report on the Housing Committee agenda for 29th July. At that meeting the Opposition challenged the process used by the Majority Party in particular the fact that Counsel's advice was some months old and did not include key issues, such as the sales target of 500 per year. Also on that day, the Leader of the Council wrote to her Party's Members and stated "..... our legal advice is that policy is completely judge

proof". This was Mr. Sullivan's view on 5th May but only based on the information that he was given and if his recommendations were followed. Further advice was sought from Mr. Wilkie on 9th May 1989 with regard to homelessness. At the same time a detailed report had been prepared for the informal meeting of Chairmen on that day. The District Auditor recorded the note made by the Council's Managing Director (vol 4 para.734) "don't go to Counsel - he'll want everything in the report". This suggests that information was being kept away from Counsel to avoid the Council being given advice contrary to their goals.

The Housing Committee met on 5th July 1989 and considered a report entitled Homeless Persons' Review. The report did not highlight Counsel's advice on the statutory duty to homeless households and the information available at that time to the Chairmen's Group which showed that such households exceeded the available supply. Neither did it mention the consequences, financial or otherwise, of this position. On 19th July 1989 the *Panorama* programme about the Leader of the Council was shown. The comments of Councillor Kirwan provoked much activity from the Opposition, such that the Council sought legal advice from Mr. Sullivan. However, over the next three months as his services were used, he was only given parts of the picture. For example on 12th October 1989 he was given instructions which included extensive documentation. Amongst the paperwork was "BSC Campaign - Plan for Action" which was undated, but had been produced in summer 1987. The profiles of the eight key wards which accompanied the document were not supplied to Mr. Sullivan and he was told it was not a Council document, even though it had been produced by the Head of the Policy Unit, working to the Managing Director, and with assistance from various directorates of the Council. Overall Counsel was used to provide advice that backed up the Majority Party's position. Unfortunately this was achieved by the partial provision of information or misleading Counsel.

On 28th May 1987 a meeting was held to discuss the creation of Westminster Housing Trust (WHT). Present were the advisor to the Leader, Richard Loftus, the Managing Director, the City Solicitor and the Divisional Director of Housing (Private Sector). A paper written by Mr. Loftus suggested that the Trust would

provide sensibly priced, middle-market affordable residential accommodation. The WHT would have to be established as a non-profit making Trust to develop and sell residential units and the Trustees would need to be of unquestionable status, but politically cooperative. The Council would transfer freeholds of its land bank or other empty sites in the key wards to WHT. A file note made by the City Solicitor records (vol 4 para.278):

Mr. Loftus accepted that the role of the Housing Trust was not strictly necessary and that its intervention was purely to sanitise what might otherwise appear to be politically motivated decisions.

By 10th June, the Director of Housing had prepared a paper on the creation of WHT and sought the City Solicitor's views. This led to the Chairmen's Group considering a strictly confidential paper on 29th June. The Head of the Policy Unit then produced in the next week a Next Steps paper which outlined that an organisation separate from the Council was required. The paper was considered by a mixed members and officers group who agreed that 'planning gain should be used to achieve more residential accommodation of the right sort' (vol 4 para.361). Further meetings were held in July and of note is the fact that both agenda and minutes were annotated strictly confidential. A review meeting of progress was chaired by the Deputy Leader on 19th November 1987. Notes of the meeting record (vol 4 para.509):

24 sites have been identified, seven of which were in target wards.....it was agreed that sites in target wards should always receive priority, but that sites in other wards should not be disregarded. In addition planning gain residential accommodation would be another source for the Trust.

By the following year the Opposition had become aware of the development work. Councillor Coleman wrote to the Managing Director of the Council in April and asked for details of all discussions, copies of all papers and information on any unminuted meetings. In addition he wanted to know which Majority Party

members were involved. Mr. Phillips responded on 5th August 1988 and implied that a couple of Conservative Councillors had been exploring an idea and some officers were informally investigating the feasibility of such a scheme. If it looked possible, then a report would go to the Housing Committee. On 11th August, Mr. Sullivan QC advised on the establishment and funding of WHT; his advice was pessimistic. September saw a situation report on WHT which identified the advantages and disadvantages. It concluded that good stage management would be required to maximise the former and minimise the latter. A strategy weekend produced a set of actions agreed by an informal meeting of Chairmen. It included “WHT continue with it”. That is what happened until the Opposition made its Representation. However at that stage the Managing Director wrote to the Director of Housing in terms which can only be described as covering his back, despite the fact that he had been involved in most of the key meetings (vol 4 para.790). Officers expended considerable energies in the pursuit of an approach to housing policy which had not been debated, let alone agreed within the Council’s formal decision making procedures. Whilst in the early days, it could be argued that a possible innovative idea was being explored, two and a half years after WHT was first raised, the Housing Committee was still unaware of the proposal.

6.2.2. Management Control

Following the election in May 1986 the Majority Party decided to review its policies. Part of this work was to undertake a housing and economy study in Westminster. On 30th June 1986 the firm Jones Lang Woolton were consulted about this work. A revised brief for the study was the result a few days later. On 11th July 1986 the Director of Planning and Transport invited proposals from four consultants to carry out the study as the Council’s Planning and Transport Committee had approved the work. In fact the Planning and Transport Committee Appointed Members Panel did not meet until 22nd July when approval was given, the budget was £30,000. In August following presentations to a group of Members and officers a report was prepared for the Appointed Members Panel. It recommended the appointment of PA CEC and was agreed at

the start of September. On 15th September there was a meeting with the consultants and involved both senior officers and politicians. Further work followed at officer level, however it was not until 29th September 1986 that the PA CEC was formally appointed by the Council to undertake the study. The report went through various draft stages and was submitted in April 1987. However PA CEC's lead consultant Victor Housner continued to be involved with the Council as it developed its BSC programme from the study. On 2nd October the Managing Director advised the Leader that there was work for Housner who was offering 120 days time at about £285 per day (vol 4 para.489). This proposal was worth in excess of £30,000 and was not an extension of the original study. No other consultants were given the opportunity to bid for the work nor was the expenditure approved by any Council Committee until it went to the Planning and Development Committee on 17th November.

On 23rd April 1987 the Home Ownership Team Leader, Garry Peltzer Dunn wrote to the Department of Environment (DOE). The letter went over the issues of right to buy schemes and it acknowledged that normally a tenant could purchase their existing property at a discount up to a maximum of £35,000. However, Westminster City Council wished to offer vacant properties to tenants under the same terms and conditions as if they already occupied the property (vol 4 para.224):

in an attempt to increase home ownership and at the same time maintain letting stock, the City Council formally requests authority to undertake sales on a like basis in respect of the disposal of vacant flats to existing Westminster City Council tenants, without the necessity of granting a tenancy of the vacant flat to the tenant prior to disposal.

Two months later on 23rd June 1987 the DOE responded that their legal department were of the view that the Council could proceed and special consent was not required. This advice appears to have been accepted and acted upon by the Council. Further correspondence took place with the DOE at the beginning of

July. The Head of the Director of Housing's office wrote on the subject of Homeless Persons. The letter enclosed a copy of a report on the expansion of home ownership to be considered by the Housing Committee in the following week. It was argued that due to the scale of homelessness in the Borough and the fact that other London Boroughs used a lot of accommodation within Westminster, designation of Council property for sale would require alternative solutions to the homelessness issue. Therefore the Council wished to embark on a significant property acquisition programme outside the Borough. Ministerial approval was sought for this action. The letter stated specifically "the City Council therefore as a matter of urgency wishes to....." (vol 4 para.349). In reality the matter had never been placed before the Council and therefore had never taken the decision to pursue an acquisition programme. The decision had been taken by the Chairman's Group at its meeting on 29th June 1987.

The Housing Committee met on 8th July 1987 and discussed an agenda item entitled "Review of Home Ownership". As part of the review the paper discussed the problem of ensuring that property that was sold remained at affordable levels when resold in the future so as to allow other first-time buyers to benefit. The fear was that prices would escalate as companies bought the properties for transient accommodation or individuals would buy as holiday homes. The report recommended that officers take up the issue with the DOE so as to create a scheme which delivered the Council's aims. This action was agreed by the Committee. The Home Ownership Project Leader wrote to the DOE on 17th July 1987 and sought agreement to three key proposals. Firstly, that clauses would be inserted into the lease of property for sale to stipulate that the accommodation must be the owner's sole or main home. Secondly, it was proposed that the resale price be restricted to 70% of open market value in perpetuity. Thirdly, the Council wished to make available capital grants of £15,000 to Council tenants who wanted to buy a property on the open market. The DOE replied on 27th July 1987 and whilst sympathetic to the aim of increasing home ownership to the less affluent, expressed reservations and put forward three alternatives. They argued that the ceiling of 70% represented shared ownership as the purchaser would only be buying 70% of the equity of the property; the options addressed this problem.

The DOE passed back the issue of capital grants and stated that it was for the Council to decide whether they could proceed legally under the Local Government Act 1972. They advised that the Council should consider whether such a policy would be open to all residents or some individuals.

This cautionary advice was never passed on to the Council or any meeting of the Housing Committee. This omission is remarkable in that as the absence of the legal clauses and price cap had been described by officers (vol 4 para.412) as “the major difficulty which the Council faces in securing its long term objective to retain affordable housing in the City.....’. In addition only four days after the DOE letter, the Director of Housing wrote to the Chairman of Millbank Estate Leaseholders Association (vol 4 para.434):

the DOE has not yet reached a final decision on the Council’s proposals for limiting the sale of flats purchased by non-tenants. Once DOE decision has been received it will be reported to the members of the Housing Committee.

Towards the end of September 1987, the DOE replied about the Council’s proposals to commence a major property acquisition programme outside of Westminster. In general the response was unsupported as blanket approval for an unspecified number of purchases would not be given by Ministers. Also Local Authorities are normally expected to address homelessness issues from within their existing housing stock. In October 1987 the Council went back to the DOE and sought a review of their position on the proposed restrictions on the resale of properties. A response dated 2nd February 1988 made it clear that the DOE could not support the Council’s proposals. The receipt of this letter was never reported to the Council, any Committee or Sub-Committee.

On 2nd September 1987 a joint session of Appointed Members Panels of the Housing and the Policy and Resource Committees, met to consider a report entitled “Home Ownership Services”. Within the report there was a section on temporary accommodation for the homeless. It concentrated on the Council’s

statutory duty to house the homeless and pointed out that “suitable” accommodation applies to permanent housing whilst it was wished that temporary accommodation would meet this standard as well. The report informed members that future reports would address the provision of permanent housing for the homeless. No such report was ever presented to an Appointed Members Panel or the Housing Committee.

At the meeting of the Housing Committee on 28th September 1988 members discussed a report entitled “Homeless Persons Review” which had been prepared by the Director of Housing. The Committee was informed that additional temporary accommodation was to be sought outside the Borough as a result of the levels of homeless families housed within the Westminster area by other councils. However the Director of Housing neglected to inform the Committee of the key fact which he had already passed on to the Council’s Managing Director. The need for extra accommodation was fuelled mainly by the reducing supply of permanent housing as a result of designated sales and right to buy programmes. The Director offered no advice to members as to how they should take action to ensure that the Council met its statutory duty to the homeless.

The decision-making process of Local Government is operated through formal Committees or Sub-Committees of a Council. Some policy issues can be agreed by a particular Committee but key policy decisions usually are approved by the full Council. In the case of Westminster City Council there was in existence a body known as the Chairmen’s Group. The District Auditor found Terms of Reference which stated (vol 4 para.12):

the Group shall be responsible for advising the Party (i.e. the Conservative Party) on matters of policy and political tactics but shall not be empowered to take decisions or take action binding on the Party without reference to a Party meeting.

It is clear that this Group existed for party political purposes and had no formal executive authority within the Council. Under the governance arrangements for Chapter 6

Local Government any decision taken by the Chairmen's Group did not become formal Council policy until adopted by the full Council, a Committee, Sub-Committee or officer of the Council acting under delegated powers. The Westminster case has many examples of the Chairmen's Group acting as an executive committee with decisions taken that were never proposed or adopted under the due governance process. At some meetings senior officers were present and contributed to the debate:

- (i) Following a meeting on 22nd June 1986, "Policies for Future" were agreed as was the establishment of a performance review group which encompassed the Leader and two Majority Party Councillors to monitor officers' implementation of the programme;
- (ii) A paper to the Chairmen's Group on 10th July 1986 stated (vol 4 para.28) ".....the Chairmen's Group to decide which items go to the Policy and Resources Committee";
- (iii) A key housing policy decision was taken at the meeting on 2nd September 1986 (vol 4 para.48) "..... provision for the homeless should be made in specific wards within Westminster in terms of rehousing..... In addition temporary accommodation should be sought outside Westminster";
- (iv) Ten days later, under the subject of 'Budget Strategy' the minutes record (vol 4 para.50) "..... it was agreed that it was particularly important to have no rate increases in the last two of the next four years but the overall aim ought to be to achieve a nil rate of increase over the entire period";
- (v) The Group met on 23rd September 1986 and discussed the Homeless Action Plan. A number of decisions were made (vol 4 para.74) "it was agreed that there should be a reduction in the intake of cases. Officers should adopt a tougher policy without reference to Committee.... Increased productivity in interviews\assessing homeless persons agreed....Reduce use of hotels and costs of temporary accommodation - agreed to provide more units but outside of the City's boundaries.....Permanent rehousing outside WCC - all options were agreed";

- (vi) In November 1986 the Opposition challenged the existence of the Chairmen's Group and stated that it was a Committee of the Council. As such the Opposition was entitled to any papers submitted to the Group. The City Solicitor advised that the Group did not take decisions and for that reason it did not constitute a Committee;
- (vii) The Chairmen's Group committed Council staff to undertake a detailed analysis of Council owned property in the key wards;
- (viii) At a meeting of the Group on 24th March 1987 there was discussion of a draft report "Review of Home Ownership". It became clear that designation of properties for sale would have to go to the Housing Committee. The report was rejected. The District Auditor notes (vol 4 para.202) that ".....the message from members was that they did not want to go through everything, they just wanted to get on with designated sales";
- (ix) The following month the Group was invited to approve a revised list of Building Stable Communities schemes for implementation and to decide the method of approval for each scheme;
- (x) At a Group meeting on 29th June 1987 a strictly confidential paper on Homelessness was discussed. Attached was another paper marked very strictly private and confidential and entitled "Homelessness: Mapping the Way Ahead and Summary of Recommendations". This same meeting discussed the possibility of establishing a Westminster Housing Trust;
- (xi) On 9th July 1987 the Managing Director prepared a note following a Chairmen's Group meeting. The correspondence identified "Member and Officer Priorities 1987\88". Each chief officer was tasked with reviewing their activities in light of the agreed list;
- (xii) Later that month the Group agreed to establish an Officers' Steering Group to drive forward BSC. This new group would report to two of the Majority Party Councillors;
- (xiii) The Group rather than the Housing or Finance Committees, came to a number of decisions on 1st September 1987 (vol 4 para.461):

officers to look at the implications of emptying Bruce House as quickly as possible and disposing of the property through the Housing Trust for conversion into ‘Yuppie’ flats....That the site, reserved for library use in Bishops Bridge Road should be disposed of through the Housing Trust...The MD to make sure that resources were made available (using outside consultants if necessary) to maximise the disposal of opportunity sites throughout the city.

- (xiv) Two weeks later the Group commissioned regular monitoring reports on BSC. The first report was reviewed on 29th September 1987. This meeting records the following (vol 4 para.487) “the Leader opened the meeting by stating that the Chairmen’s Group must concentrate only on important matters and problems. For example every effort must be made to accelerate right to buy sales and to clear the backlog”;
- (xv) The meeting on 17th November 1987 discussed the manipulation of Ratepayer Reporter which has been discussed previously;
- (xvi) In December the Group discussed “Corporate Priorities for next three months” which included right to buy, Westminster Housing Trust and BSC Action Plan. At the subsequent meeting in January 1988 the District Auditor could find no copy of various papers. In fact under the heading “Chairmen’s paper;” he found the entry “File copies only being retained, others shredded” (vol 4 para.526);
- (xvii) At the 26th January meeting the Leader made it clear that future minutes would detail agreed action, deadlines and who was responsible. Also it was this meeting which targeted the Ratepayer Report at two further key wards.
- (xviii) On 17th March 1998 the Leader of the Opposition challenged the Council’s Managing Director over various activities and stated (vol 4 para.557):

I have to say that I find it extraordinary that officers of the Council should be allocating resources and monitoring action on the basis of a secret party political strategy decided by the Majority Party members.

This broadside did not inhibit the activities of the Chairmen's Group at all;

- (xix) The Group met on 29th March 1988 and agreed an action plan following receipt of the PA CEC report. In April the Group discussed progress to achieve budget savings of £500,000 on housing homeless families. Also it was recorded that the Director of Housing would report to a Chairmen's strategy weekend on designated sales. In particular what was going wrong and proposed solutions;
- (xx) Meetings of the Group over the next few months concentrated on monitoring BSC and right to buy with the Leader stressing the importance of achieving the targets for property sales;
- (xxi) The Group met on 18th October 1988 and recorded (vol 4 para.690):
the accommodation of homeless families in Westminster hotels and the escalating cost of it must be dealt with by 1990. The main priority of officers would be to find much cheaper accommodation outside Westminster. Although a target would not be set publicly there must be management impetus in this area reflected in the covert key tasks of the Director of Housing. The Managing Director would need to make sure this was done and to monitor progress closely;
- (xxii) November and December concentrated on monitoring targets, particularly for four of the key wards;
- (xxiii) The 17th January 1989 meeting considered important detailed reports on homelessness and the financial implications. The Group decided to identify vacant land both within and outside the Borough for the use of portacabins\mobile homes for the homeless. Also it was agreed to de-designate four bedroom plus flats because of pressure for this type of accommodation. The Director of Housing actioned this decision on 6th

February without any Committee authority to do so. Seven days later a further meeting agreed to pursue direct leasing immediately.

(xxiv) The 9th May 1989 meeting discussed a revised business plan on homelessness. It clearly identified the need for £1.78m savings if a supplemental estimate was to be avoided. It was this report which the Managing Director advised “Don’t go to the Counsel - he’ll want everything in the report” (vol 4 para.734). Decisions included examination of current offers of accommodation from housing association but no implementation without the Group’s approval, and the use of temporary accommodation on sites in the Borough. The notes recorded the point that housing association voids should be in non-key wards.

(xxv) Over the next few months the Group were fully appraised by senior officers of the growing crisis of homelessness. However on 18th July 1989 the Group recorded that policies would remain unaltered. However by the meeting on 22nd August the record shows that the Group decided that the matter had to be tackled which would include additional financial resource for the homeless issue at a possible cost of £750,000 and the de-designation of property earmarked for sale;

(xxvi) Around this time the Council’s Managing Director began to have reservations about the Chairmen’s Group and wrote a confidential memorandum on 24th April 1989 to the Head of the Policy Unit on the subject of the Group. He stated (vol 4 para.728):

informal meetings do not of course have formal notes made of them. But on occasion some informal jottings are made and circulated to the members present. On such occasions, I would very much appreciate sight of those jottings before they are circulated. I would be grateful if this could be arranged.

This note implies that Bill Phillips did not really know about the workings of the Group when in reality he had been Head of the Policy Unit himself from July 1986 – February 1987 and therefore was fully aware that the Group functioned like a formal Committee with agenda, papers and minutes.

6.2.3. Audit Committees

Unlike other parts of the public sector, such as the NHS, Local Government has no requirement to establish audit committees as part of the governance process. It is argued that Councillors are accountable in two specific ways which make the provision of audit committees unnecessary. Firstly each Councillor has a personal accountability to ensure probity with regard to the expenditure of public money and decision-making. Failure to do so can lead to individuals being surcharged as has happened in the Westminster case. Secondly Councillors are elected by the community through the ballot box and therefore local people can hold Councillors to account. These arguments have some validity but are flawed in practice.

The threat of surcharge is akin to the analogy of nuclear deterrence. The fact that you have nuclear weapons means that you deter countries from acting inappropriately. The intention is never to use the sanction but the implied threat is sufficient to modify behaviour. Similarly the use of a surcharge is the deterrence to misconduct by Local Government members and officers. However it has had to be used in a number of Local Authorities in recent memory; Liverpool in the early 1980s for example. It is strange that the actual use of surcharging and therefore the failure of deterrence has not led to different mechanisms being used to ensure probity.

The fundamental problem with the threat of the use of a surcharge is that it is a reactive rather than a preventative approach. Maladministration has to take place before formal processes are brought to bear. The time-scales are unrealistic also. This review of Westminster shows that inappropriate behaviour began in 1986, was not reported to the District Auditor before 1989 and who took until 1996 to publish his formal audit report which was still the subject of legal challenge until 2001.

The lengthy time-scales for the District Auditor's investigation also means that the power of the ballot box is illusionary rather than real. Several local elections

have passed since 1989 which means that the offending political party can claim to have mended its ways and that upright individuals are now in place. Coupled with the relative stability of voting preferences at local elections that are exhibited by the majority of voters, electoral punishment does not appear to be a serious consequence. In Westminster the Conservative Party have remained in control of the Council.

In the Westminster case the heart of the matter was that the senior member, i.e. the Council Leader, and the senior officer, i.e. the Managing Director, promoted and fostered the maladministration. This meant that there were no checks and balances to intervene in a proactive manner. It is suggested that an audit committee could have undertaken this role and followed the principles adopted in other public sector agencies. This would have included the exclusion of the two senior member and officer individuals, i.e. the Leader and the Managing Director, from the committee, direct access for the committee to the external auditors, and an annual audit programme which reviewed the key policies that had been implemented and the decision process behind them. In addition the principle of the Public Accounts Committee could have been upheld, namely the Chairmanship of the Audit Committee is not a member of the Majority Party. The presence of such a corporate governance mechanism may have prevented the failure of probity at Westminster City Council.

6.2.4. Agency Theory

As stated at the start of chapter 6 a principal-agent relationship exists in this case. The community of Westminster elected a number of individuals to manage Local Government affairs on their behalf. The case study demonstrates that the goal of the agent was to retain power and control whilst the principal's goal was the effective delivery of local services. The principal has very limited means of monitoring the efforts of the agent and therefore must rely on the incentive method to align the goals of principal and agent. In the Westminster case the implicit incentive is effective delivery of services will lead to re-election and thereby maintenance of position. Unfortunately this led to the issue of moral

hazard and the agent putting their interests before that of the principal.

The use of Rowley's (1997) classification of stakeholders, as outlined in chapter 4, defines Westminster Council as "Commander". There was low density of the stakeholder network but high centrality at the Council. The outcome was that the organisation was in a very strong position and controlled the flow of information. Mitchell's (1997) categorisation of stakeholders supports this view. The Council Opposition was a dormant stakeholder with the attribute of power, albeit limited, whilst local ratepayers are discretionary stakeholders with the attribute of legitimacy. Over time the Opposition became definitive stakeholders as they acquired both legitimacy and urgency. At that point they became stakeholders who could no longer be ignored and triggered the review by the District Auditor.

6.3. Summary of the Case Study

Local Government involves the steward demonstrating accountability to the principal through the democratic process. As such it is a very different context from that of the NHS which is an arm of national Government and has appointees rather than elected members of the community. Westminster has a root cause which is unlike either of the two NHS cases. The driving force is power with the ability to influence on a national stage and play to a large ego of the key figure at the centre of the scandal. Irrespective of the lack of similarity of backgrounds the identified elements from the Wessex case remain valid. Also, the application of agency theory to the Westminster case study is useful in understanding what took place.

Chapter 7.

CORPORATE GOVERNANCE FAILURE IN THE PRIVATE SECTOR: THE BANK OF CREDIT AND COMMERCE INTERNATIONAL

The fourth case study is from the Private Sector. A notorious scandal has been selected so as to allow a broader comparison and contrast to be undertaken. As with the other cases the purpose of this chapter is to describe what transpired and identify the causes of corporate governance failure. The core source of information is from two books that were written independently by investigative journalists who had followed the unfolding events which lead to this infamous disaster; Kochan and Whittington (1991) and, Truell and Gurwin (1992).

7.1. The Story of the Bank of Credit and Commerce International

The creator of the Bank of Credit and Commerce International (BCCI) was Agha Hasam Abedi who was born in 1922 in Lucknow. He was well educated with a degree in English literature, philosophy and law (Kochan & Whittington 1991). His first job was as a trainee in the Habib Bank in Bombay. However the next year in 1947, as a Muslim, he moved to Karachi following the creation of Pakistan. His career blossomed and he was promoted swiftly. It appears that it was during this time that he discovered the importance of networking to build the banking business.

In particular, Abedi cultivated the Saigol family who were wealthy textile producers with significant political connections. This relationship flourished to the extent that Abedi convinced the Saigols to invest in the creation of a new bank. The United Bank was launched in 1959. Eight years later Abedi began a new relationship which was to encompass the full life term of BCCI. In 1967 Abedi was granted permission to open a branch of his bank in Abu Dhabi

following a visit to Pakistan by its ruler Sheikh Zayed bin Sultan al Nahyram. Unexpectedly within a few years, Sheikh Zayed became one of the richest men in the world following the discovery of oil in his small arabic country.

Abedi convinced the Abu Dhabi ruler to help him establish a new bank. At the same time he became aware that the prestigious Bank of America wished to expand in the Middle East. The result was that on 21st September 1972, BCCI was incorporated in Luxembourg with start-up capital of \$2.5m of which the Bank of America contributed 25% (Truell and Gurwin 1992). Initially the headquarters was in Abu Dhabi but quickly moved to Leadenhall Street in the City of London. Abedi's aim was to create a global bank for the Third World.

The wealth created by the large rise in the value of oil reserves following the Oil Crisis, saw Sheikh Zayed and many hundreds of others from the arab world, deposit their money with BCCI. At the end of the first year of trading, i.e. 1973, BCCI had 10 branches in five countries; four branches were in the UK. Two years later there were 64 branches in 13 countries with 19 branches in the UK. Rapid expansion followed with branches in every Middle Eastern country. Often they were joint venture banks in partnership with other banks and/or local investors, for example the National Bank of Oman. The result was by the end of only 1977 BCCI had 146 branches in 32 countries with total assets of \$1.6 billion.

A significant event took place in 1976 (Kochan and Whittington, p. 40):

BCCI formed a parallel company, sometimes called the bank within the bank, based in the Cayman Islands. Abedi would later claim that there was no connection between this parallel company, ICIC and BCCI.

This company was to be used extensively by BCCI to circumvent normal business practice.

Abedi received his first set-back in 1979 when the Bank of England refused to let BCCI expand to 150 branches in the UK and a limit of 45 was set. In October a new Banking Act came into force and defined two types of constitution. Firstly “recognised bank” and secondly “licensed deposit taker”. The latter could not call themselves a bank which infuriated Abedi as BCCI had been given this classification. The Bank of England were not the only organisation to be nervous of the rapid growth of the newcomer to the banking world. The Bank of America’s enthusiasm of the early 1970’s had evaporated. BCCI appeared to have large concentrations of lending with a limited number of borrowers. In the US a chartered bank cannot exceed 10% of capital and reserves and BCCI was over this mark. Bank of America had major concerns over the apparent large loans to insiders, i.e. directors, shareholders and officers. In addition there were inadequate loan-loss provisions and lax internal controls. In 1976 the Bank of America asked Abedi to remove its logo from BCCI letterheads and declined to invest new capital to finance expansion. Two years later it produced a critical report on BCCI’s management of its loans. By June 1980 the Bank of America had divested itself of its holding in BCCI. The world banking community was suspicious of this major player’s withdrawal at a time of apparent prosperity for BCCI (Truell and Gurwin, p. 29-30).

The early years of BCCI saw the development of strong links between Abedi and the Gokal brothers. This family was also from Pakistan and had extensive business operations, particularly shipping, through the Gulf Group. They moved to BCCI from the United Bank and remained with the bank until two days before the close of BCCI when Gulf International Holdings went into administration on 3rd July 1991. During the relationship it is clear that Abedi lent money to the Gokals in a manner which other international banks would not have condoned. For example most of the ships owned by the Gulf Group were mortgaged by BCCI at extremely high and unrealistic valuations.

Abedi had aspirations to break into the American banking arena. However the banking regulators policed the ownership of banks and would oppose BCCI owning a US bank. Abedi did not let this stop him and attempted to buy Chelsea

National Bank in 1975 by using Abass Gokal as a front man (Beatty and Gwynne 1993 p.148). Abedi was not deterred by his failure and in 1977 used another intermediary, Abdul Sami, to attempt to buy the New York Bank of Commerce. However the banking regulators were very suspicious and Abedi pulled out from making a formal offer, he had found a way to achieve his objective without falling foul of the authorities.

In November of that year Abedi was introduced to Bertram Lance. This man had had a successful career as a banker and was a personal friend of Jimmy Carter, future US President, who he knew as a Georgia State Senator and then Governor. In fact Carter supported Lance as his successor as Governor when he left office in 1974 however he lost the election and incurred large financial debts. In 1975 he became chief executive of the National Bank of Georgia (NBG) and through various financial improprieties, he purchased shares in the bank before moving on to become President Carter's budget chief. Unfortunately in September 1977 Lance's past sins caught up with him and he had to resign. It was an embattled and financially embarrassed Lance who was introduced to Abedi. After a discussion on BCCI's goals Lance saw an opportunity to rescue his personal financial position and he proposed two significant pieces of action. Firstly, he suggested that BCCI purchase his 12% holding of the National Bank of Georgia. The front man was a Saudi businessman who lived in the US, Gharth Pharaon. He paid \$20 per share when a few weeks early the stock was trading at \$10. Abedi was interested in the foothold in the US banking market and the close political connections of Lance with the US President. Lance received \$2.4m for his NGB shares and Abedi paid off an outstanding loan of \$3.4m from the First National Bank of Chicago by using the device of creating a new loan from the Cayman Islands, except no paperwork ever existed. In addition BCCI's Cayman Islands setup hired Lance as a Consultant on a salary of \$100,000. However it was Lance's second idea that was to have a profound effect on BCCI and would ultimately lead to its demise. He suggested that Abedi buy NBG's parent institution, Financial General Bankshares (FGB).

FGB was unusual in the US banking market in that it was exempt from the normal ban on interstate banking, with the result that in 1977 FGB controlled banks in the states of Maryland, New York, Tennessee, Virginia and the District of Columbia. The opportunity for Abedi to acquire FGB shares came about because of the action of the Federal Reserve Board. FGB was controlled by General George Olmsted through a holding company. However the Federal Reserve was of the view that this arrangement was illegal as the holding company owned other financial organisations such as an insurance company. The result was that all FGB stock had to be sold. Abedi began buying up stock through intermediaries such as Lance, Jackson Stephens (an investment banker and friend of Lance) and Eugene Metzger (a Washington Lawyer). The shares were recorded as being owned by four prominent Arab investors; Karmal Adham, the Saudi Head of Security, Faisal Saud al-Fulay, the former owner of Kuwait Airways, Sheikh Zayed of Abu Dhabi and his money man, Abdullah Darwaish. Each held just under 5% of FGB's total stock and therefore under US law they were not obliged to disclose their holdings as long as they acted as individuals and not as a group.

FGB did not sit still for the attempted takeover and sued BCCI, Abedi, the intermediaries and the Arab investors for the acquisition of FGB shares through an illegal tender offer. The SEC followed with their own legal action accusing the same group of violation of securities laws. Lance and Abedi turned to a prominent law firm who became significant players in the remainder of the BCCI saga. Clark Clifford was an eminent lawyer who had been a trusted adviser to Presidents Truman and Kennedy and as such he was well acquainted with both the political and legal environment of Washington. At his side was the up-and-coming Robert Altman.

The SEC suit was quickly settled with no admission of guilt. Part of the agreement was that BCCI could not own stock in FGB. The result was that behind the backs of the regulators Abedi created a new company, Credit and Commerce American Holdings (CCA), based in the Netherlands Antilles. The investors were a variety of Arab intermediaries such as Kamal Adham, and

initially they provoked serious concerns from the regulators that they worked for BCCI. Assurances were given that BCCI was not involved and the shareholdings were approved. From that moment Abedi began to acquire other FGB shares in order to take-over the bank. In April 1982 CCAH and another BCCI shell company, Credit and Commerce American Investment (CCAI), based in the Cayman Islands, had control of all the shares. Clifford was appointed chairman of FGB and Altman became chairman of FGB Holding Corporation, the direct parent of FGB. Both measures were aimed at giving comfort to the regulators and were added to by the appointment of Robert Stevens, former chairman and chief executive of BancOhio Corporation, as president and chief executive of FGB. With the further appointment of former Missouri Senator, Stuart Symington, as vice chairman, an air of respectability had been given to FGB. However of these four senior appointments only one was a banker whilst the others were political operators. The transformation was completed in August 1982 when FGB was renamed First American Bankshares.

By the end of 1983 (Truell and Gurwin p.63-64) BCCI had a global network of 360 offices in 68 countries. Acquisition played a major role in this growth e.g. the purchase of the 26 branch bank in Spain, Banco de Descuento S.A. However the approach in the US was different. BCCI did not attempt to buy banks but opened branches and representative offices. In addition Abedi opened agencies which were not full-fledged branches and were located in San Francisco, Miami, Los Angeles, Palm Beach, Tampa, New York and Boca Ratan. The result was that at the end of 1988 the network had grown to 417 offices in 73 countries. There were 14,000 staff of 90 nationalities and total assets were \$20.6 billion.

First American Bankshares grew rapidly but there was little contact between the major shareholders and the bank however there was regular involvement of BCCI in First American's business (Truell and Gurwin p.76); 47 BCCI branches, subsidiaries and affiliates had accounts with First American Bank of New York. The first president of this particular bank was hired after three meetings with Abedi, and only then was Bruno Richter introduced to Clifford and Altman who formally offered the appointment. Richter promptly hired two BCCI executives

for senior posts at First American; Aijaz Afridi as executive vice-president and Khusan Elley as chief financial officer. Both men continued to benefit from BCCI concessionary mortgages even though it was BCCI policy for such loans to be repaid on leaving the bank.

First American developed strong links to the intelligence community. J. William Middendorf, who was president of FGB in 1978, had served on President Regan's Central Intelligence Agency (CIA) Transition Team and went on to work with the CIA in Latin America when he became Ambassador to the Organisation of American States. Richard Helms, the ex CIA Director, had been defended by both Clifford and Adham when prosecuted over CIA activities. In addition the First American board included two other individuals with close intelligence community links. Firstly Robert Grey, a lobbyist, who was a close friend of the existing CIA Director, and secondly Karl Harr who had served on the staff of the Operations Coordinating Board which oversaw the CIA's covert operations. It was no surprise that both the CIA and Abedi saw mutual advantage in working together. Aid to Afghan rebels was channeled through BCCI in Pakistan and BCCI became involved in what became known as the Iran-Contra scandal. In 1984 Colonel Oliver North opened three accounts of BCCI's Paris branch in the name of a Panamanian-registered shell company, Devon Island (Kochan and Whittington p. 127). The purpose was to sell \$10m of arms and with the profit transferred to a Saudi Arabian branch of BCCI, pass the money to the Nicaraguan Contra rebels. The CIA used BCCI for routine business, using branches in London to pay a variety of British contacts. In the mid-1980s the Deputy Director of the CIA described BCCI as the bank of crooks and criminals international and said so with some satisfaction as BCCI facilitated many of the CIA's financial transactions.

As BCCI grew the real financial position of the bank became more precarious. Much of the supposed growth was generated by different parts of BCCI lending to nominee investors to carry out acquisitions. The bank moved on to collect customers' deposits and deliberately avoided recording these liabilities whilst using the money to make interest payments on its loans to the nominees. Kochan

and Whittington (p.139) record that it is now known that the largest unrecorded deposit was £246m and was owed to the Faisal Islamic Bank of Egypt. Truell and Gurwin (p.198) state “by stealing depositors’ money BCCI had become a Ponzi scheme”. Therefore the issue for Abedi and Navqi was how to find a way to plug the widening hole in BCCI’s accounts. They turned to the riskiest of all financial markets, futures and options. Effectively you bet on the future prices of commodities and whilst rewards can be huge so can the losses. In 1980 Sheikh Zayed lost \$100m in the metals’ side of the market. BCCI’s Treasury Department led this work and was headed by Syed Ziaddin Ali Akbar who was appointed in 1982. He claimed to make large profits however the Treasury’s results were consolidated with those of the Grand Cayman branch which was also managed by Akbar. This meant that any losses on futures and options could be hidden. Akbar resigned from BCCI in 1985 but promptly operated Capcom Financial Services based in London. In reality this was the Treasury Department in another guise. However stories began to emerge about BCCI losses and on June 2nd the bank issued a statement that it had lost \$285m. When Akbar left Capcom in 1986 Navqi was given a detailed summary of BCCI losses for the period of Akbar’s involvement with the bank. For the period of 1982-86 accumulated losses of \$849m and inflated profits of \$108m (1982), \$136m (1983) and \$234m (1984) were the reality. Akbar had covered his tracks through use of \$400m of unrecorded deposits, which included the Faisal Islamic Bank money and \$60m belonging to the Cameroon Government, \$250m managed by ICIC, bogus loans and deposits from the banks Abu Dhabi subsidiary.

BCCI demonstrated throughout its life that it was willing to participate in a variety of illegal acts. One of these was laundering drug money and was to result in high profile arrests of BCCI staff. In April 1980 a BCCI branch was opened in Panama City. The following year saw the election of General Manuel Noriega as the leader of the Panamanian state. Noriega opened accounts at BCCI and formed a relationship with the branch manager, Amjad Awan, who was to become known as Noriega’s banker. Noriega had close connections with the major drugs dealers in Columbia and facilitated the flow of illegal money from these sources through BCCI in Panama. So strong was the relationship between Noriega and

his banker, that when Awan was transferred to Miami in 1984, Noriega pursued the issue with Abedi to seek its cancellation. Two Americans, Steven Kalish and Bruce Ritch, became deeply involved in smuggling drugs to the US and laundering the money in Panama. BCCI was used as the conduit for the money and for Noriega's fee for allowing Panama to be used. As the illegal business flourished BCCI bought a Columbian bank with branches in Medellin and Cali, both centres of the cocaine trade.

Panama came under pressure from the US in the mid 1980s to halt the drug smuggling. The result was a major undercover US Customs investigation called Operation C-Chase. In 1987 two undercover agents set themselves up as drugs money launderers and opened accounts with BCCI at Tampa in the US and Panama. During the operation the agents received the following advice from Awan (Kochan and Whittington p.99-100):

we collect cash in the US and transfer it via cable to France or London where it is used to issue fixed term deposits. These certificates are used as collateral to obtain loans, which are then transferred by cable to Panama to be credited to our current account. You can continue to take funds from this current account as you do now.

However as the problems mounted for Noriega, which resulted in his arrest following the invasion of Panama by the US and indictment in 1988, Awan advised the Customs agents to use an alternative location to Panama. In June a switch was made to use Tampa and Europe, in particular London. The practice that was used was to send the money from the US to BCCI London via Liechtenstein. A certificate of deposit was created and a comparable loan to the same value was made from Nassau in the Bahamas. The loan was never repaid and the certificate of deposit moved to Nassau so the books balanced. BCCI continued to help Noriega and attempted to thwart the US Authorities who were trying to trace his financial assets. In August 1988 BCCI established an account, in the name of Finley, at their satellite company Capcom. \$20m of Noriega's

money was moved through various banks and accounts in Europe and New York over a six month period.

By October 1988 the US Customs' operation had gathered enough evidence to arrest the various individuals involved in the illegal activities. The undercover agents invited all concerned to a wedding and once gathered the arrests were made. Ten current and former BCCI employees, including Akbar and Awan, were indicted by a federal grand jury. In addition four corporate entities were involved in the indictment; BCCI Holdings (Luxembourg) - the main holding company, BCCI SA (Luxembourg) - the flagship bank of the group, BCCI (Overseas Limited) - the holding group in the Cayman Islands, and Capcom. All were accused of conspiracy to possess with intent to aid and abet others with the distribution of cocaine, conspiracy to defraud the US Inland Revenue Service (IRS), and conspiracy to launder the proceeds of cocaine sales. In addition many of the individuals were charged with knowingly laundering \$14m of cocaine revenues (Truell and Gurwin p.247-248). BCCI decided not to fight the case and went for plea-bargaining. BCCI (Overseas Limited) pleaded guilty to money laundering conspiracy charges and 30 specific acts of violating federal laws. The company was fined \$14.8m, put on probation for five years and subject to increased regulation by the Federal Reserve. However no other investigation would take place and therefore the linkage between BCCI and First American was not pursued. Charges against BCCI's other companies were dropped as part of the deal. BCCI individuals did not fare so well as on 29th July 1990 five former employees were found guilty and sentenced to prison. Awan received 12 years which was reduced later because of his willingness to testify against Noriega. Two other BCCI officers, Akbar and Asif Baakza, were tried in London, found guilty and sentenced to prison in the autumn of 1990.

Involvement with the drugs trade was not the only illegal activity in which BCCI became involved. In the late 1970s, Ben Banerjee, a legally registered arms dealer, opened a BCCI account in London. In 1981 he introduced Samir Najmeddin, supposedly an Iraqi Government representative, to BCCI so that an account could be opened. \$48m was promptly transferred into BCCI. A further 11

accounts were set up and the bank organised an offshore trading company for Najmeddin which was registered in Panama with headquarters in Warsaw. The company had three directors; Najmeddin, Adnan al-Banna and Shakir Farhan. In reality Shakir Farhan was the Palestinian terrorist leader Abu Nidal and Najmeddin was not an Iraqi Government official but the financial controller of Nidal's organisation (Kochan and Whittington p.113-131). Over the next five years Najmeddin completed numerous transactions at the Hyde Park branch of BCCI. For example a \$30m letter of credit was opened with Banerjee for the purchase of arms. Najmeddin used BCCI for all his letters of credit and each one over the value of half a million dollars was approved by a group of senior BCCI managers which included Abedi's right-hand man, Swaleh Naqvi. When in London Najmeddin used BCCI offices and staff as if they were his own. For example in 1985 Najmeddin completed the purchase of Israeli made Uzi machine guns at the Hyde Park offices. This activity continued until 1985 when Najmeddin's role with Nidal was exposed in a French magazine. The result was that despite his public protestations of innocence he transferred all the money in BCCI accounts to Poland and Switzerland.

By the mid-1980s concerns about BCCI's activities had grown considerably. The losses of the Treasury Department, the emerging picture of a bank with connections to the drugs trade and the involvement of the US and UK's security services meant that BCCI was a marked organisation. The diverse nature of the various components of the BCCI entity with differing legal jurisdiction meant that the official regulators did not act swiftly or in a coordinated manner. The first to act was the Luxembourg Monetary Institute (LMI) as the overarching BCCI holding company was registered in that country. Their concern was that BCCI's assets had grown by 800% in just eight years and stood at \$1.6 billion. There was a belief at LMI that such growth would challenge the best-run organisations. Also evidence was beginning to emerge about the losses BCCI were incurring on the options and futures markets. Pierre Jaans, the head of LMI, attempted to get the attention of other regulators such as the Bank of England but to no avail. Therefore in 1985 he asked Price Waterhouse, BCCI's external auditors, to review the Treasury Department's work. The auditors found that BCCI had

incurred large losses which had not been recorded properly but this was put down to incompetent staff. LMI asked Abedi how the losses were to be covered and how the regulator's expected solvency ratio would be met. Abedi promised LMI that a new source of funding was imminent and he approached the prominent Saudi family of bin-Mahfouz who controlled the National Commercial Bank of Saudi Arabia. Abedi was in a poor negotiating position and the proposed new investors drove a hard bargain which included indemnity against loss if they wanted to sell their shares. The bin-Mahfouz bought 10% and then 20% of the shares and then began a campaign to oust Abedi and take over the bank (Kochan and Whittington p.142-144).

Until 1987 BCCI had a variety of external auditors for different parts of the organisation. However in this year Price Waterhouse became the sole auditor for the BCCI Group. In 1988 the regulators began to act more cohesively to oversee the activities of this bank. They formed the College of Supervisors which included representatives from Luxembourg, Spain, Switzerland and the UK, and met for the first time in May. Additional countries joined subsequently; Hong Kong and the Cayman Islands in 1989, United Arab Emirates in 1990 and France in 1991 (Truell and Gurwin p.288).

Abedi had always managed BCCI as a large extended family with himself as the patriarch but the continuous stresses of operating in this manner together with the ongoing financial difficulties took their toll in February 1988. Whilst in Pakistan where he had arranged a dinner with President Zia in honour of Sheikh Zayed, he had his first heart attack. The result was surgery and ongoing health problems which in time confined Abedi to a wheelchair and effectively removed him from the helm of BCCI.

The public concerns about BCCI were growing as the bank's problems in the US, with regard to money laundering, were given extensive coverage. Price Waterhouse qualified the 1988 accounts because of the likely financial consequences of the US criminal proceedings. At the same time the bank reported a net loss of \$49m for the year. The outcome was in October 1989 the bin-

Mahfouz family chose to extricate themselves from BCCI and activated the exit clause in the legal agreement which had brought them into the bank. Despite his health problems Abedi arranged for the Sheikdom of Abu Dhabi to buy the shares for \$528m. The majority of this equity was bought by Sheikh Zayed's son Khalifa and the finance department of the Abu Dhabi Government. The Bank of England finally stirred itself in the autumn of 1989 and asked Price Waterhouse to conduct a special audit. The report was available in January 1990 and made awful reading. Its key points were:

- there were no loan agreements on many of its largest loans;
- in many cases there were no official third party witnesses;
- in many cases improper appraisals had been used for the basis of loans.

Subsequent reports found:

- frequent absence of critical information to support very large loans;
- irregularities in loan approval procedures;
- unreliable management responsibilities;
- improper servicing of loans e.g. Khalil's loans had not been serviced for five years.

The external auditors discovered that BCCI made very large loans to some of its shareholders who used BCCI stock as collateral. Price Waterhouse's report of 3rd April 1990 demonstrated that the bank had apparently lent \$1.48 billion to its own shareholders against 60% of BCCI's equity. Approximately half of this sum had been loaned to the Gokal brothers' shipping operations and BCCI was unable to call in the loan as the Gokals would have collapsed and so would have the bank. At the same time BCCI faced other difficulties in both the UK and the US. In Britain the Inland Revenue warned the bank that it had failed to file correct tax returns. Price Waterhouse expressed their concern to BCCI on this issue and on the others which had been exposed by their ongoing audit work. One consequence was that some of the bank's clients who realised that they had been

used by the bank, e.g. annotating large loans against clients' names when they did not exist, began to cause problems. The heads of the Gulf States of Ajman and Fujairah repudiated \$270m worth of loans.

Meanwhile in the US the true ownership of First American had been exposed. The Bank of England had uncovered the information and immediately informed its fellow regulator, the Federal Reserve. They wrote to Robert Altman on 13th December 1989 and asked if First American's shareholders had borrowed money from BCCI. Nearly two months later he responded that he did not have access to that information but enclosed a letter from Naqvi. This correspondence denied that BCCI had any part in the financing of First American purchase and no further action was taken.

Price Waterhouse would only sign BCCI's 1989 accounts without a major qualification unless new equity could be obtained; the losses for the year were \$498m. The auditors were reassured by Ghanim al-Mazrui, Sheikh Zayed's adviser and a BCCI investor, that the Abu Dhabi Government would provide the necessary financial support to cover the losses. The accounts were signed without any qualification. In May 1990 further capital was required and the Abu Dhabi Government responded by injecting \$400m into the bank for a controlling 77% stake. Immediately the new owners attempted to sort out the bank. Naqvi was replaced as chief executive at BCCI and a plan to restructure the bank was made. A public limited company would be established in London and would be wholly regulated in the UK, a company in Hong Kong would deal with the Far East and Abu Dhabi would handle everywhere else. The bank's headquarters moved to Abu Dhabi in September which resulted in a large reduction in the UK branch network and the loss of some 800 jobs.

Meanwhile in the US a damaging article was written by Larry Gurwin in the publication *Regardie* in May 1990. It alleged close ties between BCCI and First American but only circumstantial evidence was produced. This was followed by an article in the *Wall Street Journal* which argued that BCCI was a rogue bank. One of the events to trigger this damning article was the failure of CenTrust

Savings Bank which had been taken over by the regulators at a cost to the taxpayer of more than \$2 billion. It eventually emerged that Pharaon had been a front man for BCCI. Later that summer in France the Bank BAI, which had strong links with BCCI, had to be taken over by the Banque Nationale de Paris at a cost of over \$100m (Truell and Gurwin p.288-296).

During the attempted restructuring of the bank Price Waterhouse was undertaking further investigations into BCCI's affairs. They found the special files kept by Naqvi which revealed the full extent of the manipulations by the special duties department. The auditor's report of 3rd October 1990 presented the real picture of activity at BCCI. The following day at a full BCCI board meeting Abedi and Naqvi resigned and Sheikh Zayed launched his own inquiry led by Ernst and Young who had been pushed aside by Price Waterhouse as auditors three years earlier. In January 1991 BCCI's new chief executive, Zafar Iqbal informed Price Waterhouse of \$600m of unrecorded deposits. Despite this further evidence of illegal operating, the bank was allowed to continue. Two months later the Bank of England approached Price Waterhouse and instigated an independent examination of BCCI under Section 41 of the Banking Act 1987. In April the BCCI board approved the 1990 accounts and in May Sheikh Zayed agreed to cover the unrecorded deposits and the dubious loans at a value of \$4 billion.

The Price Waterhouse report arrived at the Bank of England on 22nd June 1991 and made for extremely uncomfortable reading. It articulated the case that systematic fraud had been ongoing in all areas of the bank for many years. Meanwhile in the US, BCCI's affairs had received another major setback. In December, William Ryback, head of the Fed's international supervision division, flew to London and went to BCCI headquarters where he demanded to see the auditor's report of October. Unfortunately the report belonged to the Bank of England who refused to let Ryback have a copy as it knew that the American would use it for legal purposes in the US at a time the Bank of England were trying to persuade Sheikh Zayed to cover all losses. However, later that month in Washington Sheikh Zayed's American lawyer, Sandy Martin, paid an unannounced visit to the Fed's general counsel, Virgil Mattingly. Full details of

the hidden control of First American by BCCI were given. It was stated that 60% of First American's parent holding company, CCAH, shares were pledged and the loans were nonperforming (Beaty and Gwynne p.103-104). The Fed began a formal investigation into the control of First American and received further assistance from Sandy Martin in the form of documents that were part of the Naqvi files. Both Clifford and Altman denied any involvement but documentary evidence proved otherwise. On 4th March 1991 the Fed issued an order stating that BCCI had illegally acquired control of First American and must produce a plan for the divestiture of the stock. In addition BCCI was to cease all banking operations in the US.

The June report to the Bank of England made senior officials quickly conclude that BCCI had to be seized. An emergency meeting of the College of Supervisors was called for 2nd July but Abu Dhabi was excluded and representatives from both the Fed and the Federal Reserve Bank of New York were invited. The aim was to coordinate the seizure. It was agreed to shut down BCCI on Friday 5th July 1991 after the close of US West Coast markets, however due to legal requirements in Luxembourg the seizure was arranged for 1 p.m. London time which preceded the opening of US markets. Sheikh Zayed's representative, Mazrui, would be told on Friday morning in Luxembourg. Whilst this planning was taking place BCCI's biggest debtor went bust. The Gokal family Gulf International Holdings was put into administration by the Luxembourg authorities on 3rd July. During 18 years as customers of BCCI the Gokals had amassed loans of \$2 billion.

At 1 p.m. on 5th July 1991 liquidators Touche Ross descended on all 25 branches of BCCI in the UK and took control. The same action occurred in France, Luxembourg, Spain and Switzerland. In the Cayman Islands a receiver was appointed by the Governor of the colony to take over BCCI operations. In the UK approximately 120,000 residents had deposits of £250m at the bank whilst some 30 Local Authorities had £81m on account of which the Western Isles Council based on Skye was the biggest loser with £23m on deposit (Truell and Gurwin p.305-319). In the US proceedings moved on at a fast pace. On 29th July, Robert

Morgenthau, New York District Attorney, announced a 12 charge indictment. He stated (Kochan and Whittington p.14):

this indictment spells out the largest bank fraud in world history. BCCI was operated as a corrupt and criminal organisation throughout its entire nineteen-year history. It systematically falsified its records. It knowingly allowed itself to be used to launder the illegal income of drug sellers and other criminals, and it paid bribes and kickbacks to public officials.

The indictment implicated all the major players in the BCCI affair. Abedi and Naqvi were accused of swindling up to \$20 billion from depositors around the world. The action asked for a \$200m fine against the bank and a permanent ban on any involvement with US banks for anyone involved in the covert takeover of First American. The list included Abedi, Naqvi, Adham, Pharaon, Kazmi, al-Fulay, Khalil and Elley. Clifford and Altman resigned from First American in mid-July but continued to deny any knowledge of BCCI's involvement in First American. Back in the UK angry depositors led by the MP Keith Vaz, increased the pressure on national politicians for an inquiry. The Bank of England's Governor, Robin Leigh-Pemberton, played down the need of such action but the Chancellor of the Exchequer, Norman Lamont, acceded to the demands and Lord Justice Bingham was appointed to review the supervision of BCCI. However proceedings would be in private.

Sheikh Zayed was furious with the Bank of England's actions on 5th July, particularly as there had been no consultation with the Abu Dhabi Government which was a member of the College of Supervisors and the majority shareholder in BCCI. The Sheikh took the highly unusual action of placing full page advertisements in newspapers to vent his displeasure. One of the targets for his anger was Price Waterhouse who it was pointed out had been involved with BCCI as an external auditor for 15 years and sole auditor since 1987. On 2nd December 1991 in London the winding up order for BCCI was postponed in court until January 1992. Touche Ross had found assets of \$1.159 billion but

liabilities of \$10.641 billion which meant creditors would receive a payout of less than 10% of the sums owed. Investigations in the US continued and on 29th July 1992 the Federal authorities made an indictment against Clifford and Altman on charges of:

- misleading the Fed about the BCCI - First American relationship;
- obstructing the Fed's inquiries;
- seeking to gain favour with BCCI by arranging for First American to buy NBG and depositing \$45M in ICIC;
- lying about BCCI loans to First American shareholders.

At the same time Morgenthau also made a separate indictment against the two men for participating in a scheme to defraud (Truell and Gurwin p.407-408).

7.2. Failings of Bank of Credit and Commerce International

7.2.1. Conflict of Interest

In the rush to build the business there was no obstacle for obtaining new customers. Ghassan Qassem, a senior branch manager in London stated (Kochan and Whittington p.37):

they made the staff open an account for anyone, just for the sake of reaching targets. They never went through proper opening procedures, and that was an invitation for crooks to join the bank.

The bank grew rapidly using this approach such that in just four years assets grew from \$200m to \$2.2 billion, deposits went from \$335,000 to \$25m. The basis of the growth was the large number of accounts from overseas private individuals. The bank became a haven for money to be hidden from tax or law enforcement agencies. In particular BCCI organised a specific operation to facilitate the movement of illegal cash between the Indian sub-continent and the UK. The

system is widely known as Hundi or Hawalla and circumvents foreign exchange rules. The basic principle is that the bank allows a deposit in local currency in one country and a withdrawal in the local currency in another country. There is no paperwork or audit trail.

Abedi had the dilemma of wanting to build an international bank but at the same time wishing to avoid the prying eyes of the various national banking regulators. His solution was to develop a network of offshore companies of which ICIC was at the heart. Rahmann, BCCI's chief financial officer, described ICIC as "a secret bank within the bank" (Beaty and Gwynne p.58). The Cayman Islands had been chosen by Abedi because of a number of important factors. Firstly, there is no personal or corporate income tax, nor inheritance or death duties. Secondly, there is no tax disclosure treaty with the US. Thirdly, the strict secrecy laws are policed by the Caymans Protection Board which controls citizenship, visas and work permits, and therefore controls the various professionals who make large sums of money from the banking system. The Cayman Islands operate a form of virtual banking as of the 548 registered banks in the early 1990s only 6% had actual staff and offices on the Islands. The majority booked accounts to the Caymans from their main operating base such as the UK or US (Beaty and Gwynne p.113-114). Abedi would claim on many occasions that there were no connections between BCCI and ICIC. However such a link was proved by the Fed and included in the indictment against BCCI was the following statement (Kochan and Whittington p.40):

ICIC Overseas operated under the control of and at the direction of senior BCCI management, including Abedi and Naqvi, to further the business interests of BCCI, and acted as the alter ego or agent for BCCI in connection with the acquisition of CCAH and a number of other transactions The two groups generally operated as a single entity.

However in the early days of the bank when this relationship was not understood ICIC was a significant shareholder in BCCI and appeared as an independent

investor (Truell and Gurwin p.27). Clearly this deception was a major conflict of interest that was well illustrated by the withdrawal from BCCI of the Bank of America which had become increasingly nervous of the questionable practices of BCCI and felt it should distance itself from BCCI. This began in 1976 with the removal of the Bank of America from the BCCI letterhead and the unwillingness to invest new capital in Abedi's expansion plans. In 1978 the Bank of America issued a press statement which indicated that it would divest its BCCI shareholding by 1980. By July of that year the shares had been acquired by the ICIC Staff Benefit Fund, in reality BCCI bought its own shares whilst giving the false impression that two independent investors had conducted a trade without any BCCI involvement.

Corporate hospitality takes place in international business throughout the world. Similarly hospitality is a key aspect of eastern culture and would be natural to individuals from the Indian sub-continent. However BCCI took both the corporate and cultural perspective on hospitality to extremes. When overseas clients arrived in London they were met by BCCI Rolls-Royce cars which were at their disposal. As part of the arrangement the bank would arrange and pay for all the accommodation and whatever entertainment was required. In addition members of the bank's staff were delegated to accompany the client or his family on shopping trips and pick up the bills with the cash that they had brought with them from the bank. This level of service meant that it was not uncommon for bank officials to be summoned in the middle of the night to sort out some problem. Whilst it can be argued that this high level of service was no more than excellent customer care there is no doubt that elements of the service would be classed as illegal in the UK and included procurement of individuals for sexual favours (Beaty and Gwynne p.143).

The take-over of FGB was a blatant example of Abedi's disregard for rules and regulations which he saw as obstructions to his goals. US banking regulations were clear that a foreign bank could not own a US bank but Abedi's aim was to achieve that objective. Because he knew that he could not purchase the shares Abedi chose to use his favourite device of nominee shareholders. Using Sheikh

Zayed, Abdullah Darwaish, Kamal Adham and Faisal al-Fulary, nearly 20 percent of FGB's shares were obtained between December 1977 and February 1978. As the shares were to be used as a single block rather than four individual holdings, a violation of Federal law had been committed. It is at this point that legal proceedings began by a number of parties and both Clifford and Altman became engaged for the first time with BCCI. Because BCCI was not supposed to be involved the two lawyers became the front men for all legal proceedings and discussions with the Fed and the various state banking regulators. Unfortunately for Abedi the fight for control of FGB dragged on into 1980. Many observers believed that the goal of the FGB shareholders was to force up the share-price which by this time was nearly double the original offer of \$15 per share. In early 1981 Clifford received a telephone call from an old acquaintance and FGB investor, Armand Hammer, the chairman of Occidental Petroleum. He suggested a roundtable discussion to broker a deal. After a day and a half of negotiation it was agreed that the Arab investors would buy out all of the FGB shareholders for a considerable premium, in most cases double their original investment. The remaining problem was to convince the banking regulators to approve the proposal.

A public hearing was held on 23rd April 1981. Clifford and Altman presented their case along with Kamal Adham and some of the Arab investors. Clifford was a skilled presenter and highly regarded as a man with the utmost integrity and a long career of successful public service. Therefore when he said 'There is no function of any kind on the part of BCCI' and "I know of no present relationship. I know of no planned future relationship that exists", these statements were highly influential. Altman gave further support when questioned on the dummy companies that would be the vehicle for the FGB purchase, by stating "There is no connection between these entities and BCCI" (Beaty and Gwynne p.159-161). The regulators relented and the acquisition was approved and took place in 1982. The original group of investors had grown to fourteen and now included Sheikh Zayed and his son Khalifa; Adham and his assistant Sayed Jawhary; Saudi businessman Abdul Khalil; Rashid al-Maktoum, ruler of Dubai; Rashid al-Naomi, crown prince of the emirate of Ajman; and Sheikh Hamad bin

Mohammed al-Sharqi, ruler of Fujairah. All had been recruited through Abedi's extensive network however not all were BCCI intermediaries. Those that were given BCCI loans to purchase shares in CCAH were Adham (16.32%), Fulaij (8.58%), Khalil (8.49%), Jawhary (0.51%), Sharqi (6.56%), Shorafa (6.51%) and Naomi (6.06%). These seven nominees covered 53.03% of the total CCAH equity and thereby gave Abedi a majority control from the outset. This constitutes a major conspiracy and a clear violation of US law.

The use of nominee shareholders and companies was a habitual mechanism used by BCCI. It became a vital mainstay to create the illusion of financial health and a robust balance sheet when the opposite was true. Jack Blum, an investigator for the US Congress, did much to uncover the BCCI scandal in the US. He describes what occurred (Kochan and Whittington p.85-86):

it's a shell-game, because you have several off-shore entities, BCCI in the Cayman, BCCI in Luxembourg, and ICIC, and they were able to lend money one to another and capitalise each other. One morning a loan would be created and you would wind up as a shareholder, just having borrowed millions of dollars. The paper would follow showing you as a shareholder and a loan where you would neither have to pay back the principal nor the interest because they would simply increase the amount of the loan as the interest increased. There was no substance in it, it was all high-flying paper.

A good example of the practice took place in August 1982 when CCAH wanted to raise new equity through the issue of FGB shares. Sheikh Khalifa bin-Zayed al Nahyan, the Crown Prince of Abu Dhabi appeared to purchase the shares but the money came from the Sheikh's personal BCCI account. The only security for the loan to Khalifa was the shares themselves. The same process was used to fund extra share purchases in FGB by al-Fulaij, Khalil and Shorafa. Adham built up a nominal investment of 16.8% of CCAH shares through loans with either BCCI or ICIC. Each time BCCI promised that he would have "no liability for any

deficiency”. Al-Fulaij, meanwhile, gave his name to various ICIC investments and in return he was to receive 25% of the profits, an incentive he renounced in 1985. At that time he told ICIC to do what they wanted with the shares and enclosed blank share transfer deeds. Between 1986 and 1989 al-Fulaij received \$100,000 every year and in 1990 he was given \$606,000 for his services as a nominee. In 1986 CCAH had another rights issue supposedly to generate new funds for First American. A company called Mashriq, owned by Sheikh Sharqi of Fujairah, was to buy the proposed 15,292 share offering, however BCCI arranged that it only took 8,550 shares even though the price was less than the current market value. The remaining shares were picked up at the below market price by Clifford and Altman. The other key nominees in the CCAH acquisition received significant financial rewards. Khalil was paid \$15m for the use of his name; Jawhary was paid \$150,000 per year; Shorafa received double that sum; and Sheikh Naomi was given \$6.5m for CCAH shares which were worth no more than \$4m. Further evidence that BCCI controlled the holdings of various investors such as al-Fulaij and Shorafa, was provided with the involvement of the Saudi banking family bin-Mahfouz. The shareholder register was dramatically reshaped with this large investment however when they withdrew after three years, the CCAH shares reverted to the original nominees.

At the time that BCCI became a prominent banking force in Florida in the 1980s the CenTrust Savings Bank of Miami, under the leadership of David Paul, showed incredible growth similar in style to BCCI. Paul funnelled depositors’ money into high-risk real estate loans, junk bonds and unusual investments. Through Pharaon, Paul caught the attention of Abedi who helped him to circumvent the regulators when CenTrust began to come apart. They insisted that Paul produce new investment to support his deposits. Originally the regulators wanted \$200m of new capital but agreed on \$150m. Paul turned to Drexel Burnham Lambert to find the finance but the investment bankers could produce no more than \$125m in junk bonds. The solution was provided by Abedi. He used Pharaon to purchase \$25m of CenTrust debentures with BCCI money. Less than one year later Paul secretly repurchased the bonds through a CenTrust subsidiary but had to pay substantially more as the value of the bonds had

dropped significantly. However Paul and Abedi were pleased with their arrangement and over two years BCCI acquired a 28% holding in CenTrust though Pharaon was the nominee. Unfortunately in 1990 CenTrust was seized by Federal authorities and on 15th November 1991 Pharaon, Abedi and BCCI were indicted by the US Justice Department for their role in the bond manipulation at CenTrust (Beaty and Gwynne p.184-187).

One of Abedi's other covert forays into the US banking system was the purchase of the Independence Bank of Encino, California for \$23m. Pharaon acted as a nominee for Abedi and had money channelled secretly from BCCI through the Parisian Banque Arabe et Internationale d'Investissement (BAII), a bank run by a BCCI board member. BAII, using language given by BCCI, told the Californian bank regulators that Pharaon had clear funds to buy the Independence Bank. Pharaon immediately put in place BCCI personnel including a senior officer, Kemal Shoaib, as president. The bank's capital was raided and it had to be rescued in 1991. The US Justice Department indictment of November 1991 included prosecution of BCCI for the secret ownership of the Independence Bank (Beaty and Gwynne p.178-179).

Abedi developed strong links with the leaders of Pakistan. He knew many of them when he operated his United Bank but when it was nationalised by President Ali Bhutto in 1972 Abedi was forced to seek his fortune elsewhere. Despite the early success of BCCI Bhutto prevented Abedi from opening branches in Pakistan. However in 1977 there was a military coup and Bhutto was arrested and ultimately executed. From the time of his arrest Abedi was back in favour in Pakistan and swiftly forged a strong relationship with the new military leader, General Zia ul-Haq. In 1978 BCCI's major partner, the Bank of America, hired Ijaz Zin-al-Haq, the General's son, even though it would appear he was completely unqualified for the position. Abedi became vital to the new Pakistani Government as the country was in poor financial health. There was a shortage of hard currency and the World Bank wanted the rupee to be devalued. The International Monetary Fund (IMF) were monitoring Pakistan's central bank and made it clear that Pakistani banks could not extend further credit to the

Government without Pakistan increasing its US dollar reserves. Abedi arranged for a \$1m loan to the Pakistani Government which was portrayed to the IMF by the Pakistan authorities as an increase in the dollar reserves. The IMF deferred the imposition of further restrictions and the threatened devaluation. Further help was needed in 1979. Abedi used Kuwait International Finance Company (KIFCO) to make a \$100m deposit in BCCI's Karachi branch. KIFCO received \$100m in exchange from a loan from BCCI's Cayman Islands operation. \$50m was held by Pakistan's central bank as part of its hard currency reserves for three months. The IMF had agreed that if the central bank increased its reserves by at least \$50m for ninety days, it could raise lending limits for commercial banks. The central bank held out the incentive that the lending limits of any bank bringing in such a deposit would increase by 50%; BCCI's new branches were limited to \$750,000. Abedi used his fund of \$100m to pump phoney deposits into the central bank to increase BCCI's local lending limits to \$100m. These manipulations of international banking regulations were included in the various indictments that followed after BCCI's collapse (Beaty and Gwynne p.285-293).

For Abedi to maintain the false image of a successful international bank he had to depend on a select group of people to undertake the detailed work. Naqvi provided the financial brains behind the operation and together with Abedi they established the Special Duties Department of the London headquarters. Picked employees, with unquestionable loyalty to Abedi, manned the Department which was separated physically from the rest of the headquarters so as to minimise interactions between the two groups of staff. The Department dealt regularly with the Cayman Islands operation which by the mid-1980s had grown to \$2.5 billion or approximately 15% of all BCCI assets. Unfortunately the high use of nominees began to take their toll. To compensate the nominees Abedi and Naqvi agreed to buy back shares at particular prices so that nominees would receive specific rates of return on their investments. By the end of 1989 as much as 45% of all equity in BCCI was held by nominees and a further 11% by ICIC. The Special Duties Department began collecting customers' deposits without recording these liabilities in the bank's accounts. The money was used to pay the interest

payments on its loans to nominees but clearly a massive illegal operation had begun (Truell and Gurwin p.190-197).

The losses of BCCI through its treasury activity had come to the attention of the Luxembourg regulator, LMI. Its head, Pierre Jaans, asked Abedi how he was going to plug the gap in the bank's finances. \$150m arrived and the impression given was that it was Abedi's benefactor Sheikh Zayed. However many years later investigators discovered that it came from the Staff Benefit Fund which was part of ICIC. Abedi had plundered the BCCI staff pension fund (Truell and Gurwin p.206).

BCCI attempted to portray the Tampa drugs money fiasco as the wrongdoing of a small number of employees in one local branch of the bank. The response of BCCI should have been to disown these individuals to reinforce the impression of an isolated instance of criminality. The reality was that BCCI's lawyers came to an arrangement with the Department of Justice whereby the defendants were held in comfortable private accommodation and guarded by off-duty Tampa police officers; the bill was picked up by BCCI. Clifford and Altman oversaw the defence team which was made up of fifty lawyers from twenty law firms. They represented some of the best legal expertise available in the US and by the time of the trial in 1990 had cost over \$20m in fees (Beaty and Gwynne p.329-330).

The Tampa Scandal did not only illustrate a conflict of interest for BCCI but it raised major issues with regard to Clifford and Altman. Firstly both men were lawyers for First American which was supposedly an independent bank but at the same time they were senior officers of the bank. This is a conflict of interest between executive and legal responsibilities. Secondly they were lawyers for BCCI but how could they carry out legal responsibilities for one bank when in the same industry they were running a competitor bank. Thirdly they acted as paymasters and co-ordinators for the Tampa defence team. As \$7m of the drug money involved in this case had been laundered through a BCCI account at First American they should have been outraged at this illegal activity which involved

an organisation for which they were responsible (Kochan and Whittington p.253-254).

Abedi strenuously denied any linkage between BCCI and First American, evidence shows otherwise. When First American wanted a new chief executive, the proposed candidate Bruno Richter travelled twice to London to be interviewed by Abedi. A third meeting followed in New York before Richter was passed on to Clifford for hiring. When Richter began recruiting senior staff the same process occurred. For example David Palmer went to London to meet Abedi and was offered a position on his return to New York. Abedi made recommendations that First American should hire two senior BCCI managers and they were taken on immediately. When Robert Stevens was interviewed by Clifford for the senior executive position at First American, Abedi was present. In 1982 First American wanted to buy two branches from Bankers Trust. The negotiation was led by Khusro Elley, a BCCI executive, which led Bankers Trust to believe that BCCI were acting on behalf of a subsidiary. Elley, at Abedi's behest, became a senior vice-president at First American.

It is arguable whether Manuel Noriega could have been so successful in making money from criminal activities without the willing co-operation of a bank. On 19th January 1982 Amjad Awan, the BCCI Panama manager opened an account in Noriega's name but using \$1.3m of National Guard funds; further sums were added to the account. The money was laundered through accounts in London, in particular, the Cromwell Road branch which then saw over \$3m moved to another branch in Edgware Road. Large shopping bills in excess of \$200,000 were paid from these accounts. The accounts moved on to BCCI Luxembourg where in February 1988 the balance was nearly \$15m. From there BCCI facilitated their transfer to the Union Bank of Switzerland in Zurich and the Deutsche Sudamerikanische Bank in Hamburg, Germany. To cover the movement of National Guard monies an account was opened by the National Bank of Panama in the name of Finley showing a false deposit of \$23m. The balance of over \$12m was moved from Germany to BCCI in London and joined by \$11m from Switzerland. The account was in the name of Finley. It is clear

that BCCI were a willing accomplice in this money-laundering operation (Kochan & Whittington p.109-111).

Abedi was a Muslim and wished to extend influence in many countries which were Islamic, such as Saudi Arabia, Iran and Pakistan. The Koran is clear that Muslims are not allowed to earn interest as it is classed as usury. The common way round the problem is to call interest profit and use Murabaha transactions. An investor lends money to a bank which agrees to buy goods from a third party who will use the money to buy raw materials for production. The bank agrees to buy at a rate normally linked to existing interest rates and the profit is made when the goods are sold. The risk is that the manufacturer will fail and be unable to pay off the debt so a letter of credit is often given by another bank for which the manufacturer pays a fee. This system is a form of Islamic banking. BCCI set up its own Islamic banking unit in London and it was within this department that much of the serious false accountancy occurred. BCCI chose not to go to a second bank for a letter of credit but issued their own with the result that they bore all the risk if the debtor went bust. At its peak in 1989 \$1.4 billion had been placed with BCCI by Islamic customers. Western bankers do not regard such funds as deposits as defined under the Banking Act, but a form of asset management which should be kept completely separate. These customers were unaware that their money was being used elsewhere in the BCCI Group. The lack of proper management was picked up and severely criticised by the auditors in their key report of June 1991 (Kochan and Whittington p.56-57).

Abedi spent a fair amount of his time trying to obtain political influence sometimes through a direct bribe, sometimes through more oblique payments which had an illusion of respectability, and sometimes by appealing to philanthropic issues close to the heart of individuals. In Nigeria, head of the global oil producers group OPEC for much of the 1980s, Abedi recruited a well connected individual to oversee his operation. Alhaji Ibrahim Dasuki was a member of the powerful royal family of Sakoto in the north of the country and became Sultan in 1988. His son was a chief aide to the ruler of Nigeria, General Babangida. Dasuki received very large sums of money in exchange for access to

the enormous Muslim deposit base, some 55m people. BCCI became a major player in the country's foreign-exchange market and a conduit for flight capital out of the country. This was money, often illegal acquired by influential individuals in Nigeria, which was moved to a safe haven abroad. The usual approach was to over invoice for imports. The importer would change the inflated figure from Nigerian currency to US dollars and pay the invoice. The difference between the real and inflated sums was banked at BCCI's Cayman Islands branch. Elsewhere in Africa similar illegal systems operated. In Cameroon BCCI built up its share of export financing to 80% because of the speed at which it moved money around the globe. In Zambia Abedi had cultivated President Kaunda who turned to BCCI in 1987 when the fall in copper prices plunged the country into recession. Abedi arrived in a corporate BCCI Boeing 727 jet having sent on ahead a loan to tide over Zambia. Kaunda met him with the words "The money arrived just in time" (Lascelles et al 1991 p.11). Alongside Abedi was the former UK Prime Minister, Lord James Callaghan who was a paid BCCI consultant. Activities in Pakistan and Panama have been covered in other sections of this case study.

The oblique approach was that used by Abedi to reward Clifford and Altman. In 1986 CCAH had a rights issue but it was arranged that only 8,550 of 15,292 shares were taken up by Sheikh Sharqi. Clifford borrowed \$9,960,920 from BCCI under a nonrecourse note which meant that if Clifford failed to repay the debt, the bank had no charge against his personal assets. For that sum of money Clifford received 4,495 shares. Altman received a similar deal for the balance of shares. In August 1987 Clifford borrowed another \$2,310,930 from BCCI for an extra 951 shares; again on the same terms. In February 1988 both Clifford and Altman wanted to sell their shares and approach Naqvi as Abedi was convalescing, to find an interested buyer. Very quickly Mohammed Hammoud said that he would offer \$6,800 per share, more than three times the purchase price. In March Clifford sold 3,200 shares for \$21.76m. He paid off his BCCI loans of \$12,271,850, \$1,411,831 in interest and \$1,500,000 in commission to BCCI. This latter payment was highly questionable as no broker had been

involved. At the end Clifford had \$6,576,319 in cash and 2,246 in shares worth \$15,272,800 (Beaty and Gwynne p.181-183).

In other cases Abedi was far more subtle. BCCI funded an annual \$100,000 prize which was awarded to the individual who contributed most to the Third World. Abedi was not only interested in who received the award but who presented it as the presenters received much international recognition as well as the recipient. Presenters included Kurt Waldheim, UN secretary-general; Indira Gandhi, Prime Minister of India; Zhao-Ziyang, the Chinese Premier; Belisario Betancur, President of Columbia; Javier Perez de Cuellar, UN secretary-general; Mahathir Mohammed, Prime Minister of Malaysia; Jose Sarney, President of Brazil; and Robert Mugabe, Prime Minister of Zimbabwe. Recipients included Julius Nyerere, President of Tanzania; Willy Brandt, former German Chancellor; Nelson Mandela; and Gro Harlem Brudtland, the Norwegian Prime Minister (Kochan and Whittington p.60-62). Another major political figure Abedi managed to get alongside was Jimmy Carter, the former US President. He met Carter after his defeat by Ronald Regan through Bart Lance who had worked for Carter. Nor was it a coincidence that the biggest single lender to the Carter family's peanut farm was the National Bank of George which was secretly owned by BCCI. Abedi played on Carter's interest in the Third World, particularly the issues of financial and technological assistance. As they got to know each other Abedi donated \$500,000 to help establish the Carter Presidential Centre at Emory University in Atlanta, Georgia. This was followed by a further \$300,000 when the centre was dedicated in 1986 (Truell and Gurwin p.83-84). In 1985 Carter established Global 2000 Foundation to provide health care to the Third World. During the 1980s BCCI gave \$8.1m to Carter and Abedi arranged a further \$2.5m from Sheikh Zayed via the Abu Dhabi Investment Authority. Abedi offered Carter the use of the BCCI corporate jet and offered Global 2000 office space at BCCI headquarters, both offers were accepted. In 1987 there was a world tour by Carter aboard the jet accompanied by Abedi. Stops included London, Hong Kong, Tibet, Peking and Moscow. It was no coincidence that in many of the countries BCCI was pursuing business developments. Carter claims that he did not know Abedi was corrupt nor that he was being exploited though

he still accepted at least \$11.5m from BCCI after the bank was convicted in Florida. As the public criticism mounted the Foundation ceased taking money from BCCI. However up until that time Abedi had garnered a large amount of influence and prestige through his long association with the former US President (Beaty and Gwynne p.194-196).

7.2.2. Management Control

In 1978 the Office of the Controller of the Currency (OCC) of the US Government decided to examine the books of the Bank of America with regard to its BCCI investment. A bank examiner, Joseph Vaez, was sent out with a team of auditors. His report concluded that the extremely complex conglomerate structure meant that it was impossible to ascertain how much money had been borrowed by BCCI or its associates. He was also worried about the doubling of the total loan sum, from \$511m to \$1080m over some eighteen months. He believe that it indicated poor risk assessment, and risk concentration with a small number of borrowers. He notes that BCCI did not use the interbank market where banks deposited money with one another. Vaez highlighted other concerns such as delays in reporting loans to its board, weak credit analysis and loan documentation and highly personal relationships with major clients. Also there was no bank policy on a maximum lending limit when the industry norm was a maximum of 10% of capital to one borrower. As BCCI's total capital was \$63m in 1978 it should have had loaned no more than \$6m to any one client. The reality was that the Gokal's Gulf Group had a massive \$185m set of loans which was three times the bank's total assets and thirty times the accepted maximum lending limit. In addition Vaez was of the view that BCCI was carrying \$226m of questionable loans, i.e. substandard and liable to default. Over half this sum, \$122.5m, was to the Gokals (Truell and Gurwin p.187-189).

In the mid-1980s as BCCI began to have problems with both questionable loans and servicing the interest payments to nominees, the bank turned to its Treasury Department to seek for solutions. Normally such departments raise and lend money to other banks, invest in short-term investments and deal in financial

markets. The aim is to use skill, knowledge and experience to produce a profit. Unfortunately the Treasury head, Akbar, convinced Abedi that trading in the futures market would produce the sums of money that BCCI required. It appeared that a separate department within the Treasury Department was set up. It used customer's names, money and companies for its own account. These were known as Number Two accounts and escaped normal audit scrutiny but posed major risk and cost BCCI very large sums of money in losses. Number Two accounts were used to cover the losses but just before the auditors arrived Akbar and his team would sell options from BCCI. The money would then appear as profit rather than as part of a transaction which might produce a loss rather than a profit. Between 1977 and 1985 the estimated total loss and fictitious profits were \$633m, but a further adjustment of \$225m had to be made to the 1985 accounts by Price Waterhouse as a result of their treasury review (Kochan and Whittington p.138-139). As the BCCI entrails were picked over after its demise the scale of the risk taking was seen to be astronomical. The bank exposed itself to \$11 billion in the futures and options markets. This was eleven times the maximum exposure that BCCI's treasury committee had set for investment in these markets. Akbar used the Grand Cayman branch to mask his activities and was assisted by the usual practice of these markets to only have to pay 10% of the investment when the position is taken. The downfall of Akbar was in the period of 1983-85 when he lost heavily taking large bets on the US Treasury bond options market (Truell and Gurwin p.201).

In the heady days of the start of BCCI Abedi had been keen to be seen as a major player in the international world of finance. He established a relationship with the Gokal family which gave him credibility in the Middle East and Indian sub-continent. Ultimately the huge debts, which BCCI allowed the Gokals to amass, were the key issue that undermined the financial health of the bank. Because BCCI could not afford the Gulf Group to default, as that would bring down the bank, larger and larger loans were allowed when it was clear that the Gokals were unlikely ever to be able to repay their debts. Naqvi was the technical, financial genius behind BCCI and he knew how to hide the exact exposure the bank had to the Gulf Group. Even when Sheikh Zayed tried to save the bank in 1991 the

picture he was given was not real. Naqvi inflated the Gokal loan with penal interest which overstated BCCI assets. In truth the Gokals had been unable to pay any of their debts for a number of years. Price Waterhouse discovered that Naqvi and Abbas Gokal had spread over \$1 billion loans around 750 companies. Over the fifteen year association with BCCI the Gokals had 750 accounts whose turnover was \$15 billion. Even towards the end of the Gulf Group when it was evident to the international business community that it was only a matter of time before collapse, BCCI continued to support the Gokals. They started using “charter parties” which are agreements between two parties whose documentation can be used at the bank as a guarantee for an upfront loan. Normally banks will only engage in such arrangements with shippers who are trustworthy and where there is no risk of non-payment. The Gulf Group did not meet these criteria but many charter parties were done in the days leading up to the failure of the Gokal empire. Even when the first agreement failed it must have been obvious that fraud existed but BCCI went through with further agreements (Kochan and Whittington p. 158-159).

7.2.3. Auditors

One of the key parties to come out of the BCCI scandal with its reputation damaged was the firm Price Waterhouse. As one of the world’s leading audit companies it had a lot of experience in auditing large, complex organisations. Yet for the first thirteen years of BCCI’s existence it had audited BCCI’s accounts in conjunction with another major audit firm, Ernst and Whinney, without a murmur. In fact Price Waterhouse had been responsible for auditing the Cayman Islands operation which was used extensively by BCCI to hide much of the illegal and questionable activity. In fact the cleared BCCI’s accounts for this branch included the following statement dated 18th October 1985 (Beaty and Gwynne p.60):

customer deposits consist of confidential accounts which are not conducted as open accounts requiring periodic dispatch of statements. Furthermore because of company policy we have not been able to confirm any deposit balances directly with customers, and therefore it is not possible for our examination of such accounts to extend beyond the amounts recorded.

At its simplest this statement means that Price Waterhouse agreed the accounts without confirmation or checking of any kind.

In 1987 Price Waterhouse became the sole auditor for BCCI. The first sign of Price Waterhouse taking any action did not occur until they reported on the 1988 accounts which they qualified because of the future possible penalties over the Tampa affair, however no other action was taken. This was also the first year BCCI had made a loss which leapt dramatically from \$49m to \$498m in 1989. Throughout this time BCCI's senior management worked very hard to reassure the auditors of their determination to control bad debts. Loan loss provisions had risen from \$145m to \$600m from 1988 to 1989. By March a further \$150m had been added to the outstanding loans.

In the autumn of 1989 the Bank of England and LMI commissioned a special audit from Price Waterhouse on BCCI. The report in January 1990 began to show the real position within the bank. On many of the largest loans there were no loan agreements, in many cases there were no official third party witnesses and often there were improper appraisals for the basis of the loans (Truell and Gurwin p.289). Around the same time the UK's Inland Revenue was indicating that BCCI had failed to file correct tax returns. The auditors took up some of these issues and wrote to the bank on 14th March 1990. The letter expressed major concerns that nothing was what it appeared, loans which were recorded as assets had never existed or were being repudiated by the alleged borrowers. As this information became more widely known some of the borrowers realised that BCCI had used their names to create bogus loans. The rulers of Ajman and Fujairah in the Gulf rejected any responsibility for loans totalling \$270m. Christopher Cowan, Price

Waterhouse partner, took a tough line with BCCI as the auditors had finally uncovered a \$750m exposure to the Gokals, a number of disputed loans valued at \$870m to CCAH and other questionable loans of \$477m to other BCCI shareholders (Kochan and Whittington p.148-149).

As the auditor carried out further work further failures came to light. There were frequent absence of critical information to back up huge loans, irregularities in loan approval procedures and unreliable management representations. In addition some of the questionable loans were in the names of Adham and Khalil of which the latter had not properly serviced his debts for five years. Price Waterhouse's report of 3rd April 1990 showed that BCCI had lent its own shareholders \$1.48 billion against 60% of the banks shares. The auditors advised BCCI that "certain accounting transactions had been either false or deceitful". Despite these major findings the auditor in discussion with the Bank of England believed that BCCI could be turned around.

Price Waterhouse did threaten to qualify the bank's 1989 accounts which would have been a disaster for BCCI. The auditor explained that an injection of new capital would prevent this action. Naqvi and a wheelchair-bound Abedi went to see Sheikh Zayed. The result was that Price Waterhouse were assured that the Abu Dhabi government would underwrite any losses. On 30th April 1990 BCCI's annual report for 1989 was issued and included a Price Waterhouse endorsement that the accounts were "true and fair" (Truell and Gurwin p.290-292). However there was some small print in that Price Waterhouse included the following (Kochan and Whittington p.153):

they [the Government of Abu Dhabi] have advised the directors of their intention to maintain the group's capital base whilst the reorganisation and restructuring necessary for its continuing development is undertaken.

This statement was used in the aftermath of the BCCI scandal by Price Waterhouse to indicate some form of oblique qualification of the accounts

without causing a run on the bank. However many commentators, such as Timewell (1991b), argued quite strongly that it was disingenuous for the auditor to claim that they had warned investors.

In the summer of 1990 Sheikh Zayed moved the headquarters of BCCI to Abu Dhabi. In this transfer went Naqvi and all his paper files which recorded the true position of BCCI as the bank did not use a corporate computer system. The auditors finally had access to the real situation and they outlined thirty pages of inappropriate transactions and led to the Price Waterhouse report of 3rd October 1990. They concluded that \$5 billion of new capital would be required to cover potential losses (Truell and Gurwin p.303). Sheikh Zayed continued to implement his restructuring plan and the auditors continued to allow the bank to trade even when in January 1991 the new chief executive, Iqbal, told Price Waterhouse of \$600m of unrecorded deposits. On 4th March 1991 the Bank of England asked Price Waterhouse for a secret, independent review of BCCI under section 41 of the Banking Act 1987. This action in asking the incumbent auditors to carry out this work, has to be questionable as it constitutes a conflict of interest. Price Waterhouse will have known that a request for a formal audit from the banking regulator under a banking statute represented a serious step down the road to seizure of BCCI. Price Waterhouse had been an auditor for the whole life of BCCI and sole auditor for five years. They will have recognised the precarious position in which they were situated but were given an ideal opportunity to produce a tough audit which allowed them to also show how the auditors were deceived. Price Waterhouse appear not to have a problem with this ethical dilemma.

Whilst Price Waterhouse went about this new audit the BCCI board met in early 1991 and approved the 1990 accounts. The audit report was presented to the Bank of England on 22nd June 1991 and spelt out the reality of BCCI. It stated “accounting records had been falsified for a substantial number of years” (Truell and Gurwin p.306). The regulators moved in and seized BCCI but questions began to be asked about Price Waterhouse not least by Sheikh Zayed. He was so

incensed by the seizure that he took out full-page newspaper advertisements which indicated his displeasure and included (Kochan and Whittington p.178):

the majority shareholders feel that they cannot absolve Price Waterhouse from all responsibility since they have been auditors of a major subsidiary (BCCI Overseas) for fifteen years and auditors of the whole group since 1987

Since the seizure Price Waterhouse have attempted to defend their position. They argue that in law auditors owe a duty to members of the company and to no one else. If they discover fraud they are not obliged to report it to the regulators but may do so if they wish. Auditors have a duty of confidentiality to their clients and it is from behind this particular principle that Price Waterhouse defended itself. Ian Brindle, the new senior partner of Price Waterhouse, who took up post five days before the seizure of BCCI agreed that qualifying accounts of a bank can only be done on solid evidence as half-measures can lead to major problems.

7.2.4. Regulators

The most striking issue in the case of BCCI was the failure of the various authorities to act despite early information of illegal activities. In the US it is now known that the CIA knew that BCCI was involved in criminal activity as early as 1979. By 1983 the Agency was distributing information to a variety of key government departments such as Treasury, Customs, Justice, the Federal Bureau of Investigation (FBI), and the Fed. The following year the CIA described BCCI's money-laundering activities to the Treasury Department. A further twelve months on the CIA informed fellow government agencies that BCCI secretly owned First American. The OCC was informed but took no action even though the deputy controller was given the information. In 1986 the CIA told the State Department about BCCI's links with Abu Nidal and in 1987 BCCI's role in illegal weapons sales. Also in that year the FBI, the US Attorney in Miami and the IRS received a full criminal referral from the Fed concerning large-scale money-laundering in BCCI's Miami branch. There was no response from the

Justice Department even though by now the C-Chase undercover operation was in full swing in Florida. In 1988 the Fed made another criminal referral to Justice about BCCI's New York office; no action was taken. The Justice Department failed to act on another occasion when it had explicit information from the Tampa investigation which described BCCI's secret control of three US banks, bribes paid to politicians and systematic attempts to fix a congressional investigation.

The evidence available to government agencies was substantial and sufficient to take action under the severe Racketeering, Influenced and Corrupt Organisations (RICO) Act which would have allowed the Justice Department to seize all of BCCI's assets. In fact the deal done between BCCI and the authorities over Tampa was aimed explicitly at avoiding an indictment under the RICO statute. Much of the \$20m of legal fees went on hiring former Justice Department officials to defend BCCI. The bank succeeded until July 1991 when the full force of RICO was used against BCCI. Despite various senate hearings after the demise of BCCI answers for the failure to act have not been forthcoming as many of the details have been classified (Beaty and Gwynne p.325-344). However for America the impact of BCCI was much less than elsewhere as Norton (1991 p.92) points out. The Fed had never allowed BCCI to accept retail deposits or make bank loans in the US so the regulator, with hindsight, did make an astute decision when the bank set up in the US. Other writers were not so charitable, King (1991) reminds readers that for the preceding thirteen years *Euromoney* been voicing its concerns about BCCI and back in July 1978 had described them as "that cowboy bank in the Middle East".

Authorities on the east side of the Atlantic were equally to blame as their US colleagues. In 1984 Pierre Jaans of the LMI had tried to engage his fellow regulators, particularly the Bank of England, in tackling BCCI. He failed as he did again the following year. In that year LMI asked Price Waterhouse to carry out a detailed investigation into BCCI. Though they found significant losses which were unrecorded, incompetent management was blamed. LMI suggested a new approach to ensure better regulation of BCCI. It was proposed that the bank

be incorporated in its three main locations of business; the UK, the US and the Cayman Islands. The proposal never went beyond the planning stage. There were signs of problems with BCCI in other areas. The Johnson Matthey banking failure in 1984 led to a police investigation. Individuals who had defrauded that banking institution had accounts with BCCI who were less than co-operative with the police inquiry. In that same year it is suggested that Bank of England officials were quietly warning against involvement with BCCI. In 1986 there were problems in India where BCCI had been allowed to establish a branch in the previous year. The director-general of India's Revenue Intelligence at the time, B V Kumar, states that BCCI had tried to circumvent foreign exchange rules which prohibited the transfer of foreign exchange out of the country without the explicit agreement of the Reserve Bank of India. The bank breached the Conservation of Foreign Exchange and Prevention of Smuggling Activities Act. The BCCI general manager and three of his staff were arrested. It was found that BCCI was selling unsigned and unrecorded traveller's cheques to people leaving the country and thereby avoiding foreign exchange controls. BCCI quickly engaged the top Bombay lawyer to defend itself. Further difficulties followed in India as Kumar states that the authorities acquired evidence that BCCI was assisting the Pakistan government to spy on India but it was decided to maintain a watching brief on the bank.

Back in the UK Ghassan Qassem began supplying the security service, MI5, with information on the Palestinian terrorist connection with BCCI. Qassem went on to give much more information on many other BCCI accounts. By 1989 MI5 went to the Bank of England with the evidence gained over a two year investigation. Together with the auditors, Price Waterhouse, the regulator mounted the Project Q financial examination of BCCI. The team included a partner in Price Waterhouse, two senior Bank of England officials and a Special Branch officer from the police. They found unauthorised transfers of large sums of money for illegal arms deals and numerous financial irregularities. Details were sent to the Bank of England. However as the regulator along with LMI, Price Waterhouse and BCCI thought the bank could be saved by Sheikh Zayed, no formal move was made. By the middle of 1990 Sheikh Zayed had taken action

to try and save BCCI. In the UK 800 of the 1460 workforce was made redundant. One of the embittered staff, Vivian Ambrose, wrote to Labour MP Tony Benn and accused BCCI management of widespread corruption and nepotism. The letter was passed to the Treasury who passed it to the Department of Employment and so on. A game of pass the parcel had commenced amongst ministers, none of whom wanted to have to act. The UK government was able to stall for a few months more but once the Bank of England appointed Price Waterhouse in March 1991 to undertake a special examination of BCCI books, it was inevitable that real action would have to be taken (Kochan and Whittington p.132-138).

Following the seizure of BCCI the Bank of England took a low profile stance and implied that there was no need for an inquiry. Unfortunately for Robin Leigh-Pemberton, Governor of the Bank of England, the British government was under pressure from livid depositors and disgruntled employees. The charge was led by MP, Keith Vaz, who had a legal background. Eventually the government conceded and announced an inquiry by Lord Justice Bingham into the supervision of BCCI but evidence would be heard in private. This action contrasted very starkly with the US where televised congressional hearings were taking place (Kochan and Whittington p.172). It was from one of these hearings that a stinging criticism of the Bank of England was made. The Senate's Foreign Relations Sub-committee on Terrorism, Narcotics and International Operations was chaired by Senator John Kerry and had been interested in BCCI since the mid-1980s. In its final report on 30th September 1992 the sub-committee stated (Beaty and Gwynne p.106):

by agreement, the Bank of England had in effect entered into a plan with BCCI, Abu Dhabi and Price Waterhouse in which they would keep the true state of affairs at BCCI secret in return for co-operation with one another in trying to avoid a catastrophic multi-billion dollar collapse. From April 1990 forward, the Bank of England had now inadvertently become partner to a cover-up of BCCI's criminality.

One of the perceived failings of the Bank of England involved the large sums of money lost by various Local Authorities in the UK. They argued that BCCI was on a Department of Environment list of financial institutions and therefore by implication deemed to have official approval for the public sector to use. The Bank of England argued that they were obliged to formally list banks with a license to take deposits. However from the banking regulator in the UK this argument seems to lack substance as at the time of issuing the list, BCCI was under investigation for fraud. It can be argued that if you cannot depend on the banking regulator to protect public money then there is a major failing in the system. Leeming (1995 p.549) would argue that 6,018 former BCCI depositors agreed with this view and brought a negligence claim against the Bank of England. A number of commentators, Jones (1988), the editorial in *Business Weekly* (1991), Herring (1993) and Passas (1996), all ask the same fundamental question. How did the Bank of England allow BCCI to continue to operate when the depth and breadth of the problems appear to be so well known ? In an interview with Skeel (1991) Brian Quinn, the Bank of England director in charge of banking supervision, defended the regulator and stated very forcefully that there had been no delay or political interference, and the Bank of England had reacted correctly when required. The biggest loser was the Western Isles authority in the Outer Hebrides who had invested £23m, the last £1.3m was deposited only fifteen minutes before BCCI was seized. Whilst York City Council invested £1.3m after taking advice from their brokers and checking if the bank was on the Bank of England list. In total £81m of poll tax payers money was lost (Kochan and Whittington p.195-197).

7.2.5. Agency Theory

BCCI has the classical principal-agent relationship with the company's shareholders being the principal and the chairman/chief executive as the agent. Agency theory indicates that there are two methods by which the principal controls the agent. The first is to have extensive monitoring systems in place so that the principal has detailed information on which to judge the actions of the agent. At BCCI no such systems were implemented and the agent controlled the

flow of information and the picture that it painted. The second method is to incentivise the agent to deliver the principal's goals. Abedi created the illusion for many years that BCCI was a success and therefore the shareholders did not ask pertinent questions. Weir (1997) points out that where there is a weak group of non-executive directors and a combined chairman/chief executive position, the potential for problems to occur is high as is the likelihood that they will be undisclosed. As with the other cases the matter of moral hazard is relevant as the agent pursued his own rather than the principal's agenda.

Mitchell's (1997) work supports the view as his classification illustrates that stakeholders from customers to regulators were discretionary stakeholders, they had the attribute of legitimacy. As the problems became known the regulators became definitive stakeholders through the acquisition of power and urgency, whereas customers and staff were expectant stakeholders as they possessed legitimacy and urgency however without power they were dependent on other players. As with Westminster, using Rowley's (1997) work BCCI was in a "Commander" position through the control of information and the fragmentation of the network of stakeholders.

7.3 Summary of the Case Study

An international bank with business in many parts of the world is far removed from either Local Government or the NHS in the UK. However there is a clear link to agency theory with both agent, Abedi, and principals, mainly Sheikh Zayed, as key players in the situation. It might have been expected that little corroboration for the identified elements from Wessex would emerge from the world of high finance. This case was similar in aspects to Westminster as it involves power and personal influence but as with the West Midlands scenario it also suggests that personal gain was not unimportant. The manifestation of the root causes are remarkably consistent with the other cases and once again accountability, directors and management control, and conflict of interest are high on the list with the absence of audit committees notable. Similarly, the use

of agency theory to explore BCCI have demonstrated their relevance to a broad range of organisational environments.

Section C

Public Responses to Corporate Governance Failures

Chapter 8.

PUBLIC REPORTS ON CORPORATE GOVERNANCE

FAILINGS

The analysis of the four major corporate governance failings is complete but a further test of the emerging theoretical framework is possible. The 1990s saw an upsurge in corporate governance initiatives in the UK from a variety of significant players in the field, such as Government, the accountancy profession and the Confederation of British Industry. These have been followed by official NHS guidance on corporate governance. This chapter examines four generic initiatives whose reports are invariably known by the name of the chairmen of the group scrutinising various aspects of corporate governance; Cadbury (1992), Greenbury (1995), Hampel (1998) and Nolan (1995). Chapter 9 will examine the recent NHS responses to these reports and its development of guidance. By the end of this overall section it should be clear as to whether the theoretical framework is supported by the extensive work which was taking place around the same time the case studies came into view to a wide audience through the publication of the various source documents.

The aim of this chapter is to see how far the reports pick out corporate governance elements that have been identified in the framework. Also the reports will be examined to explore how they reflect agency theory. Each report is analysed to understand the main issues that were deemed to be pertinent.

8.1. Cadbury

8.1.1. Introduction

A review of the history of the development of corporate governance in the UK shows that it evolved slowly over time with the main drivers being the various statutes of company law. However in the second half of the 1980s the UK business arena was subjected to a number of scandals which were seen as good examples of poor or no corporate governance. Boyd (1996) highlights the numerous notorious cases that are quoted regularly in academic texts. Relatively simple cases of fraud by founding chief executives include Barlow Clowes and Brent Walker who both stole investors' money. A more complex scandal was the transfer of funds from the conglomerate, Polly Peck, to offshore companies owned by the founder and chief executive, Asil Nadir, who subsequently fled the country whilst on bail. The Maxwell case was an even more complicated scenario and involved the theft of over £1 billion in employee pensions by Robert Maxwell to support his various businesses. Other cases involved stock manipulation. In the infamous Guinness scandal, a number of prominent individuals went to jail for attempting to inflate the value of Guinness shares during the takeover fight for Distillers. Similarly in the Blue Arrow affair the merchant bank, County Natwest, was accused of inflating the success of a rights issue of Blue Arrow shares. Finally, there was the spectacular collapse of BCCI which has been covered in detail in this thesis but raised major concerns over the detection of fraud and the role of external auditors. At the same time society saw the business community pay large salaries and bonuses to senior managers which caused much public disquiet. Firstly the proportionate size of increases was out of line with the prevailing economic circumstances and secondly, often the company was not performing and therefore high payments to individuals appeared to be based on greed.

The outcome was that in May 1991 the Financial Reporting Council, the London Stock Exchange, and the accountancy profession in the UK established a committee to examine financial reporting and accountability for companies in the

private sector. The committee's chairman was Sir Adrian Cadbury, a successful businessman and chairman of a large public company.

To consider the following issues in relation to financial reporting and accountability and to make recommendations on good practice:

The published report of the Committee is entitled *the Financial Aspects of Corporate Governance* (1 December 1992) and is commonly known as the Cadbury Report. In its preface (p.9) Cadbury emphasises that the work of the Committee was necessary because of public concern over BCCI, Maxwell and directors' pay.

8.1.2. The Cadbury Report

This report has three main sections. Firstly the structure and responsibilities of boards of directors, secondly the role of auditing, and thirdly the rights and responsibilities of shareholders. Each section will be examined in turn.

- **Board of Directors**

The Committee decided to tackle this subject through the development of a Code of Best Practice and made explicit the three principles which underpin the Code; openness, integrity and accountability. To encourage companies to adopt this self regulatory Code, the Committee recommended that companies should record in their report and accounts whether they complied with the Code and any areas of non-compliance. It was further envisaged that external auditors should review statements by companies, and if non-compliance was not disclosed properly by the company, to draw attention to it in their report on financial statements.

There was explicit reference to two key functions of non-executive directors. Firstly *reviewing the performance* of the board and the executive. Secondly *non-executive directors* should take the lead where conflict of interest may occur. Directors' pay, executive succession and takeovers are examples where there is

the possibility for *divergence of view* between the needs of the company and individual executive directors. The role of chairman in leading the board and achieving effective corporate governance was recognised as vital. The Committee recommended that there should be a separation of the roles of chairman and chief executive otherwise there is a concentration of power which can lead to unchecked decisions.

The Cadbury Report went further with regard to non-executive directors. *Independence of judgement* was seen to be crucial and therefore they should not have any dependant relationship with the company such as a supplier of service to the organisation and there should be a minimum of three outside non-executive directors of whom one should ideally be the chairman.

Boards need to have in place *internal control mechanisms* which include the minimisation of the risk of fraud. The Committee expected to see statements of the effectiveness of the control system to be made in the annual report and accounts, and auditors should confirm the accuracy of these statements.

Cadbury recommended that all listed companies should have an *audit committee* which should have clear terms of reference and an explicit relationship with the board. Membership was defined as a minimum of three non-executive directors and they should meet at least twice a year. The Committee outlined the duties that audit committees would undertake normally:

- making recommendations to the board on the appointment of the external auditor, the audit fee, and any questions of resignation or dismissal;
- review of the half-year and annual financial statements before submission to the board;
- discussion with the external auditor about the nature and scope of the audit, co-ordination where more than one audit firm is involved, any problems or reservations arising from the audit, and any matters which the external auditor wishes to discuss, without executive board directors present;

- review of the external auditor's management letter;
- review of the company's statement on internal control systems prior to endorsement by the board;
- review of any significant findings of internal investigations.

It is clear that the Committee saw the appointment of a separate audit committee as crucial. The Report states (p.29):

....it enables the non-executive directors to contribute an independent judgement and play a positive role in an area for which they are particularly fitted, and it offers the auditors a direct link with the non-executive directors. The ultimate responsibility of the board for reviewing and approving the annual report and accounts and the half-year report remains undiminished by the appointment of an audit committee but it provides an important assurance that a key area of a board's duties will be rigorously discharged.

To support the function of the audit committee and to monitor the effectiveness and integrity of the internal control systems, the Committee saw the establishment of an internal audit department as good practice.

The Report has several recommendations on board remuneration and included the disclosure of directors' total emoluments and those of the chairman and highest-paid director, the length of time for a director's service contract, and the establishment and membership of remuneration committees.

The final main section of work covered by the Code concerned financial reports. The Committee emphasised the point that the use of different accounting treatments together with various presentational techniques did not allow for transparency and openness. Therefore included in the Code is a requirement for boards to present a balanced and understandable assessment of the company's position.

- **Auditing**

A significant part of the Report is devoted to this subject as the annual audit is described as “one of the cornerstones of corporate governance” (p.36). The Committee made the point that the board report on their *stewardship* to the company’s owners through the annual report and financial accounts. The audit is an external and objective view on the validity of these key documents and is a safeguard for the shareholders.

The Report highlighted an expectations gap that existed between what audits do achieve and what it is thought they do or should achieve. In 1990 the House of Lords gave a judgement in *Caparo Industries plc v Dickman and Others* which clarified the position of auditors. The company and the shareholders as a body are owed a duty of care by auditors but not individual shareholders, third parties or subscribers to new shares. The Companies Act 1985 places specific duties on auditors at sections 235 and 237:

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- (1) a company’s auditors shall make a report to the company’s members on all annual accounts of the company...;
- (2) the auditors’ report shall state whether in the auditors’ opinion the annual accounts have been properly prepared in accordance with this Act, and in particular whether a true and fair view is given:
 - (a) in the case of an individual balance sheet, of the state of affairs of the company as at the end of the financial year;
 - (b) in the case of an individual profit and loss account, of the profit and loss of the company for the financial year;
 - (c) in the case of group accounts, of the state of affairs as at the end of the financial year, and the profit or loss for the financial year, of the undertakings included in the consolidation as a whole, so far as concerns members of the company.

- (3) the auditors shall consider whether the information given in the directors' report for the financial year for which the annual accounts are prepared is consistent with those accounts; and if they are of the opinion that it is not they shall state the fact in their report.

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- (1) a company's auditors shall, in preparing their report, carry out such investigations as will enable them to form an opinion as to :
 - (a) whether proper accounting records have been kept by the company and proper returns adequate for their audit have been received from branches not visited by them and;
 - (b) whether the company's individual accounts are in agreement with the accounting records and returns;
- (2) if the auditors fail to obtain all the information and explanations which to the best of their knowledge and belief are necessary for the purposes of the audit, they shall state that fact in their report.

Under section 4 of the same Act, accounts have to be prepared on the presumption that the company is a "going concern". This concept is defined in accounting standards as the assumption that the organisation will operate for the foreseeable future. This vague period of time is not made any clearer, however auditing guidance states that it should normally extend to a minimum of six months following the date of the audit report or one year after the balance sheet date which ever is later.

The audit report is based on the concept of reasonable assurance, it cannot be seen as a guarantee of no fraud. With regard to reporting detected fraud, the issue is not as many expect. Confidentiality is an implied term of the auditors' contract and therefore usually the auditor reports fraud to senior management. An auditor can report fraud to a proper authority and is encouraged to do so if there is a lack of confidence that management will deal adequately with the issue. The Report summarised the auditors' role (p.40):

to report whether the financial statements give a true and fair view, and the audit is designed to provide reasonable assurance that the financial statements are free of material misstatements. The auditors' role is **not** to prepare the financial statements, nor to provide absolute assurance that the figures in the financial statements are correct, nor to provide a guarantee that the company will continue in existence.

The Report examined the area of *conflict of interest* for auditors. Potentially this can arise if the auditor undertakes non-audit work and it is thought that the auditor might take a softer line with management in order not to jeopardise the non-audit source of income. The usual scenario is where the auditor is part of an organisation which supplies consultancy services. The Committee recommended that there should be full disclosure of non-audit fees paid to auditors.

The *Caparo* judgement exploded two major misconceptions around auditors' liability. Firstly that the audit report is a guarantee both to the accuracy of the accounts and the viability of the business. Secondly that the report can be relied upon by a wide range of parties, such as investors and creditors, not only in a general sense but also specifically for negligence claims against auditors.

- **Shareholders**

The shareholders are the owners of the company and elect the directors who report on their *stewardship* to the shareholders. In addition they appoint the external auditors to provide an independent view on the directors' financial statements. Cadbury believed that the issue for corporate governance was how to improve the *accountability* between agent and principals. The Report commented that shareholders have the opportunity to call their stewards to account at the AGM. Unfortunately often shareholders fail to do so and boards do not offer encouragement. The Committee stated that both agents and principals should explore how to improve the effectiveness of AGMs

Finally in its conclusion the Cadbury Report stated (p.53):

no system of corporate governance can be totally proof against fraud or incompetence. The test is how far such aberrations can be discouraged and how quickly they can be brought to light. The risks can be reduced by making the participants in the governance process as effectively accountable as possible. The key safeguards are properly constituted boards, separation of the functions of chairman and of chief executive, audit committees, vigilant shareholders and financial reporting and auditing systems which provide full and timely disclosure.

8.1.3. Post Cadbury Comments

Publication of the recommendations of the Cadbury Committee prompted much written comment. In general business was broadly supportive however some businessmen and academics raised varying concerns which can be grouped into five issues; self regulation, prevention, external directors, auditors and company size.

Morris (1995 p.48) spoke to a number of leading, successful industrialists for their views. Sir Owen Green, former chairman of the conglomerate BTR, was sceptical about self-regulation at a time when there was a generation of high earning directors who had come to the fore in the era of Thatcher's free market. He stated:

Cadbury's non-executive directors were supposed to sit on remuneration committees and control executive pay, and anyone can see that that hasn't worked. All it has meant is that your average non-executive director has three or four directorships instead of one or two.

The Economist (1992b p.78) expressed its concern at the lack of enforcement and noted that whilst the London Stock Exchange would require company accounts to identify whether the Code was being observed, delisting was not regarded as an appropriate sanction for non-compliance. Finch (1992), Osman (1992) and Short et al (1998) expressed similar opinions. An interesting perspective came from a director who had been involved in one of the cases which prompted the creation of the Cadbury Committee, the Maxwell affair. Phillips (1992 p.2) wrote:

as a former director within the Maxwell empire who must admit to taking the shilling gladly (for a while, at least) may I be permitted one observation about the pension scandal ? If the fate facing the directors for not standing up to Maxwell had been worse than the prospect of his wrath or the sack then much of what occurred would have been avoided. Directors have legal and moral obligations to shareholders, employees and suppliers. Until officeholders are made through the imposition of the severest penalties (such as the confiscation of assets) to understand that power and responsibility must go hand-in-hand there will always be the risk that the desire for the trappings of power and will overwhelm the requirement of responsibility. The flea goes where the dog wishes; if it doesn't fancy the prospect, it should jump off. Staying is eloquent testimony of satisfaction.

A balanced and arguably a pragmatic view was articulated by Laurence (1992 p.12):

the notion of self-regulation in the financial services industry has become a bit of a joke. The British seem to favour the idea, yet it has done little for the likes of Maxwell pensioners and Barlow Clowes investors. But before we become too carried away with the idea that any regulation is useless unless underpinned by law, bear this in mind: Peter Clowes did break the law; so did Robert Maxwell. The threat of being imprisoned didn't stop them.

A complementary argument was made by Bain (1992) who was of the opinion that attempts to make the issue one of mechanisms which involved rigid rules, legislation and complex accounting standards, was flawed. He said (p.30):

the truth is that corporate governance is more about commitment than compliance. The real solution resides with the board which must lift its integrity and raise its standards and its performance.

The second area of concern was that of prevention. Morris (p.48) reported the findings of a Coopers and Lybrand survey of medium-sized and smaller listed companies in November 1993. Only 12% agreed with the Cadbury Committee that if the Code had been in existence then a number of business failures and frauds would have been spotted earlier. Martin (1992 p.20) put it more starkly when he said “where was the magic bullet that would rid the world of future Robert Maxwells ?”.

The Cadbury Committee put great faith in the non-executive director. David Barber, chairman and chief executive of the highly successful HalmaGroup, was very sceptical when talking to Morris (p.48-49). He said:

as a full-time, committed manager, I think it’s illogical to believe that a non-executive director can perform a useful function with a limited knowledge of the company. Part of my job is to act as a non-executive director and when I sit in on a meeting that I’m not chairing the more I understand about the business, the more I can contribute. The thing that always troubles me about non-executives is that they are not well enough briefed.

Some commentators quote the evidence of continuing business failings to pour scorn on the role of the non-executive director. Brummer (1993) points out that six independent external directors and an audit committee failed to detect the problems at the Queens Moat House hotel chain and did not prevent a write-down of \$1.5 billion just after the company received an unqualified audit report.

One of the most scathing critics was Corrin (1993). In his article he is derisory in the elevation of the non-executive director by the Cadbury Committee to sainthood whilst portraying the executive director as the villain and the auditor as a tarnished angel. He argued that every scandal had non-executive directors involved and they served no useful purpose. Boyd (p.174) lists some of the pejorative descriptions used by the press and commentators to depict outside directors. They include decorations on a Christmas tree, maraschino cherries, the parsley on fish, and management's pet rocks.

Boyd calculated that for each of the 6,000 listed companies on the London Stock Exchange, at least 18,000 outside director positions were required if the Code's minimum three non-executive directors were to be met. His legitimate question was, "is the stock of available suitable candidates big enough if multiple directorships were to be avoided?" In addition with the recommended rotation of external directors so that they have a maximum of three years, additional strain is added to the supply of candidates. Finally with regard to outside directors there is evidence to suggest that chief executives receive higher pay in companies with remuneration committees and not the reverse (Main and Johnston 1993).

The Code placed a responsibility on auditors to check for compliance on eleven out of nineteen items, of those most were relatively uncontested however two provoked concern amongst auditors. Firstly the auditor is expected to comment on the effectiveness of the company's internal control systems and secondly on the 'going concern' statement. Auditors were reluctant to be involved in the detection of fraud and in taking a stance on the future viability of the company. Behind this unhappiness was the fear of an explosion in legal liability claims. However as standards were being formulated by the UK's Auditing Practices Board these two elements of the Code had been deferred.

The final issue was that of size of company. The Cadbury Report treated all businesses as the same with the result that smaller firms faced proportionately larger costs than the big companies in enacting the Code. Doble (1997) surveyed a range of companies in the period of 1990-1994 and found that the smaller

company was having difficulties in meeting the demands of the Code. The proportion of companies in 1993/94 with three or more non-executive directors was only 60% and he concluded that even small new companies that went through the listing process were not being forced to adhere to some aspects of the Code such as three outside directors.

8.2. Greenbury

8.2.1. Introduction

The early 1990s saw increasing pressure on the UK Government with regard to executive remuneration in public companies. Headlines in newspapers such as the *Financial Times* (26th November 1994) with “Executive Gluttony Under Attack” were becoming more frequent. Cheffins (1997) records that a survey of top managers in key UK businesses in 1994 found that the average total remuneration for chief executives was £351,000. The Government contemplated introducing legislative changes but was grateful when in January 1995 the UK employers’ organisation, the Confederation of British Industry (CBI), stepped in with the offer of an independent review of executive pay. A study group was established under the chairmanship of Sir Richard Greenbury, at the time he was chairman of the major retailer Marks and Spencer. The Study Group’s findings were published on 17th July 1995 and inevitably they are known as the Greenbury Report.

8.2.2. Greenbury Report

The approach taken by the Study Group was to adopt the codification route as had Cadbury. The Code of Best Practice has four sections; the remuneration committee, disclosure and approved provisions, remuneration policy and, service contracts and compensation. It was noted that whilst the Code had been prepared predominantly for large companies the principles would apply to smaller organisations.

- **The Remuneration Committee**

The Code was unequivocal that there should be a remuneration committee which had been established by the board. The committee should have agreed terms of reference and should develop, on behalf of the board and shareholders, executive remuneration policy and individual packages for each executive director. Membership of the committee should comprise of *non-executive directors* who are independent which Greenbury defines as having no personal financial interest other than as a shareholder, no potential conflicts of interest arising from cross-directorships, nor any involvement in the daily operation of the company.

- **Disclosure and Approved Provisions**

The Code introduced a new requirement for an annual report of the remuneration committee to the shareholders on behalf of the board and is the main mechanism for *accountability* to the company's owners. In presentational terms the report should form part of or be an annex to the company's main annual report and accounts. Disclosure should be made for each director of the remuneration package, broken down into the key components such as basic salary, benefits and long-term incentive schemes as well as service contracts with notice periods in excess of one year or predetermined early termination compensation of more than one year's salary and benefits..

- **Remuneration Policy**

The Code started off by recognising that remuneration committees must develop reward packages which recruit and retain directors of the required standard but must avoid paying more than is necessary. With regard to performance-related components of remuneration, Greenbury effectively argued for adherence to *agency theory* and the need to align the interests of the directors with that of shareholders. With that in mind it was recommended that remuneration committees should consider very carefully whether annual bonuses should be paid and if so, the criteria should be clear and designed to enhance the company.

- **Service Contracts and Compensation**

Remuneration committees should work through what compensation commitments should apply if a director's service contract is terminated early and in particular take into account the issue of unsatisfactory performance. Within legal obligations, approaches to early termination should be tailored to individual circumstances so as to deal fairly with directors whose departure is not for poor performance but to avoid rewarding unsatisfactory performers.

8.2.3. Post Greenbury Report Comments

Merrick (1995) pointed out that following the publication of the Greenbury Report, the Study Group had been lampooned in the popular press as a group of "fat cats". The seven industrialists earned in excess of £3.5 million and declined to recommend placing limits on executive pay. It was argued that this outcome was inevitable considering their backgrounds. Merrick reported that John Monks, the Trades Union Congress (TUC) General Secretary, said the report did not go far enough, "voluntary disclosure backed up by a voluntary code will not stop greedy executives paying themselves double-figure pay increases".

Pickering and Mayho (1995) examined some aspects of the Report and concluded that the costs to companies would rise. The Report strove to reduce the financial burden on organisations which had occurred when large pay increases were given to directors in the last three years before retirement but higher basic salaries for longer periods or the introduction of equity-based investment plans would end up costing the company more.

In October 1995 the London Stock Exchange issued Amendment 6 to its Listing Rules which put the bulk of the Greenbury recommendations into effect. The outstanding issues such as long-term incentive schemes followed as Amendment 8 in September 1996.

Chandler (1996) was of the view that greater disclosure was the best method for curbing excessive pay awards. He said (p.132):

there seems to be no doubt that the statutory disclosure requirements (little changed since 1967) are woefully inadequate in a modern context.

The Economist (1995b p.17) wrote an article immediately after the publication of the Report and effectively concluded that it was like a curate's egg. It liked many of the recommendations such as those for share options, service contracts and remuneration committees. However it thought that on the likeliest cause of market failure, the indifference of shareholders, Greenbury did not go far enough:

true, it says that remuneration committees should consult big shareholders on major changes to pay policy, and report at every annual general meeting. But it should also have recommended that executive pay be put to an annual vote of shareholders, and that the votes of the biggest shareholders be disclosed. This might cause hostile headlines and a louder outcry, but the gain would more than outweigh this nuisance. Disclosure, combined with a requirement to vote, would make it harder for institutional shareholders to evade their duty to the investors whose savings they manage. If "bosses' pay is 'excessive", it is because big shareholders have let it be so. The remedy must work through them.

In the following year the publication *Accountancy* (1996) reported that a number of major companies had rapidly implemented the Greenbury Code, in fact ahead of the required date of the Listing Rules. However many of the critics knew that Cadbury II was imminent and would include a review of the Greenbury Code.

8.3. Hampel

8.3.1. Introduction

The third review of corporate governance in the 1990s was undertaken by a committee chaired by Sir Ronald Hampel. Both the Cadbury and Greenbury Committees had recommended that a review of the implementation of their findings should be carried out in due course. The result was that in November 1995 the Hampel Committee was established by the London Stock Exchange, the Confederation of British Industry, the Institute of Directors, the Consultative Committee of Accountancy Bodies, the National Association of Pension Funds (NAPF), and the Association of British Insurers (ABI). At the time Hampel was the chairman of the major industrial company, ICI. The Preliminary Report of the Hampel Committee was published in August 1997.

8.3.2. The Hampel Report

The Report was split into a number of sections; principles, directors, directors' remuneration, shareholders and the AGM and, accountability and audit.

- **Principles of Corporate Governance**

The Report commenced by articulating a number of principles of corporate governance which were seen to be different from the guidelines of the Cadbury and Greenbury Codes.

A chairman is required to lead the board and a chief executive to run the company's business. The firm should decide how to apportion these responsibilities and explain publicly the reasoning behind their decision. The board should include a balance of *non-executive and executive directors* so that the board is not controlled by any one group. Appointments to the board should be made via an open and formal process, and all directors should re-submit themselves for re-election at least every three years.

Remuneration of directors should be at the level necessary to recruit and retain good calibre managers but it should be associated with individual and corporate performance. Remuneration packages should be derived from an organisational policy on executive remuneration which has been developed in an open and formal manner. The company's annual report should outline the remuneration policy and give the remuneration of each director.

On the issue of financial reporting, the board should present a balanced and understandable view of the firm's position and future prospects. Internally there should be *effective control systems* to protect investors' equity and the organisation's assets. To assist in this process the board should arrange explicit arrangements with external auditors to establish an appropriate relationship. The auditors will report to the company's owners in accordance with statutory and professional requirements and thereby independently assure the board with regard to their duties under financial reporting and internal control.

- **Directors**

The Committee concluded that there should be no change to the duties of executive and non-executive directors under the law. On the appointment of executive directors, boards should recruit only those individuals whom they assess able to take a broad view of the company's overall interests. The Committee was of the view that there should be no prescription of length of service or age of *non-executive directors*. The Report concluded that the majority of non-executive directors should be independent, irrespective of the size of the company. Finally the Committee believed that diverse backgrounds of non-executive directors gave the best contribution to the board. With regard to board structure the Committee concluded that the unitary approach was clearly supported in the UK.

- **Directors' Remuneration**

The Committee was clear that companies should have remuneration committees chaired by a *non-executive director*. They should develop an overall remuneration policy and packages for individual executive directors. No further changes to the Greenbury Code with regard to performance related pay were recommended.

Disclosure is at the heart of Hampel's work and this was the case with directors' remuneration. The requirement to include a statement on remuneration policy in the annual report was recommended for retention and the Committee commented that it hoped that these statements would become more informative.

- **Shareholders and the AGM**

Notice of the AGM together with the related papers should be sent to *shareholders* at least twenty working days before the meeting. At AGMs boards should make a full business presentation and have a question and answer session for shareholders who should have access to the chairmen of the audit, remuneration and nomination committees.

- **Accountability and Audit**

The Report had a number of recommendations with regard to audit. Firstly there should be an *audit committee* with at least three non-executive directors of whom one should be the chairman and two should be independent. Secondly no additions or removals were recommended to the existing requirements on auditors for reporting on governance issues. Thirdly it was recommended that the appropriate bodies should consider reducing from 10% the limit on the proportion of audit income which an audit firm may earn from one audit client. Fourthly the audit committee should keep under review the range and depth of non-audit services provided by the auditors to ensure a continuation of objectivity in dealing with the company. Finally there was recognition that auditors could

not go beyond their existing functions because of concerns over the law on liability which should be taken into account by those relevant bodies responsible for statutory changes.

Away from audit, the need for directors to have *internal control processes* was extended from purely financial to a whole system approach. The Committee recommended the modification of point 4.5 of the Cadbury Code to drop the word effectiveness and would say ‘the directors should report on the company’s system of internal control’ but also recommended that auditors should report privately to the directors on this matter. There was retention of the ‘going concern’ statement in the annual report and a firm recommendation that companies without an internal audit function should keep the matter under review.

8.3.3. Post Hampel Comments

As with Cadbury the Hampel Report drew its share of criticism. One of the most strident was Tricker (1998) writing an editorial in the academic publication, *Corporate Governance*. He argued that the principles articulated by the Committee reflected conventional wisdom but completely missed the longer term view. He said (p.2):

corporate governance is about power – the wielding of power over corporate entities, which are now the most significant organs of the modern developed and developing world. Nothing less than a complete re-think of the nineteenth century concept of the corporation will fit it for the next century. Failure to face this reality can only lead to further dissatisfaction in societies around the world (including Britain) with the wielding of corporate power.

He was highly cynical that a committee with its membership drawn from major public companies and their professional advisers, could criticise contemporary

corporate governance, nor introduce constraints on the powers of directors and broaden the scope of accountability. Tricker went on to express concern that the findings of the Committee did not seem to be rooted in the extensive body of research and academic knowledge from around the globe. Instead wide consultation has taken place with groups and individual of directors or professional advisors, and therefore these were vested interests. In particular, Tricker was scathing about the lack of consideration of the wider notions of stakeholders rather than shareholders which he believed was based on opinion and belief rather than argument and an articulation of the strengths and weaknesses of each position. He argued passionately (p.3):

societies' expectations of companies are also changing, currently seen in demands for better consumer, environmental and societal behaviour, but expect wider and more penetrating demands in the future. Investigative journalism is becoming ever more inquisitive. The inexorable rise of the litigious society is set to continue and to accelerate. Corporate and investor regulation – both self-regulation and government legislation – is converging globally. International standardisation of accounting and financial reporting is approaching. Information technology offers new governance challenges and opportunities to governance practices. There is none of this in Hampel.

Elsewhere others criticised the Hampel Report. Percival-Straunik (1997) interviewed a number of individuals working in the corporate governance field and found a variety of responses. Anthony Carey from the Institute of Chartered Accountants believed that broad principles needed to be supported by a fairly robust code. John Kay, director of London Economics consultancy, was of the view that Hampel had missed the point that there is no real accountability of management. Peter Butler from Hermes institutional pension fund thought that Hampel had now made it more difficult to separate the key posts of chairman and chief executive. However similar to Cadbury, Percival-Straunik concluded that in the short term the basic findings of the Committee were sound and sensible.

8.4. Nolan

8.4.1. Introduction

The early 1990s in the UK did not only see concerns with the governance of public companies, e.g. Polly Peck and Maxwell, and the size of executive pay but also the standards of behaviour of individuals working in the public sector, be it as full-time employee or in some part-time role. The Prime Minister of the time, John Major, established the Committee on Standards in Public Life in October 1994 under the chairmanship of Lord Nolan, a distinguished appeal judge

Its first priority was to consider what standards of conduct were appropriate for Members of Parliament, Ministers, Civil Servants, executive Non-Departmental Public Bodies (NDPBs) and NHS Bodies. The First Report was published in May 1995 and was followed up by the publication of the Committee's Fourth Report which reviewed progress on implementation of recommendations made in the First Report but concentrated on NDPBs and NHS Bodies. The Government published its response to the First Report (UK Government) in July 1995.

8.4.2. First Report

This Report was underpinned by the articulation of the seven principles of public life which were defined as:

Selflessness holders of public office should take decisions solely in terms of the public interest. They should not do so in order to gain financial or material 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 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 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.

As the aim of this overview is also to examine the Fourth Report, it will concentrate on NDPBs and NHS Bodies as ongoing issues around Members of Parliament, Ministers and Civil Servants did not allow Nolan to follow up on his initial Report. Twelve recommendations were made concerning appointments and eleven recommendations on the topic of propriety. The majority were accepted by the Government and only where there was disagreement will any comment be made.

Nolan began by recommending clarity on the issue of ultimate responsibility for appointments which should remain with Ministers and that all such appointments should be made based on the overriding principle of merit.

Any appointment to NDPBs or NHS Bodies should only be made after advice from an interview panel or committee which includes at least one independent member and such individuals should form at least one third of the membership.

At national level to oversee the appointments process a new independent Commissioner for Public Appointments (CPA) should be appointed who may be one of the Civil Service Commissioners; in 1996 the scope of appointments for NDPBs and NHS Bodies encompassed some 8,000 posts.

Nolan was of the view that there was a need for a review by the Government to produce a more consistent legal framework for propriety and *accountability* in public bodies. At the same time a code of conduct for board members and staff should be mandatory and when new appointees take up post they should undertake to uphold and abide by the relevant Code, with compliance being a condition of the post.

With regard to independent scrutiny Nolan recommended that the Audit Commission should be able to publish public interest reports on NHS Bodies at its own discretion. Also the Treasury should review the arrangements for external audit of public bodies in order to ensure best practice is applied universally.

Finally NDPBs with support from their sponsor Department should develop their own codes of openness and publicise their existence. The Departments should work to bring all bodies up to the highest standards whilst the Cabinet Office should periodically update guidance on good practice.

8.4.3. Fourth Report

This Report reviewed the implementation of the recommendations of the First Report but focused on NDPBs and NHS Bodies. The Committee believed that there was merit in returning to previously considered matters as it wanted to confirm the favourable impression it had received from Government and NDPBs after the First Report.

The review commenced with questionnaires being sent to sixty high-spending NDPBs and to three regional health authorities (Anglia and Oxford; South Thames; and North Thames) in which NHS Trusts had a role in their own

appointments. In addition questionnaires were sent to all Establishment Officers in Government Departments and a number of organisations interested in the Committee's work. NHS Trusts were only asked for their views on the appointments system as propriety in the NHS was now covered by the Code of Conduct: Code of Accountability (1994) and the Code of Practice on Openness in the NHS (1995).

There were a number of observations and conclusions which arose following an analysis of the completed questionnaires. Advertising of posts was generally thought to be helpful as it increased the range of candidates but Nolan concluded that advertisement of positions should not be the sole mechanism for finding suitable candidates but should be complementary with other methods. The key issue was selection on merit.

Whistleblowing produced a patchy response as it appeared that some organisations were struggling to implement clear practical procedures. Nolan re-emphasised the need for all NDPBs and NHS Bodies to institute codes of practice on whistleblowing, appropriate to their circumstances, so as to enable concerns about malpractice to be raised confidentially inside and, if necessary, outside the organisation.

The re-appointment process received criticism as individuals have to go through the same procedure as on first appointment. The CPA had issued guidance that re-appointments should not be automatic and that performance of the individual should be reviewed. The Committee considered the rule that re-appointments to the same post should not be automatic should be clarified so that Departments and NDPBs are aware that candidates for re-appointment do not have to undergo the whole appointment process. Similarly on the matter of second re-appointment, Nolan observed that the CPA's rule that such appointments should be exceptional, went further than the Committee recommended originally and had caused problems. Nolan argued that the issue is the effectiveness of the body concerned and therefore the appointment process should have some flexibility.

8.5. The Conceptual Framework and the Reports

8.5.1. Accountability

Cadbury was very clear that accountability is at the heart of corporate governance. Specifically, the report argued that stewards could exercise part of their accountability through the annual board report which was supported by an external, objective view through audit. Whilst Greenbury was concerned primarily with remuneration, the recommendation to have an annual report of the remuneration committee to shareholders was seen as an accountability mechanism. Hampel argued for well notified holding of the AGM so that shareholders could receive a full business presentation followed by a question and answer session with the board. Nolan began his report by defining the seven principles of public life which included accountability. He went on to argue for a mandatory code of conduct by boards and for the development of a more consistent legal framework under which boards should operate.

8.5.2. Directors and Management Control

Cadbury had a number of specific points on this issue. Boards should work to a code of best practice and have clear internal control mechanisms in place. A key function was to review performance of executive directors. Greenbury's sole observation was to stress the need of independent non-executive directors to operate the remuneration committee. Hampel had the most comments and began with recommendations on board structures and the balance between executive and non-executive directors with the latter in the majority. Similar to Greenbury, Hampel highlighted the role on the non-executive director on the remuneration committee. Additionally the need for effective control systems was made and that they should be extended from a concentration on finance to a whole system approach. Nolan's contributions were in two areas. Firstly the requirement for transparent systems of recruitment of non-executive directors, and secondly the importance of whistleblowing processes so that the organisation could be warned of undetected impropriety.

8.5.3. Conflict of Interest

Cadbury made an explicit statement on this topic. Non-executive directors should take the lead where conflict of interest might occur but emphasised the need for the independence of judgement of non-executive directors if they were to exercise this function. Greenbury continued this theme and specified the need for non-executive directors to have no cross-directorships, nor any involvement in the day-to-day running of the organisation. Hampel makes no explicit comment on conflict of interest but many of the recommendations were aimed at good corporate governance and therefore by implication the prevention of conflicts of interest. Nolan's contribution is through the seven principles of public life. Selflessness, integrity, objectivity, openness and honesty have definitions which aim to avoid conflicts of interest.

8.5.4. Audit Committees

Cadbury had a clear opinion on the need for audit committees. The report articulated the structure of the committee and the main functions that should be undertaken. Hampel endorsed this view and stressed the role of independent non-executive directors in the running of the committee. At the same time the report raised the need to keep the non-audit services of the external auditor under review to ensure that no conflict of interest occurs. Both Greenbury and Nolan are silent on the subject of audit committees.

8.5.5. Agency Theory

Cadbury referred directly to agency theory. The report saw corporate governance as the method for improving accountability between agents and principals. Effectively the mechanisms recommended in the report were aimed at achieving this end. Greenbury made an explicit reference to agency theory as well. The report argued specifically for adherence to agency theory and the need to align the interests of agents (directors) with principals (shareholders). Hampel made no observation explicitly on organisational theory. However the report developed

further the work of Cadbury and therefore it is reasonable to assume Hampel agreed with the agency theory model. Similarly Nolan is silent on the subject of organisational theory but by implication supported the need for agents to account to principals for their actions.

8.6. Summary

The four reports were significant pieces of work in the field of corporate governance and responded to growing concerns in Government, professional bodies, business and the general public following a number of high profile corporate governance failures. Examination of the reports has shown that the elements identified in the Wessex case tend to occur in one form or another. There are clear discussions of accountability and a recognition of the need to discharge the function of stewardship. Directors and management control, audit committees, and conflict of interest featured in the reports which confirms the identified key elements in this thesis as relevant. At the same time it is possible to argue that two of the reports are based explicitly on agency theory and an implicit assumption that the same applies to the other two reports.

Chapter 9.

NHS RESPONSE TO CORPORATE GOVERNANCE

The development of corporate governance in the NHS started in the 1990s in response to three separate stimuli. Firstly, two significant NHS corporate governance failures, both of which have been discussed in this thesis. Secondly, the perceived need by the UK Government to react to a number of failures in other sectors, such as BCCI and Westminster. Thirdly, the publication of the various reports and initiatives which were outlined in chapter 8. DoH (1997b) stated “the NHS has responded positively to the principles of sound corporate governance as recommended by Cadbury, Nolan and others”.

The aim of this chapter is to assess what responses the NHS has made to the need to develop corporate governance and whether the conceptual framework of this thesis is congruent with the developments.

9.1. Financial Management

Since “corporate governance” appeared as a recognised topic on the agenda of the DoH initially it was under a financial heading. One of the first official communications, that can be found on reviewing DoH publications, was issued in 1995 in the form of a Finance Directorate Letter (FDL) which meant that it was circulated within the finance community of the NHS and therefore was not disseminated widely. This meant that a corporate governance issue had been raised within a finance document which seems to imply that corporate governance was viewed as part of financial management and not the other way round. The limited distribution of this letter and its associated annex would have been seen as the business of the finance departments of NHS trusts and nothing to bother the general management of hospitals.

By the following year this approach had changed. The mid-1990s was the period when the DoH (1994) introduced its Code of Conduct and Accountability for

NHS Boards and began to invest time and effort into the subject of corporate governance. In March 1996 the DoH (1996a) issued *Directions on Financial Management* in England through the publication of a Health Service Guidelines (HSG) which is a form of communication circulated widely in the NHS. The document defined responsibilities and parameters and as such set part of the corporate governance picture of the NHS at that time.

The financial trend in publications continued that year with the *Review of the Trust Framework Regime* published by Tinston (1996). He reviewed the first five years of the internal market of the NHS which had been introduced by Government in 1991. In particular, he examined a range of issues which included the primary financial duty of NHS trusts, financial management of the system, and how hospitals costed and priced services. Also in 1996 the NHS Executive undertook a scrutiny of the bureaucracy of the NHS with the aim of saving significant sums of money. Much of what was recommended for abolition or reduction effected the corporate governance systems of NHS bodies.

Communications from the DoH could be on individual technical accounting issues but key to corporate governance. In HSC 1998\144 (DoH 1998e) alterations were made to the financing structures of NHS trust balance sheets and involved early repayment of interest bearing loans and the issue of new public dividend capital. The significance of this HSC was to effect the delivery of trusts' statutory financial duties so the change affected how responsibilities were discharged. Similarly at the end of that year the DoH (1998f) altered one of the three duties in a fundamental way. NHS trusts were expected to make a six percent annual return on average net assets. The drive behind this particular duty was to ensure that when taken with depreciation, NHS trusts absorbed the full cost of their capital. Unfortunately there were a number of difficulties which meant that this duty could be breached through no fault of a NHS trust. The HSC introduced a revised arrangement of the capital cost absorption duty of six percent. The following year further guidance (1999g) was published on the statutory financial duty of break-even. Whilst another technical document relating to whether deficits sit in the accounts of trusts or health authorities, it

represents a key piece of guidance which dictated the delivery of a corporate governance responsibility.

In 1998 the financial theme encompassed the new, specific subject of fraud which has continued to the present day. The DoH (1998h) published its Counter Fraud Strategy as it was perceived that this area of corporate governance in the NHS was weak and open to abuse. The strategy launched the establishment of Counter Fraud Services with its own national director and dedicated staff who were professionally trained and accredited. Further HSCs followed with 1999\057 (DoH 1999c) identifying a timetable for action in different parts of the NHS, NHS bodies had to nominate staff to receive training, and information on proposed new legislation to introduce new criminal offences to facilitate prosecution where appropriate. Later that year HSC 1999\175 (1999h) took the subject on further by discussing the Professional and Ethical Approach to counter fraud.

9.2. Accountability – Individuals and Groups

A different strand that runs through the DoH publications is that of accountability as applied to key individuals or groups rather than structures or organisations which will be addressed separately.

Health authorities have always held their regular board meetings in public, usually but not mandatory on a monthly basis. When NHS trusts were created in 1991 they were exempt, if they chose, from meeting in public. With the change of Government in 1997 a HSC was published quickly (DoH 1998g) which compelled NHS trusts to fall into line with health authorities. This HSC summarised the introduction of the *Public Bodies (Admission to Meetings) (NHS Trusts) Order 1997: No 2763* which came into effect on 6 February 1998. The HSC provided for meetings to be open to the public, for public notification of the date and venue of the meeting at least three days in advance and, enablement of the media to report on the meetings and be given agenda and papers. The circular went further and included good practice at the meetings. This included details

about seating, nameplates, audio loops, availability of agenda and papers, public viewing of presentation material, and pre-meeting press briefings.

The same year saw the publication of HSC 1998\010 (DoH 1998a) which pronounced on the personal liability of non-executive directors of NHS bodies. It specifically gave advice on the issue of suitable indemnities based on the following text:

a chairman or non-executive member or director who has acted honestly, reasonably, in good faith and without negligence will not have to meet out of his or her own resources any personal civil liability which is incurred in furtherance, or purported furtherance, of the execution of the NHS Acts.

The circular makes plain that the law is unclear on the whole issue and at paragraph 7 states:

in most cases, non-executive directors.....will probably be personally liable for their decisions or actions whether acting as an individual or as a member of a board.

The document goes on to indicate that NHS bodies do have the power to issue indemnities and NHS trusts could take out commercial insurance if they chose but it was suggested that such actions were unnecessary and expensive. Interestingly the Secretary of State, who at the time appointed non-executive directors, has no statutory power to indemnify or reimburse a trust which had in turn indemnified or reimbursed a non-executive director but could do so if he/she chose for a health authority. Final advice was to stick to the actions allowable under the board's standing orders and if in doubt, seek formal legal advice.

With the change of Government in 1997 came the publication in the following year of a new, broad strategic direction document, *The NHS, Modern and Dependable* (DoH 1998d). From this work emerged the concept of clinical governance which is seen as the systems and processes that ensure clinical

services are of sufficient quality and are appropriate. A number of circulars followed and detailed how clinical governance should be implemented. The DoH (1999a) told the NHS what it had to do over the succeeding twelve months. As part of the introduction of this concept chief executives had had their personal accountabilities expanded so that in addition to being accountable to Parliament for the use of public money, they were designated as Accountable Officers for the quality of clinical care that is provided within their organisations.

On a different tack the *Public Interest Disclosure Act 1998* became law on 2 July 1999 and saw the DoH (1999j) issue HSC 1999\198 on the subject. The thrust of this legislation was to protect employees who disclose information reasonably and responsibly in the public interest and may be victimised as a result. The Government was keen to ensure that staff had confidence to speak out if they perceived serious concerns were not receiving attention. The circular tasked NHS bodies to put in place systems, policies and procedures which would enable “whistleblowing” and to remove any confidentiality “gagging” clauses from contracts of employment and compromise agreements which seek to prevent disclosure of information in the public interest.

The performance management of chief executives is a key corporate governance function of chairmen and non-executive directors. However there are difficulties often with how to handle an individual where one of a number of scenarios has occurred. This can encompass loss of competence, loss of confidence, lack of direction, a breakdown of relationship with the chairman, or organisational/system failure resulting from actions involving the chief executive. Historically there has been no written guidance on how to approach these issues which has meant that individuals have been dealt with on a continuum which ranges from fair and sensitive through to unfair and brutal. In June 2001 Nigel Crisp, chief executive of the NHS and permanent secretary at the DoH, issued a protocol with detailed advice on how to tackle these difficult scenarios.

Guidance has been issued on changes to the appointment system for chairmen and non-executive directors of NHS bodies. The NHS Executive (2001) published information on the establishment of the NHS Appointments Commission which began operating as from April 2001. This body is at arms length from Government and took over from ministers the responsibility for appointments of chairmen and non-executive directors to all NHS bodies. As a fundamental tenet the Commission is expected to build on the work of Lord Nolan's First Report (UK Government 1995). The Commission has a chairman and eight regional commissioners, and their remit is broader than appointments but takes in mentoring and supporting appointees once they are in post.

Finally, in this section, additional responsibilities have been placed on chief executives with the passage of the *Regulation of Investigatory Powers Act 2000* on to the statute book. The DoH issued some guidance (2001h) which outlined that the Act had been introduced to ensure that public bodies are regulated and comply with the Human Rights Act 1998 with regard to covert surveillance activities. If the issue involves suspected fraud then the matter lies with the Counter Fraud Service however if theft of money or property on NHS premises is suspected the decision as to whether covert surveillance is authorised lies personally with the chief executive and cannot be delegated. Authorising officers may be required to justify their decision and all activities are subject to inspection by the Office of the Surveillance Commissioners

9.3. Accountability - Organisations and Structures

Many of the available documents fall into the category of defining new organisations or new structures, or focusing on core organisational corporate governance. The *NHS Trust (Consultation on Establishment and Dissolution) Regulations 1996* (DoH 1996c) is an early example. This statutory instrument lays out the basis on which an organisation could apply to become a NHS trust or equally how a trust could apply to be dissolved, usually because of merger with another NHS organisation. In the same year under FDL 1996\18 (DoH 1996b) health authority example standing orders were released to be used by all

health authorities to produce their own local versions. This document set the governance framework for the work of health authorities. It defined the composition of the authority, the appointment of the chairman and members, their terms of office, and appointment and powers of the vice chairman. However it went on to lay down how the meetings of the authority should be conducted. So clear guidance was available on calling meetings, setting agenda, notices of motions, withdrawal of motions, chairman's ruling, voting, minutes, and quorum to list some of the key subjects. However it went further in defining the delegation of functions to both committees and officers whilst there were explicit sections on declarations of interests and conflicts of interest where pecuniary involvement was concerned. The wide area of tendering and contract procedure were detailed as were the custody of the seal and the sealing of documents. The FDL also included model standing financial instructions. This type of centrally issued document ensured consistency across the NHS and prevented the wastage of time and effort through all NHS bodies starting from a blank sheet of paper.

Public bodies can only operate within powers given to them by statute and to do otherwise means that the body is acting *ultra vires*. With the advent of the Private Finance Initiative (PFI) into the public sector in the mid-1990s, it was discovered that trusts did not have the authority to enter into private finance contracts. These arrangements encompass the building of whole or part hospitals or purchase of major equipment by the private sector who recover their outlay and profit over an extended time period such as twenty five years. The DoH (1998b) issued a circular which allowed the amendment of the establishment orders of NHS trusts, if required, and advised that PFI schemes would require application for this discretion.

Circulars are used to launch corporate governance arrangements for new types of organisation. HSC 1998\139 (DoH 1998d) introduced primary care groups (PCG). They were local organisations that brought together GPs, community health professionals and social care workers. Their governance was not as a stand alone statutory body but as a sub-division of the local health authority. The circular addressed how PCGs would be formed and governed. With regard to the

former, consultation was required with the staff who would form part of the prospective PCG. The views of GPs were seen as vitally important such that a ballot of all GPs in the area was expected. External consultation had to be pursued with the public and stakeholders through a formal consultation exercise. The circular defined the composition of the PCG board and specifically gave the GPs the position whereby they would have a majority if they so chose. As one of the aims of the creation of PCGs was to begin to bring health and social care closer together, the local social services department was given a seat on the board. At that time it was unclear as to whether the person was to be nominated or to be appointed after interview. Boards also had to have a lay member who were seen as the patients' advocate in a different way than non-executive directors who sat on the boards of other NHS organisations. In addition because PCGs had no statutory authority of their own, health authorities were given a position on the boards through the nomination of one of their non-executive directors.

This particular circular went further and addressed the issue of accountability. It laid down the ground rules for the relationship between health authority and the PCG, the PCG and its stakeholders, and for dealing with cross border patients who were individuals who might live in one PCG area but whose GP practice was in another. As part of the overarching arrangements annual accountability agreements were specified. In addition clear statements were made about probity and financial governance as concerns existed in the NHS at that time over the possible conflicts of interest between GPs as independent businessmen and GPs as PCG board members making financial allocations and decisions. Financial risk management was also covered in the circular as were incentives to encourage PCG staff, in particular GPs, to innovate and save money, e.g. prescribing expenditure. Finally explicit guidance was given on how much a PCG could spend on management costs as against the provision of clinical services. Overall HSC 1998\139 can be seen as a significant corporate governance framework and is a good example of how the DoH can use this mechanism to set parameters for organisations.

Despite the detail on PCG governance with the 80 plus pages of the circular, some loose ends had been left. The GP community nationally had concerns over who would control PCGs and therefore had raised issues on chairmanship and the make-up of boards. In addition Local Government was very unhappy at the suggestion that the social services seat on the board should be anything other than their nomination. The result was a further circular, HSC 1998\230 (DoH 1998i), four months later. It pronounced on the exact composition of the board which was to be:

- 4 to 7 GPs;
- 1 to 2 community or practice nurses;
- 1 social services nominee;
- 1 lay member;
- 1 health authority non-executive director;
- 1 PCG chief executive.

With regard to chairmanship the circular gave the right to GPs to decide if they wanted to hold this post. If so, the four to seven GPs on the board would nominate the GP chairman and the health authority would be the approving agency. Interestingly the PCG chief executive and the health authority non-executive director were deemed not to be eligible to become chairman if the GPs chose not to exercise their right. The issue with Local Government was resolved by giving them nomination rights for an officer but not an elected member.

This circular introduced a different twist to accountability arrangements. The chief executive of the PCG, a full-time NHS employee, was made accountable to the PCG chairman, a part-time post. This setup appears to mirror both NHS trusts and health authorities except in the PCGs' case the chairman would normally be a GP who is an independent businessman with a significant personal interest in the decisions of the PCG. In addition the part-time chairman was designated as the "Responsible Officer" which was meant to be analogous to the "Accountable Officer" role of chief executives of NHS trusts and health authorities. This arrangement struck many people inside the NHS and commentators outside, as inconsistent.

Finally, HSC 1998\230 introduced an amendment to the *Health Authority (Membership and Procedure) Regulations 1986* which originally would have excluded a sub-committee of a health authority from having a majority of membership who provided services to that authority. The amendment allowed GPs to have a majority on PCG boards.

A few months later the DoH (1999b) issued HSC 1999\048 which gave PCGs further corporate governance instructions. Model standing orders and standing financial instructions were made available and expected to be used by all PCGs. Health authorities were expected to action this guidance which would be audited by local internal audit departments as part of their annual programme. As PCGs' main focus was primary and community services, which were the areas where the DoH had most concern about fraud, an example fraud policy and response plan was made available with the expectation that it should be used as the basis for a local version.

Though PCGs had just been established in April 1999, they were seen as an interim step on the road to the development of stand alone statutory bodies, primary care trusts (PCT). The DoH wanted to see a move from PCG to PCT within a couple of years. They would allow a pioneering tranche of PCGs to lead the way by becoming PCTs in April 2000, with a second tranche in October 2000, and a much larger group in April 2001. In reality PCGs ceased to exist after April 2002 as they had become PCTs or joined with other PCGs to become PCTs.

In mid-1999 the DoH (1999d) published *Primary Care Trusts: Establishment, the preparatory period and their Functions*. This document covers how the PCT would operate between the agreement from the DoH to become established and the operational date, usually a period of two to four months. The governance arrangements are detailed and are different to that of a PCG. The PCT board is similar in make-up to a NHS trust with a non-executive lay chairman and a majority of non-executive directors appointed, at that time, by the Secretary of State for Health, but now the Appointments Commission. A NHS trust has one discretionary and four compulsory executive position on the board; chief

executive, director of finance, medical director, and director of nursing. A PCT would have only a chief executive and director of finance prescribed, with the other three executive seats being filled from the professional executive committee (PEC) and must include the PEC chairman. The PEC was seen by the DoH as the engine of the organisation and was in reality the same group of people that had formed the PCG board. This difference takes into account the wish by Government to have a less involved role by the PCT board in the running of the organisation. The board was expected to provide strategic oversight and verification of the work of the PEC. As a model it is more akin to a board of governors or trustees rather than that of a NHS trust which is based on private sector business organisations.

The document offered at paragraphs 14-16 for prospective PCTs to suggest alternative governance arrangements if it could be demonstrated that they would contribute to the PCT's ability to improve the health of local people. Explicit guidance on the appointment of the chief executive was made and includes details of who should comprise the selection panel. Similarly the same approach was taken for appointment of professional members to the PEC which was a marked change from that of PCGs, however the social services representative remains the prerogative of Local Government. With regard to chairing of the PEC the chief executive was barred from taking on this role. The remainder of the document outlined the key functions that the new organisations would undertake. These were confirmed by the DoH (2000b) through the issue of the *Primary Care Trust (Functions) Directions 2000*.

The establishment of PCTs created a new type of governance relationship within the NHS. Historically whatever the label attached to differing NHS bodies there has been a lay non-executive chairman and a professional chief executive or equivalent. The relationship has been clear with the chairman running the board to set policy and strategy, and performance manage the chief executive. His/her role was to run the organisation and to deliver the agreed objectives and targets. With the advent of various corporate governance failures discussed elsewhere in this thesis, the mid-1990s saw the introduction of the role of "Accountable Officer" with the additional accountability, for both NHS trust and health

authority chief executives, to Parliament for the stewardship of public money. Within a PCT there are not two at the top but three. In addition to the chairman and chief executive has been added the PEC chairman who is accountable to the trust board chairman and not the chief executive. However the *Corporate Governance Framework for Primary Care Trusts* issued in August 2001 (DoH 2001d) is clear that the PCT chief executive is the organisation's Accountable Officer. The jury is still out as to whether this form of accountability will work and will stand up to be seen as effective especially if serious errors are made.

The framework is quite comprehensive and runs to 171 pages. For the first time in such a publication there is a specific section on the role of Accountable Officer within the PCT, as well as the usual delegation of powers and functions. The substantial part of the document covers internal financial control and includes the expected annexes on standing orders, standing financial instructions and, fraud and corruption. However there are separate annexes on audit committees, remuneration committees and internal audit. In addition advice on systems to ensure control of both the day to day budget and fixed assets with a link to financial and performance reporting.

Even though the NHS has only created both PCGs and PCTs within the past two years, a third new organisation is on the horizon. The Government has the view that health and social care should operate as one holistic system rather than the two separate systems that have operated for the past fifty years. The involvement of social services in both PCGs and PCTs was a first step which is to be taken further through the establishment of care trusts. The aim is to take the range of services that can exist in a PCT and combine them with a range of local authority services. The starting point for consideration will usually be social services but could encompass other services if integration would be seen as advantageous. To promote local discussion the DoH (2001f) issued *Draft Guidance on Governance of Care Trusts*. This presents a difficult corporate governance challenge as the NHS is centrally controlled by the DoH through quasi-autonomous non-governmental organisations (quango) whereas Local Government is locally controlled through the election of councillors. The statutory framework governing the two systems are very different but the purpose of the guidance was

to create the first care trust from April 2002; in reality this turned out to be unrealistic as the deadline passed without a single care trust. The guidance overcomes some of the problems by spelling out that care trusts will be NHS organisations with accountability to strategic health authorities (SHA). However it states also at paragraph 9:

The care trust will be corporately responsible to the local authority for its activities as a whole, and accountable for the functions which have been delegated to the care trust. The accountability for the delegated functions from the local authority will be set out in a locally determined agreement, and set out in the corporate governance framework. This will include the scheme of delegation, how services will be monitored, what standards and targets are to be aimed for, and what information will be made available on outputs, outcomes and expenditure, as well as other issues about resources, and managing them, etc.

The possible composition of the body varies depending on whether the prospective care trust is emerging from a PCT or NHS trust. If it is the former then the board can have up to seven non-officer members whereas if it is the latter, it is up to seven non-executive directors. In addition there will be a chair and up to seven officer members for both scenarios. From within the seven non-officer/non-executive director contingent, there must be at least one local authority member, and it is for the local authority to nominate to that position. They have the right also to change the individual in consultation with the care trust chair. However this individual will not be the formal line of accountability for delegated local authority functions. The guidance goes on to cover the role and appointment of the chief executive, and the appointment of other members of the care trust board. In addition there is a discussion of the implications on the PEC if the care trust emerges from the PCT model but, at the time of publication of the guidance, there is no comment as to whether the three at the top structure would be transplanted to the new organisation.

Alongside the publication of directives on how to implement new organisations there is often a need to clarify the role and functions of existing agencies. HSC 1999\92 (DoH 1999i) fulfilled that purpose in clarifying the health authority role following the creation of PCGs and with the imminent arrival of the first tranche of PCTs. In corporate governance terms it emphasised that PCGs were part of health authorities who remained accountable for the performance and actions of PCGs.

Circulars have a role in notifying changes to core corporate governance functions. The DoH (1999e) issued amendments to standing orders and, fraud policy and response plans, to reflect a number of policy changes that occurred in the preceding twelve months.

Corporate governance has grown year on year as to the breadth of subjects that have come under this general heading. As has been shown the mid-1990s saw financial management as the major issue for corporate governance. By 2001 the extensive PCT corporate governance framework had moved the subject in the NHS on to a different level. In the same year the boundaries were pushed out even further. Many NHS organisations undertake clinical and/or scientific research and the manner in which they do so can help or hinder the quality of the patient experience. This is a clinical governance issue which is a key subset of corporate governance for NHS bodies. Accountability for research has been problematic as it normally involves a number of agencies from NHS trusts to universities to major charities such as Imperial Cancer Research. A good example of difficulties with accountability arose in 2000 with the retained organs scandal at Alder Hay Children's Hospital. This NHS hospital has university academics working within it and one of them chose to retain a collection of organs removed from deceased children but without their parents' consent. In February 2001 the DoH (2001a) issued *Research Governance Framework for Health and Social Care*. For the first time the NHS has a framework which lays down the responsibilities and accountabilities for individuals and organisations undertaking research. For example, there are sections on the responsibilities for researchers, the principal investigator, the research sponsor, universities, and research ethics committees. With regard to the latter subject specific guidance on

Governance Arrangements for NHS Research Ethics Committees was issued in July 2001 (DoH 2001c) and tackled significant subjects such as working procedures of the committee, multi-centre research, and the process of ethical review of a research protocol.

9.4. Audit

Scrutiny of the vast DoH publications' list is more illustrative of what is not present rather than what is. Over the past seven to eight years only three documents have been issued on the subject of audit. The first was issued in 1998 by the NHS Executive and was on the topic of audit risk assessment. It was a technical paper aimed at internal audit practitioners and produced by an internal audit practitioners group under the aegis of the NHS Executive. The second document *Governance in the NHS: The Role of Internal Audit* issued by the DoH (2000a) will be examined in a later section.

The only substantial piece of work was published by the DoH (2001g) and is the *Audit Committee Handbook*. It is an overview of the membership, accountability and broad remit of the committee and offers specimen terms of reference, self assessment checklist for the committee, and an example annual committee timetable.

9.5. Corporate Governance Frameworks

The DoH decided to approach the overall subject of corporate governance through the development of the NHS National Controls Assurance Project. HSG(97)17 (DoH 1997b) gave the following summary:

The NHS has responded positively to the principles of sound corporate governance as recommended by Cadbury, Nolan, and others. A range of measures has already been implemented which provides a clear framework for corporate governance. The intention of the Controls Assurance Project is to bring all of

these measures together.....Put simply the concept of controls assurance requires that boards of health authorities and trusts are satisfied that systems are in place within the organisation to ensure that risks are assessed and properly managed. The requirement to produce a statement accompanying the annual report and accounts is confirmation to the general public that the board of directors believes these systems are in place and operating effectively.

The NHS Executive (1997b) launched controls assurance into the NHS through the release of a pack containing video, booklets and circular. The first stage was for the annual report and accounts for both NHS trusts and health authorities for 1997\98 to carry a statement of internal control by the board. HSG(97)17 gave guidance on what the statement should cover and indicated that a model disclosure statement would be issued by the DoH. In essence the statement would address:

- safeguarding of assets;
- the maintenance of proper accounting records;
- the reliability of financial information;
- confirmation that appropriate internal financial control systems existed;
- confirmation that minimum control standards had been in existence for the financial year in question.

At this time these control standards covered basic corporate governance subjects and included standing orders, standing financial instructions, fraud and corruption policy and response plan, audit and remuneration committees, internal audit, control of assets, and budgetary control systems. The next step was the issue of HSC 1998\070 (DoH 1998c) which discussed controls assurance statements for the subsequent two financial years, 1998\99 and 1999\2000. Between 1997\98 and 1998\99 it was proposed to amend the minimum control standards. The first statement had contained a requirement to identify and evaluate business risks but for 1998\99 this standard was dropped. Two

additional standards were included. The first required NHS bodies to reassure the public that the impact of the “millennium” had been assessed and, where necessary, contingency plans developed. In particular there was a real concern that information technology systems would fail to function on 1st January 2000. The second new standard involved assurance that mandatory requirements within the NHS Executive costing guidance had been followed.

The circular went on to give advance warning of an additional assurance statement for 1999\2000 and to consult on its probable content. The new statement would be introduced to confirm that the organisation had a comprehensive risk management strategy to cover all significant non-clinical areas. The statement would appear in the annual report and the NHS trust or health authority would have to have evidence that the strategy was being implemented, that systems/procedures were reviewed regularly, and that improvements and developments were taking place. It was proposed (paragraph 15) that the statement would cover:

- business planning;
- corporate strategy;
- environment (property and estates);
- human resources;
- service management.

The outcome was the issue of HSC 1999\123 (DoH 1999f) which was titled *Governance in the new NHS* and dealt with controls assurance statements for 1999\2000. Effectively this document took the outline of the advance notification and expanded it to cover organisational controls and risk management. It argued that issues to do with the quality of care would be dealt with under clinical governance but the link between this area of activity and organisational controls would be risk management. The circular argued (paragraph 12) that the benefits would be:

reduction in risk exposure through more effective targeting of resources to address key risk areas;

improvements in economy, efficiency and effectiveness resulting from a reduction in the frequency and/or severity of incidents, complaints, claims, staff absence and other loss;

demonstrable compliance with applicable laws and regulations;

enhanced reputation through public disclosure of achievements in meeting objectives and managing risk; and, consequently,

increased public confidence in the quality of services provided by the NHS.

However for the first time controls assurance would move away from self-regulation. Internal audit would be responsible for the verification of organisational controls assurance statements and the Audit Commission would take on an external review role. To allow judgements to be made on how effective NHS bodies tackled the expanded controls assurance agenda, a new set of control standards were introduced under two broad headings.

Firstly, there were a group of standards against which organisations could assess their approach to risk management. Leadership and commitment, and policy and strategy were two of them. In total there were ten in number and covered a variety of subjects such as incident reporting and investigation, claims management, audit, and risk management process. The second group established standards for seventeen risk areas. They covered a very diverse range of topics from catering and food hygiene to medicines management to records management to waste management.

The director of finance for the NHS confirmed the role of internal audit in the verification process through the issue of Misc(2000)3 (DoH 2000a). This correspondence laid out a number of practical support measures that he was

putting in place to ensure internal auditors throughout the NHS were prepared to take on their additional role. He wrote again a year later under the title *Governance in the NHS* (DoH 2001i) in which he discussed governance convergence:

we are committed to achieving a fully integrated approach to governance where clinical and corporate governance sit side by side – clinical governance focusing on continuous improvements in quality and corporate governance focusing on having the necessary systems in place to minimise risk. I am confident that by 2004\05 we shall have achieved our level 3 milestone under controls assurance with fully operational clinical systems in place and working effectively. These systems will be based on controls assurance standards incorporating the NHS Litigation Authority’s clinical risk management standards supported by the recommendations coming out of NICE and the National Service Frameworks.

This letter added an additional control standard, which had arisen out of the national concern over “mad cow” disease with the possible link to humans, and concerned the decontamination of medical devices. A few weeks later a further circular emerged in the form of HSC 2001\005 (DoH 2001b) and covered controls assurance statements for the forthcoming financial year of 2000\01. The key development was the introduction of a control and risk maturity matrix which comprised of three levels:

- level 1 – minimal;
- level 2 – moderate;
- level 3 – expected.

These gradings have between 12-14 criteria per level which allow organisations to make an assessment of their position. Misc(2000)3 indicated clearly that the goal is for all NHS organisations to achieve level 3 by 2004\05.

A further document (DoH 2002a) was published on the controls assurance website of the DoH in March 2002. This guidance outlined that the statement on internal control for 2001\02 and onwards, would be underpinned by three core standards of governance, financial management and risk management. Additionally it was stipulated that chief internal auditors had to give boards an opinion of the effectiveness of the internal control system and copy the opinion to the DoH. Also the control and risk maturity matrix was downgraded for internal use by NHS bodies as internal audit no longer had to report on compliance. In the same month the DoH (2002b) issued supplementary guidance on the internal control statement.

9.6. The Conceptual Framework and the NHS Response

9.6.1. Accountability

The NHS has focused a great deal on accountability. On an individual basis there was the introduction of the Accountable Officer, and the guidance on the personal liability of non-executive directors. At the organisational level many documents spelt out the accountabilities and responsibilities of new and existing organisations. Also the introduction of the Code of Conduct and Accountability for NHS bodies (DoH 1994) clarified the purpose of the board of each statutory organisation.

9.6.2. Directors and Management Control

Each of the documents, which established new organisations e.g. PCTs, contained clear guidance on what mechanisms were to be put in place to ensure corporate governance; for example the requirement to have a remuneration committee made up principally of non-executive directors. Without doubt the main initiative to assist boards in the exercise of management control was the establishment and ongoing development of the Controls Assurance Project. This holistic approach is designed specifically to ensure that effective management control systems of NHS organisations are in place.

9.6.3. Conflict of Interest

The organisational structure documents in this chapter contain mechanisms put in place to minimise conflict of interest. There is no possibility of combined chairman/chief executive roles and non-executive directors are always external appointments, now made by the independent Appointments Commission. The introduction of the whistleblowing policy had as one of its key purposes the reduction of conflict of interest. Similarly the establishment of the counter-fraud service has had the purpose to achieve the same aim. The Alder Hay Hospital scandal exposed a conflict of interest between the NHS and the university sector which the subsequent guidance (DoH 2001a) sought to remove.

9.6.4. Audit Committees

An examination of publications made by the NHS on this topic gives a false impression. The issuing of *the Audit Committee Handbook* (DoH 2001g) was to provide explicit guidance to all NHS organisations and updated a previous version. Within the various documents establishing new organisations always there is a reference to the mandatory requirement to have an audit committee and lays out its membership and purpose. The NHS Code of Conduct and Accountability is clear that audit committees are required by every NHS body as a formal sub-committee of the board.

9.6.5. Agency Theory

When the NHS response to corporate governance is examined with regard to organisational theory there are no explicit references, however implicit links with agency theory is common. Section 9.1 covered guidance on financial management that has been issued over the years by the DoH. It can be argued that this is the principal setting out boundaries in which the agent must operate. Similarly the many publications on organisational structures and responsibilities fall into the same category. The introduction of the role of Accountable Officer is a clear example from agency theory and is the classic principal-agent relationship defined within the NHS context.

At the same time the publications articulate that within principal-agent environment of the NHS stakeholders have a place. Specific guidance on public meetings and the need to have whistleblowing policies and procedures brings into play a variety of stakeholders which include the general public, the media, staff and trades union. The establishment of the Appointments Commission is aimed at the removal of political patronage and the broadening of stakeholders who can apply to become chairmen and non-executive directors. In a different vein, the guidance on research governance covers a number of stakeholders outside the NHS and include universities, charities and, pharmaceutical and medical equipment manufacturers.

9.7. Summary

This chapter has shown that the predominant theme for NHS corporate governance has been accountability. The majority of the documents deal with the accountability of organisations in the main but do touch on that of key individuals. There is a strong coherence with the theoretical framework with regard to management control and the need for the board to ensure that internal control systems exist. Audit committees, as a subject, have little comment but this could be because they have been a compulsory corporate governance requirement throughout the time period in question. The issue of conflict of interest received no individual attention as an issue but many numerous documents included specific references as time has progressed. With regard to organisational theory it can be seen that agency theory provides the backdrop in the various initiatives and publications that have been reviewed. In general the evidence of this chapter is to support the theoretical framework.

Section D

Conclusion

Chapter 10.

CORPORATE GOVERNANCE IN THEORY AND PRACTICE

This thesis started with a preliminary case of significant corporate governance failure in chapter 1 from which some possible concepts were identified. Through the use of academic literature these concepts were articulated and a conceptual framework was suggested. Due to the nature of the command and control system which operates in the NHS an exploration of the most appropriate major theory of how organisations work completed the development of a theoretical framework which was tested by reference to three further cases of corporate governance failure, four corporate governance reports, and a review of how the NHS has approached corporate governance. The outcome is the delivery of four products; the definition of corporate governance in the NHS, the recognition of organisational theory around the relationship of agent and principle which can underpin corporate governance in the NHS, the identification of the key elements of corporate governance in the NHS and the development of practical advice for use of the key elements by practitioners in the NHS. The chapter articulates the four products and concludes with a brief reflection on how the research methodology for this thesis has worked.

10.1. Definition

The easiest way to define “corporate governance” is to examine the two words separately and then derive one definition. As shown in chapter 2 corporate is a word normally associated with an organisation or body, and as such it implies as much relevance to the public sector as to companies in the private sector. Governance is to do with organisational control and therefore the processes, systems and procedures for the exercise of that control. Therefore at its most simplest corporate governance in the NHS could be defined as “the processes, systems and procedures through which individual NHS organisations exercise control”. Unfortunately such a definition would be deficient in three major areas

which were identified in the literature review in chapter 3; the issue of accountability, the importance of stakeholders, and governance by principles.

As shown in chapter 4, with the exception of the owner-manager, all other organisations have stewards who have to account for their actions to their principals. In the private sector the principals are shareholders, in the voluntary sector it is the membership, and in the public sector it is the community, though in the NHS the route is indirect. Within local government there is the direct principal-steward relationship between a council and the local community which forms the electorate. The NHS is controlled ultimately by central government and its Department of Health. This means the steward-principal relationship is between a NHS organisation and the Department. The community is one step removed and calls health ministers to account through the general election process. In business parlance the Department is the customer whereas the public is the consumer. An appropriate analogy is family shopping where the parent is the customer and the children are the consumers. The parent makes the decision and receives feedback from the consumers on the wisdom of their actions. Whilst accountability in the NHS is to the Department of Health, three separate initiatives in chapter 9 have sought to increase greater perceived public accountability.

Firstly in 1995 the role of “Accountable Officer” was introduced for all chief executives whether from health authorities or NHS trusts. An explicit link was formed between each NHS organisation and Parliament, usually exercised by the Public Accounts Committee. A standard memorandum for chief executives of trusts was drawn up and issued on 1st November 1997. It had to be signed by incumbent post-holders and since, by any new chief executive taking up his/her position. It states:

the essence of your role as accountable officer is to see that the trust carries out these functions in a way which ensures the proper stewardship of public money and assets.

It can be argued that any chief executive of an organisation has the same responsibilities to their principals. However the Accountable Officer role goes further. Under a section of the memorandum concerned with advice to the board, the chief executive is given the following instruction:

if the board or the chairman is contemplating a course of action which you consider would infringe the requirements of propriety and regularity, you should set out in writing to the chairman and the board your objection to the proposal and the reasons for it. If the board decides nonetheless to proceed, you should seek a written instruction to take the action in question. You should ensure that the audit committee, which has specific terms of reference and delegated powers to inquire into matters of propriety and regularity, and which may require your attendance before it any time, receive copies of the document which describe your objections. You should also inform the NHS Executive, if possible before the board takes its decision or in any event before the decision is implemented so that the Executive can if necessary intervene with the board and inform the Treasury.

The second initiative built on the first following the election of the new government in May 1997. It believed that the role of Accountable Officer did not go far enough and argued that the focus was primarily on money when the NHS was in the business of care and people. The mid 1990s had seen the public scandal at Bristol Royal Infirmary where a significant number of children had died following surgery by heart surgeons who were not competent to undertake a particularly complicated technique. Despite the expression of concerns by a variety of interested parties, surgery continued as did the deaths. When the case became public knowledge the surgery stopped and an investigation was held. The chief executive, even though by chance he was a doctor, tried to argue that he was not responsible for the clinical performance of doctors. This view did not find widespread support and the incoming government took the action of adding the responsibility of the quality of clinical care to the role of Accountable Officer.

The third initiative introduced, by the DoH (1997b) under HSG (97)17, the concept of controls assurance to the NHS. It required NHS organisations to assess themselves against explicit standards for the risks to which the organisation was exposed. Whilst in the first year most of the standards were of a financial nature, by 2000 they had grown to encompass the complete range of organisational life, such as emergency planning. External auditors are required by the Department of Health to audit the assessments against the standards and to make explicit statements, which are published in the trust's public annual report, on compliance. Effectively, failure of the auditors to accept the trust's views on this matter, can mean that the final accounts for that financial year may be qualified. The trust is required to include controls assurance statements in the annual report and these must be signed by the chief executive. The approach to controls assurance is that of risk management linked to internal control systems which is mirrored in the private sector by the recommendations of Turnbull (1999).

In addition in chapter 9 there are other actions required of NHS organisations aimed at public accountability. Since 1997 all board meetings must be held in public where normal business is to be conducted unless there is discussion around a named patient or member of staff which is allowed to take part in a closed part of the meeting. The NHS Plan (Department of Health 2000) has introduced the concept of the patients' forum which has to be in place in 2003. They will comprise of former patients and members of the community to monitor the performance of a trust in the delivery of patient services; a member of the patient's forum will have a seat on the board. The conclusion that must be drawn on the issue of accountability is that whilst NHS organisations have to account to ministers through the established bureaucracy of the NHS stakeholders are important.

The key stakeholders have been explored in chapter 4 but there are others and all want involvement and the ability to influence how services are developed and delivered. The sum of these demands from all stakeholders will far exceed any NHS organisation's ability to meet those demands even if it wished to do so. The

tools in chapter 4 gave some examples of how managers could tackle the issue of prioritisation of stakeholders. However it would appear to still mean that the organisation will allow itself to be influenced by some stakeholders and not by others, and as such represents a “how long is a piece of string” type issue. The crux of the matter is how do you meet stakeholder expectations and the logical answer has to be when they are reasonable. The accusation that can be made immediately is reasonability is a subjective concept and depends upon your view point. In reality reasonability is set by a range of environmental factors such as finance, staff, buildings and equipment and, changing societal attitudes. Effectively it can be argued that pleasing all of the people all of the time is impossible but pleasing most of the people most of the time, is achievable

The high profile cases in both the public and private sector in the late 1980s\early 1990s in chapters 5, 6 and 7 involved individuals who did not appear to have been guided by any set of fundamental principles. For a definition of corporate governance in the NHS to be useful it must tie up with some principles to which individuals can be held. As shown in chapter 8 the Cadbury Report identified three key principles which should be applied.

The first is Openness and implies transparency of decision making and actions which includes the rationale that has been employed. This norm should be in use most of the time with restrictions applied only when they can be justified. The second principle is that of Integrity which means avoidance of conflicts of interest and thereby ensuring the performance of any individual is not influenced by financial inducement or obligation to any individual or organisation. Thirdly Accountability which as discussed previously, means that an individual must account to their principal for their actions.

These three principles were proposed for the private sector but were deemed by Nolan to be suitable for the public sector. In addition he added four other principles. Selflessness is at the heart of public service and implies the notion of taking decisions and actions to benefit the public and not for personal gain. Objectivity involves the concept of equal opportunity so that individual rewards,

appointments or awarding of contracts is based on merit. Honesty requires the declaration of any private interest that may lead to a conflict of interest. Finally, Leadership is to act out the other six principles as a role model and ensure compliance from others. These seven principles, articulated by Nolan, appear to be consistent with the furtherance of good corporate governance and should be used as the underpinning guiding principles.

It follows that a definition of corporate governance for the NHS could be:

underpinned by the Nolan seven principles of public life, corporate governance in the NHS involves the processes, systems and procedures through which control of the organisation is exercised, public accountability is satisfied, and reasonable stakeholder expectations are met.

10.2. Theoretical Base

This thesis examined in chapter 4 agency theory whose proponents would argue, is the basis for most modern organisations in the developed world and seems appropriate for the command and control system of the NHS.

In the UK, as the 21st century begins there are many that would put forward the view that the Conservative Government of the 1980s and a large part of the 1990s, created a “Me” culture. This was epitomised by a drive for personal gain and the acquisition of material possessions. Some have unflatteringly called this approach as greedy and selfish because it is based on self-gratification. If this culture is examined from an organisational theory perspective, agency theory is a good fit. Davis et al (1977) are clear that agents are motivated by personal gain. The studies in chapter 3 of Gomez-Meija (1987), Abrahamson and Park (1994), Tosi and Gomez-Meija (1987) and, Stroh et al (1996) provide consistent evidence that positive outcomes occur for organisations that target the motivation of agents for personal gain.

:The description of agency theory as a nexus of contracts immediately focuses attention on the mechanism by which the relationship of agent – principal operates. In the real world of the practitioner, the key issue is relationships between people as they dictate the progress or not of business. Eisenhardt (1989) describes the agency problem that flows from this arrangement. Firstly the need to align goals between the two parties and secondly, verification of the agent's actions is both difficult and expensive. In addition there is another dilemma for the relationship around risk sharing with potentially the agent varying with the principal on the degree of risk to be taken. On some occasions the agent may expose the organisation to higher risk than the principals would like, and in effect, is risking someone else's money. However at different times the agent may be risk adverse so as to avoid the possibility of loss of employment. Under both scenarios the principals' welfare will be reduced. For example in Wessex there is no doubt that the agent exposed the organisation to significant risk without the knowledge of the principals. A similar observation can be made of the other three cases. Therefore the important contribution from agency theory is not that it is contractually based but that it is founded on a relationship between agents and principals. In reality in the NHS this is a changing scenario. Ministers are principals and senior civil servants are agents but at the next level the latter become principals and SHAs are agents. Downward again the SHAs are now principals with NHS trusts and PCTs as agents, and finally, boards of NHS trusts and PCTs are principals and their staff are agents. It confirms that the NHS is a hierarchical command and control system which can be explained by agency theory but also it confirms that relationships are fundamental.

When stakeholders are considered as in chapter 4 it can be seen that relationships are key as well. Agents are employed to maximise the benefits of the organisation for their principals. In most scenarios the best way for agents to achieve their objective is to recognise the validity of stakeholder interests. For example, in a high skills industry where there is a scarcity of appropriate labour, it is not in the agent's interest to ignore the concerns of the employees; enlightened self-interest will motivate the agent to interact positively with stakeholders. However not all

occasions align the goals of agent and stakeholders, and at that time the needs of the principal will come first.

If it is established that agents need to consider stakeholders, Quinn and Jones (1995) introduce the issue of agent-morality into the debate. They believe that efficient markets have in-built moral minima. Firstly, the principle of honouring agreements which is fundamental to agency theory. If one or both of the agent and principal chooses to avoid delivery of their agreed contractual commitments then the agent-principal relationship is built on sand. Similarly the second principle involves the avoidance of lying. If the relationship is to prosper it must be based on trust otherwise chaos would ensue. The third principle requires the prevention of harm to others whilst the fourth needs respect for the autonomy of others. Both these principles are necessary for constructive agency and business relationships.

The in-built principles help understand one of the major assumptions behind agency theory. It is argued that the alignment of agent-principal goals is a significant problem as both parties can be morally hazardous. However it has been pointed out that effective relationships cannot exist without observance of the moral minima and if a trusting partnership is not present, then in the short term the costs of monitoring the agency relationship are very high, and in the medium to long term, the relationship is unsustainable. It can be seen from the case studies that moral hazard was a fundamental issue. In each situation it appears that a trusting relationship was present between agents and principals. However once the agent chose to pursue their own agenda the absence of detailed close monitoring by the principals meant that the actions, for example, of John Hoare could not be detected.

It has been suggested that agency theory concerns relationships between people. Examination of the NHS response to corporate governance in chapter 9 reflects this perspective. Many of the initiatives and guidance involve defining relationships both within NHS organisations, e.g. between executive and non-

executive directors, and with outside stakeholders such as local government.. Agency theory is a valid model for considering the key relationships in the NHS.

10.3. Framework of Corporate Governance

The case studies and the literature review illustrate the need for boards to actually control their organisations. In both Wessex, chapter 1, and West Midlands, chapter 5, cases the absence of any board involvement in the key strategic decision-making and the monitoring of the implementation of plans were major factors in the disasters that followed. Clearly Westminster, chapter 6, had a different accountability environment but the statutory body, i.e. the Council, failed to check the excesses of the Majority Party Leader. In the case of BCCI, chapter 7, there is no evidence of an effective board at all. With the exception of West Midlands the cases demonstrate the dangers of strong individuals dominating organisations without any checks and balances. Cadbury, Greenbury, Hampel and Nolan in chapter 8 are clear that boards are the cornerstone for effective corporate governance. Both controls assurance and Turnbull (1999) have indicated that a focus on risk management with clear internal control systems should be the approach for boards.

Within the private sector the literature shows the need for boards to be composed of a balance of external or outside and internal or executive directors. The NHS at first glance does not face this difficulty as all chairmen and non-executive directors were appointed by the Secretary of State for Health until 2002, and now by the newly created, independent Appointments Commission, chapter 9. However if the role of NHS boards is to steer the organisation, monitor performance and exercise accountability, it is imperative that non-executive directors are recruited with appropriate skills and experience, and then provided with ongoing training and support to deliver their role in large, complex organisations; this latter point is supported by Hampel, Vinten (1992 p.5), Cadbury (1999 p.19) and Harrison (1998 p.145 –146). At the same time it is imperative that the Appointments Commission removes the impression that

political bias influences appointments of chairmen and non-executive directors. This accusation has been levelled at both the Conservative administrations of the 1980s and 90s, and the present Labour Government. If boards are to work effectively they require the appointment of individuals who can discharge their functions which are underpinned by the Department of Health's Code of Conduct. Cadbury stressed the need for independence of judgement in all non-executive directors. Nolan made the point that merit should be the overriding principle.

The other key issue for non-executive directors is the availability of accurate, timely information which allows them to take informed decisions and make informed judgements on performance; a matter emphasised by Cadbury and Hampel. The literature and case studies illustrate vividly how often executive directors, in particular chief executives, neuter non-executive directors through the control of information. Both Wessex and West Midlands has this issue at the heart of their difficulties which is caused by executive directors wishing to be left alone to get on with their work and often believing that non-executive directors are ill-informed part-timers who get in the way. The problem with this attitude was shown by John Hoare at Wessex as it assumes that executive directors know everything and are always right. Ultimately a poor flow of information raises the likelihood of a corporate governance mishap.

NHS organisations are normally significant entities involving thousands of staff with budgets of many millions. On average most NHS trusts employ 2-3000 staff and direct budgets of at least £70-100m. No board is able to monitor effectively such bodies through monthly meetings without detailed work occurring at other times. The researched literature is clear that audit committees have a fundamental role to play. They are the link between the organisation and the external auditors but also, importantly, influence the work programme of both internal and external audit, and receive detailed reports on completed pieces of work. The case studies illustrate the need for a more proactive role in monitoring major strategic change and significant developments; Firstenberg and Malkiel (1994 p.34) argue strongly that audit committees should take on this type of role in the private sector in the

US and there is no reason to see why the idea is not relevant for the UK. Both Wessex and West Midlands show a failure to provide detailed scrutiny of large change programmes. Within the NHS, chapter 9, the introduction of controls assurance has meant a focus on risk management with subsequent risk reduction and elimination plans. Auditors are required by the Audit Commission to audit this work and as such it means that audit committees have a legitimacy to examine an organisation's performance in this area. However there is a danger that this scrutiny is performed at the end of the process and not on a planned ongoing basis. The aim should be to prevent corporate governance failures not simply to detect them after they have happened.

The start of the 21st century has seen the NHS embark on a programme of major change to implement the government's NHS Plan. This involves the creation of new bodies, mergers, disinvestment, and the development of public-private partnerships; all these areas have the potential for mishaps. In fact the public-private partnerships have echoes of Wessex if not handled correctly. The use of the Private Finance Initiative (PFI) to fund and build many new hospitals is a challenging new arena for most public sector managers. To prevent another Wessex there is an argument for enhancing the role of the audit committee to include an internal scrutiny mechanism. Non-executive directors have the ability to stand back from the hurly-burly of day-to-day activities and form an objective view of whether major projects are consistent with public sector values and in line with NHS corporate governance. If this role had been in place then it is more likely that Wessex and West Midlands would not have happened. Similarly if audit committees existed in local government there would have been a greater chance to avoid the Westminster debacle.

Turnbull (1999) supports this argument by calling for audit committees to take on the overview of how boards discharge their responsibility to ensure internal control and risk management. Both Zaman (2001) and Jones and Carey (2001) raise concerns that audit committees will become immersed in detail and will not have enough time to take on this expanded role. This view muddles principles with process and therefore does not negate the proposal to broaden the remit of

audit committees whilst it is acknowledged that the process would need careful construction.

Allied to the issue of audit committees is that of the use of auditors, both internal and external. The Public Accounts Committee commented in the two NHS failures of Wessex, chapter 1, and West Midlands, chapter 5, that internal audit were noticeable by their absence. All NHS bodies have an internal audit service, often purchased from a regional consortium of NHS organisations. The issue must be to focus the work of this service. There is an ongoing need to undertake regular audits on financial probity but there is still time within the year to carry out specific work on key issues. Similarly external auditors have specified areas of activity that they must examine but also have discretionary time which the audit committee should direct. The case of BCCI, chapter 7, should not be repeated even though the auditors argued that they did nothing wrong. Morally it cannot be right that an organisation has major levels of maladministration and illegal activities over which the external auditors observed for many years, yet took no concrete action. Both types of auditors are a resource for audit committees to deploy to help reduce the risk of corporate governance failures

The four case studies have one very evident common strand and that is conflict of interest. Without doubt each case had individuals who had personal agendas, such as monetary or political gain, which overrode the discharge of their duties and responsibilities. Interestingly, despite the many NHS publications on various corporate governance themes, there is no writing specifically on conflict of interest. Whilst the literature does not provide one commonly agreed definition of conflict of interest, it is possible to generalise. No individual should be swayed in the delivery of their work through the receipt of some form of inducement to favour a particular course of action. Carson's exacting definition, chapter 3, intuitively seems correct but poses real difficulties in every day life. It effectively asks all individuals to make every decision on an objective basis and to disassociate any personal implication from that decision-making process. The reality is that this approach asks too much of human beings. For example it implies that no person should initiate a course of action which may bring

personal recognition as part of an ambitious person's drive for promotion. In the practitioner's world the emphasis has to be to achieve the desirable and not some unrealistic, theoretical notion. Cadbury, Hampel and Nolan, chapter 8. stress the independence of judgement of the non-executive director and, in particular, their leadership where there is a danger of conflict of interest

The four case studies, the four corporate governance reports and the NHS response to corporate governance demonstrate that the elements below whilst not exhaustive, are both central and consistent to good corporate governance:

- Accountability - the accounting of the discharge of duties and responsibilities by the agent to principals whilst considering the expectations of stakeholders;
- Separation of executive from non-executive responsibility - clarity that executive directors manage the organisation on a day-to-day basis to a strategy and policies agreed by the board but have their performance monitored by non-executive directors to ensure compliance;
- Management control of operations - the establishment of clear and explicit internal control mechanisms to ensure delivery of the board's objectives;
- Management of conflict of interest - the establishment of a system and culture which ensures that individuals cannot influence the decisions of the organisation in the pursuit of personal gain;
- Independence of audit committees - the establishment of a non-executive controlled mechanism to provide independent scrutiny of key executive activity which impacts on the organisation.

10.4. Operationalising the Framework

One of the drivers behind this thesis, as stated on page 1, has been to identify advice for practitioners to help them realise corporate governance in NHS organisations. The aim of this section is to take the learning that has emerged from the theoretical investigations and provide practical suggestions which match the conceptual framework and therefore directors and management control, audit committees, conflicts of interest and accountability will be discussed in turn.

10.4.1 Directors and Management Control – Role of the Board

The board is the key decision making mechanism of any NHS organisation and as such, it has to be managed to ensure it is effective which includes the delivery of good corporate governance. The first set of reflections concern a number of issues which I have found useful in this task.

There needs to be clarity about how often the board holds a formal meeting in public. Traditionally in the NHS, this has come to be seen as monthly. However it is important to understand how these meetings work. Normally there are a number of formal papers presented which address subjects that have been placed on the agenda. Sometimes they can be quite simple e.g. current waiting list numbers and times, or very complex e.g. a business case for a major development. In reality the board meeting is not the best place to examine an issue in depth. Time constraints involving the indicative length of the meeting and the press of business items on the agenda usually mean that no one issue can be given more than 30-45 minutes. At the same time there is no doubt that a proportion of all board directors feel uneasy about criticising complex matters as they are aware that they may be showing their ignorance, and/or if the media are present, they might be scoring a perceived own goal of bad publicity in the local newspaper or on the local radio/television. Board directors are expected to exercise a stewardship function and therefore appropriate time for complex issues is vital. A suggestion, that has been successful, is to hold public board meetings every two months but on alternate months hold board seminars/workshops. This

allows key issues and topics to be scrutinised in depth without time pressures. Involvement of external stakeholders will avoid the charge that the board is making decisions in private and any formal decision making must be done at a formal public board meeting.

An important corporate governance decision is what matters appear in the public part of the formal board meeting and what is moved to the private section of the meeting which is out of the gaze of the public and media. Experience has shown me that NHS organisations often place difficult issues in the private section simply because they do not want to have a public debate. A recent example that I came across was of a large NHS trust which never took a board report on complaints in public. This meant that local people had no idea of the level of complaints that organisation had received, what they were about, was the level rising, falling or static, what the trends were, and so on. This is a practical example of a failure of public accountability. The danger of a board making a key decision in private is that if an individual or group of individuals felt aggrieved and chose to use the judicial review process the NHS organisation would find itself in a compromised position. A suggested simple rule is that every proposed agenda item should be placed in the public part of the meeting unless the matter concerned named members of staff or patients, or if a commercial in confidence issue could not be made anonymous and would lead to the identification of a potential business partner. This approach is usually supported by non-executive directors but disliked by executive directors who are uncomfortable in defending their positions on issues in public. The key is that public bodies need to be seen to make key decisions in public.

Linking with this last point is the need to pay attention to the language used in public board meeting papers. Often loose use of language can cause unnecessary public concern or bad publicity. This is not about sanitising papers but ensuring that they are factual and unemotional. The chief executive should see all draft papers for the board as experience shows that loose language draws bad publicity which draws the attention of the press machinery of government of the day. The

outcome is normally the expenditure of large amounts of time and energy unnecessarily.

There is a need to ensure that the board is clear on the decisions that it has kept for itself and those that it is happy to delegate to another forum e.g. the management team. This decision should be made at a formal board meeting.

It is suggested that a programme of reports and information needs are agreed to allow the board to deliver one of its key purposes, the monitoring of the performance of the organisation. This will mean a mixture of monthly, quarterly, six monthly and annual reports and information presentations. Staggering of them throughout the year lessens the likelihood of overloading any particular agenda.

The chief executive should agree with the chairman how the board meeting will be run. In particular identify how key stakeholders will or will not be allowed to participate. I would advocate the involvement of trade union/staff side representatives on staff issues, and patient representatives, e.g. the local community health council, on all other matters. To assist this process my current trust has divided the agenda into three headings; patient issues, staff issues, and performance. With regard to public involvement in board meetings there are a variety of choices which work. They include dedicated time for public comment at the start of the meeting, at the end of the agenda, or when each issue is discussed. It is possible to allow no voice at all but it is not a course of action that I would recommend as it would probably be interpreted as a lack of public accountability. At the same time the chairman should be encouraged to think about the use of voting as a board tool. On reflection of many years involvement with boards I am not a strong advocate for regular use of voting as where that has happened it has produced dysfunctional boards where individual directors do not trust each other. I would recommend that voting is kept for very serious issues e.g. the proposed closure of a major facility. This does not preclude any individual director from recording their support or objection in the minutes but in general if a routine matter looked like splitting a board my advice would be to withdraw the matter and work on it for representation at the next meeting.

Finally with regard to managing the board, a prudent chief executive should place any key external performance reports on the organisation on the agenda of a public board meeting. Each organisation has an external auditor, appointed by the Audit Commission, and in the autumn of every year the appointed auditor produces a Management Letter. This is a formal critique of the organisation for the preceding financial year and covers subjects such as financial probity, legality of key decisions, and adoption and implementation of individual audit reports on specific subjects. This document is a significant corporate governance document and forms part of an organisation's public accountability. Many NHS organisations do not place this document before its board but send it to the board's audit committee whose minutes go before the board but do not contain the detail of the Management Letter. This can lead to accusations of covering up problems and should be avoided. In the same category are a number of other reports and include the annual performance ratings, commonly known as Star Ratings, and controls assurance returns.

The relationship between chairman and chief executive is key in any type of organisation but particularly so in the NHS where the chairman is part-time, non-executive and appointed by the Appointments Commission whereas the chief executive is a full-time professional manager. The relationship usually has an easier development where the chairman has recruited to a vacant chief executive post as both parties have the opportunity to see if the personal chemistry works as the recruitment process takes place over a number of weeks. It is more difficult when the vacant post is that of chairman as the successor simply turns up after appointment, often has little knowledge of the organisation and usually the two individuals have never met. In governance terms the new partnership needs to agree how it will operate. This will include frequency of meetings, preferred method of briefing, who will lead on which major issue, and how the board will be managed. Often it is thought that as the chairman is non-executive then he/she will not lead on any key topic other than the functioning of the board and an ambassadorial role for the organisation. Reality is somewhat different as different personalities bring a wide range of expectations from chairmen, at times this can lead to a more executive approach. One important area that requires early

agreement is who is to take the main role in media handling. A definite chairman function is that of management of non-executive directors. Personal style of chairmen can vary from a democratic approach where non-executive directors are made to feel very involved through to total non-involvement other than at formal meetings. The findings of this thesis are reflected in practice in that these individuals have a significant role to play in the governance of the organisation and therefore their expertise and knowledge should be utilised. As a starting point the formal roles should be split amongst the group of non-executive directors and include audit committee chairman, clinical governance committee chairman, patient and public involvement lead, and complaints conveners. In addition there are different ways of involving non-executive directors to gain benefit from their experience and, at the same time, allow them to grow their understanding of the organisation. Twinning with an executive director is one method whilst another is to match an individual with a range of services. Use of this half of the board allows greater objectivity to be brought to board discussions and can act as a counter-balance to the views of executive directors who can at times lose sight of key objectives.

If the board is the key decision making body it is important that attention is paid to its development needs. Too often thirteen individuals are thrown together and expected to function effectively when there is a wide range of experience, knowledge and capability. A board development programme is recommended as over time it allows the individuals to be comfortable at operating as a board whilst not losing sight of the key non-executive function to challenge executive directors. This objective can be achieved by the chairman and chief executive devising a programme which meets the needs of the board at that point in time. It may be delivered by the employment of a development facilitator or by using an external development mechanism. On taking up my current appointment my chairman agreed to allow me to enrol the board in the NHS Modernisation Agency's Board Development Programme which has a focus on clinical governance. This meant that over the following twelve months the board focussed on the key topic effecting patient care but also learnt to work with each

other and utilise the strengths around the table. There is no doubt that a development programme can deliver a more effective board.

A separate dimension of directors and management control is that highlighted by the Wessex case. The NHS has embarked on a variety of new ways of working with the private sector which invoke the potential dangers as indicated in chapter 1 of this thesis. Hospitals are now built through the Private Finance Initiative (PFI) where the private sector fund and design the new facility to a specification provided by the NHS. Such schemes vary in value from £5-250 million and involve contracts whose life is normally 25-30 years. Currently I am undertaking my fifth PFI scheme and the goal-posts have never been the same and therefore there is always a learning curve. Also the NHS is involved in Public and Private Partnerships (PPP) which are a form of joint venture. My recent experience involves the provision of a private infertility facility with profit sharing for both partners. Other models involve the establishment of treatment facilities built and staffed by the private sector but for use by the NHS. These varying types of activity can be a corporate governance nightmare as NHS organisations have certain powers to act under statute but must ensure that they do not act *ultra vires*. To avoid another Wessex there are practical steps that can be taken.

Firstly, ensure there is a business case which outlines the benefits and risks, and has been examined in depth by the board and approved formally. Secondly, use a recognised project management methodology, which includes regular reports on progress to the board, to manage the project. Thirdly, involve some non-executive directors on the project board and encourage them to adopt the role of critical friend because in the middle of an exciting scheme the same mistakes as made in Wessex can be made again. Finally, commission external legal advice to ensure that the organisation has an independent, professional opinion that the NHS organisation can legitimately do what it proposes. If there is any doubt, seek a view from the organisation's appointed external auditors because as part of their annual probity audit they will review the legality of all major decisions.

I have offered a large number of suggestions in this section, many of which require effective administrative processes. In the private sector which is governed by a variety of business laws, organisations the size of the average NHS organisation generally employ a company secretary to undertake the lead role in ensuring corporate governance compliance. Within the NHS the demands of public accountability have grown significantly in the past ten years with the outcome that an equivalent role in the NHS to the company secretary is now essential. Where these posts exist they are often known as board secretary. Such posts should be accountable to the chief executive but be a resource for the whole board. The role has a major interfacing function with non-executive directors. This involves facilitating the work that they need to complete within the limited time that non-executive directors have available to undertake their duties, but also to be a focal point for effective communication with the organisation. The board secretary has the responsibility for drafting the formal agenda for board meetings which means that there must be compliance with board wishes on the programme of reports and information, and the presentation of subjects which require board approval. The role includes the complete organisation of formal meetings from public notification, to production of board papers to the drafting of the minutes of the meetings. The board secretary should organise and service all board sub-committees and thereby have a complete picture of the business of the board at any given time. The post should be a focus for all high level corporate governance activity which would include the organisation's work on controls assurance and the implementation of the Freedom of Information Act that takes effect on public bodies in November 2003. The postholder is not a minute clerk but an important senior manager who works closely with all of the board, but in particular the chairman and chief executive, to ensure that the organisation's corporate governance responsibilities are met.

10.4.2. Audit Committees

The audit committee in the NHS tends to be viewed by many managers as unnecessary and/or a distraction rather than an important resource for the organisation. Every NHS organisation is required to have an audit committee

however the establishment of such a mechanism is no guarantee that it will be used effectively. The key is to have an enthusiastic non-executive director as chairman and have an expanded remit from that of probity alone. This can mean that the discretionary areas of both internal and external auditors' work programme is directed by the audit committee to help the organisation become more efficient and effective, and thereby extract added value from the audit fee.

Separately, if the board chooses not to establish a risk management committee as a formal sub-committee of the board, there is a need to have a board forum for the discussion of non-clinical risk. The audit committee can take on this role and would cover risk including financial, buildings, information technology, equipment, and overall business continuity. As discussed in the thesis, controls assurance in the NHS has at its heart the creation of board assurance about all the key risks and whilst clinical risk is covered by the clinical governance committee of the board, the audit committee can pick up all other risks. In effect the audit committee becomes an internal scrutiny mechanism and because it meets in private it can ask the awkward questions that sometimes do not arise in public settings.

In the previous section I discussed the dangers of new ventures and advocated the involvement of non-executive directors and a project management methodology. In addition it might be appropriate to have the audit committee examine in detail some elements of a scheme, For example, the establishment of a private patient unit on a NHS hospital site may cause little concern with regard to the design and operation of the facility. However the financial risks and returns will be of major importance because business failure could well have an adverse effect on public money. Detailed scrutiny by the audit committee in such circumstances could reassure the board when it comes to approval of the business case and/or to sign off the contract.

Finally the attitude of the chief executive to the audit committee sets an important marker for the organisation. My recommendation is to attend audit committee meetings only when necessary and do not attempt to control or

shackle its activities. The result will be that a strong message of the independence of the committee will be established. This ethos can be reinforced by ensuring that all staff understand that they must attend when requested to contribute to discussions, and emphasise the importance of the committee as part of the clinical governance system of the organisation. A key point is that guidance on audit committees advises that they meet once a year with the external auditors but without executive directors present. Directors of finance usually try to prevent these meetings as they wish to hear what is said. I suggest that such meetings take place as they are a backstop to ensure corporate governance own goals are not scored.

10.4.3. Conflicts of Interest

The reality of the NHS in governance terms conflicts of interest do not present a large risk as long as some practical steps are taken. The main risk is that identified in Wessex with a non-executive director who has or may wish to have a business relationship with the NHS organisation through their main occupation. There is a wide range of backgrounds where this may apply but can be split into two broad groups. Firstly, professional services which include solicitors, architects, management consultants, and auditors. Secondly, suppliers who include pharmaceutical companies, computer firms, construction companies, and medical equipment/consumable suppliers. It is key that a non-executive director from this background has no involvement in deciding where an order or contract is placed. All NHS organisations are required to hold a register of interests which is a record of declared activities, by all board directors, where there may be an impact on their NHS duties. A board secretary can ensure that the register is kept up-to-date and should request a formal verification annually of the information held for each individual. It should be made clear to all directors that they have a responsibility to notify the organisation of any change in circumstances which are applicable. Separately, at every board meeting a simple reminder can be made by the chairman at the start of the meeting to the fact that any potential conflict of interest that may arise from the published agenda should be declared at that time.

The other category of individuals where conflicts of interest can arise, is that of local politicians. A large proportion of NHS organisations have local councillors as non-executive directors. Often they have roles within local government where there are direct linkages to the NHS. For example a councillor can have a major influence on policy development and delivery of services within social service with whom the NHS has a close relationship. At times issues of funding will be discussed with regard to which agency should allocate resources. In such debates within the NHS organisation the councillor should declare an interest and take no further part in the discussions.

Outside of the board the major conflicts of interest within the organisation arise in the areas highlighted in the West Midlands case. Predominantly this is around the awarding of orders and contracts and usually will concern the purchase of medical equipment/supplies, the procurement of computer hardware and systems, the use of management consultants, and the provision of building works. In all cases the processes must be compatible with the organisation's standing orders and standing financial instructions and, crucially, not left to the discretion of a single individual. Orders worth over £15,000 should go to tender unless there is a specific reason why a sole supplier is the only way forward, in which case the system should require the agreement of both the chief executive and director of finance.

10.4.4. Accountability

This thesis has explored to whom are NHS organisations accountable and there is no doubt that agency theory still applies and the answer is the government of the day. However the rhetoric at the present time is that the NHS must become more accountable to local stakeholders. Clearly this is not instead of the government but in addition. There are two practical steps that can be taken to reconcile these two potentially conflicting directions.

Firstly, the NHS organisation at board level must ensure that robust plans are in place to deliver the government's key targets. Within the lexicon of the NHS they

are known as 'the must do's' and are predominantly concerned with waiting times for access to services and financial control. There are many targets in addition and the board needs to exercise a judgement on those targets where it needs to focus the organisation's energies. Usually these are areas where the organisation is perceived to be an outlier when considered against other NHS organisations.

Secondly, ensure that the systems which gather the data on key targets are robust and adhere to government policy. In 2002/03 the DoH commissioned a sample of inspections of NHS trusts to examine their waiting list systems. Of the randomly selected forty plus organisations only three received a clean bill of health. Several chief executives lost their jobs as a result and many organisations were left with the stigma of either incompetence or as organisations which were happy to fiddle the figures. As one of the three organisations with no problems I watched as huge amounts of time and energy were spent to rectify the positions that these organisations caused them-selves.

Experience shows that if the two steps above are achieved the organisation can avoid the spotlight of attention from the DoH and allows the NHS organisation to spend time developing relationships with local stakeholders which this thesis has identified as the crux of the accountability wording as used by politicians.. In all cases the key resource is time which must be given to each of the stakeholders to explain what the organisation is trying to achieve, to listen to views that are expressed, and where possible to involve stakeholders in the work of the organisation. For local people and organisations such as the voluntary sector, it is the opportunity to participate and be involved that usually wins them round but it must not be tokenistic or a one-off exercise. I believe that this approach is at the heart of the Foundation Trust movement where despite the promise of local accountability comments from the DoH have indicated that boards of these organisations will be more like governors or trustees and they will not be able to interfere in the day-to-day running of the organisation. I believe this reinforces the accountability of NHS organisations to the government and practitioners would do well to remember that the creation of trusts in 1991 promised local

control but when history is considered there is now more central control than at any other time in the history of the NHS.

It is suggested that if practitioners address these areas of activities then the risk of corporate governance failure would be dramatically reduced.

10.5. Reflection of Thesis Methodology

A particular approach has been adopted to generate this thesis because of the inability to disregard objectively the experience of the writer as a practitioner in the field of corporate governance.

The case study method has been successful for identifying some common factors which contribute to corporate governance failure. The differing cultural and organisational backgrounds of the four cases did throw up discrete issues for each individual scenario and logically that could have been expected. The review of written material illustrated that whilst it is only in recent years that the term “corporate governance” has gained currency, numerous aspects of corporate governance have been studied individually and collectively for many years. The theoretical conclusions that have been drawn resonate with my daily work as a practitioner. At the same time the various corporate governance initiatives have shown that they support to differing degrees, because of their own centre of attention, the conclusions that this thesis makes. Greenbury was the least relevant report as its focus was executive remuneration. However the work emphasised the importance of the non-executive director in organisations, a key conclusion of this thesis. Cadbury, Hampel, Nolan, and the NHS review had much that was in common with the main themes that emerged from both the literature review and the case studies.

Finally, there is no doubt that this research has significantly influenced my work as a chief executive in the NHS, in particular the way corporate governance is enacted which is underpinned by the findings of this thesis. Nevertheless the

reliance on cases informed by a practitioner's need to find an operationalisable framework may have limited the enquiry. Clearly there is a need for more empirical research to test the validity and reliability of the conclusions.

Section E

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