Schrödinger's cat and corporate governance reporting

KPMG Board Leadership Centre

Corporate governance reporting and an Austrian feline may not initially have any obvious connection, but the FRC's renewed focus on transparency and the quality of corporate governance disclosures – as illustrated by the 2024 revisions to the UK Corporate Governance Code (the Code) and the FRC's latest Review of Corporate Governance Reporting – has more in common with Schrödinger's cat than you might think.

For those not up to speed with their quantum physics, back in 1935 Austrian physicist Erwin Schrödinger composed a thought experiment involving a cat, a steel box, an atom and some rather nasty poison. The experiment aimed to shed light on the fluctuating nature of atoms (see box). The conclusion drawn was that the cat was both alive and dead inside the box until it was opened and the cat was observed. This is what is known as the observer's paradox: observation or measurement itself affects an outcome and the outcome as such does not exist unless the measurement is made.

The concept may be derived from quantum physics, and many still struggle to get their heads around the idea, but similar things could be said to be happening all around us – even when it comes to how boards (and audit committees) articulate their governance arrangements and provide transparency over how they have exerted responsible oversight, whether that be over strategy formulation, principal risks and material controls, or the integrity of corporate reporting and the associated audit and assurance activities.

Effective oversight

It is in the interest of investors for companies to be well governed and in an ideal world both boards and investors would welcome some assurance as to the effectiveness of a company's governance arrangements. However, providing assurance over the robustness of board oversight is more difficult than it might first appear.

It's a fairly easy task to benchmark a board or board committee against a list of perceived good governance criteria. Are the roles of chair and chief executive exercised by different individuals; are at least half the board non-executive directors whom the board considers to be independent; do the non-executive directors have sufficient time to meet their board responsibilities; and has the board reviewed the effectiveness of material internal controls?

What's in the box?

Schrödinger's cat is a famous thought experiment, devised by Erwin Schrödinger in 1935, which describes one of the key properties of quantum mechanics – namely, that atoms can exist in different states and locations until they are observed.

He imagined a cat locked inside a steel box with a "diabolical mechanism" that would activate and kill the cat depending on the actions of a single atom. The conclusion was that, since atoms can exist in more than one state, while the box remained unopened, the cat was both alive and dead at the same time. Not until the box was opened and the cat was observed would it actually become one of those two definite states. This is the observer's paradox – that the act of observation and measurement itself affects the outcome and that there is no outcome until the measurement/observation is made.

The idea may sound bizarre, but the principle of atoms having many possibilities until the moment of measurement is today the backbone for one of the most important branches of physics.

But ultimately these things are either organisational or process matters – and that doesn't really answer the question of effectiveness nor provide useful information for shareholders. Indeed, many observers would argue that good corporate governance is less about structures and process, but more about board culture and behaviour.

In this case, things like what is the board doing in practice; how is the board (and audit committee) ensuring the integrity of corporate reporting; how successfully is the board engaging with stakeholders and considering their views during board discussions and decision-making; and how is it satisfying itself that the material internal controls are effective?

Providing comfort to investors over these and other aspects of corporate of governance is much more difficult than ticking some checklist of organisational criteria.

Short of observing the board 'in action', how would an investor assess the robustness of the governance and oversight processes? How could they tell if the board's activities were proportional and focussed on the areas of greatest risk to the organisation? How could they tell if the audit committee had taken appropriate steps to ensure auditor objectivity and independence is safeguarded? How could they tell if the audit committee have exercised professional scepticism – or at least sought appropriate validation to support management's assertions?

The answer lies in being open and transparent as to what the board and board committees have done, how they did it, what they concluded and how they reached their conclusion – and this comes down to disclosing information in the annual report that enables investors (and others) to assess the rigour of the board's governance and oversight activities, or at least provide the necessary hooks on which to start a meaningful dialogue with the company. This is essentially what the FRC are calling for when they talk about the need for governance reporting to focus on decisions and outcomes – as set out in the 2024 UK Corporate Governance Code.

This brings us back to Schrödinger's cat and the paradox that observation itself affects the outcome. In this case the very act of disclosing (say) how the board has monitored and reviewed the effectiveness of the risk management and internal control framework, along with a declaration on the effectiveness of the material controls may well affect how the board actually exerts oversight over such issues – including the scope and depth of its review and the assurance it seeks. And, the outcome – more effective internal controls – would not 'exist' unless the new disclosures are taken seriously by boards and others.

That is to say that open and transparent communications with investors (and others) will directly impact the effectiveness of a company's corporate governance arrangements and in doing so, support long-term sustainability.

Outcome reporting

Investors value robust information on a company's governance arrangements. For example, we heard throughout the recent consultation on the revisions to the Code that the now dropped proposals on board capacity would have helped investors assess potential over-boarding. Similarly, we regularly hear that there is insufficient dialogue between investors and boards/audit committees on audit related issues. Perhaps the solution is, as the FRC have requested, improved corporate governance reporting focused on board decisions and outcomes in the context of the company's strategy and objectives (including clear and meaningful explanations of any departures from the Code's provisions).

That said, though the 2024 Code is still fresh off the press, there is a danger that boiler plate and minimal disclosure will win out over useful reporting unless both preparers and investors show a willingness to engage with each other. Investors must be prepared to articulate what they like and what they don't like. Preparers must be prepared to be 'bold' and transparent.

Genuine two-way dialogue is required, and investors and preparers should work together to ensure that the opportunities afforded by the new Code disclosures – particularly those around material internal controls – are not allowed to lapse into boiler-plate. If they do, then the opportunity for not only providing investors with better information, but also improving the robustness of internal controls, will have been lost.

The KPMG Board Leadership Centre

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