

Measuring the Effectiveness of Governance Programs

By Rick Westerman

Most of our business partners are aware of governance, a fundamental component in managing businesses with purpose. You no doubt have learned from the example of others by reading or hearing about companies suffering and even collapsing from a lack of proper corporate governance. But you may ask: What is governance and how do I know if our company has enough of it?

Corporate governance is the collection of rules, policies, authority, and responsibilities created by and given to those persons who are the custodians of a corporation or business. While corporate governance began in the early 20th century with significant focus on public company legal issues, more recent trends in organizational behavior are promoting good governance as a key component in the success of organizations regardless of size.

Governance can be viewed in terms of leadership attributes as well as actions. Consider attributes the characteristics that describe those who are charged with governance, while actions are the motions made by that same group. Attributes include size, age, competency, independence, multi-discipline, and compensation. Actions include financial transparency and information disclosure, attention to risk, selection and compensation of senior management, meeting frequency, involvement in key issues, attention to regulatory compliance, continuing education, assignment of responsibility, ethics and code of conduct, hotline and investigations, governance self assessments, and monitoring equity compensation. Other characteristics more typical in public company governance include shareholder rights, meetings, and takeover provisions.

As prominence increases, companies and other stakeholders have sought ways to determine the effectiveness of their governance. Certain stakeholders, primarily institutional investors, lenders and insurance companies, have sought ways to predict corporate stability by using governance ratings. As the fabled management consultant Dr. W. Edwards Deming said, 'In God we trust, all others bring data!'

By 2002, numerous rating agencies began publishing public company governance "scores." There have been three well-known rating agencies, which prepared a quantitative analysis to assess a company's governance. Standard and Poor's (S&P) provided governance ratings until 2005. They now provide GAMMA (Governance, Accountability, Management Metrics, and Analysis) ratings in the non-US markets. The two other rating agencies are Institutional Shareholder Services (ISS), and Governance Metrics International (GMI). While each offers a unique approach to evaluating corporate governance, the majority of measurements are grouped along the lines of the attributes mentioned above.

Consistent with most topics, there exist studies that either positively or negatively endorse quantitative metrics. For example, a 2003 study published by The Wharton School finds a positive correlation between high shareholder rights and firm value. On the other hand, critics of governance metrics offer evidence that many typical governance measures do not correlate with actual results. A study by the Stanford

Graduate School of Business questioned the correlation between governance ratings and actual performance.

Corporate governance ratings should be viewed as an indicator and not a judge or “final word” vindicating or condemning the effectiveness of the corporate governance program and corporate performance. Low scores indicate that there may be problems in the corporate governance structure requiring further investigation. However, high scores do not necessarily indicate a lack of problems, as recent events prove.

How should we approach governance? While the Board of Directors is ultimately accountable, each stakeholder has different yet overlapping responsibilities for an organization's governance. External auditors opine on financial transparency, a key governance characteristic. Internal auditors perform assessments to ensure that governance structures are operating properly. Senior management develops and executes strategic plans, manages risks, and provides tone and direction to the organization. Each party plays a critical interrelated role. Perhaps the key to good governance is understanding its characteristics and your responsibility; then keep rehearsing the mantra - inspect what you expect!