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Corporate Governance after Enron and World Com

Applying Principles of Results-Based Governance

Abstract

This paper discusses corporate governance in the wake of the recent failures of large corporations such as Enron and World Com and the consequent collapse of equity markets. It discusses the historical relevance of corporate boards, the relationship between boards and their CEOs, factors contributing to failed corporate governance and levers for improving governance practices. It suggests some principles of good governance and accountability, provides an outline of a 'Results-Based Governance' model and a brief description of the Governance Self-Assessment Checklist, a tool for assessing and improving board performance. Finally, it enumerates important questions for legislators and corporate boards that emanate from the current context and suggests some steps essential to restoring accountability, trust and credibility in corporate governance and the capital market system.

Governance Defined

Governance is typically thought to be the purview of boards of directors. However, in the broader context, it is a responsibility delegated by shareholders and the public, defined by legislators and regulators and shared by boards, in some measure, with managers. The logical point at which to begin any discourse on governance is with a working definition[i]. The following definition is offered to provide context for the current discussion:

"Governance is the exercise of authority, direction and control of an organization in order to ensure its purpose is achieved. It refers to who is in charge of what; who sets the direction and the parameters within which the direction is to be pursued; who makes decisions about what; who sets performance indicators, monitors progress and evaluates results; and, who is accountable to whom for what. Governance includes the structures, responsibilities and processes/practices that the board of an organization uses to direct and manage its general operations. These structures, processes and organizational traditions determine how authority is exercised, how decisions are taken, how stakeholders have their say and how decision-makers are held to account."

Governance is:
"**The structures, traditions and processes of Leadership and Stewardship that**:

- Assign Power
- Define Roles, Responsibilities and Relationships
- Govern Communications with Stakeholders, and
- Ensure Accountability (from which legitimacy is derived)

That is:

⇒ Who has influence
⇒ Who decides
⇒ How decision-makers are held to account"

Relevance of Boards

The responsibility for governance, in the narrower sense, is legally vested in a corporation's board of directors. Carver has described the traditional board as "an incompetent group of otherwise competent individuals".[ii] It is probably the sense of frustration derived from that perception that would have many CEOs ascribe to boards the sentiments of a Quaker widow who is said to have remarked: "having no husband is better than having almost any husband at all." As we all know, the relationship between CEOs and 'their' boards is among the most contentious of governance issues in corporate, public and nonprofit organizations.

Leighton and Thain[iii] report a typical comment about his board from a young CEO: "If they can get someone better than me to do the job, then that's what they should do. Until then let them back off and stay out of my way." Indeed, "In countless individual companies, boards have (done just that) stood by and approved widely-publicized mistakes that have led to staggering losses, painful layoffs, costly legal proceedings, and endless grief for countless thousands of investors, employees, creditors and suppliers."

Peter Drucker[iv] in 1992 said: "In every single business failure of a large company in the last few decades, the board was the last to realize that things were going wrong." This is pretty scary since a substantial proportion of boards has historically been comprised of the corporations' senior managers ('inside directors')…and the same individual typically filled both the CEO and Board Chair positions. Consequently business failures must be construed largely as failures in management. The failure in governance has been a failure to protect investors and the public from poor, if not fraudulent, (mis)management.

One wonders why high-tech executives didn't anticipate the classic 'mushrooming' or 'bullwhip' effect in inventory build-up cautioned by Senge's[v] example of poor supply chain management by a beer retailer. Management with a bit more foresight might have prevented or, at least mitigated, the creation of the high-tech bubble that burst with such disastrous results between 1999 and 2002.

David Leighton and Donald Thain[vi] cite numerous examples of respected experts on corporate governance who, over the past few decades, have decried the vacuum in board leadership, accountability and relevance…not to mention effectiveness. Some typical comments:

- "While ostensibly the seat of all power and responsibility, directors are usually the friends of the chief executive put there to keep him safely in office…they can and must judge the chief executive officer, and throw him out when the time comes…If they can ask important questions that the CEO hasn't already thought of, he ought to be replaced…(but)…Since this task is painful, it is rarely performed even when all the directors know it is long overdue." (Robert Townsend, 1970)
- "95% of boards are not doing their jobs…legally, morally and ethically…and couldn't even if they wanted to." (Harold Geneen, 1984)
- "Boards play little role in corporate governance." (Michael Porter, 1990)
- "Boards have been largely irrelevant throughout most of the twentieth century." (James Gillies, 1992)
- "Boards are in trouble." (Leighton & Thain, 1998)

Levers for Influencing Good Governance Practices

An animated debate about the relative merits of principles-based rather than rules-based approaches to ensuring improved governance practices has been precipitated by the wake of the recent corporate implosions and meltdown in equity markets. Certain regulators[vii] and institutional investors[viii] argue strongly for rules-based solutions on the premise that reliance on market forces and voluntary implementation of 'guidelines' has gotten us into the current mess.

Others, like the Canadian Council of Chief Executives,[ix] favour principles-based solutions. They argue that people will either aspire to meet the minimum standards prescribed by regulations, will seek loopholes in laws and regulations, or regulators simply won't have the capacity to enforce them (as evidenced by the recent disclosure of the Ontario Provincial Auditor that "half of Ontario corporations did not file 2001 income tax forms because nobody checks up on them"[x]). They also contend that principles-based guidelines can set a higher standard of excellence towards which corporate boards will be encouraged to strive. They give as evidence the substantial improvements in corporate governance in Canada since the 1994 Dey Report. (Seventy percent of Canadian corporations now split the CEO and Board Chair responsibilities.[xi]) They also argue that the improved performance in the 'bottom-line' of corporations that have adopted governance 'best practices', as identified in recent studies[xii], will provide a market incentive for improved governance.

There are really six primary points of intervention or means for influencing corporate governance on this continuum:

- Legislation and Regulations (e.g. Corporations Act & Regulations; Security Exchange Regulations; tort, tax and criminal law)
- Bylaws and Governance Policies
- Best Practice Standards (GAAP – Generally Accepted Accounting Practices; Best Governance Practices)
- Market forces and investor confidence
- Shareholder 'control' of boards
- Recruiting 'principled and informed' leadership as directors and senior management

I'll deal with these in reverse order.

The majority of corporate directors may be well-intentioned people of integrity. However, a fundamental understanding of the propensity of human nature to succumb to greed and the corruption of power would suggest that '<u>principled leadership</u>' is not the foundation upon which you ought to build your retirement home. It's just not good risk management! Holding directors personally accountable for principled leadership through legislative and regulatory sanctions can mitigate that risk, but don't bet the ranch (or the oil fields) on it.

Most objective observers would conclude that <u>shareholder control</u>, certainly by the average investor, is more democratic fiction rather than reality. And <u>market influences</u> on corporate governance have typically come into play only after the 'horses have already stampeded out of the barn' with often catastrophic social and economic consequences.

Forensic accountant Al Rosen, in a recent article in 'Canadian Business',[xiii] says: "Recent accounting changes make hiding losses – and bad decisions – much easier. Don't be fooled by claims that Canadian accounting rules (<u>best practice standards</u>) are being tightened, and that the 'quality of earnings' might therefore be improving in the market. In fact, corporate reporting evidence seems to point in the opposite direction…(because) small improvements brought about by management's tighter application of accounting rules are simply lost in comparison to the loosening of the Canadian definition of income. [i.e. taking a write-down of goodwill by reducing retained earnings (on the balance sheet), instead of increasing expenses (on the income statement)…as required by U.S. law.]"

So we come to bylaws and governance policies. The former are effectively in the hands of directors and controlling shareholders. Governance policies, too, may be influenced by institutional and other large shareholders but are effectively controlled by the board. Whether actual practices comply with policy is entirely under the control of directors and senior management and can only be discerned by careful scrutiny through an audit mechanism.

Finally, on the point of influencing governance practice, it's useful to examine the potential for perverse effect through the use of legislation or regulation. A July 16th article by Daniel Gross posted on MSNBC[xiv] examines the impact of the U.S. Congress's ban on the deductibility of executive salaries above $1 million. Exemption of incentive or performance-based compensation from this 'deductibility limit' had the 'perhaps' unintended consequence of "funneling executive compensation into these murky areas, which are far more difficult for investors and the public to understand…and created tax-based incentives for companies to craft some of the 'pornographic' CEO compensation practices that helped get us into the current mess…It is clear that executives at many companies used aggressive, and occasionally illegal, accounting methods to protect the source of their greatest compensation: the company's stock price."

Christopher Byron, in another article for CNBC & the Wall Street Journal described the real problem with stock options as "the accounting lie that has fueled the un-fettered, runaway growth of executive stock options…that spawned hundreds – and possibly even thousands – of boom era businesses that never (otherwise) had a chance of surviving a single business cycle."[xv]

It could be argued that principles-based solutions tend to be more porous than a sieve while rules should at least get everyone to a minimum standard. However, as evidenced here, there are no easy solutions. We are, at best, likely to end up with a typical Canadian compromise balanced somewhere between the two extremities. All of this reinforces the need for very careful analysis of what points of intervention are most appropriate to resolve a particular problem and caution regarding the potential for unintended consequences.

Does Governance Matter?

"Governance does matter, and it matters that we get it right."[xvi] The 1992 Cadbury report and the 1994 report of the Toronto Stock Exchange (Dey Report) both "stressed the importance of improved governance, of better board operating practice, and of the independence of boards from management."[xvii] Did we, after these reports…after Royal Trust, Confederation Life, Olympic & York and the BreX fiasco really need another wake-up call from Global Crossing, Enron and World Com? And corporate America has no monopoly on governance failures. In the public and voluntary sectors, the United Way of America, Canadian Red Cross Blood Supply, National Arts Centre, International Olympic Committee and B.C. Fast Ferries fiasco come readily to mind.

Will we tackle the causes of these governance failures now or will we 'paper them over' with good intentions and await yet more catastrophic failures, if such can be imagined, before we get serious in our pursuit of real safeguards to mitigate future risks? And should we really rely on the good intentions (the voluntary actions) of corporations as suggested by the CCCE? Should our confidence be based on current rhetoric or past performance?

Henry Mintzberg, echoing the perspectives of many others, attributes the failure to act on past lessons to "legal corruption…in the sense that business is out of control…corporate executives taking huge salaries and bonuses…what justifies the greed is the economic dogma that says that if you get as rich as possible, society will be a better place…a chief executive protects himself on the upside (with stock options) and on the downside (with a golden parachute) so no matter what happens, he wins…What kind of gamblers are CEOs? What kind of gambler wins no matter what happens? And, they're gambling with other peoples money."[xviii]

Mintzberg also criticizes the 'hero worship' of CEOs as having destroyed leadership. He says, "The press builds them up as something larger than life or almost godlike. The big problem is when CEOs start to believe it."[xix] Ninety-eight percent of senior corporate managers responding to the 2002 KPMG Fraud and Misconduct Survey[xx] indicated that they believed their employees held them in high esteem. That too is a bit scary and certainly stretches the credibility of the survey results on other items.

The same KPMG survey suggests that only 30 to 40% of corporations have well-defined procedures for managing, documenting and reporting fraud risks. It also indicates that about 30% do not have conflict of interest policies. Both sound 'risk management' and conflict of interest policies are essential elements of good governance…but the practices must comply with the policies.

Links between Good Governance and Organizational Effectiveness

There is increasing evidence of the links between governance 'best practices' and effective corporate performance.[xxi] [xxii] The importance of effective governance grows with the level of public interest and investment in a corporation as well as the size and complexity of the organization. So does the moral and ethical obligation of directors to shareholders, suppliers, consumers and the public at large. Economic decisions have social consequences!

Corporate Governance

Leighton and Thain suggest that "corporate boards, as representatives of the owners of a business – the shareholders – are intended to do four things:

1. Optimize long-term shareholder value (increases in share prices plus dividends), with minimum acceptable performance being to earn a return on investment greater than the cost of capital;
2. Earn a profit that compares favourably to the long-term return on investment of businesses in the same or similar industries;
3. Lead a business that is strong and competitive relative to its challengers, actual and potential'; and,
4. Add value to the company by guiding its strategic management, particularly by appointing, supporting, overseeing, and controlling the best available management team."[xxiii]

This articulation of board functions omits the critical notions of safeguarding the organizational mission, establishing a values framework, ensuring sound risk management practices and accounting to the broader public interest.

Governance Models

Many boards, following the debacles of the past decade, have considered alternative governance models including the Carver 'Policy Governance' model. Can you imagine corporate directors, a la Carver, spending hours ad infinitum developing policies on 'Ends/Means' distinctions, 'Executive Limitations', 'Governance' and 'Board/Staff Relationships'. Or what board could set corporate direction independent of the CEO? A recent "Primer for Directors"[xxiv] suggested that a board employing the Carver model may not even be fulfilling its basic statutory obligations. My own research has identified eight governance models[xxv], including Carver's, typically used in nonprofit and public sector organizations. Many of these have analogs in private sector corporations.

Results-Based Governance

Results-Based Governance[xxvi] is one of the eight models identified in my research on over 30 nonprofit and public sector organizations. This is a hybrid model emerging out of the many failed attempts to implement the Carver Policy Governance Model[xxvii] and the search for a substantive role for boards of directors in corporate direction and accountability. Its focus is on defining and monitoring results in relationship to organizational mission. It is an Audit/Oversight function concerned with establishing direction, monitoring performance, evaluating results and accounting to a broadly defined set of stakeholders including the public interest. Key to this Audit/Oversight focus is clear definition of:

- ⇒ Mission and Values
- ⇒ SMART objectives
- ⇒ Inputs (efficient and economical use of resources)
- ⇒ Outputs (units of production or service)
- ⇒ Outcomes (what benefits for whom at what cost?)

A board needs to be at 'arms length' from management to do this effectively. It needs to ask 'tough questions' of management…to maintain sufficient independence from management to objectively scrutinize management/corporate performance… And at the same time balance this posture with the need for a partnership with management that depends on its advice and maintains a functional level of trust and confidence. This is a delicate balancing act. I don't believe that it can be achieved…with sufficient transparency in accountability relationships…if CEOs and their senior managers are members of the board of directors.

Good Governance Relative to Good Management

The following text boxes compare good governance and good management using a transportation metaphor:

Good Governance: Providing a Framework	Good Management: Implementing within Framework
• Vision/Values • Destination/outcomes • Resources/inputs • Monitoring • Accountability to owners/stakeholders	• Piloting/Steering/Driving • Knowing: Map/Resources/Conditions • Selecting Course from alternate routes • Ensuring Efficient use of Resources & Good Organizational Maintenance • Assessing Progress and Conditions • Reporting to (Board/Crew/Passengers)

This postulates that a board is 'entrusted' with establishing a broad framework within which management is delegated the responsibility for operational achievement of corporate goals and accounting to the board for results. The board is responsible for accounting to share/stakeholders and the public interest for overall corporate performance. It is responsible specifically for the following:

- Defining or acting as 'Custodian' of the corporate mission;
- Creating the values framework within which management must operate;
- Defining desired outputs, outcomes and measurement benchmarks (What benefit for whom at what cost);
- Evaluating management/corporate performance against industry standards and the corporation's historical trends;
- Ensuring risk management practices adequate to protect the corporation, shareholders and other key stakeholders from catastrophic events and bad management; and,
- Accounting to shareholders, other stakeholders and the 'public interest' for the corporation's performance and conduct.

Importance of Accountability

The job of the CEO and the board is tough. It is an intense juggling act that they must perform in the face of many conflicting demands. Little wonder that so many businesses fail. But, as the fates of Ken Lay, John Roth and many of their peers attest, very few captains 'go down with the ship'.

Accountability is crucial to effective governance. The lines of accountability and responsibility are badly blurred when senior managers comprise a substantial proportion of board membership. Boards cannot govern 'independently and objectively and ensure proper accountability' when 'effective control' over corporate direction and board membership is vested in the CEO and other 'related directors'.

The GSAC: A Tool for Measuring Board Performance

I developed the 'Governance Self-Assessment Checklist' (GSAC)[xxviii], based on recent 'best practices' research, to provide boards with a tool to assess their own performance, affirm those tasks which are being performed well and aid in development of a blueprint for action to improve performance where needed. It serves both assessment, educational and strategic planning purposes. The following is an outline of the specific dimensions of governance measured by the GSAC. Recent research[xxix] shows a high degree of correlation between the 15-item 'Quick Check' and the overall 140-item comprehensive version of the GSAC.

- Governance Self-Assessment Checklist (Overview)
  - Governance Effectiveness Quick Check (15 item 'snapshot' of board performance)
  - Structure
  - Culture
  - Responsibilities
  - Processes/Practices

- Board Responsibilities
  - Mission & Planning
  - Financial Stewardship
  - Human Resources Stewardship
  - Performance Measurement & Accountability
  - Risk Management
  - Stake/Shareholder/Public Representation & Advocacy

- Board Processes/Practices
  - Board Development
  - Board Management
  - Decision-Making

Some Important Questions

Corporate failures during the past decade beg answers to questions like:

? Should the focus of governance and management be on short-term stock prices or the enduring (sustained appreciation in) value of the company to shareholders?
? Do corporations have a responsibility to link corporate mission, inputs and outputs to broader social and economic outcomes?
? What value/benefit (outcome) does the ordinary shareholder derive from multi-million dollar loans (input) to corporate executives or directors?
? What value (outcome) does the ordinary shareholder derive from the use of stock options (input) as a means of executive compensation?
? How can corporate management be seen to be accountable to a board that has substantial representation from that corporation's managers? Or, indeed, any representation from that corporation's managers?
? Does 'off-book' accounting or capitalizing expenses meet the test of transparency and openness that are essential to build and maintain investor trust and confidence?
? Would anyone exercising the due diligence of a reasonably prudent person create or defend a capital market system where share values are so heavily influenced by

analyst expectations, quarterly guidance and speculative trading, as is currently the case? What about the ethics of brokerage firms flogging shares of companies in which they have a major investment?

? Is capitalism as an economic order at risk if citizens no longer have the confidence to invest in public companies as KPMG cautioned in its 2002 Survey?[xxx]
? What are the alternatives to the capital market system?
? How will trust in the system be restored? Will it be politicians and regulators or corporate accountants and lawyers who move to deal with poor governance, bad or dishonest management and conflicts of interest in their many manifestations?

Conclusions

Publicly traded corporations have a social and economic responsibility to the public as well as to their shareholders and employees. They need to look beyond their responsibilities to shareholders when defining outcomes and focus on broader societal impacts if they want to sustain a viable capital market system. Canadian solutions to specific factors contributing to failed governance and corporate 'implosion' need to be developed, though in cognizance of the transnational context in which corporations operate.

Some Essential Steps to Accountability and Credibility

1. Strictly limit use of stock options as a method of executive compensation to 10% of base salaries; make them available to all employees; award them only on the basis of sustained performance rather than short-term share values; offer them only at the then current market value of the stocks; prohibit downward adjustments to the option price; expense them in the year they're provided.

2. Restore some reasonable balance between executive and employee compensation. Eliminate obscene executive compensation levels where CEOs are compensated at rates hundreds of times higher than the average employee.

3. Eliminate the practice of having 'inside directors' on boards. The CEO and senior managers can influence corporate direction sufficiently with 'voice without vote' in board decision-making.

4. Establish a Canadian Securities Commission with real teeth to issue sanctions for breach of shareholder and public trust. Vigorously enforce existing civil and criminal sanctions and examine what new legislative or regulatory safeguards and sanctions may be needed.

5. Establish a mechanism under such a newly created CSC to 'accredit' the governance practices of corporations against established 'best practices' as a condition of obtaining and maintaining public trading rights on Canadian stock market exchanges.

6. Encourage (or require) corporate boards to establish 'Risk Management' Committees that audit corporate risks that derive from operations beyond those which may be discovered through the financial statements which are the focus of 'Audit' Committees.

Someone recently defined a Canadian as "An unarmed American with health care." Let's add to this distinction from our southern neighbors "and ethical corporate governance practices…that respect the public trust".

Endnotes:

[i] Adapted from working definition of governance, Institute On Governance, www.iog.ca.

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[iii] Leighton, David and Thain, Donald, Making Boards Work: What Directors Must Do To Make Canadian Boards Work, McGraw-Hill Ryerson Ltd., Whitby, Ontario 1997, p. 6

[iv] Drucker, Peter F., Managing for the Future, New York: Truman Talley Books/Dutton, 1992 p. 208.

[v] Senge, Peter M. The Fifth Discipline: The Art & Practice of the Learning Organization, Doubleday, New York, N.Y. 1990 pp. 28-40

[vi] Leighton and Thain, op. cit. 1997, pp. 4-14

[vii] See The U.S. *Sarbanes-Oxley Act* and *Bill 198* tabled in Ontario's legislature Oct. 30, 2002

[viii] Ontario Teachers' Pension Plan and Canadian Coalition for Good Governance. See: Apperley, Trevor, '*Shareholders Demand Governance Action*', presentation to Insight Information Co. conference on Corporate Governance, Calgary, Dec.2-3, 2002

[ix] '*Governance, Values and Competitiveness*' A Statement of the Canadian Council of Chief Executives, Thomas d'Aquino and Charles Baillie, September 2002, p. 10

[x] '*A Litany of Waste*', Ottawa Citizen, Dec. 4, 2002, p. 1

[xi] "*Governance, Values and Competitiveness*', op. cit., p. 9

[xii] Brown, David, et.al. op. cit.; McKinsey & Company, '*Global Investor Opinion Survey: Key Findings*', July 2002.

[xiii] Rosen, Al, 'Buried Skeletons', "*Canadian Business*' December 9, 2002, p. 3

[xiv] Gross, Daniel, "*Give that CEO a pay raise!*" http://ww.msnbc.com/news/781181.asp

[xv] Byron, Christopher, "*The Senate Bill Misses the Point*", CNBC & the Wall Street Journal, http://www.msnbc.com/news/781188.asp

[xvi] Leighton and Thain, p. 12

[xvii] Ibid. p. 12

[xviii] Interview with Henry Mintzberg, McGill News, Alumni Quarterly, Fall 2002

[xix] Mintzberg, Henry, ibid.

[xx] "*2002 Fraud and Misconduct Diagnostic Survey*", KPMG, www.kpmg.ca.

[xxi] Brown, David, Brown, Debra and Birkbeck, Kimberley, "*Canadian Directorship Practices 1997: A Quantum Leap in Governance*", Ottawa, Conference Board of Canada, January 1998, p. 3.

[xxii] Gill, Mel, Flynn, Dr. Robert & Reissing, Dr. Elke, "*The Governance Self-Assessment Checklist: Linking Board Performance to Organizational Effectiveness*" paper presented at annual conference of ARNOVA (Association for Research in Nonprofit Organizations and Voluntary Action), Montreal, Nov 14, 2002 at www.synergyassociates.ca.

[xxiii] Leighton and Thain, op. cit. p. 2

[xxiv] "Primer for Directors of Not-for-Profit Corporations: Rights, Duties and Practices", Broder, Peter, Coordinating Editor, Industry Canada 2002, p. 64

[xxv] Gill, Mel, op.cit. "*Governance Models: What's Right for Your Organization?*"

[xxvi] Gill, Mel "*Governance Do's and Don'ts: Practical Lessons from Case Studies on Twenty Canadian Nonprofits*" Institute On Governance, Ottawa, Canada at 'Board Governance' www.iog.ca or www.synergyassociates.ca.

Gill, Mel , "*Building Effective Approaches to Governance*", Nonprofit Quarterly summer 2002 issue or www.synergyassociates.ca under the title "Governance Models: What's Right for Your Organization".

[xxvii] John Carver, Boards That Make a Difference Jossey-Bass, San Francisco 1990.

[xxviii] See description of *Governance Self-Assessment Checklist (GSAC*) and www.synergyassociates.ca.

[xxix] Gill, Mel, "*The Governance Self-Assessment Checklist*" op. cit.
[xxx] KPMG *Survey*, op. cit.