

1

Now that Everything is in Place, Does it Matter?

It's a familiar pattern: a scandal erupts followed by a public outcry, and leads to a political push for new regulation – and rueful sinners search their souls and promise to better themselves.

Rarely has this pattern worked as perfectly as in the corporate governance 'reforms' of 2002. Barely known to a broader management audience, let alone the public, corporate governance rocketed to the top of the political agenda. It will take lawyers and courts years to sort out the practical relevance of the new regulation, especially in the USA, propelled through Congress by the urgent need to 'restore investors' confidence' (a noble translation for the hope to drive share prices to previous heights).

Remorseful top executives gather in blue-ribbon panels, creating 'codes of conduct', best-practice recommendations, guidelines, handbooks, etc., with a rabbit-like growth rate. Consultants and academics have not been able to resist the temptation to jump on the bandwagon: boards are probably now

one of the best surveyed and researched economic institutions ever (we plead guilty here, too). And ethical advice is being dispensed by the score.

Whether mired in scandal or not, in today's interconnected world, all countries move on corporate governance in the same direction (only the 'rouge states' and notoriously corrupt countries miss out). Greece, for example, used the opportunity to try to shed its emergent market image. South Africa combined its corporate governance efforts with black empowerment. In the European Union, the commission made yet another important announcement. The list could continue nearly indefinitely. The reaction was quickest in the USA, because the most dramatic collapses happened there and created probably the provisions with the maximum bureaucratization of corporate governance. In Asia and especially Japan the response was slow, as always, but will continue (probably even when the US again switches course).

Everything is now in place: independent directors, committees of all sorts, CEOs and CFOs who are now held accountable for the figures they release (weren't they before?), auditors who should by now be watchdogs rather than lapdogs, and companies around the globe will report to which code of conduct they adhere.

Will it help placate angry shareholders and a concerned public beyond having a placebo effect? Maybe up to a point, but there are three items of bad news.

The first is that there is no evidence that any of the corporate governance structures, such as stipulations concerning the proportion of independent directors, equity ownership of management or any of the other remedies recommended (e.g. eliminate the former CEO from the board), have had any

detectable impact on board performance. A revealing example is General Electric, undoubtedly one of the most successful US corporations, which in past decades had a fairly poor corporate governance structure, in light of today's standards (see Box 1.1: GE's corporate governance reforms).

Box 1.1: GE's corporate governance reforms

The corporate governance standards of General Electric (GE) under its most admired management hero, Jack Welch, are best illustrated by considering the changes his successor, Jeff Immelt, pushed through (mostly in early 2003) after GE lost approximately 50% of its market capitalization. These changes were the following:

- Strict implementation of the Sarbanes-Oxley Act¹ (e.g. Audit and Compensation Committee)
 - Two-thirds of GE's directors should be independent (under a strict definition of independence²)
 - A lead director, who advises on the committee chairs and the board agenda
 - Three 'executive sessions' (of independent board members) per year
 - A 'strategy retreat'
 - Every director should visit GE's businesses on a yearly basis, thus interacting directly with operational management
 - A self-evaluation process for the GE board
 - Increased responsibility for the audit committee, as well as greater financial disclosure of GE, especially its many and complex SPEs (Special Purpose Entities)
-

- More variable compensation, and under stricter conditions, for management and board members.

Equally important may be more on the symbolic side: GE's century-old, forbidding, dark wood-panelled boardroom was replaced by an airy meeting room with daylight.

(For details see GE's website: www.ge.com/en/commitment/governance/highlights.htm)

- 1 Sarbanes-Oxley Act was passed in 2002 and is also known as the public accounting reform and investor protection act. Its intention is 'To improve quality and transparency in financial reporting and independent audits and accounting services for public companies, to create a Public Company Accounting Oversight Board, to enhance the standard setting process for accounting practices, to strengthen the independence of firms that audit public companies, to increase corporate responsibility and the usefulness of corporate financial disclosure, to protect the objectivity and independence of securities analysts, to improve Securities and Exchange Commission resources and oversight, and for other purposes.' (<http://www.sarbanes-oxley.com>)
- 2 'Directors will be considered "independent" if the sales to, and buys from, GE are less than one percent of the revenues of companies they serve as executive officers, and if loans provided by GE to a company they serve as executive officers, and loans received by GE from such companies, constitute less than one percent of the total assets of such company. Moreover, if a GE director serves as an officer or director of a charitable organization, the GE director will be considered "independent," if GE donates less than one percent of that organization's annual charitable receipts.' (See GE website.)

Disney multiplied its sales and profit over two decades by nearly a factor of 20, with what a somewhat cynical observer called the 'typical' US board: the CEO, his eight friends, a woman and an African-American.

The 'black box' of corporate governance obviously defies any simple input-output relationship of the following kind: increase your number of independent directors (or any other input variable) to increase the output (in this case, financial performance). The reverse today makes more sense: Disney's CEO Michael Eisner had to relieve three friends from their board duties – a teacher, an actor and his architect – after it became obvious that the previous success factors of Disney's strategy were no longer valid. But corporate governance advocates will be hard pressed to identify and isolate any lasting impact on Disney's or GE's share price. As often, markets punish laggards, but rarely reward front-runners.

The second piece of bad news is that corporate failures will occur again. A market economy is not foolproof; on the contrary. If companies do not take risks (with a certain risk of failure), there would be no rationale for profits greater than the cost of capital. A market economy compared with other systems reveals mistakes early, forces their correction and limits the overall impact through decentralization and risk diversification. But some companies will go bankrupt due to the inability to make a sufficient response to the mistakes they unavoidably made.

All the big blunders in the past – e.g. Swissair, Vivendi, Kmart, Tyco, etc. – were due not to a lack of corporate governance structures or misapplied accounting rules, but rather a flawed strategy or a mistaken implementation. Never was a company ruined due to a failure to properly apply technical accounting rules or a lack of corporate governance structures. Rather, it was the other way around: when the strategy failed to deliver the promised and often unrealistic results, top management first began to 'massage the numbers', moving from the 'creative', to the misleading, to outright falsifying.

Enron was the most spectacular example for this pattern. First and foremost, it had a risky, verging on speculative, business model, which did not deliver on the excessively high expectations created. Somewhere along the line, Enron began cheating to cover up results delivered by the real economy.

But beyond these examples of obviously flawed business strategies (sometimes with the benefit of hindsight), it should be clear that top management and the board can err, despite having a best practice corporate governance system in place. After all, the more diffusely structured problems are, the more they tend to move up the hierarchy, eventually reaching the board. The information for the decision is often ambiguous and biased. It can be interpreted in different ways. There are a large number of influencing factors, such as unknown competitive responses and shifting macroeconomic conditions, creating complexity with little certainty of any one outcome (especially as in most cases many influencing factors – e.g. the reaction of competitors – cannot be controlled). Even the best-founded judgement can be wrong, and this cannot be prevented by any corporate governance structure (and in my view, it is even dangerous to encourage this illusory belief).

If our reasoning is correct, it has important implications for the corporate governance discussion. It shifts the focus from structure and the tendency of ‘ticking boxes’ to the content and context of corporate governance and its decision-making process including influencing factors, biases and the potential traps. Such an approach can add greater value for the practical work of corporate governance and its key institution, the board. However, before we go on to elaborate upon the content of corporate governance in this chapter and the rest of the book, there is a third piece of bad news.

The corporate governance discussion in public has now departed from how to best organize accountability and responsibility at the helm of the company. It has moved on to a more fundamental debate about corporate roles in society, basic attitudes and behaviours in businesses, which are perceived as more powerful than governments. Few understand the irony that ‘the biggest peacetime wealth transfer in history’ (Warren Buffett) occurred under the banner of shareholder value – to the detriment of shareholders and the benefit of some high-level corporate officers. Others see this already as the emerging of new class warfare. This time rather than workers versus capitalists, it is knowledge workers versus shareholders (although few CEOs fit the usual description of a knowledge worker as an expert professional with a specific know-how).

But for the broader public, the current corporate (mis-)behaviour is simply a question of greed and lack of accountability in exercise of power. ‘Corporate governance is for me just the question, how can you tame the excessive greed and egregious abuse of power in the big corporations. We cannot allow spoiling the rest of society – it would blow up the whole of social fabric’, stated an NGO leader voicing the opinion typical in non-business circles. Politicians – ever sensitive to shifts in public mood – do not stand on the sidelines. The result is simple: the age of deregulation is over; re-regulation is the new game in town. The Bush Administration, which can hardly be labelled anti-business, pushed more pages of regulation to the Federal Register¹ in 2002 than any other government in any given year in US history. In Europe, the shift will be slow, because new regulations have tended to overcompensate for the abolishment of old prescriptions. And media scrutiny of corporate deeds (and especially misdeeds) will not go away. Since CEOs have started competing with film divas for public attention, they are now

subject to the same media rules: you are twice as long ‘written down’ as you have been ‘written up’.

What are the main implications of this – somewhat brief – evaluation of the current corporate governance debate? As discussed, it means we need to avoid the dominant focus on structures. After all ‘structure follows strategy’ is one of the most fundamental wisdoms of management. First, you have to be clear about your corporate governance strategy and its leadership contribution. Just as in any other business function, how to add value remains the key imperative. This requires first and foremost examining – as in any other strategy formulation – the corporate governance context and content and clearly defining the goal to be achieved. (The current dominant goal appears to be keeping the CEO out of jail, which we consider as necessary, but merely complying with the law is insufficient. For this purpose alone, a board is probably not necessary.)

After this consideration, we look at structures and processes appropriate to achieve this goal. In particular, the processes for decision making, the method of cooperating and contributing to provide leadership require greater attention than the formal structure indicators, which dominate the current debate.

Therefore in this chapter of the book we try to adopt a value added corporate governance focus. In Chapter 2, we analyse where corporate governance failed in the strategic dimension, rather than the structural or formal dimension. We use the Swissair case as a template for this analysis, and derive the four fundamental dilemmas that each board has to confront.

Based on this consideration, in Chapter 3 we analyse the fit between the business environment (context) and the corporate governance clusters identified, and we explore and critically review one basic assumption of many codes of conduct – that there is *a* best practice of corporate governance. This is also where we discuss issues of board leadership and working processes in greater detail.

Chapter 4 deals with the specifics of corporate governance in global companies, confronted with many different rules and regulations that find themselves very much in the public spotlight due to their sheer size (DaimlerChrysler serves as an example here).

In Chapter 5 we look ahead and discuss some of the nagging questions of corporate governance.
