

Oversight – not good enough, not now | BY THOMAS L. DOORLEY, III

Once again a few spectacular failures of oversight have given rise to another sharp drop in confidence. All of the rest of us who strive to meet our responsibility to provide effective, “watchful and responsible care” get tarnished. Providing such care is the essence of governance. It is what directors are supposed to do. Too often of late, too many have not delivered on this promise.

Contemporary failures of oversight take us back to an earlier time... The signature scene in the Academy Award winning movie *Network* features a beleaguered network news anchor, Howard Beale, introducing his final newscast with an impassioned rant. After recounting a list of troubles facing his viewers, he tells them to “...go to the window, open it and shout, ‘I’m mad as Hell and I’m not going to take it anymore!’” At the time (the mid 1970s) the US was reeling from the Watergate political scandal, facing a sharp spike in energy prices, and living with an economy mired in low growth and high inflation.

Today the discourse has the same sound. And why shouldn’t it? When the US housing market surged on the foundation of exceptionally cheap and broadly available mortgages, then spectacularly imploded, the citizens had a right to cry out “where was the responsible care embedded in the US Congress, the funding agencies, the lenders themselves?” Obviously the supposedly built-in oversight was sorely lacking. When the CEO of Bank of America, Ken Lewis, shut down the bank’s securities business claiming he’s had “all the fun I can stand”, then in short order mounted a bid to buy Merrill Lynch, shareholders had the right to ask the Board of BofA, “How could you effectively offer an opinion on such a major transaction so quickly after affirming the decision to withdraw?” It strains credibility to assume that they could have been prepared to opine in an informed and productive manner. These are two of several notable examples of the failure of oversight and they demean us all.

Given that such failures reoccur, one is tempted to believe these are cyclical calamities we must accept as the normal course of life. This must not be so. Getting governance back on the right track, once again restoring trust in our institutions, is our collective obligation right now. We can meet this pressing and serious challenge by adopting a set of principles taken from the practices of organisations and enterprises which, even in the midst of the current maelstrom, provide the effective oversight needed in more corners of our world. Here is a start on our path to recovery.

Foundation One: Become a value-creating director. To deliver on oversight’s goal, each board member must accept that, at the core, he or she must protect and enhance the value of the enterprise. Boards have two overriding roles. One is to maintain or restore trust. For public companies, requirements such as the Sarbanes-Oxley regulations target this element. But the second role, often called the performance element, must be internalised as well. Here there are no universally accepted rules. For guidance, directors need to look at practices adopted by the best at gov-

ernance. Directors must ask themselves: how am I adding value to this organisation? Nominating committees must address this issue as well. When they cannot provide a candid answer, they must step out of their role or be removed.

Foundation Two: Accept a naturally, downright messy relationship. The working relationship between the board and its leadership team is always complex, even messy. CEOs rail at boards that get too involved in operational details, while boards complain about a lack of information from a distant CEO. It will always be so. These lines can never be clearly defined. We must accept the dilemma and work to build enough trust that the CEO will openly discuss issues and opportunities early and often. When this level of mutual trust exists, the CEO can be described as a ‘first light’ CEO – one who brings the board into considerations of major issues early and often, at first light. If a CEO arrives with an important decision to review with the board, armed with a crisp PowerPoint presentation and a raft of internal and external advisers, but without weeks or months of prior discussion, the board is compromised.

Armed with these two foundations as the underpinning, directors must act with commitment, competence, and character.

Commitment implies giving enough time and attention to the enterprise or organisation to understand it. Today, according to a variety of surveys, the average director at a large company (one with revenues in excess of \$5bn) spends around 300 hours annually on board business, including travel time to and from meetings. This is barely one half day per week. Clearly, to be effective for an enterprise of scale with product, service and geographic breadth, this is woefully inadequate. It is no wonder directors get criticised for being in a comfortable club, for not being dedicated. The proper number of hours to spend weekly or annually will vary, but a doubling or tripling of the time commitment begins to bring the average board member into a more adequate range. Counting the hours alone does not rectify the problem, but it is a measure of the level of commitment.

Competence implies bringing enough experience and knowledge to the table to be a value-creating director. Throughout the board, diversity of competence is required. This means matching the organisation’s strategic direction market conditions and business model to the directors’ collective competence. It is decidedly not simply a matter of counting heads to ensure ethnic or gender diversity per se. Competence (and commitment and character) trumps those measures of diversity. With the exception of its competent chairman, General Motors’ now deposed board met ethnic and gender diversity metrics but failed to bring enough competence to important issues. Thus, a great American manufacturing institution and a pillar of the successful Allied effort in World War II, failed. Often a board can meet both definitions of diversity, but the priority needs to be clear.

Character implies the willingness to make honest and tough decisions with a sharp eye to the principle of creating value. This is the toughest ►►

to measure because it is not merely an issue of outright fraud. The best accounting firms and other outside counsellors are developing processes to identify egregious behaviour at early stages. Rather, it is based on the director's history in other settings to step up to their role and actively participate, to spend the time and energy required to be able to contribute. Being hard to measure is no excuse for ignoring the need.

Are there examples of boards delivering effective oversight, just as there are examples of the inverse? Certainly. At the mega-corporate level, Swiss pharmaceutical company Novartis consistently receives high scores from governance rating agencies. One such agency, RiskMetrics, gives them a Corporate Governance Quotient (CGQ) exceeding 90 percent; that is, their governance practices place them within the top 10 percent of all public companies. Beyond this quantitative metric Novartis' practices are instructive, e.g., for requiring significant time commitments from their directors – in the range of 700-1000 hours per year. That's a strong measure of commitment. The full arc of Novartis' practices are worth studying and adapting.

Each of the five practices enumerated above can be tied to effective

oversight within a large or small enterprise or organisation. For example, the lead director of a \$100m wellness products manufacturer tells of his board's relationship with its CEO. Over time, the CEO became comfortable enough to bring issues-- both potential initiatives and problems – to the board by portraying his early thinking on a white board. While barely half of the issues became reality, the directors had enough information that when decisions were required they could draw upon depth of knowledge. This is the definition of a 'first light' CEO, and a prime example of working through potentially messy relationships.

Other examples of effective oversight exist. It is incumbent upon us to search out these examples, adapt them to our circumstances and in turn change the often cynical view many have of governance and its process of oversight. ■

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The role of governance in the construction of corporate value

BY ROBERT A. G. MONKS AND ALEXANDRA R. LAJOUX

A key element in the construction of corporate value is governance. This is a broad term with many possible definitions. We define it as accountability to owners based in disclosure and compliance with legal and ethical standards.

The corporate governance structure of a company can impact its value. This is why over the past century shareholders have been increasingly active in setting forth proxy resolutions about governance. This activism itself adds value.

The governance-value connection has given rise to governance rating methodologies, which compare corporations based on a variety of governance practices. It is also one of the reasons that organisations representing managements and boards continually address the subject of governance.

Definitions of exactly what constitutes governance vary. Perhaps the most well known system is the Corporate Governance Quotient (CGQ), which was based on the Proxy Voting Guide developed at Institutional Shareholder Services (ISS) – now absorbed into RiskMetrics. The RiskMetrics system rates 65 items in the following categories: Board, Audit, Charter/Bylaws, Executive and Director Compensation, Qualitative Factors, Ownership, and Director Education. Most CG categories have multiple items.

For example, here is a list of the items that RiskMetrics lists under Board: Nominating Committee (see also Governance Committee); Compensation Committee; Governance Committee (see also Nominating Committee); Board Structure; Board Size; Changes in Board Size; Cumulative Voting; Boards Served On-CEO; Boards Served On-Other Than CEO; Former CEOs; Chairman/CEO Separation; Governance Guidelines; Response to Shareholder Proposals; Board Attendance; Board Vacancies; Related Party Transactions – CEO; Related Party Transactions – Other Than CEO; Withhold Recommendations; and Majority Voting.

The National Association of Corporate Directors has collected statistics and issued guidance on these and other board activities since its

founding in 1977. Although these surveys and publications are written for use by corporate directors, some of the guidance can be useful to investors as well.

But the CGQ is not the only system. There are many more, including, for example, Governance Metrics International and The Corporate Library. The major securities rating agencies (Duff & Phelps, Moody's, and Standard & Poor's) include governance among the factors they rate.

The Corporate Library has identified the following red flags for governance traits associated with poor financial performance: (i) pro-management bias in board and committee makeup (e.g., lack of independence in composition of the board and key committees); (ii) runaway agency costs (e.g., CEO compensation that is poorly aligned with shareholder interests); (iii) management and/or board entrenchment (e.g., overly powerful takeover defences); (iv) poor board oversight of accounting (e.g., failure to prevent a finding of weak internal controls under with SOX 404); and (v) subordinated minority shareholder interests (e.g., dominant or controlling shareholder concerns).

Some recent studies have suggested that commercial governance ratings cannot be used to predict financial performance. One study team, led by Robert Daines of Stanford University, tested to see if ratings by four services, Audit Integrity, RiskMetrics, Governance Metrics International, and The Corporate Library, could predict five events: accounting restatements and class action lawsuits (as two bad outcomes) and accounting operating performance, Tobin's Q, and excess stock returns, 'alpha' (as three good outcomes). Daines et alia found that predictive ability was low – although they did find that The Corporate Library's governance scores predicted a company's future operating performance and future earnings' multiples.

Sanjai Baghat of the University of Colorado took it one step further and critiqued to test the correlation of corporate governance to corporate performance using a variety of multi-factor indexes, both academic and commercial. Professor Baghat and his fellow researchers wanted ►►

to know which if any of them were the best predictors of positive performance (measured by Return on Assets). But they found only weak correlations using multi-factor indexes, and concluded that use of such indexes raises econometric problems (such as distortions caused by subjectivity in weighting). Baghat and team concluded that one governance practice with a strong correlation to stock price is director ownership of stock. Most recently (28 October 2009), Charles W. Calomiris and Joseph R. Mason, in a paper on 'Conflicts of Interest, Low-Quality Ratings, and Meaningful Reform', asserted that governance ratings suffer from some of the same problems that have plagued debt ratings.

But these problems do not prove that investors can safely ignore governance. Recent studies point to some meaningful correlations.

Stock exchange study. The Australian Treasury did a study of financial performance of firms on the Australian Stock Exchange that did vs. did not comply with the 10 Principles and 28 best practices recommended by that exchange. The study showed a high correlation between compliance and return on assets.

Pension fund investment results. The CalPERS Focus List Program, the earliest such program by any pension fund, has produced excess returns to CalPERS assets in the order of about 3 percent per year. Every year, the program identifies companies' domestic internal equity portfolio that show both poor economic performance and poor corporate governance. CalPERS focuses on reforming the companies' governance practices with an emphasis on accountability, transparency, independence, and discipline in an attempt to improve shareowner wealth.

Some of the governance rating organisations have published studies showing that positive ratings on their systems correlate to positive financial performance. For example, Governance Metrics International, which institutional investors regard highly, has identified six studies that show the correlation of positive GRMI to positive stock performance. Conversely, there is evidence that poor corporate governance hurts performance. And there is evidence that special purpose funds that invest based on governance do better than comparable funds. Overall, however, the problem may be too complex to solve.

In any event, investors are heeding governance. As Robert Ferris of R.F. Binder told us, "Institutional investors are much more attuned to corporate governance measures/policies undertaken by issuers. Of course, setting standards of accountability is not a recent phenomenon. What's changed is that managements and boards, post Enron and SOX, have really taken this to heart in terms of implementation and enforcement. More important, foreign issuers and regulators have modelled corporate governance platforms on the US. system (in part, of course, because unlike most securities regulations, SOX compliance is applicable to foreign issuers whose securities trade in the US.)."

Disclosure

But whatever one believes about the link between governance and value, it is clear that disclosure matters enormously. To value the securities of a corporation, investors need to see not only what the company discloses but also how it discloses it. One of the Catch-22s of disclosure is that the more companies are required to disclose, the more diluted the impact of each disclosure becomes (as it get buried in an avalanche of disclosure). Also, the time that it takes for companies to prepare the information becomes a tax on productivity.

The solution is to communicate key points simply and honestly. The

Berkshire-Hathaway 2008 annual report is a great example of this. The company lost money that year, and said so:

"To the Shareholders of Berkshire Hathaway Inc.:

"Our decrease in net worth during 2008 was \$11.5 billion, which reduced the per-share book value of both our Class A and Class B stock by 9.6%. Over the last 44 years (that is, since present management took over) book value has grown from \$19 to \$70,530, a rate of 20.3% compounded annually.

"The table on the preceding page, recording both the 44-year performance of Berkshire's book value and the S&P 500 index, shows that 2008 was the worst year for each. The period was devastating as well for corporate and municipal bonds, real estate and commodities. By year-end, investors of all stripes were bloodied and confused, much as if they were small birds that had strayed into a badminton game.

"As the year progressed, a series of life-threatening problems within many of the world's great financial institutions was unveiled. This led to a dysfunctional credit market that in important respects soon turned non-functional. The watchword throughout the country became the creed I saw on restaurant walls when I was young: 'In God we trust; all others pay cash'."

(Yes, those were the opening paragraphs of the 2008 annual report of Berkshire Hathaway!)

Once one starts down the road to greater candor, accounting models can change. Consider the one proposed by valuation expert Al Rappaport, for a new kind of corporate performance statement. The new statement would separate cash flows from accruals and classify accruals by their levels of uncertainty, from low to high. Accruals not relevant to realised cash flows would be eliminated. The statement would spell out all assumptions and risk levels. This would enable managers and investors to make better predictions of future cash flows. Rappaport says the new statement would go far in helping analysts and investors estimate future cash flows. He wants the equity market to forsake its obsession with short-term earnings as the metric to measure value and stick with long-term cash flows instead. Better disclosure is at the center of enabling the market to make better calculations of future cash flow. The new Corporate Performance Statement would be the source of that better disclosure.

XBRL can help disclosure as well. XBRL is way of tagging electronic records so that they can be totalled, compared, grouped and otherwise treated as data. Certainly this is a great tool for investors. We would agree with the American Institute of Certified Public Accountants that "the use of XBRL will provide major benefits in the preparation, analysis, and communication of business information through cost savings, greater efficiency, and improved reliability to all those involved in supplying or using financial data." Furthermore, XBRL can be used for the reporting of social values – the ultimate creator and sustainer of corporations and their owners. ■

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Thomas L. Doorley, III practices within both of our client segments. As we discovered at the World Economic Forum, young, venture companies can teach the larger, public enterprise about reaction speed and creativity; the larger, established companies can share the value of process and structure as scale and complexity increase. Carrying experiences across the segments has proven to be valuable for both.

As co-founder of Braxton Associates, Tom traveled the full cycle from concept to venture to business to global entity (identified by Consulting News as one of three truly global consultancies), then to acquisition (by Deloitte) and finally to successful integration and ongoing growth. When Tom left Deloitte to start Sage Partners, Braxton was embedded in the Firm as the strategy and operations practice, generating over \$500 Million of revenue with 1,000 professionals. Braxton's average annual growth rate: twenty five per

cent per year! Throughout his consulting career Tom has focused on the strategic issues clients face as they strive to achieve high levels of performance. His work in this arena led to writing Value-Creating Growth (Jossey-Bass) in order to codify the lessons learned over the years. Clients such as GE, Northrop Grumman, Kimberly Clark and Deloitte have leveraged these concepts within their business practices. On entrepreneurial side, he has assisted a number of young companies to realize their visions. His longest running relationship is with StratBridge, where he assisted the Founder/CEO at the concept stage and continues to serve on the Board eight years later as it emerges as a highly successful provider of analytic software and services.

Tom brings deep knowledge of strategy and governance to a variety of Board assignments. He serves as the Lead Director and Chair of the Compensation Committee for Natrol (NTOL: NASDAQ), a manufacturer and marketer of

vitamins and supplements, StratBridge where his focus is strategy and growth, and on the Advisory Board for the Dean of Penn State's College of Engineering. In addition, Tom was the inaugural Chair of the World Economic Forum's Technology Pioneers, and served as a director of Advanced Ticketing Systems (UK).

Tom has contributed his experience and intellectual capital over the years through writing, e.g. Teaming up for the 90's, Dow Jones Irwin; articles in the Wall Street Journal and Harvard Business Review; and speaking, e.g. the World Economic Forum and the Conference Board. His educational background provided him with a solid grounding in technology (B.S. in Chemical Engineering from Penn State), and a broad appreciation of society and culture (B.A. in Arts & Sciences from Penn State). Tom's MBA, with Highest Honors, from Columbia rounded out the formal learning by adding Marketing and Organization Behavior to his knowledge base.