A blueprint for good governance

Building better boards by design
Structures to address the root causes of poor governance
Page 2

Global strategy faces local constraints
The varying influence of stakeholders around the world
Page 4

Ratings add fire to the governance debate
Questioning the link between governance and performance
Page 6

When earnings management becomes cooking the books
The audit committee must learn to make the distinction
Page 10
Important board decisions are often hampered by constraints of time, knowledge and group process. To address these difficulties, directors need to pay careful attention to performance, leadership and structural issues.

For 20 years, I have been observing and working in boardrooms, as a director in the US and Europe, as a consultant to boards in those continents and Latin America, and as a researcher and author. I have also been leading education programmes for corporate board members at Harvard Business School for the past decade.

My perspective on the current state of boards is that there has been a significant improvement in their functioning in the past two decades. New laws, regulations, guidelines and rising investor and public expectations have had a positive impact. The great majority of boards are less under the thumb of their CEOs than they once were, and are seriously trying to govern their companies. A set of best practices has emerged that are documented in country corporate governance codes, stock exchange listing requirements and company annual reports.

For sure, boards are being asked to do more because of these new expectations. It is also true that too many of these demands focus on matters that are visible from public documents but are not central to what actually takes place in boardrooms. Nevertheless, I find individual directors are willing to accept these additional duties and spend more time on them. Further, I see no evidence that there is a shortage of suitable new candidates for board seats.

This is all good news. However, because so many directors are trying to do more and do it better, they are also frustrated by difficulties that they encounter. The most common concern I hear is: “We don’t spend enough time considering and dealing with company strategy.” Obviously, this is related to a second worry: “We are spending too much time focused on issues related to complying with new laws and rules.” This is a particular concern in the US because of the Sarbanes-Oxley Act. Directors are also often troubled that they are so regularly criticised about their CEO’s compensation. Finally, they often admit that the trend to bring in more new CEOs from outside is the result of their failure to do an adequate job in ensuring sound management development and succession planning. All these concerns are important because they are about matters that directors consider their core responsibilities.

**Limits on board effectiveness**

Boards are experiencing these difficulties for several reasons. The first is the increasing emphasis on independent directors. While the precise definition of independence varies from country to country, as does the desired proportion of such directors on each board, the basic idea is the same. Most directors should not have any other connection with the company, past or present.

The goal, which certainly is a worthy one, is to ensure that boards are objective and have no conflicts of interest. However, the problem is that, with this emphasis on independence, boards are usually made up of directors with little current or past knowledge about their company’s industry or businesses. Further, independent directors are truly part-timers. They have other day jobs that limit the time they can realistically devote to each board. Consequently, well-intentioned directors find that they have insufficient time and knowledge to perform their jobs well.

A director’s lack of knowledge is complicated by another problem – the quality of information they receive from management. Oddly, it is not that they receive too little, but that they receive too much, which is often poorly organised and does not illuminate the most significant issues.

Another problem is that boards are often unclear about what role they should be undertaking and, in most countries, their legal duties and responsibilities are broad and vague. The one exception is Germany, where laws are quite specific, but boards there have other difficulties because of their size and the emphasis on co-determination.

Rather than considering carefully what their focuses should be, too many boards simply do what they have always been doing, and respond reflexively to new requirements, such as the Sarbanes-Oxley Act, without explicit attention to how to deal with the additional duties. As a result, directors lack clarity of purpose.

As the old saying goes: “If you don’t know where you are going, any road will get you there.” This is the problem too many boards have. They have no clear criteria to use in determining how to allocate their precious time together. Rather, they focus on whatever issues management feels are most pressing and on what they have traditionally done.

A third problem stems from the basic fact that boards are groups of individuals who must work cooperatively to get things done. The advantage of having many individuals on a board is that there should be diverse perspectives, healthy debate and sound decisions. The difficulty, as anyone who has worked in a group setting or studied social psychology will immediately recognise, is that effective group decision-making takes time and requires skillful leadership.

Achieving effective leadership is a complicated and related matter. First, there is the question of whether the board chair and the CEO should be two individuals (as they are in most European, Australian and Canadian companies) or whether the functions should be performed by the same individual (as is common in the US). My own view is that either structure is workable, but the roles and responsibilities must be clearly defined and agreed.

Regardless of the structure, the person who is in the chair often has difficulty creating agendas and leading discussions to reach consensus in the time available. To some extent, this may be due to a lack of leadership skill on the part of chairs, but I think the more important reason is that all board members legally are equal and they expect to be treated that way by each other. This makes it hard for a chair to control the meetings effectively and requires self-discipline on the part of all the members.

**Board concerns and their causes**

These impediments to board effectiveness underlie the concerns that so many directors express. For example, complaints that too much time is being spent on compliance and not enough on matters of strategy usually arise because the board has not paid explicit attention to its role. As boards are asked to do more, they simply try to cram more into the same size container, and this does not work.

Additionally, because boards are unclear about their role, directors’ complaints about lack of strategic involvement, while heartfelt, are unclear and vague. How do they want to be involved in strategy? What contribution to strategic decisions do they have the knowledge to make? Where should the line be drawn between the board and management on strategic matters? How can the board provide effective oversight of the company’s strategic direction and progress within the limits of time and knowledge? All are important questions that are too rarely addressed.

I recently encountered an example of this with the board of a financial services company that operates in several distinct businesses. Because almost all the directors were independent, they were unfamiliar with the complexities of these financial service businesses and their underlying economics. Further, the information that management was providing was either too complicated and not well organised. On top of all this, boards by design
this, the board was intent on complying with the requirements of the Sarbanes-Oxley Act. The directors were frustrated and anxious to get more involved in strategy, but unclear how to do so in the time available and with their limited understanding of the company’s businesses.

Succession planning

While there are a few examples of companies (and boards) that handle management succession well, such as General Electric and UPS, there are certainly the exceptions. In my experience, when directors complain that they do not effectively monitor management development and succession, the problem is not that they are unclear about the role they should play. Rather, the difficulty is that the topic is not properly addressed due to the constraints of time. It is a longer-term issue and its consideration can always be postponed because of more urgent matters.

For example, on one board with which I am familiar, the question of how to ensure a smooth transition between the current CEO and the next initially came up at meetings five years before the incumbent’s retirement. The topic was put on the agenda of meeting after meeting, but it always was squeezed out by a new acquisition opportunity, or a crisis in a particular business. Suddenly, or so it seemed to the board, the old CEO was going to retire in 18 months, and there was only one internal candidate that he believed could replace him. The other directors did not consider his candidate satisfactory, but they had done nothing in the previous years to address the issue. Not surprisingly, the situation evolved into a bitter dispute between the CEO and the rest of the board.

The root cause of the problem was simply that the topic, which all recognised was the board’s responsibility, was never given priority. It is also true that the lack of time to address this issue (as so often happens) was the result of allowing other discussions to wander about with little or no attempt by the chairman to keep them on track and the inability of other directors to help manage the boardroom dialogue.

Executive compensation

The issue of executive compensation can also be a problem for boards. Many reasons have been put forward to explain why boards end up rewarding their CEOs so richly. Some even suggest that directors, who are themselves CEOs, conspire to make sure their CEOs, despite having this connection with management, are too often not aware of the desire of shareholders. In essence, there is an information asymmetry. Directors understand and empathise with what top executives expect but are less aware of shareholder concerns. In the UK, where shareholders are now given an advisory vote on the past year’s director compensation, this has changed, as directors at GlaxoSmithKline, WPP and some other UK companies will doubtless confirm.

Board design

It seems clear that the constraints of time, knowledge and group process make it difficult for many boards to accomplish what the public and shareholders expect of them, and what they, themselves, are trying to do. In my judgment, all the new rules and guidelines in the world will not solve such problems. Rather, the key to improving the board’s capacity to deal with such problems rests in the hands of each board.

These difficulties are likely to get worse unless we can find a way to get directors to step back and reflect together on how they can be more effective and efficient. Fortunately, there is good news on this front. Some new regulations, such as the NYSE and Nasdaq listing requirements in the US and the Combined Code in the UK, are requiring boards to undertake a self-evaluation of their performance on an annual basis. Elsewhere, many boards are doing this on their own initiative. These assessments are like an annual physical exam. The purpose is to identify problems and what should be done about them. They also enable directors to identify opportunities to work together more effectively. I have been involved in many such assess-

“Boards are often unclear about what role they should be undertaking and, in most countries, their duties are broad and vague”
Global strategy faces local constraints

Variations in national corporate governance systems and the degree to which groups of stakeholders influence strategy decisions can have a substantial impact on a company’s efforts to look beyond its borders.

Corporate governance systems vary across countries, and these differences directly affect both the process for developing global strategies and the kinds of strategies that can be adopted. In this article, we examine how different corporate governance systems influence decisions about company globalisation and, in particular, decisions to take operations abroad.

Global strategy decisions pose a very tough test for the effectiveness of corporate governance systems in that they seek to maximise profits and global competitiveness, often at the expense, at least in the short term, of some corporate governance players. By definition, a global strategy means taking a global, rather than a single-country, view of strategy, and this can be hard for those players with strong ties to the company’s home country. Moreover, some aspects of global strategy, particularly the overseas relocation of jobs, mean real sacrifices for some, especially employees.

Players in corporate governance

We identify five critical stakeholder players that most affect the company’s decisions about global strategy: employees and their collective organisations, such as unions and work councils, have various legislated, statutory, contractual or negotiated rights, such as employment conditions, that must be considered.

The board of directors is the ultimate governing body of an organisation and, as such, it must approve all company strategies, including global ones.

The top management team is charged with day-to-day responsibility for strategy and operations. Shareholders exercise their voice through their shareholder rights, such as cumulative voting or proxy voting, but they can also exit the company by selling their shares if they do not agree with globalisation strategies or other decisions.

Finally, governments set and enforce the overall rules of national corporate governance; they design specific norms about international business, such as trade policies; and they can selectively intervene in individual globalisation decisions, such as moving operations abroad, or subsidising a given company because of its national strategic relevance. Supranational governments, such as the European Union, also play a role in regulating corporate governance, the consultation rights of workers, bankruptcy procedures, and the like. We exclude other stakeholders, such as customers, suppliers and competitors, because they tend to be less involved with corporate governance.

Cross-national differences

Corporate governance systems vary by country, so the roles and power of the five corporate governance players figure 1 summarises these differences for some major countries and types of corporate governance systems: the “Anglo-American” systems of the US and UK; the “Continental” systems of Germany, France and Italy; and the “Extended” system of Japan.

In the rest of this article, we briefly describe the main characteristics of these corporate players across countries and their potential influence on global decision-making.

Employees

Two main variables differentiate employees, as a collective group, across countries. First, the country’s labour market will influence the flexibility and mobility of employees. Countries such as the US that have employment at will, whereby a contract can be terminated at any time, are likely to have flexible labour markets and short-term labour commitments. Generally, the consequence is that labour training is done outside the company and employees have general and portable skills.

In more rigid labour markets, such as Germany and Japan, companies invest a great deal in bespoke, in-house training, which tends to result in more highly skilled labour forces and company-specific skills. These, in turn, are less transferable from one company to another.

Second, the strength of labour unions and unionisation rates varies from one country to another. For instance in France, where union rights are extended to all employees regardless of union affiliation, unionisation will have a much greater influence on corporate decision-making than in the US or UK, where only union members benefit from collective bargaining agreements. Japanese companies tend to have enterprise unionism, which leads to collective bargaining at the company level and grants a strong voice to employees.

We consider that employees who are less mobile and who have a stronger voice within the company will get more involved in global strategy decisions. Generally speaking, these employees will seek to keep their jobs domestically as opposed to moving them around the globe.

Cross-national variation in top management teams is mostly reflected in their functional background and their international experience, as well as in the patterns of managerial career mobility. Managers in the US and UK tend to have professional backgrounds (often with formal business school education) and strong functional backgrounds in finance or marketing. This is not the case in Germany, where managers are more technically oriented. In France, managers often share a common grandes écoles background and ideology, frequently linking them back to government positions that they have previously held.

There is also variation in the international experience and background of managers, with US managers having the most foreign-born individuals in their management teams and France, Italy and Japan the least. Managerial career mobility tends to be very fluid in the US and UK due to open labour markets whereas, in Japan and France, managers tend to remain with a company for a long period of time.

The presence of foreign nationals and managers with prior international experience, combined with open labour markets, means that teams will be more likely to push global
Countries vary in their mix of types of shareholders. At one extreme, the US and UK have mostly arms-length, neutral shareholders, who are focused on shareholder value maximisation. Although many UK shareholders are large institutions, such as pension funds, they generally play passive roles, compared with the shareholder activism that arose in the US among institutional investors such as Calpers. Japan has plenty of institutional shareholders, but these tend not to be neutral and often act as part of a network, or *keiretsu*, that supports the role of the company and, for the time being, their dominant management. Germany’s main trait is that banks play a leading role in influencing corporate policy at many companies, both as lenders and shareholders.

Employee shareholders typically use their ownership to block the global relocation of jobs. This applies even in the US where United Airlines provides a rare example of a large public company with majority ownership by its employees (55 per cent owned by an employee stock ownership plan). This employee stake and, hence, control has greatly constrained the freedom of the airline to relocate jobs overseas. For example, United’s flight attendants’ union has been able to block plans to move flights from its lower-cost Taiwan base.

The composition of boards of directors also shows strong contrasts across countries. For instance, Japanese companies are renowned for having very few outsiders on their boards. It is often said that the board has to meet the president, or *shincho*, in the morning; other outsiders are rarely represented. Japanese boards also have few outsiders to monitor managers and the strategic direction of the company.

Italian and French boards are considered medium-sized, although still quite inefficient due to the lack of outsiders. Germany is unusual because it tends to have a wide variety of stakeholders represented in the upper (supervisory) board, such as employees, industrial banks and suppliers. In November 2004, a commission convened by BDA, the German employers association, concluded that the German co-determination system had become a hindrance to German companies’ international competitiveness and a barrier to inward investment. It recommended changes to the laws, which were last revised in 1976. Under this proposal, individual companies would have the right to dismiss up to 20 per cent of its workforce for economic reasons. Although privatised in 1997, France Telecom still has significant intervention by the French government. Out of 15 members of the board of directors, only seven are elected by the shareholders meeting, while three represent employees and five members represent the French government. The most active boards are in the UK and US, in terms of setting strategy and overseeing the executive. In the UK, the Cadbury Report and subsequent codes of good governance have had a great deal of influence in designing efficient boards. In the US, the Sarbanes-Oxley Act of 2002 has also introduced pressure for a higher percentage of outsiders on boards.

Finally, countries also differ in terms of the power of government intervention in their economies and protectionism of their markets. Government intervention is usually in the form of market regulation. A representative measure of government intervention in the economy is regulation around takeovers. The US and, to a lesser degree, the UK have weak takeover barriers, and it is up to individual companies to design anti-takeover measures. Conversely, in countries such as France, Germany, Italy and Japan, government intervention often provides strong takeover barriers, such as golden shares, which bestow on the holder veto power over changes to the company’s charter.

The various hindrances to hostile takeovers in many continental European countries continue to make it difficult for foreign companies to make acquisitions across borders in Europe. In 2001, plans for a European takeover register, which would guarantee the right of shareholders to be consulted during bids, were shelved following objections from the German labour ministry. In the previous year Vodafone, the UK telecoms company, made a successful hostile bid for Mannesmann, a German telecommunications company, and the German government was worried that a hostile bid would see the company fall into foreign hands. For example, Volkswagen is protected from takeover by special law and the European code threatened to trigger a hostile takeover. The Wallenberg family, for instance, owns only 7 per cent of Ericsson, the telecoms company, yet controls the company by owning a class of shares that carries 1,000 times the rights of ordinary shares. France is also particularly active in preserving national ownership of major companies. In 2004, the French government brokered the takeover of Avantis, a French-German pharmaceutical company, by France’s Sanofi-Synthelabo, while blocking a bid from Swiss-based Novartis. Similarly, France blocked Germany’s Siemens from bidding for Alstom’s railway operations, which manufacture the high-speed TGV trains.

How managers can use their corporate governance systems

Top managers need to recognise that they are not in sole charge. Global (and other) strategy is an equilibrium game among corporate governance players, and factors large and small used on building coalitions and aligning interests behind a common approach.

Assuming that you want to improve your use of global strategy, then how can you do this from the various countries? If you are a manager in an Anglo-American system, then you are generally in luck. Your country’s corporate governance system is a source of competitive advantage. A manager in a Continental system faces many constraints, especially from the legal involvement of employees. But, committed employees can be a source of global competitive advantage.

In the Continental system, managers have to align, trade off and meet other shareholders’ interests halfway. They have to craft their language and rhetoric to meet the other players’ expectations. The watchwords here are consensus and social cohesion.

In the Extended (Japanese) system, companies have generally capitalised on their export-oriented model and high innovation driven by employee loyalty. But because of the rigidity of their corporate governance system, they have not exploited as much as they could the different dimensions of global strategy. We would recommend that the system becomes more open in terms of the diversity of the top management team and more flexible in their governance by introducing leaner boards as well as allowing greater levels of shareholder activism. In sum, if governments care to sustain national competitiveness and to help their companies to globalise, then they should assess the degree to which the players in their corporate governance system are aligned with each other and with their intended global strategies. For example, France might need to upgrade its compensation policies to recruit and retain world-class talent in the top management teams of its global companies.

Government policies should also become less inimical to foreign owners and to other capital to provide the much-needed global knowledge. This can only be accomplished if the right mechanisms are in place to give a voice to these foreign owners. We think that governments must take responsibility as well as the policy tools to gear the country’s corporate governance system so that it enhances national competitiveness.
There is a widespread belief that good governance ratings generally lead to improved stock market performance. But is there any evidence to back up this assertion?

What is this thing called “corporate governance” that is occupying more and more time in the boardroom?

Does having more of it create value for stakeholders in the company? Are institutional activists, politicians, regulators and media pundits justified in their efforts to reform it? And are the costly changes they are proposing likely to be socially desirable?

Corporate governance clearly matters to shareholders, customers, employees and parties that interact with the company. Moreover, there is little doubt that governance mechanisms are a necessary and vital part of economic growth and the functioning of a liquid capital market.

The separation of ownership and control that characterises the structure of the corporation means that managers can potentially make self-serving decisions at the expense of stakeholders. It is therefore important to put in place a set of mechanisms to constrain such managerial decisions in a way that maximises the net benefits to stakeholders. As well as giving general protection to stakeholders, an appropriate governance structure should lead to better performance.

In order to understand whether there are indeed net benefits from corporate governance, it is necessary to take an agnostic and scientific look at the data and assess the merits of the claims made by the business press, ratings agencies and many others. For example, are companies with more independent directors on the board or a separate CEO and chair priced at a premium in the market? And do managers of these companies make higher-quality reporting, investing and financing decisions?

There is substantial variation in governance structures across different countries and even across companies within a country. One interpretation of this observation is that each company faces a unique set of problems and costs to institute various mechanisms, and thus a different governance structure is optimal. In other words, governance should not be considered a “one size fits all” proposition.

In contrast, there is a widely held belief among consultants, politicians and ratings agencies that there is a single, optimal governance structure, and that any company that deviates from this has a governance problem. This type of “boiler-plate” governance benchmark is obviously simple to apply. At face value, recommendations such as the appointment of a majority of independent directors to the board and the separation of the roles of CEO and chair seem reasonable. However, adopting these “boiler-plate” recommendations is a costly process and it is far from clear whether these changes will produce better-managed companies as well as satisfy stakeholder objectives.

**Measuring corporate governance**

Before attempting to assess the impact of governance or managerial decisions on company performance, it is necessary to come to grips with how to measure corporate governance. Can a complex structure of governance be reduced to a summary statistic? How does one go about identifying which of the myriad governance mechanisms should be included? As might be expected, researchers and ratings services use a multitude of measures. For example, the Institutional Shareholder Services Corporate Governance Quotient is based on 61 variables and the Governance Metrics International Corporate Governance Score is based on 450 data points.

Regardless of the precise computation, most of the ratings examine factors related to board and committee structure, executive pay, anti-takeover provisions, concentration of equity ownership and other measures.

Any external assessment of the quality of corporate governance is limited to what can be observed. This means that the majority of measures captured by the various ratings agencies and academic research is based on characteristics, such as board structure and processes, disclosed executive compensation, distribution of ownership, various anti-takeover provisions and so on.

However, these simple measures do not include insights into the inner workings of the corporate board. There are no detailed interviews with management and board members to assess whether their objectives are consistent with stakeholder goals, and no assessment of whether various constituencies are directing the right questions to top management. As a result, ratings based on observable governance characteristics do not answer questions such as: “Are the number of board meetings, the composition of the board and sub-committees, the age of the directors and other structural measures sufficient to capture the complex nature of how an effective board should work?”

Yet, these are the types of measures that are the focus of the business press, customers, employees, investors and regulators.

**Analysis of governance measures**

We obtained data from four major intermediaries that specialise in rating corporate governance practices of companies: Governance Metrics International (GMI), Investor Responsibility Research Center (IRRC), Institutional Shareholder Services (ISS), and Standard & Poor’s (S&P).
How do you say corporate governance in Djibouti?

It’s hard enough to know what you’re getting into with mergers and acquisitions in your own country. But what about when your new affiliate is based in Tadjoura? Or Turkmenistan? Or the Côte d’Ivoire? Just how much do you know about their corporate governance regulations?

Today, it’s as important to know business regulations abroad as it is at home. Can your business deliver good governance across 42 different offices in 29 different countries? Ignorance simply isn’t an excuse. The penalties for an innocent mistake can be severe.

Effective corporate governance can lead to better controls, better market understanding, and ultimately, better performance. At Ernst & Young we believe a proper dialogue with all stakeholders is the key ingredient to delivering that value. And we think that’s a conversation worth having.

But if that’s something you’re not interested in, just remember "غير مذنب" That’s “not guilty” in Arabic. Just in case.

To carry on the conversation, visit us at www.ey.com/conformance

As the world continues opening up to more and more opportunities, at Ernst & Young we think it’s critical that people start talking about conformance and the impact the many other aspects of corporate governance are having on the way they do business. Whether governance regulations are central or marginal to your investment decisions, we believe it is an essential debate to have.
There is still a strong interest from equity investors in the governance risk of their portfolios. Results for operating performance were strongest with data from TSL, so we explain the analysis of these specific ratings in more detail below. The analysis for the TSL data was drawn from 2,012 companies for the period 2002-2004. The overall TSL "board effectiveness" rating is based on the following components: board composition, CEO compensation, shareholder responsiveness, accounting quality, strategic decision-making, litigation problems and takeover defences. Thus, the TSL rating appears to be a relatively comprehensible and broad-based measure of corporate governance.

Each of the components is given a rating between A and F, and the combination of the categories also yields an A-F overall score for board effectiveness. Companies receiving an A, B or C grade are considered to be have "good" governance and those with a D or F rating to have "bad" governance. We utilised the discrete (good versus bad) distinction in the TSL ratings and examined stock price performance after the issuance of these ratings. The analyst reports are compiled after the end of each proxy season. To ensure that the information in the reports is available to investors, we tracked the stock performance from July 1 in the year that the ratings were issued through to June 30 the following year. TSL's analysts conduct their analysis in conjunction with other sources during the proxy season up to the month of the proxy season. Therefore, examining stock returns for the period of July 1 2003 through to June 30 2004 will capture the 12-month period following the observations may be subsuming any ability of the governance measures to predict future returns. Finally, for measures of governance to be associated with future stock returns, it must be demonstrated that these measures provide a more direct way to assess performance, as opposed to some evidence that governance ratings are associated with the level of future operating performance. The

The table shows the cumulative returns for companies with "good" and "bad" governance. The table indicates that companies receiving an A, B or C grade have higher returns than those with a D or F rating. We utilised the discrete (good versus bad) distinction in the TSL ratings and examined stock price performance after the issuance of these ratings. The analyst reports are compiled after the end of each proxy season. To ensure that the information in the reports is available to investors, we tracked the stock performance from July 1 in the year that the ratings were issued through to June 30 the following year. TSL's analysts conduct their analysis in conjunction with other sources during the proxy season up to the month of the proxy season. Therefore, examining stock returns for the period of July 1 2003 through to June 30 2004 will capture the 12-month period following the observations may be subsuming any ability of the governance measures to predict future returns. Finally, for measures of governance to be associated with future stock returns, it must be demonstrated that these measures provide a more direct way to assess performance, as opposed to some evidence that governance ratings are associated with the level of future operating performance. The
denotes a limitation of our analysis is that we have only used overall scores. Furthermore, these governance ratings are somewhat unsophisticated aggregates of multiple measures of governance structures. To address this limitation, we expanded our own study on the relation (or lack thereof) between corporate governance and company value. This involved a detailed statistical analysis of 2,106 US companies with fiscal years ending in June 2003 and June 2004. Our sample spans many sectors of the economy and represents over 70 per cent of the market capitalisation of the US stock market. We used a broad range of measures of governance, including board composition, CEO compensation, shareholder responsiveness, accounting quality, strategic decision-making, litigation problems and takeover defences. Thus, the TSL rating appears to be a relatively comprehensible and broad-based measure of corporate governance.

Each of the components is given a rating between A and F, and the combination of the categories also yields an A-F overall score for board effectiveness. Companies receiving an A, B or C grade are considered to have "good" governance and those with a D or F rating to have "bad" governance. We utilised the discrete (good versus bad) distinction in the TSL ratings and examined stock price performance after the issuance of these ratings. The analyst reports are compiled after the end of each proxy season. To ensure that the information in the reports is available to investors, we tracked the stock performance from July 1 in the year that the ratings were issued through to June 30 the following year. TSL's analysts conduct their analysis in conjunction with other sources during the proxy season up to the month of the proxy season. Therefore, examining stock returns for the period of July 1 2003 through to June 30 2004 will capture the 12-month period following the observations may be subsuming any ability of the governance measures to predict future returns. Finally, for measures of governance to be associated with future stock returns, it must be demonstrated that these measures provide a more direct way to assess performance, as opposed to some evidence that governance ratings are associated with the level of future operating performance. The
do not necessarily damning of corporate governance is of modest importance. As might be expected, many conjectures about the features of superior corporate governance have been proposed as the basis for the design of governance structures. While these ideas make for interesting discussion, one compelling result that clearly demonstrate how corporate governance produces the outcomes desired by stockholders or, more broadly, stakeholders. Thus, there is little evidence that the costly governance changes that are currently being imposed on companies will produce expected net benefits in terms of improved performance.

Conclusions
The relationship between corporate governance and organisational performance has received considerable attention in recent years. As might be expected, many conjectures about the features of superior corporate governance have been proposed as the basis for the design of governance structures. While these ideas make for interesting discussion, one compelling result that clearly demonstrates how corporate governance produces the outcomes desired by stockholders or, more broadly, stakeholders. Thus, there is little evidence that the costly governance changes that are currently being imposed on companies will produce expected net benefits in terms of improved performance.

We certainly believe that appropriate governance mechanisms are a necessary and vital part of a capitalistic sector that is functioning efficiently. Before improving some governance structure on a company, it seems necessary to verify scientifically that the changes are likely to produce the desired outcome. This statement, of course, assumes that we are interested in learning about the value that can be produced from making costly changes to governance mechanisms. If, however, the debate continues to rage based on the use of rhetoric, we should be aware that costly policy decisions are being made without a careful and rigorous analysis of the data.
Avoiding the issue?

Corporate governance isn’t a simple subject. And as we all know, when faced with a difficult matter, the tendency is to not talk about it. The problem is, when it comes to corporate governance, communication is essential – both internally and externally.

According to a recent study, there is a clear connection between the quality of a company’s earnings and financial transparency and its corporate governance practices. Meanwhile, the Financial Standard Authority say that as many as 50% of UK FTSE companies have not communicated the full impact of reporting under International Financial Reporting Standards to their shareholders. How can you make sure every single stakeholder is aware of exactly what is at stake? Are you telling your shareholders what they need to know?

We think it’s time people started asking questions about their communication strategy, and talking about the impact of the many other aspects of corporate governance on the way they do business. Effective corporate governance can lead to better controls, better market understanding, and ultimately, better performance. At Ernst & Young we believe a proper dialogue with all stakeholders is the key ingredient to delivering that value. And we think that’s a conversation worth having.

For more insights, visit us at www.ey.com/communication
When earnings management becomes cooking the books

The line between legitimate and inappropriate accounting techniques can be a blurry one, but the audit committee must endeavour to make a clear distinction.
communities to produce our February 2000 report entitled “Improving the Effectiveness of Corporate Audit Committees.”

The report focused on the reforms that were needed to ensure “disclosure, transparency and accountability.” We recommended that generally accepted auditing standards require the outside auditor to discuss with the board that the auditor’s judgments about the quality, not just the acceptability, of the company’s accounting principles as applied in its financial reporting.

The report also emphasised the discretionary nature of much financial accounting work means that there cannot be a “one size fits all” solution to preventing accounting irregularities. It encouraged each audit committee to think deeply about its role and to develop its own guidelines to assist with supporting and monitoring both the preparation and the communication of financial disclosure, and active oversight. The NYSE and the NASD embraced many of the suggestions set out in the report, by mandating that they be included in audit committee charters. However, these rules do not require audit committees specifically to think about earnings management and the resultant ability for management to distort financial reporting.

Rather than focus exclusively on process and mechanics, it is important to bring attention back to the substance of financial reporting or risk even the perception. The audit committee has a key role to play in this process by focusing committee members on looking beyond GAAP when evaluating discretionary judgments.

Guidance on how this may be gleaned from the approach taken in the UK. The United Kingdom’s Companies Act of 1985 requires directors to prepare an audit report for the financial year that give a “true and fair view of the state of affairs of the company” (sections 236 and 227). Directors of listed companies must also comply with the Combined Code’s requirement to “present a balanced and understandable assessment of the company’s position and prospects” (Code provision D.1), or explain why compliance has not been achieved.

The annual report of a company listed in the UK will include a statement signed by the board. This outlines the responsibility of the directors to prepare accounts that give a true and fair view of the state of the company, confirms that suitable accounting policies were adopted, used, and states that reasonable judg-

ments and estimates were made. The advantage of the UK model is that it squarely focuses board attention on the substance of financial reporting. The UK approach compared with the more limited role of the management certification approach recently adopted in the US under section 302 of the Sarbanes-Oxley Act.

Although useful, the UK approach is not suitable for wholesale adoption in the US due to the differently con- structed company law, the differences that usually include many company man-
gers who are knowledgeable about the details. Moreover, as noted above, directors in the UK are responsible for preparing the accounts, in con-
trast to the US, where management prepares the accounts under the direction of the board.

Enforcement by SEC. An audit committee could achieve a similar result by requesting assurance from the outside auditor that the report gives a true and fair view of the company, and that reasonable and prudent judgments and estimates have been made, especially regarding revenue recognition, expenses and other items that may involve earnings management. This will bring the focus back to quality and fairness in sub-
stance, and beyond mechanics and structure. Audit committee members

can, in good faith, question the outside auditor’s views and insist that the problem be resolved in management’s favour to effect a better earnings picture both currently and looking forward, notwithstanding compliance with GAAP.

The audit committee should encourage the outside auditor to be candid and prepared to risk management displeaseure. Anecdotal evidence suggests that outside auditors, now directly employed by the audit com-
mittee, are increasingly comfortable with challenging management. For example, in January, outside auditors at Eastman Kodak issued an “adverse opinion” citing “material weakness” in the company’s internal financial controls for 2004.

This increased dialogue between audit committees and outside auditors in the quest for quality financial reporting should be the next major step in the long road of responsible audit committee improvement. Audit committees have been evolving in the US since the late 1930s and early 1940s, but did not emerge as a major feature of large corpor-
ations until the 1960s. The subsequent financial irregularities led to the collapse of Penn Central – then the largest railroad company and sixth-largest industrial corporation in the US – during the 1970s. An investigation that followed the col-

lapse specifically criticised the outside directors’ passivity and lack of financial acumen, as well as the dearth of open discussions between the independent outside directors in discussions among them-

selves. The investigation also revealed widespread inappropriate financial reporting practices.

These shortcomings ushered in the audit committee as a corporate mainstay. In a 1972 release, the SEC re-
commended “the establishment by all publicly held companies of audit committees comprised of outside directors.” Then, Stanley Sporkin, director of enforcement at the SEC, recommended “the establishment by all publicly held companies of audit committees comprised of outside directors.”

In 1974, the SEC required issuers to disclose in their proxy statements their policies regarding the appointment of outside directors to the board. Then, Stanley Sporkin, director of enforcement at the SEC, recommended that companies establish audit committees comprised of outside directors as a condition to setting enforcement proceedings.

In 1974, the SEC required issuers to disclose in their proxy statements whether they had an audit committee in place and, if so, to state the names of the committee members. Finally, in 1977, the NYSE issued rules requiring all listed companies to establish audit committees “comprised solely of direc-
tors independent of management and free from any relationship that . . . would interfere with the exercise of independent judgment.” The NASD followed suit with rules requiring Nasdaq-listed companies to establish audit committees composed of a majority of independent directors.

At this initial stage, outside directors satisfied the then-prevailing definition of independence. This was far less rigorous than the current standard. Since then, our report, the NYSE and NASD listing rules, the Sar-
banes-Oxley Act and SEC regulations have further refined audit committee requirements.

The development of requirements for independent audit committees in the UK and continental Europe has generally lagged behind the US. In the UK, audit committees comprised of non-executives were recom-

mended in the 1992 Cadbury Report. This was followed by the Combined Code, which since has become part of the Combined Code, according to which UK listed compa-

nies are required to “comply with the Combined Code. Before this happens, we may ward off even more regulation.”

“It is important to bring back attention to the substance of financial reporting or risk even more regulation”

Ira Millstein is a senior partner at the international law firm Weil, Gotshal & Manges and the Eugene F Williams Jr visiting professor in competitive enterprise and strategy at the Yale School of Management. He also serves as chairman of the private sector advisory group to the Global Corporate Governance Forum founded by the World Bank and the Organisation for Economic Co-operation and Development. ira.millstein@willkie.com

Your guide to Mastering Corporate Governance

Week 1 May 20

− Introduction
− The role of the CEO
− Corporate governance
− Risk management
− Corporate social responsibility
− Compliance
− Role of the audit committee

Week 2 May 27

− Board composition
− Governance and global strategy
− Corporate governance and performance
− Role of the audit committee

Week 3 June 3

− Corporate social responsibility
− Risk management
− Corporate governance and performance
− Role of the audit committee

Week 4 June 10

− Board performance evaluations
− Diversity in the boardroom
− Risk management
− Corporate governance and performance
− Role of the audit committee

Copy editor: Sarah Gregson
Design: Toby Hoad

We think it's critical that people start talking about their control procedures and the impact the many other aspects of corporate governance are having on the way they do business. Effective governance can lead to better controls, better market understanding, and ultimately, better performance. At Ernst & Young we believe a proper dialogue with all stakeholders is the key ingredient to delivering that value. And we think that's a conversation worth having.

To carry on the conversation, visit us at www.ey.com/change

How much detail do you give your stakeholders?

It's easy to take internal controls for granted. When you've got clients to cater for and shareholders to please, they're often the last item on your agenda. But there are some very serious questions that need to be asked.

Should your internal controls be narrow, but deep, or broad, but shallow? The cost of detailed processes can be extremely high – so what value does this kind of internal control create? How can you monitor any return on investment? How can improving the controls on what you did help improve what you do in the future?

Companies are currently spending on average, $8 million each every year on internal control reviews in response to Section 404 of Sarbanes-Oxley. And our research shows that ongoing expenditure could be as significant – as much as 75% of the first year’s implementation costs. Is your organisation ready?

We think it’s critical that people start talking about their control procedures and the impact the many other aspects of corporate governance are having on the way they do business. Effective governance can lead to better controls, better market understanding, and ultimately, better performance. At Ernst & Young we believe a proper dialogue with all stakeholders is the key ingredient to delivering that value. And we think that’s a conversation worth having.

To carry on the conversation, visit us at www.ey.com/change