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Equilibrium: A Corporate Governance Principle

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We have all heard the terms "governance," "accountability," "credibility" and "integrity" frequently over the last few years, largely thanks to a barrage of corporate frauds that paved the way to the Sarbanes-Oxley Act of 2002 (SOX). In fact, "integrity" was the most queried word of 2005 based on online lookups per Merriam-Webster Online. This noun means incorruptibility, soundness and completeness. It is synonymous with "honesty" and also a very big part of successful governance. Yet, what do these words really mean for us as individuals and our respective employer organizations? Are these concepts truly working for us, or are they simply nice words we throw around on our websites and in employee manuals?

I define corporate governance as: "The decision-making process of directing, managing, and monitoring a company with the goal of creating shareholder value while also protecting the interests of stakeholders such as customers, communities, creditors, employees, suppliers, and regulators." Without the support of your key stakeholders, defined as those who have an influence over your eventual success, your organization is likely in trouble. Clearly, long-term value creation goes hand-in-hand with happy stakeholders.

A long-term perspective is an important concept of governance since a company can maximize short-term net income by forgoing employee raises, not paying vendors in a timely manner, or ignoring regulations, but obviously, this catches up with the company. Likewise, overpaying employees or suppliers, or going overboard with compliance requirements can destroy value.

This is why SOX is catching a lot of criticism these days and rightfully so! The cost-inefficiencies borne by Corporate America in implementing the internal control mandates of Section 404 have oftentimes bordered on ridiculous. Indeed, the value destruction associated with 404 is real, predictable, and preventable as the legislation caught everyone off guard, especially the federal regulators. Therefore, a healthy equilibrium between the owner's interest and stakeholder's interest is central to the definition of governance.

A good way to look at the "big-three" of directing, managing, and monitoring a company, otherwise known as the board of directors, management team, and auditors (both internal and external) is to draw a parallel with our United States Constitution. The Constitution divided the powers of government into three branches, Legislative, Executive and Judiciary, and spelled out distinct roles for each branch. "The leading principle of our Constitution is the independence of the Legislature, Executive and Judiciary of each other." --Thomas Jefferson to George Hay, 1807. Ford Edition of the writings 9:59. Although not an exact parallel since the Constitution also says that no single branch is to have ultimate power to control the whole, and the board by definition has ultimate authority, there are many similarities in concept.

While the corporate board has strict fiduciary duties to stakeholders, as well as hiring and oversight of the CEO, the board also needs to be held accountable. In fact, the audit committees of public company boards are required to be evaluated by their external auditors as part of the annual internal control audit required by Section 404 of SOX. In addition, entire boards of companies listed on the NYSE are required to go through an annual self-evaluation process per the Exchange's corporate governance guidelines. The bottom line is that board failures were a key culprit behind the Enrons' and WorldComs' of Corporate America's credibility loss this decade. While it may have been the corporate executives actually committing the fraud, it was allowed to happen under the sleepy watch of the respective boards.

A key to strong corporate governance is the healthy separation of the directing, managing, and monitoring functions of a company. Enter "independence" which, similar to the three divided powers of government, is one of the more important factors of strong governance. Despite the growing support of this belief, the overwhelming majority of corporate boards still have directors who are friends, alliances, family members, and within the close-knit web that weaves through business, community and social activities. A strong argument can be made for filling a board with people you already know, and indeed this is often the case. However, the fact remains that you severely limit your universe to the existing knowledge base when independence is impaired. Board members are not at "arm's length" and therefore are not likely to be entirely candid and truthful. By recruiting outside his or her circle, the CEO and other board members can gain tremendous advantage of creativity, candor, and outside perspectives.

Likewise, a big part of the monitoring aspect of good corporate governance needs to rest outside the management function since this is where the majority of any organization's activities occur. No longer are the days of management hiring the auditor acceptable. The expectation is for the external auditor to report directly to the audit committee, or the full board in absence of an audit committee. In addition, many organizations are changing their reporting structures to have their internal auditors also report through the board. Another valuable tool is to have an anonymous reporting mechanism administered by an independent party to allow employees, clients, and suppliers to report suspicious activities that could be fraudulent.

As previously mentioned, a key theme for successful governance is equilibrium. You do not want to create an organization that is too heavy-handed with monitoring, as this can waste resources and create an environment of paranoia. Instead, a healthy balance among the board of directors, management, and the auditor(s) is the best way to create a corporate culture of accountability, credibility, integrity, and superior performance. After all, isn't it really an organization's name, through their shareholder and stakeholder credibility, which is its most important asset?

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