EFFECTIVENESS OF CORPORATE GOVERNANCE AND MEASUREMENT CHALLENGES

Mridula Sahay*

*Amrita School of Business, Amrita Vishwa Vidyapeetham University, Coimbatore, India

Abstract

Growth and profits are key performance indicators for sustainable Corporations. As a result of this, competition between corporations has become intense with everyone trying to outperform the other. In this process there are performers, losers, winning situations and crisis situations. These outcomes are a result of how effectively the corporations/organizations are managed/governed. The Business World in the last few years has witnessed a financial crisis due to several reasons. One of the key reasons for the crisis has been attributed to lack of good and effective Corporate Governance. In light of the Global Financial Crisis that began in 2007, this paper tries to establish the importance of effective corporate governance. The paper has traced these failures stemming from the perspective of corporate governance by looking at different reports. It goes on to define a Corporation from the perspective of the stakeholder expectation, and the importance of Governance, it brings out the systemic gaps against this background. It further goes to identify the factors contributing to effective corporate governance, how it could be measured and the challenges involved in the process. Based on this understanding it proposes an approach which can be used to define a framework to measure the effectiveness for Corporate Governance.

Keywords: Corporate Governance, Global Financial Crisis, Financial Institutions

1. INTRODUCTION

There have been some events in the last few years, which led to certain outcomes in the world markets resulting in financial crisis situations. "Weak and ineffective corporate governance in systemically important financial institutions was the key contributing factor" to the economic crisis that began in 2007. The Global Financial Crisis was the result of a "massive failure in governance at every level".

Various studies that have been conducted have pointed out that feeble and futile corporate governance of many financial institutions, particularly those of systemic importance, was one of the most important contributors to the grossly excessive risks taken and, consequently, the depth and severity of the crisis.

A common thread appears to run across the boards of the financial institutions in terms of their behavior or reaction (unwillingness and ability to exercise independent judgment, challenging management etc.) at the time of crisis. The other key factors that contribute d to the crisis included - Lack of effective challenge of management by boards; defective information flows; insufficient understanding of the situation and risks involved; insufficient board oversight of senior management; intricate organization structures. As a result of these weaknesses, financial institutions were allowed, even encouraged, by their boards to take excessive risks that included unprecedented levels of leverage and high-risk business strategies.

The governance of financial institutions was not bad but insufficient to prevent the actions that contributed to the crisis. This was not because the boards were poorly structured or had wrong guidelines/mandates or the board members were unqualified. It was due to the inability and failure of the Board to challenge the management at the required time.

The Financial Services Authority (FSA – U.K)[1] for supervisory approach in early 2006 provided criteria for evaluating the governance of financial firms, and the Basel Committee Consultative Document (BCCD)[2] also emphasized on certain characteristics for good governance (Ref: Table 1).

A quick analysis of the FSA-U.K provided criteria showed that only few of the criteria could be termed as performance-related (Ref: Table 1 Pts. 17, 18) while the others could be described as characteristics of good governance. Most of the financial institutions which were caught up in the crisis probably satisfied the criteria of good governance but failed on the performance related criteria. Similarly in Basel Committee Consultative Document it was observed that the characteristics essential for performance were missing.

The criteria/characteristics which were performance-related in both the cases were "Participation levels on committees and Willingness and ability to exercise independent judgment and to Challenge Management" when indications of excessive risk taking did surface. These were

1 The Financial Services Authority (FSA) is the regulator of the financial services industry in the UK.

2 The Basel Committee Consultative Document was published in November 2005, eliciting a number of helpful comments from banks, industry associations, supervisory authorities and other organizations. This was done to help promote the adoption of sound corporate governance practices by banking organizations.

missing in the governance of financial institutions, making the governance ineffective while the governance was considered good. It is here where the Board had failed. Additionally the Boards became proponents of the paradigm of unlimited liquidity, low interest rates, perpetual growth, and rapidly growing profits, bonuses, and stock-option benefits. These in some cases were supplemented by weaknesses in corporate values and integrity of members. In short ineffective and weak governance of financial institutions contributed to the crisis, i.e. the Global Financial Crisis.

The focus of this paper is on effective Corporate Governance. Various measures have been suggested by different individuals and groups for improving corporate governance practices and effective governance. The Walker Review provided the following potentially useful suggestions for addressing these issues:

- A board decision-making process that institutionalizes a "challenge" function;
- Greater time commitments by non-executive directors;
- Selection of a board chair with the time and expertise to provide the necessary leadership to the board;
- More extensive engagement by the board in risk oversight;
- Greater involvement by institutional investors in governance oversight.

This paper covers the definition of a corporation (including role of a corporation, expectations of a corporation), corporate governance and corporation governance before discussing effective corporate governance, a framework for measurement of the same and the challenges involved in the measurement.

2. CORPORATION

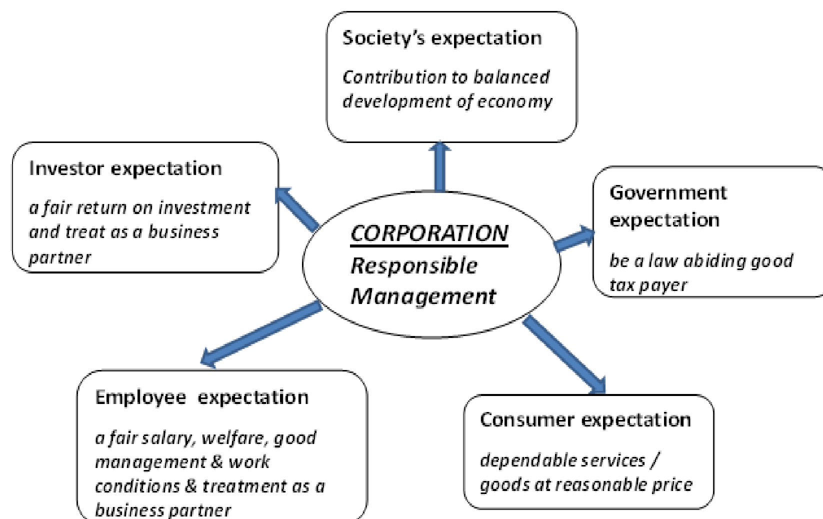
There are many definitions given for the word corporation and each of them reflects the perspective of the individual providing the definition. The core of a corporation is a structure, which got developed to meet particular needs of business. A corporation has multiple stake holders (Society, Government, Consumers, Employees, and Investors) with each one of them having his/her own expectation of the corporation.

2.1. Role of Corporation

The role of a corporation is different in different situations based on the expectations and perception of other entities. The two key expectations of a corporation amongst others are:

- ***Societal Expectation*** can be termed as the expectations of individuals/groups that are a part of the society. Individuals look for good jobs, decent pay, goods and services to meet their needs, opportunity to display their skills and challenges to show their creativity and ingenuity. They like to produce results and expect to get rewarded and protect their interests.
- ***Market Expectation.*** A corporation operates under the laws effective at marketplace. The expectation is that it fulfills the social laws of the nation/state where it operates and meets other environmental regulations (Please refer Figure 1).

Figure 1. Expectations of Stakeholders from the Corporation[3]



3 The Financial Services Authority (FSA) is the regulator of the financial services industry in the UK.

Table 1. FSA Governance Evaluation Criteria and BCCD Governance Characteristics

Criteria for evaluating Governance - Financial Services Authority U.K.		Basel Committee Consultative Document - Characteristics for Governance	
No.	**Governance Criteria**	**No.**	**Governance Criteria**
1	Role of the board in promoting a control culture	1	Board oversight of senior management (including setting & monitoring performance standards)
2	Board reviews of policies and procedures regarding controls	2	Establishment of a board risk committee for advising the board on the bank's overall current & future risk tolerance and strategy, and monitoring implementation of strategy by senior management
3	Composition of the board and board committees, and competence of members	3	Responsibility of the board for adequate corporate governance across the group, & ensure that there are governance policies and mechanisms appropriate to the structure, business, and risks
4	Existence of audit, risk, and remuneration committees	4	An independent risk management function with sufficient authority, stature, independence, and resources, and access to the board;
5	Independence of the board	5	Identification and monitoring of risks
6	Proportion of non-executive directors to executive directors AND Management of non-executive director conflicts	6	The role of the board in overseeing the financial institution's compensation system, including ensuring that its design and operation are consistent with prudent risk taking
7	Terms of reference for the board and board committees	7	Responsibility of the board to understand the complex structure and the organization of the group including understanding legal and operational risks of intra-group transactions and their impact on the group's funding, capital & risk profile under normal & adverse circumstances
8	Frequency of board meetings AND Adequacy and timeliness of information received by the board	8	Responsibility of the board to understand the purpose, structure, and peculiar risks of any special-purpose or related structures and to mitigate the risks identified.
9	Direction, understanding, monitoring, and control over business activities & related risks		
10	Existence of policies and procedures to ensure that critical decisions are made with appropriate approval		
11	Existence of processes to ensure that policy overrides are minimal and exceptions are reported to management		
12	Appointment process for non-exec directors, tenure & compensation		
13	Consideration given by the board to the relationship with the regulator		
14	Existence of a strategic-planning process, including objective setting, creation of short-term business and operating plans, and monitoring of implementation		
15	Extent to which the strategic-planning process reflects FSA's priorities, consideration given to risk profile, financial soundness, & capital adequacy		
16	Participation levels on committees		
17	Willingness and ability to exercise independent judgement and to challenge management		

3. WHAT IS CORPORATE GOVERNANCE?

The word "corporate governance" is freely used by many in the industry and has become a subject of intense debate and discussion all over the world. Majority of the discussions focused on the financial aspects and role of Board of Directors, ignoring other aspects. This is reflected in the reports produced by different committees, which were set up for reviewing and investigating different scandals that rocked the corporate world are. The Cadbury report (1992)[4] by Committee on the Financial Aspects of CG, Greenbury report (1995)[5] over concern at the size of director's pay packages and their non-disclosure in annual reports, Turnbull report (1999)[6] to provide guidance on implementation of internal control requirements, and Smith's review (2003)[7] on the role of Audit Committee.

It is essential to know that corporate governance is not limited only to financial aspects but involves many other aspects (related to different subjects like law, economics, finance, management, politics, ethics and others).

The Organization for Economic Cooperation and Development (OECD) has defined corporate governance as:

"Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders and spells out the rules and procedures for making decisions in corporate

4 The Basel Committee Consultative Document was published in November 2005, eliciting a number of helpful comments from banks, industry associations, supervisory authorities and other organizations. This was done to help promote the adoption of sound corporate governance practices by banking organizations.

5 The Cadbury report of 1992 was the result of the work of a committee that was set up to study the financial aspects of corporate governance.res This was necessitated due to the financial scandals that erupted during that period.

6 The size of pay packages of directors was high and the size was not getting disclosed in the annual reports, this became a cause of a concern. These concerns result in the formation of a committee, which produced the Greenbury report in 1995 after conducting investigations.

7 The Turnbull committee was set up in 1999 to provide guidelines for the implementation of internal controls in corporations as these were a point of concern.

affairs. By doing this, it also provides the structure through which the company objectives are set and the means of attaining those objectives and monitoring performance”[8].

Governance is the function of managing a corporation to realize the corporation objectives and its obligation to fulfill the expectations of the stake holders.

4. WHO IS RESPONSIBLE FOR CORPORATE GOVERNANCE?

Governance function is carried out by a group of individuals (the Board of Directors, Management, Workers) at different levels in the corporation with the support of other stakeholders.

There is a high degree of interdependency between the board and management for running the corporation hence a balance needs to exist between them. Realization of organization objectives and performance of the corporation depends on the effectiveness of corporate governance.

4.1. Board of Directors

Corporations are powerful and at the same time accountable. To maintain the legitimacy and credibility, corporate management needs to be accountable to some independent, competent and motivated representative. This independent body is supposed to be the Board of Directors. The Board of Directors is the link between the people who provide capital and the people who use the capital for creating value. They have the responsibility for:

- the performance of the corporation at a holistic level;
- reviewing the objectives, strategies and plans of the corporation;
- evaluating the performance of the organization;
- selecting the top management keeping in view the interest of the organization.

4.2. Management

Management of the corporation should be aware that it produces/delivers goods/services they have social effects on people/community, which consume the same. It is responsible and accountable for:

- working closely with and supporting of Board of Directors;
- short term planning;
- day-to-day operations and business of the corporation.

4.3. Investors

Investors are those who delegate power to the Management (Board of Directors and Others) for running the corporation and are responsible for:

- providing the necessary capital for running the corporation;
- reviewing and giving consent for major business investments to be made by corporation.

8 A clarity was required on the role of Audit Committees in the process of corporate governance, which resulted in the setting up of a committee to carry out a review and produce a report.

4.4. Factors impacting the governance process

Governance in a corporation is carried out by the Board of Directors and the Management with the support of other stakeholders. There is a high degree of interdependency between the board and management for running the corporation hence a balance needs to exist between them.

Therefore the relationship between amongst different individuals/groups has an effect on the organization performance. Besides the standard codes and guidelines defined for different stakeholders, there are the behavioral aspects, which impact the governing process. These include:

- Skills and experience of Board members;
- Relationships between human beings;
- Character and integrity of individuals involved in the process of governance.

(The question of character and personal integrity is of greater importance than of resume of the individual).

5. EFFECTIVENESS OF GOVERNANCE

The need for good and effective corporate governance stems from the obligation of the corporation to fulfill the expectations of its stakeholders. For a corporation to fulfill its objectives, meet the expectations of different stakeholders it needs to perform. Performance of a corporation is dependent on the effectiveness of the governance process, which is in turn dependent on the individuals involved in the process of governance. For effective governance of a corporation the Board of Directors need to perform.

In simple terms board performance means the effectiveness of the board in overseeing management and the affairs of the financial institution, and ensuring that risks accepted by the financial institution can be safely managed.

Any corporation is governed by the Board of Directors and the Management. They are responsible for good/bad/effective/ineffective governance. Good Corporate Governance:

- should ensure healthy relation between corporation and stake holders;
- should ensure compliance with set standards/code of governance;
- should ensure fairness and transparency in the corporation’s dealings with its entities.

Normally most of the Boards end up providing good but not effective governance.

Effectiveness of Corporate Governance is normally mistaken to compliance of the Board, Management to the standards and guidelines defined for governing the corporation. Compliance with the standards and guidelines defined for governing the corporation only ensures good governance. Good governance is assumed by many to be effective governance. However, Effective Governance goes beyond mere compliance with codes/standards and is also linked to the performance of the corporation.

Effectiveness needs to be measured for taking meaningful steps to improve the performance of the corporation. The measurement of Effectiveness is a challenging task as quite a few of the concerned factors are subjective in nature.

5.1. Challenges to Effective Corporate Governance

To perform any activity successfully one needs to face challenges. Similarly there are challenges one needs to overcome to provide effective corporate governance. Few of the key challenges are listed below:

- Problems masked by management (while reporting operational information) to protect itself;
- Board overlooking some of the reported problems (to cover its shortcomings);
- Lack of Trust between the management and the board;
- Understanding between the board and management to cover each other's failures;
- Outsourcing of functions/activities also pose a challenge to effective governance. (In the present day world the trend is towards outsourcing different organization functions to reduce organization costs and improve performance. As the outsource service providers take charge of outsourced functions/activities they become responsible for many things like risk mitigation, business ethics, tools, data, personnel management etc. With outsourcing, the decision making responsibility could move from internal managers to the external service providers but would not be involved in Corporate Governance activities. This non-involvement could impact the effectiveness of governance activity);
- Lack of balance between the Board and Management;
- Lack of good relationship between Board, Management and Stakeholders;
- Lack of skills and relevant experience in Board;
- Lack of character and integrity amongst board/management.

5.2. Measuring the effectiveness of corporate governance and Challenges

The valuation of any corporation will grow only when there is good and effective corporate governance. Good and effective corporate governance is very important for sustainable development and higher valuations of a corporation. Therefore, the quality of governance needs to be improving continuously. Anything that cannot be measured cannot be improved. Hence, there is a need for measuring effectiveness of corporate governance to improve the effectiveness.

Effectiveness of governance by Board of Directors is reflected by the performance of the organization. The performance of the organization is measured continuously based on the business outputs produced by the organization. The business outputs are a result of the operations carried out by the corporations based on the strategies defined by the Board and executed by the management and others. Continuous monitoring organization performance should be carried out by the Board. The monitoring of organization performance and decision making by board is possible only when relevant inputs/information is provided in time by management to the board. Finally the board also needs to study the impact of their decisions on the outputs, performance of the organization and learn about their mistakes and shortcomings for improving their own performance. The key factors critical to corporation performance are given below.

Board of Directors: Skills to deal with organization challenges, Knowledge of Organization, Relevant experience.

Inputs: Should be detailed (with cases, alternatives, assumptions cases etc.), should be of high quality, timely and relevant.

Business Outputs: Include Financial and Non-financial outputs (expectations of other stake-holders), processes adopted in realizing the outputs, impact of board decisions on outputs.

Learning Should be facilitated by a continuous feedback process to enable Board and Management improve their own performance.

The organization should provide the needed transparency and environment to allow the individuals challenge the assumptions made while taking decisions, processes followed etc. The performance evaluation to know the effectiveness of governance should be carried over a period of time and not at particular instants (this would give an incorrect measure of the performance as some time would be required for the results after the decisions have been made). While the performance evaluation is carried out by the board, the Board should also continuously strive to improve its performance. This is possible only when they learn from the results of their actions. Hence, learning is a critical aspect and for this a feedback loop is essential for the Board to learn about their mistakes, imbibe, correct and improve its own performance thereby making the governance more effective.

Apart from the above for measuring the effectiveness of governance apart from structural aspects of governance, inputs, etc. behavioural aspects such as the evaluation of sufficient number of alternatives in decision-making, inter-personal relationships, balance of power, character and integrity of individuals also play a critical role and contribute significantly to governance effectiveness. These factors are subjective and every organization should define their own norms to measure these subjective aspects. The author after a study of existing literature on the subject has developed a basic framework (Ref: Table 2) for measuring effective corporate governance, which includes all the factors that are critical to the process of effective corporate governance.

The measurement of the effectiveness of corporate governance is a challenging task. This is due to the fact that the factors critical to effective corporate governance is both subjective and objective in nature. While the objective factors could be quantified and measured, it is difficulty to quantify the subjective factors to measure them.

Performance is finally driven by individuals working with other individuals. The human element brings in a lot of behavioural aspects, which impact the governance process. Examples of this include, nature of an individual (willingness to challenge others on assumptions, decisions, etc. for improving the performance of the organization), ability to establish relationships with others to motivate them to work towards improving the organization performance. Finally the character and integrity of individuals in key positions has an impact on the effectiveness of corporate governance. Character and Integrity are not measurable as they are highly

subjective. Considering all these factors it is indeed a challenge to define a scale to measure the effective ness of corporate governance.

6. CONCLUSION

Like it is said an opportunity or a crisis should not be allowed to go waste. They should be used to understand the causes for crisis to learn and take action to improve the effectiveness of governance and prevent/minimize the chances of any crisis or non-performance. Some of the actions to improve effectiveness of governance could be as follows:

- put in place corporate governance mechanisms & internal controls to reduce inefficiencies and improve effectiveness of governance:
  - continuous supervision of management by Board of Directors and taking corrective actions as required;
  - challenging management as and when required for performance improvement of organization.
- External corporate governance controls (controls external stakeholders exercise over the organization) like competition, debt covenants, demand for and assessment of performance information, government regulations, etc.
- Demonstrate the need to be careful while making judgments in situations where they need to balance different interests like:
  - risk versus reward;
  - short term versus long term;
  - effective oversight versus motivating management;
  - ethical considerations versus market practices;
  - competing interests of different stakeholders.

The Board of Directors is the key element in the organization/corporation structure. They are like the kings of yesteryears who had the ultimate responsibility for good and effective governance. Like the old saying Yatha Raja – Thatha Praja (subjects behave like the king does) the middle management and others tend to mould themselves on the lines of the Board and Management. Hence, the Board needs to show a character, dignity and integrity, which would be respected and followed by the middle management and others in the corporation. For this the Board and Management need to ensure the prevention/minimization of the following starting with them:

- Fraud;
- utilization of company resources for personal benefit;
- lethargy, focusing on excuses as opposed to results;
- being too risk averse that may lead to overinvestment;
- being too risk prone.

The author after a study of existing literature on the subject has developed a framework for measuring effective corporate governance, which includes the factors that are critical to the process of effective corporate governance. This framework may not be covering all aspects and factors, which would impact the effectiveness of corporate governance and could be subject to improvement. However, this could be treated as the first step in working towards an effective governance model. There are a lot of challenges in the process of measuring the effectiveness of corporate governance especially with respect to the subjective factors and more work needs to be done in this area.

Table 2. A framework for developing a model to measure effective Corporate Governance

	Definition	Scope	Implementation	Continuous Progress	Sustenance
Organization Culture	Formal Organizational Value System is defined	Should become an integral part of all processes, individuals, etc. of Organization on a continuous basis	Disseminate Values and Principles across the organization through publications, lectures and demonstrations	Monitor the implementation and practice of the values and principles to identify shortcomings, rectify and loop back the learning into the system	Value System should be the bible. Zero tolerance for not adopting it
Information Dissemination	Making available correct, quality and timely information to all involved in decision making at different levels	All aspects and time-trends including alternative solutions etc.	Information should be shared and consistent to ensure proper decision making	Benchmark against available industry standard	Review, enhance information needs and provide support to achieve the same
Corporate Guidance	Based on information available, Vision, Mission and Value System of the Organization	All aspects	Defining and Establishing the needed communication structure for sharing the objectives of the organization and strategies to achieve the same	Decision making with the assessment of various alternatives, results and risks and evaluating information sufficiency	Improve decision making processes through learning feedback loop, time and financial investment
Organization Performance Monitoring	Defined processes and rules exist	All aspects	Accountability at different levels to be defined and shared with everyone	Continuous improvement of internal control practices/mechanis ms to eliminate any weaknesses or short-comings	Bring in Transparency
Learning	Document Existing Examples and Case Studies	Cover all aspects (financial, non-financial, behavioural, etc.)	Sharing of relevant and useful examples across the organization	Refine objectives of all entities through learning, imbibing, correcting at all levels to improve performance	Reward learning and development at all levels

REFERENCES

1. Corporate Governance, Christine A Mallin, OXFORD University Press, www.oup.com, ISBN 978-0-19-928900-4.
2. Kautilya's Arthashastra – Its Contemporary Relevance Indian Merchants Chamber & IMC Economic Research and Training Foundation.
3. Corporate Governance Accountability, Enterprise and International Comparisons, by Kevin Keasy, Steve Thompson, Mike Wright, © 2005, John Wiley & Sons Ltd. ISBN 0-470-870303.
4. The Human Face of Governance, Lynn McGregor.
5. Measuring effectiveness of Corporate Governance, by Dr. Yilmaz Arguden, Chairman ARGE, Istanbul, Chairman Rotshchild Investment Bank, Turkey.
6. Study: Effectiveness of Corporate Governance Programs Challenged by Outsource Model, New York.
7. Cushman & Wakefield, Business Briefings and Concerns, New York.
8. How Can Financial Supervisors Improve the Effectiveness of Corporate Governance? John Palmer and Chang Su Hoong.