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Linking CEOs Corporate Governance agenda to CIOs agenda

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Investors are demanding reforms. Companies had better prepare for it. Companies that use their IT systems to improve corporate governance are likely to improve their long-term performance as well. Given the effort and expense of meeting the rather narrow concerns of current compliance, the investment is very worthwhile.

The attempt to legislate and regulate people into good behaviour has spawned a compliance culture rather than an ethical culture. Too many boards have outsourced the task of ethics to others to define the company's values. And, then the public relation arm of the company, who defend the un-defendable actions of the company, comes out with blazing guns telling the media that the company hasn't done anything wrong as it legally complied with the rules. Ethics have become something that "other people" in the organisation worry about, leaving everyone else unfettered by such concerns. Does it matter? And if it does, what can be done about it?

Ethics do matter in business because they underpin trust, which is fundamental to running any form of business. Markets work more efficiently where there is trust between participants. Within the company an ethical culture provides the glue that makes for a cohesive and effective organisation. The cost of ethical shortfalls at Enron, WorldCom, Parmalat, Lehman and others is there for all to see.

The problem for boards is to find practical ways of establishing an ethical culture and pre-empting potentially damaging unethical behaviour. This is especially difficult for organisations whose operations span many countries and cultures. Leadership also means setting an example. And that means transparency, openness, responsiveness and courage to do the right things – not getting around rules and legislations to avoid paying, for example, corporation tax.. It is particularly about taking ownership of decisions and actions to protect the reputation of the company. There are many things board members should delegate to others but ethical responsibility is not one of them.

Probably the most common complaint in business today is that the burden of conforming with a raft of related corporate governance directives [Sarbanes Oxley/ SAS99, Basel II (Basel 2) and The Freedom of Information Act] distracts management from dealing with real business matters. It is argued that, so great is the regulatory burden that the real effort of growing a business has started to take a back seat. Like all such arguments, it is exaggerated to make its point more dramatic. Based on our research, we believe companies need to balance conformance with performance.

Corporate governance is the integration of leadership and organisation at all levels of a company. The days when senior executives could build corporate and personal wealth without paying much attention to investors' concerns are long gone. Evidence of the growing activism of shareholders appears regularly on the front pages of business publications, from reining in the pay of chief executive officers (CEOs) to the humiliating rebuff delivered to Disney's boss. In today's highly competitive economic and business conditions, CEOs are under pressure to demonstrate their control and effectiveness in guiding their organisations through rough water. Headlines about business scandals (from Enron, MCI, Global Crossing in the US to Parmalat, the Italian diary group in Europe) and images of handcuffed CEOs are powerful reminders of what can happen when corporate governance goes amiss.

Despite concerns and complaints, a recent study by Governance Metrics International (GMI) found that US companies have risen to the top of a global comparison of corporate governance standards, overtaking the UK and Canada for the first time. The study of more than 2,500 international companies found that that the Sarbanes Oxley Act and other reforms implemented had succeeded in improving the performance of large US companies by more than 10%. The 356 Japanese companies included in the study fared worst, partly due to poor financial disclosures. French and Hong Kong listed companies also performed badly. Countries with Anglo-Saxon legal traditions – Canada, Australia, the US and UK – consistently fare best.

Governance pays

Many UK organisations not affected by the US Sarbanes-Oxley legislation, which aims to prevent corporate accounting scandals, will have to comply with the Companies Bill currently passing thought Parliament. The Bill introduces criminal offences for company directors that

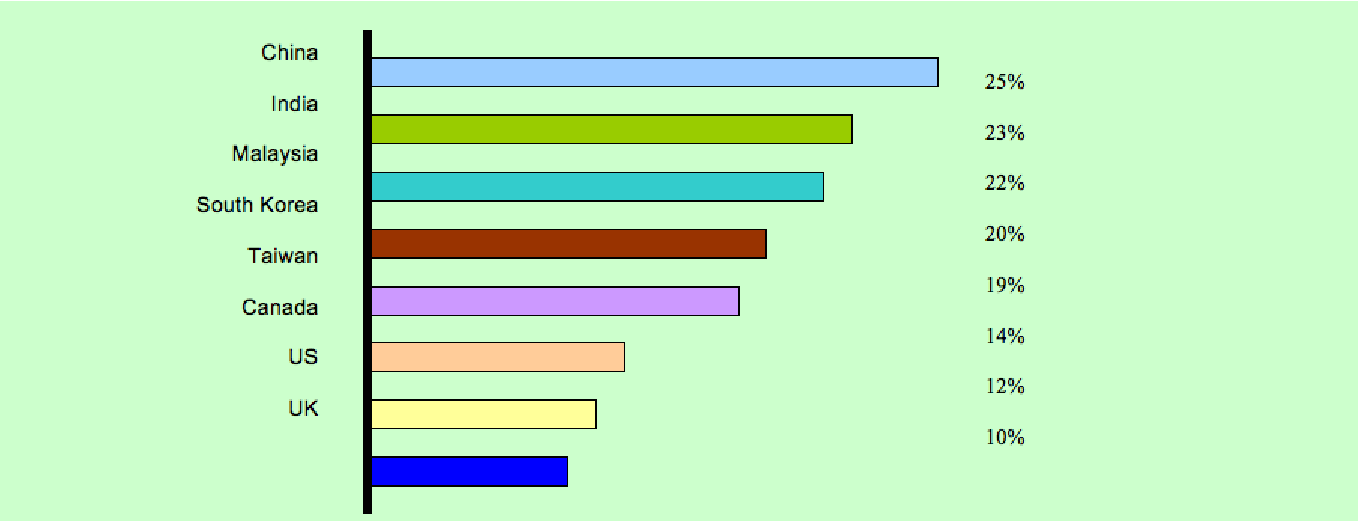

Figure 1: *The governance premium – average premium investors are willing to pay for well governed company (Source: Sirius & Company Analysis)*

knowingly make false statements to their auditors and gives auditors greater rights to demand information from firms. Companies listed in the European Union will from 1 January 2005 have to comply with new international accounting rules. Institutional investors in companies claim to be willing to pay as much as 30% for shares in companies that are well-governed (see Figure 1). Do these investors mean what they say?

In a recent study, we examined a random sample of companies from Europe, US, India, Korea, Malaysia, Mexico, Taiwan and Turkey to test the link between market valuation and corporate-governance practices. We found that companies with better corporate governance had higher price-to-book ratios, indicating that investors do indeed reward good governance and with quite a large premium: companies can expect a 10% to 12% boost to their market valuation by going from worst to best on any single element of governance.

Analysis of the results confirmed a link between share price performance and adherence to corporate governance best practices. Our study shows that shares of the 26 companies that scored highest outperformed the S&P 500 index by 10% over 5 years. Twenty of the 26 companies achieving the top score under the system are listed in the US and include 3M, Coca-Cola, Eastman Kodak, General Motors, Gillette, Dow Chemical. 33% of the 1200 US companies rated have separated the role of chairman and CEO, compared with 95% of the FTSE 350 members studied in the UK.

CIOs role in governance

The directors and senior executives with whom we work say that the most critical requirement in corporate governance is raising the quality of the strategic dialogue between the board and management. To do so, both sides must see timely information that shows a company's progress in implementing its strategy - information that isn't necessarily found in quarterly financial filings or in today's board books. What's needed is a set of consistent, unbiased reports, delivered routinely to all board members that paint a broad picture of the company's situation.

Most companies will need to change their IT systems in four ways to achieve this goal (see *Conforming to Corporate Governance in a cloudy technology world* by Sum). *First,* they must ensure the integrity of the data, which should be easily traceable back to original transactions. Managers and board members must be able to drill down through performance metrics to find the root cause of problems - or the genesis of opportunities.

Second, more attention must be paid to the timeliness of information, not only to accommodate shortened reporting deadlines, but also to facilitate faster, more flexible decision making. IT systems that are integrated across the company reduce the time needed to reconcile performance data and thus make it possible to deliver information rapidly.

Third, efficient IT systems will tailor reports to the needs and capacity of individual users - from board members looking for insights on strategic risks to managers comparing regional sales data. IT systems should deliver information on business drivers to decision makers according to their individual responsibilities and requirements. The objective is to move from mountains of data, all synthesised from different sources with different methods, to delivering targeted, consistent, context-specific information. This is hard to achieve in a decentralised and loosely controlled environment, but drives real performance.

Finally, companies should standardise the gathering of data for reports and automate them where possible to create a common, company-wide set of performance metrics - a basic good-governance requirement that a surprising number of companies lack. Standard performance metrics also make it easier to see exceptions and aberrations.

The best systems deliver automated warning alerts to senior management and the board when key performance thresholds have been passed (positively or negatively) or use other feedback mechanisms to assure compliance with company policies and standards or with legal and regulatory requirements.

IT systems most affected by the rule change include treasury, general ledger, accounting and enterprise resource planning (ERP) systems. CIOs need to do a very thorough systems audit and ensure that they can track back information from the published accounts. They might need to invest in new technology to track changes to documents. This has never had to be done before and is a major challenge.

About the author

Sukhendu Pal is the CEO & Managing Partner of Sirius & Company.