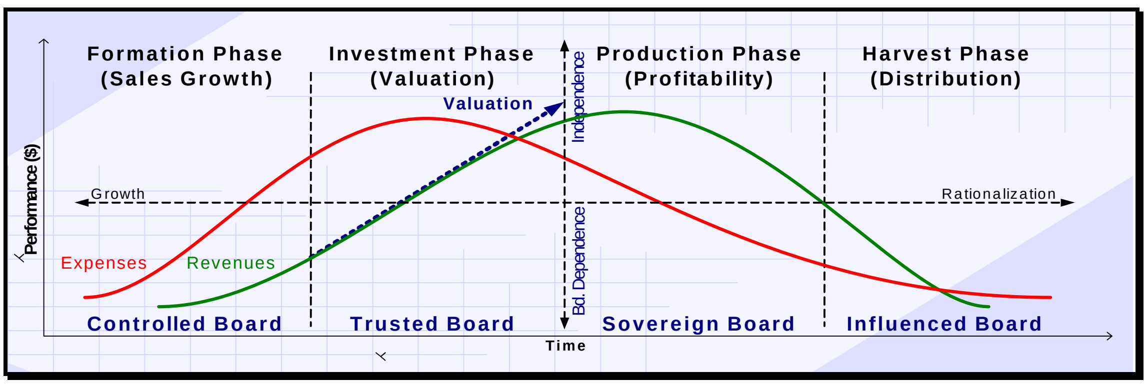
Corporate Governance Best Practices: One size does not fit all

By Alex Todd, founder and CEO, TE Research

At a time when North American business faces a higher degree of regulation and accountability than ever, corporate boards are confronted with the issues of governance and how best to improve the level and consistency of regulatory compliance. While improved compliance is necessary for the protection and enhancement of public and shareholder confidence, it has led to the prevailing assumption that a more independent and engaged board is the prescription for all that ails today's corporations. While this may be true in some cases, new research reveals that corporate governance standards cannot be consistently applied to different structures; one size does not "fit all." The research suggests that the appropriate style of corporate governance in any business is a strategic consideration directly influenced by its relative position in the *corporate lifecycle*.

Simply stated, different sets of governance practices are associated with distinct measures of business performance. Corporations need to actively consider their strategic priorities before adopting corporate governance reforms and corporate strategies that enhance both business performance and governance effectiveness.

Governance Styles linked to Evolving Performance Priorities[1]



Improving regulatory compliance is one of the most important obligations of today's boards. But as we move through the early stages of change in today's corporate and business culture, it is clear that the effectiveness of corporate boards will not be measured simply by a regulatory checklist, but by the ability of institutional investors to see evidence of proactive corporate initiatives that improve business performance. Governance management programs, designed to actively seek such improvements by regularly monitoring and refining corporate governance

[1] Abstract representation of TE Research's Governance Lifecycle Model (GLM), inferred from research conducted in 2006. It shows how different governance practices are associated with evolving business performance priorities through a typical *corporate lifecycle*. Management-controlled boards enjoy faster sales growth, which is typically a strategic priority for young companies in the Formation Phase of their *corporate lifecycle*. Boards with practices that help *establish* investors and analyst trust are rewarded with higher share valuations, which is typically a strategic priority for corporations preparing to raise capital on public markets and those seeking to leverage the value of their shares for mergers and acquisitions in the Investment Phase of their *corporate lifecycle*. Sovereign boards that are controlled by neither shareholders nor management preside over the most profitable companies – profit typically being a strategic priority for mature public companies in the Production Phase of their *corporate lifecycle*. Outwardly, independent boards that are nevertheless influenced by management tend to distribute more cash to shareholders, which is typically a strategic priority for ripened companies in the Harvest Phase of their *corporate lifecycle*.

practices in reference to key industry trends, best practices and shareholders' interests, can give boards an effective means by which to help direct and sponsor enduring improvements in both business and compliance performance measures.

Corporate governance guru Peter Dey's recent about-face on corporate governance standards (initially a voice for rigid standards, he recently proposed that now, in the next stage of governance evolution, companies are sufficiently advanced "to look at what good governance really is") suggests that a more flexible approach is in order. If the primary purpose of for-profit corporations were to make a profit, logic would dictate that good corporate governance practices, in the very least, should help businesses be profitable. However, corporate strategies for attaining and maintaining profitability vary greatly. Some corporations focus primarily on revenue growth, others on operating profits. Many companies focus on shareholder returns in the form of market valuations or cash distributions. With such a diversity of priorities it is important to do more than just recognize the impact of corporate governance on strategic performance – we must understand the nature of this impact and how it changes from business to business. This understanding will tell us a great deal more about how boards of directors can optimize their roles when formulating corporate and business strategy.

We already know from widely accepted literature on the *"monitoring hypothesis"* of governance (in which shareholders rely on a board of directors primarily to manage the "agency costs" of controlling corporate management) why privately held companies require a different brand of governance than public companies. This conventional wisdom also tells us that the board is supposed to monitor, ratify and sanction management decisions on all matters, including corporate strategy. Is it possible, however, that different business objectives requiring different strategies could also benefit from distinct governance practices? In other words, could it be that the answer to the question, "What are corporate governance best practices?" may be "It depends on your ownership structure and your strategy"? Under such an approach, different corporate strategies may best be served by distinct bundles of governance practices. If so, there would be merit in Mr. Dey's insight that "each board will decide what the right formula is."

<u>Evaluating the Relationship between Corporate Governance and Business Performance</u>

In 2004, Lawrence D. Brown and Marcus L. Caylor from Georgia State University published a research paper entitled "Corporate Governance and Firm Performance." They correlated business performance data on 2,327 companies from Compustat with 51 corporate governance provisions from Institutional Shareholder Services (ISS). They concluded that *"firms with relatively poor governance are relatively less profitable (lower return on equity and profit margin), less valuable (smaller Tobin's Q), and pay out less cash to their shareholders (lower dividend yield and smaller stock repurchase)."* They also identified the specific governance factors that contribute most to business performance:

> *"We find that the 13 factors associated most often with good performance are: all directors attended at least 75% of board meetings or had a valid excuse for non-attendance, board is controlled by more than 50% independent outside directors, nominating committee is independent, governance committee meets once a year, board guidelines are in each proxy statement, option re-pricing did not occur in the last three years, option burn rate is not excessive, option re-pricing is prohibited, executives are subject to stock ownership guidelines, directors are subject to stock ownership guidelines, mandatory retirement age for directors exists, performance of the board is reviewed regularly, and board has outside advisors….*

We identify seven factors that are associated most often with bad performance, namely, consulting fees paid to auditors are less than audit fees paid to auditors, managers respond to shareholder proposals within 12 months of shareholder meeting, board members are elected annually (no staggered board), a simple majority vote is required to approve a merger (not a super-majority), company either has no poison pill or a pill that was shareholder approved, a majority vote is required to amend charter/bylaws (not a super-majority), and all directors with more than one year of service own stock."

Although these findings are indispensable for demonstrating the business value of good corporate governance, as defined by ISS's CGQ, they do not provide much insight into whether the collections of governance best practices associated with each performance measure share common characteristics that indicate *governance styles*. Yet, it would be very useful for boards to be able to identify and associate discrete *governance styles* with strategic priorities. That would offer boards greater flexibility to modify individual governance practices within a *governance style* and to more effectively respond to evolving requirements.

Independently, TE Research has developed an assessment approach that identifies a strong correlation between business performance and business practices that enhance and protect trust.[2] Considered together with the detailed findings from the Brown and Caylor study, we believed that we would find a similar relationship between business performance and corporate governance practices that help *establish* trust. We therefore used the Trust Enablement™ Framework[3] - that helps to categorize practices by their contribution to trust - as a filter to assess conditions that help investors and analysts trust an issuer's corporate governance practices. It classifies each of the best practices associated with enhanced business performance in the Brown and Caylor study according to its key trust-enabling role, as either helping to *establish* trust or to *ensure* trust (i.e., protect from a loss or deficiency of trust).

Our findings not only validated our predictions – that we would find a relationship between business performance and trust-building processes – but also identified common characteristics within groupings of governance best practices (or *governance styles*) that correlate with distinct business performance metrics. This process identified four *governance styles*:

1. **Control** – management-controlled companies have ***better sales growth*** performance;
2. **Trust** - companies with corporate governance practices that help shareholders *establish* trust enjoy ***higher valuations*** (Tobin's Q);
3. **Sovereignty** - companies with truly independent boards, both from management and shareholders, are ***more profitable*** (return on equity and profit margins); and
4. **Influence** – companies with boards that are strongly influenced by management and where shareholders have fewer rights ***pay out more*** to shareholders in dividends and stock repurchases.

[2] It is the combination of these two forces - trust creation and trust preservation - that create the conditions for sustainable trust by stakeholders. Overemphasis on preserving trust often indicates a controlling environment. Similarly, businesses that rely excessively on *establishing* trust indicate a trusting environment, but tend to be vulnerable to losing integrity by inconsistently delivering on expectations.

[3] The Trust Enablement™ Framework encompass three categories (Experiential and Authoritative Sources of Trust, and Empowerment) that help *establish* trust, as well as three categories (Motivation, Ability, and Risk Transfer) that help *ensure* - protect from a loss or deficiency of - trust.

Each *governance style* revealed a distinctive pattern, depicting how sets of governance practices collectively contributed to creating conditions that *establish* and *ensure* trust. Our discovery that *governance styles* (beyond discrete governance practices) are associated with business performance refines our understanding of the nexus between corporate governance and strategy, and solidifies the basis for collaboration between directors and management. For example, when pursuing a share valuation strategy, it provides directors and management with a rationale to consider governance practices that *establish* higher levels of investor and analyst trust in the board's effectiveness. Likewise, it gives corporations pursuing a sales growth strategy a rationale to support governance practices that *ensure* trust through management control.

It is worth mentioning that counter-intuitively (because increased trust is associated with higher valuations), Brown and Caylor found governance practices that enhance shareholder rights (by building confidence through increased control) to be strongly associated with poor business performance. This suggests that the method used to attain confidence, whether by exerting control or ceding trust, may yield different outcomes. Moreover, it brings to question whether the "*monitoring hypothesis"* for corporate governance is sufficient to describe the role of corporate boards, as one would expect shareholder empowerment to drive a board's monitoring mandate and hence business performance. Instead, it lends support to the complementary "*mediating hypothesis*" proposed by Lynn S. Stout from the University of California, in her paper "Investors' Choices", namely that "*shareholders also seek to 'tie their own hands' by ceding control to directors….*" In other words, shareholders of public companies generally prefer to trust rather than control their boards.

Consistent with this concept of the board, in a recent article that appeared in *Director*, the newsletter of the Institute of Corporate Directors (ICD), William A. Dimma, author of the book *Tougher Boards for Tougher Times*, describes "the role of the board as an intermediary between management and shareholders." In contrast with the traditional views of *monitoring* boards being analogous to *judges*, the *mediating* role ascribes more of a *paternal* archetype to the board. Our findings support these views by revealing that higher corporate profitability and share price values reward shareholders who have reasons to trust their sovereign boards.

In fact, our finding that trust is associated with higher valuations was the most compelling. We found that seven out of the eight best practices associated by Brown and Caylor with higher valuations contributed to *establishing* trust. Our research revealed that governance best practices, such as *the average options granted in the past three years as a percentage of basic shares outstanding did not exceed 3% (option burn rate), board members are elected annually, and company either has no poison pill or a pill that was shareholder approved (in apparent contradiction, otherwise found to be associated with poor business performance)* help to *establish* shareholder trust and are associated with higher share valuations. This leads us to question what other (beyond the seven studied), yet to be defined, governance best practices that *establish* trust could corporations adopt in order to further increase share valuations and thereby reduce their cost of capital?

Would it be reasonable to expect, for example, that giving institutional shareholders a voice to periodically contribute comments directly to boards of directors could help them *establish* even higher levels of trust in the issuer's ability to sustain superior business performance? According to a recent article in *The New York Times*, publicly traded companies are increasingly moving in that direction by opening direct communication between boards and their shareholders. The article asserts "22 percent of the S.& P. 500 reported that their boards had direct contact with shareholder groups. But five years ago, it would have been close to zero." It is evident that improved communication between boards and shareholders is becoming a best practice.

Taking these factors into account, and because each performance priority is valid under different circumstances that correspond to a stereotypical maturing of a corporation, we decided there would be value in viewing these findings through the prism of a Governance Lifecycle Model™ (GLM). It provides a useful roadmap for strategically matching the best corporate *governance styles* to the strategic objectives that typify each phase of a natural *corporate lifecycle*. For example:

- **Formation Phase:** ***Entrepreneurial*** companies may benefit from having corporate governance practices that allow management more ***Control*** over the board, because entrepreneurial start-ups are typically owner managed and strategically focused on sales ***revenue*** growth;
- **Investment Phase:** ***Pre-IPO*** (initial public offering) companies and ***publicly traded*** companies involved in **mergers and acquisitions** (***M&A***) may benefit from governance practices that build investor ***Trust***, because when raising capital or acquiring assets, companies strategically focus on leveraging higher ***valuations***;
- **Production Phase:** ***More established*** **p*ublicly traded*** companies may benefit from having corporate governance practices that support board ***Sovereignty***, because public companies need to satisfy more stringent corporate governance standards, and capital markets expect them to strategically optimize their businesses for ***profitability***;
- **Harvest Phase:** ***Mature or declining publicly traded*** companies may benefit from having corporate governance practices that allow management to ***Influence*** board decisions, because a reliable, “cash cow” company may benefit from strategically adopting a proceeds ***distribution*** strategy on behalf of its shareholders.[4]

Even more broadly, our findings cast new light on some fundamental issues plaguing corporate governance reform:

a) They reveal a symbiotic relationship between corporate governance practices and business strategy;

b) They suggest that a phased, lifecycle approach to corporate governance is an important step in moving beyond simple compliance enhancement, toward helping boards achieve a sustained and positive impact on overall business performance;

c) They clarify the arguments in the “shareholder versus stakeholder” debate by demonstrating how, depending on their business strategies, boards can effectively serve the interests of different stakeholders, other than equity holders alone;

d) They distinguish between the relative roles of control and trust in corporate governance, by recognizing that each approach to attaining required levels of stakeholder confidence may be valid, depending on the company’s business strategy; and

e) They reveal the essential nature of the board as a supportive and mediating *paternal* archetype that adaptively serves the evolving needs of the corporation throughout its lifecycle, rather than a dispassionate and rigid *judge* of good and bad management.

[4] In contrast with our other findings that can be intuitively defended based on logic and plausibility, our research did not provide insights into the reasons one might expect management influence over boards to be associated with shareholder distributions.

Practically speaking, we hope these insights will help corporate governance policy makers decide on pressing issues, such as board composition of closely controlled corporations and governance best practices for income trusts. Institutional investors and analysts have reasons to consider the governance-practices/strategic-priorities dynamic of issuers when weighing investment alternatives. Corporate directors can benefit by starting a program to proactively and productively manage their own governance practices relative to their companies' strategic priorities, beyond simply managing the risks of regulatory compliance and their liability exposures. In addition, management can use new levers to engage boards when formulating strategy.

Such an approach can present a real opportunity for corporate boards to make meaningful contributions to the specific needs of their organizations and in doing so respond to Mr. Dey's notion of developing "their own brand of corporate governance best practices" with enlightenment and impactful strategic thinking.

Alex Todd is founder and CEO of TE Research, the research arm of Trust Enablement Inc. that specializes in helping corporations achieve their business goals by optimizing the trust of their stakeholders. To order a copy of the governance research report discussed in this article write to AlexTodd@TrustEnablement.com.