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Beyond Corporate Governance

Making Governance Systems a source of competitive advantage

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Management Summary: A radical solution is needed from inside

The public's confidence in the competence and ethics of corporate management has been shattered over the past few years. Public discussion got heated by the financial collapse of formerly blue-chip financial institutions, including Lehman Brothers, and culminated in a global banking bailout after immense risk-taking left all but a few of the largest global banks reeling. Adding insult to injury, many bankers as well as CEOs were paid enormous bonuses leading up to the crisis and in some cases even during the crisis as the global economy sank into a dire recession. The meltdown was accompanied by millions of job losses and a legacy of higher taxes and public spending cuts that will be required for decades to come as governments try to reverse unparalleled deficit spending.

In response, several legislative reforms have been passed and more are likely. These legislative reforms cover a broad set of aims from pushing executives to be more diligent and transparent in preparing and reporting financial information to forcing banks to hold more capital and improve their risk management processes. The reforms are also attempting to force compensation reform and make non-executive boards more aware of their responsibilities and the consequences of failure.

As welcome as these changes may be, they tackle the symptoms but fail to cure the disease. Although issues such as the integrity of financial reporting are paramount, the real scandal is that so many companies and their management teams have lost sight of the fundamental roles and responsibilities bestowed upon them by society. Given the enormity of the failings, it would be shortsighted to rely solely on a set of external rules and guidelines to provide a meaningful solution to the problem.

The attention paid to understanding the internal dimension of corporate governance has been lacking in the debate so far. This dimension deals with the important role of the internal management

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systems of a company. For this purpose, a broader definition of governance systems needs to be applied: "The set of criteria and tools necessary to ensure strategic effectiveness, operational efficiency and sustainable value creation in an organization."

To overcome the maladies of the past few years and ensure the effectiveness of these management systems, a radical solution "from within" is needed. In this paper we focus on those governance issues related to the measurement of an organization's value as well as on the strategic management and control of a company. The internal governance system consists of the following aspects.

- Target setting: What kinds of goals are set and how are they established? What are the trade-offs and what are the priorities when strategic and financial objectives conflict?
- Strategic planning: Which procedures are employed to identify the most valuable business strategies? How are strategic alternatives identified and evaluated? How are risks assessed?
- Capital allocation: How are capital spending initiatives (e.g., equipment replacement, introducing a new market entry) approved? And how, on the other hand, are decisions made to divest, downsize and outsource? Who is responsible for those decisions, and how are managers held accountable for delivering promised results?
- Performance measurement: What set of metrics is used to keep track of results and to highlight important successes and failures? What is the hierarchy of financial and operational metrics, and how are they organized into an overall scorecard?
- Incentive scheme: How is business performance measured and rewarded, and how are monetary incentives aligned with the long-term interests of all stakeholders?

In order to ensure that management is acting in the best interest of all stakeholders, compelling answers for these governance issues must be found. Numerous examples of successful companies show that the internal governance of an organization is an important source of competitive advantage. This paper offers useful ideas for the development of superior internal governance systems.

1 The malady of governance

Internal governance systems comprise a variety of policies, procedures and levers which management can use to guide, control and drive strategy and operations. Experience shows, however, that the standards, goals and terminology of existing governance systems are inconsistent and do not provide a common basis for the creation of value.

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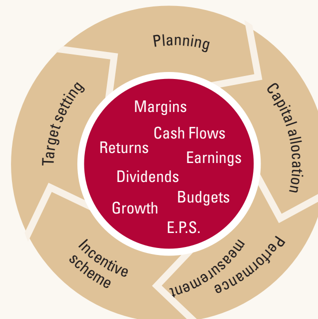
A typical governance system: Inconsistent standards, targets and terminology



Three factors, which we will call the "three pitfalls of internal corporate governance," stand out.

- >> First: External accounting standards are used for internal governance.
- >> Second: The actual application of budgeting and capital allocation processes is inadequate to guide value creation.
- >> Third: The system of management compensation leads to unintended and undesirable behavior. These three factors are associated with the failure to provide the clarity, cohesion and accountability that are essential to maximizing value creation.

Pitfall 1: External accounting standards are used for internal governance

External accounting standards have little relationship with increasing the value of a company. For example, they do not take into account the rate of return investors expect for the capital they provide. As a consequence, many managers will bask in the accounting profits they have earned even though the profit is barely above the interest rate on the borrowed capital. Unfortunately, this accounting artifact ignores the required return on equity capital and leaves the shareholders out in the cold.

Many governance systems attempt to offset the inadequate consideration of capital with relative return indicators such as Internal Rate of Return (IRR), Return on Investment (ROI) and others. However, the problem is that these approaches ignore absolute size effects and often fail to accurately reflect profitable growth. Rather, whenever possible, these indicators invite the "inflation" of the return figure through a steady reduction of the capital base. This also explains the apparently unquenchable thirst of many managers for off balance-sheet financing vehicles. It should be common sense that capital has to generate appropriate profits as long as the company bears the economic risk. However, when accounting rules and imprudent business considerations dominate the allocation of economic ownership, the temptation is great to act along these lines.

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In addition to these deficits, multiple and often conflicting performance indicators are used across different governance systems. For example, operational performance is usually measured by earnings indicators (e.g., EBITDA, EBIT, Net Income) and profit margins. Investments are usually measured by the return they yield (e.g., ROI) or by cash flow measures. Corporate targets are often expressed in sales volume, market share or profits. Bonuses are typically based on the achievement of financial and operational budget targets. Last but not least, top management often bases its dialogue with investors on the next quarter's earnings per share estimate.

Pitfall 2: The actual application of budgeting and capital allocation processes is inadequate to guide value creation

Budgeting and capital allocation decisions do not occur in a vacuum. They are closely related with and heavily impact the subsequent evaluation of management performance. Let's take a look at the process of a simple capital budgeting analysis that is quite common for most companies. Suppose that a new investment needs to be assessed. The starting point is a projection on the future cash flows from which a project's Net Present Value (NPV) is calculated. Let's assume that the NPV is positive for this project. If the project is expected to improve this year's operating profit and increase the annual return on investment, or ROI, then it's a go.

In this example, the factors that are being most heavily weighted, profit and ROI, are not necessarily consistent with the underlying discounted cash flow (DCF) calculation. Once the investment project is approved, managers know the investment will be buried in the balance sheet. Managers realize that operating profits are likely to get a boost – even from projects that turn out to have a negative NPV (e.g., in cases where the projections had been too optimistic). Why? First, because earnings can rise even when the project does not cover the associated cost of capital; the project is considered "profitable" when it simply covers operating costs for the current period.

Second, the problem with the standard DCF analysis is that it is not consistent with the other parts of the management system, particularly the measurement system. In fact, the gap between the investment approval and performance measurement processes means it is very difficult to assess project success after the event. Once the performance is consolidated into the business results, it is nearly impossible for anyone to examine the underlying assumptions. As a result, managers of operating divisions have an incentive to request as much capital as possible to grow their businesses in size and to increase their bonuses. Not surprisingly, capital often goes to the big divisions with the most political influence, rather than the ones that provide the best investment opportunities.

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Pitfall 3: The system of management compensation leads to unintended and undesirable behavior

Given the backdrop of the counterproductive investment scenario described above, it is important to understand the incentives that lead managers to exhibit specific types of behavior. Would the same decisions have been made and the same projects initiated if the decision makers owned the company, or if they held an equal stake in the opportunities and risks of their decisions and the associated consequences?

Annual bonuses are typically linked to budgeted volume, sales, or profit targets. Such a basis may encourage output at the expense of value creation. By looking more closely at how the budget process itself drives compensation, the consequences for corporate behavior become evident. Compensation is heavily influenced by political negotiations and individual "strategy". While the corporate center tries to push business units to set aggressive targets, business units are incentivized to minimize or sandbag such budget-based goals to ensure compensation goals are easily met. While investors are impacted by the actual company success, management compensation becomes more a question of the balance of power between business unit heads and the governance bodies that determine targets. The result is the business ends up with targets that are considered easy to achieve and that result in bonuses being paid for outcomes that are not aligned with investor expectations.

There's more. Too often, incentives are linked to short-term performance. If bonuses are based on single year results, managers may hesitate to invest in value-creating projects that don't provide benefits in the first year. Alternatively, managers may be encouraged to provide incentives to customers to drive up sales in the short term at the expense of the long term.

2 How to implement good governance

The key is to make value creation the centerpiece of corporate governance. This approach provides executives with a set of consistent levers that gives them not only what is required for regulation, disclosure and compliance, but also the information they truly need to achieve accountable and prudent corporate management.

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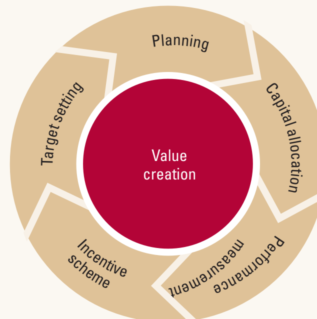
A "Good Governance" system: Consistent standards, targets and terminology



Performance measurement & target setting

A substantial prerequisite for the quality of corporate governance will be the way Finance is directed to measure the company's performance, i.e., by centering the mission on calculating and reporting "value creation". A common measure of "value creation" is economic profit. In contrast to accounting earnings, economic profit includes a charge for the use of all capital employed – equity as well as debt. Therefore, until a company earns a profit greater than its investors could earn on their own, economic profit indicates that the company operates at an economic loss.

Ultimately, every strategy must be measured against the goal to create sustainable value for the company. Boards and executives should therefore dedicate more attention to the company's true or intrinsic value – that is, the present value of expected future value creations – and less attention to short-term share price. The objective of internal and external communication, then, will be to ensure that the market's valuation of the company is as close as possible to the company's intrinsic value. As a consequence, corporate and financial strategies will be more closely aligned. Corporate strategists will determine the vision, initiate the optimal mix of businesses, and develop and oversee action plans. Financial strategists will determine and communicate how progress toward the corporate strategy contributes to value creation.

There are three basic paths to value creation:

- >> Profitable growth: Growth creates value when increased profits are greater than the cost of the investment required to achieve such growth.
- >> Improve operating efficiency: Value will grow by increasing productivity and achieving efficiencies in expenses while minimizing the additional capital required in generating such profits.
- >> Portfolio management: The goal here is to reduce excess capital in areas where it is employed inefficiently and redeploy it in value-enhancing projects.

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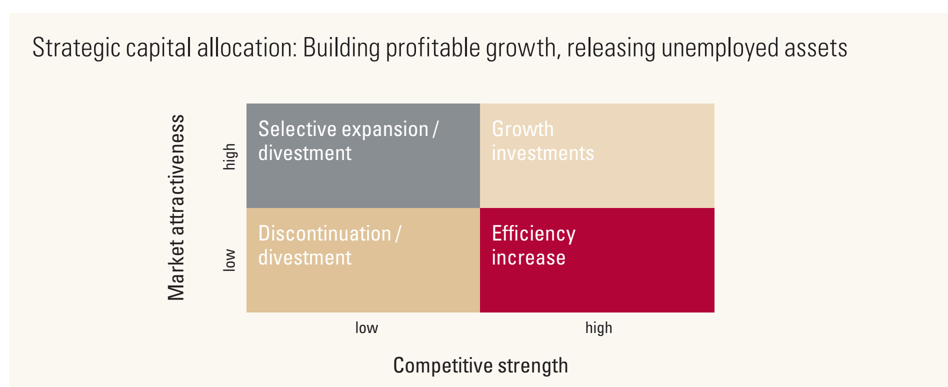
Planning & capital allocation

The first requirement here is to overcome the obstacles created by traditional budgeting systems by severing the link between budgets and bonuses. The budget can then be used for its originally intended purpose: to communicate the performance forecast and the resource allocation for the next year.

Capital allocation should be strictly aligned with the company's overriding strategic orientation. In practice, this means that every strategic option must be assessed against two criteria: First, will value creation be possible at all, based on the inherent customer benefit, and the size of the economic profit pool and growth potential of the market activity? Second, does the company have the capabilities required to realize the value potential and compare its capacities vis-à-vis its competitors (competitive strength).



Strategic capital allocation: Building profitable growth, releasing unemployed assets

Through a preliminary of market attractiveness assessment, the company's competitive strength can be attributed to certain combinations. If a company has a strong capability compared to potential competitors to realize high future value projections in a core business sector, growth investments will likely be the path of choice. Low market attractiveness, on the other hand, does not necessarily have to lead to the divestment of the unit in question. With a high degree of competitive strength, the company might be able to leverage the value potential by taking measures to increase efficiency. And in the reverse case – high market attractiveness and low competitive strength – the solution does not necessarily have to be building capabilities, as other market participants may be willing to pay substantial amounts for the high value unit. Only if results are poor in both dimensions are there few alternatives other than divesting or closing down the unit.

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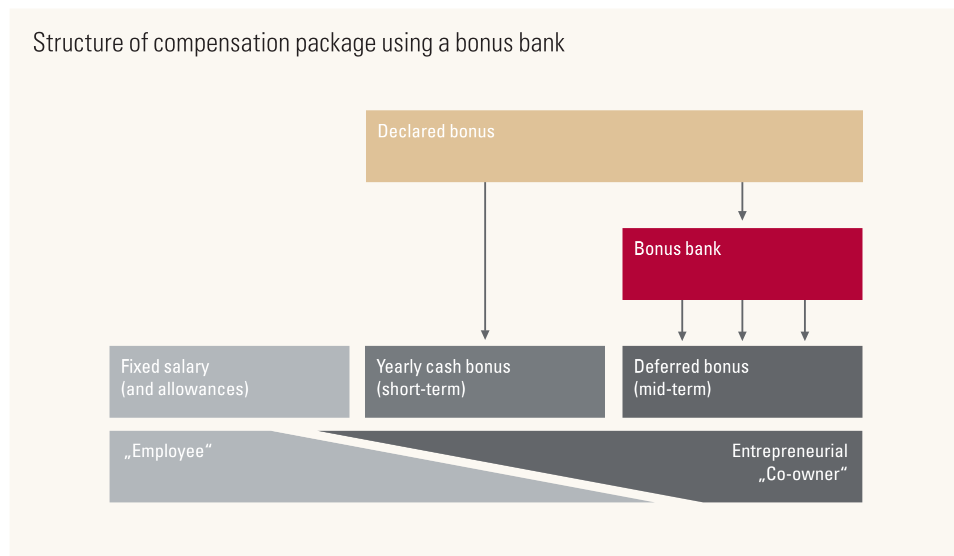
Incentive scheme

To encourage managers and employees to think and act like owners, the most effective incentive strategy is to pay them like owners. What this means, above all, is that bonuses must be based on actual value contribution rather than on a negotiated budget. This creates room for setting ambitious improvement targets. Second, managers' responsibility for entrepreneurial action must be emphasized by linking their compensation to business opportunities and risks. This means that value creation will be rewarded and the destruction of value will be penalized.



In order to prevent an overly short-term focus and ensure sustained value creation, bonus payments must be tied to long-term value development. One way to do this is to establish a "bonus bank": Rather than being paid fully and immediately, a part of annual bonuses are initially credited to a personal bonus account. A previously-determined percentage of this balance is paid out every year, while the remainder carries over. For employees to fully participate in the downside of poor performance, negative bonuses in any one year must be possible. However in this situation the employee does not pay the company the negative bonus in cash, rather negative bonuses from years of a decline in performance are entered into the bonus bank and are offset against the balance. In this way the proportion of the bonus awarded in Year 1 which is placed in the bonus bank is exposed to entrepreneurial risk and is only paid out in Years 2, 3, etc. if the increased performance in Year 1 for which it was awarded is sustained in these subsequent years.

With this approach to compensation, employees who add the most value to the business receive the greatest benefits – their rewards are uncapped and are not constrained by the company having to overpay poorer performers. This helps the company to attract strong talent since the compensation system is a strong selling point to high performers who expect to receive the benefit of greater upside

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than in traditional schemes. It also helps the company to retain its strongest performers (since they are sharing more of the upside) and to eliminate those who add the least value to the business (since the weaker performers recognize they are not receiving high incentive compensation payouts).

Moreover, the bonus bank model can be used to aid employee retention, and even more so, retention of those employees who are most valuable to the company. If the scheme is set up so that on leaving the company the employee only receives what is due from the bonus bank in that year (and future years' payouts are forfeited), employees have a longer-term incentive to stay with the company. If they stay, this ensures they remain eligible for the full payout of large bonuses awarded in previous years. If they leave, they forfeit the amounts payable in future years. In companies in which bonuses are paid out in full immediately, like in many investment banks, we often see an annual flood of resignations after each bonus round (so long as there are job opportunities in the external marketplace). Of course, this retention effect is disproportionately strong for those who have the greatest "balances" in the bonus bank, i.e., the strongest performers who have been deemed to have been adding most value to the business. Again, this is desirable.

3 Proactive improvements will pay off

Effective governance is about providing a clear roadmap as to how managers should make decisions that are in the best interests of their company.

Companies that are serious about good governance should not stand back and wait. Government legislation has not and is not going to come up with the solution. A better economic environment is not the solution either. Rather, companies that are serious about good governance should take actions to ensure they build in the clarity, consistency and strategic alignment which characterize high quality internal governance. There is no time to lose. There is a window of opportunity for companies to make high quality corporate governance a source of competitive advantage, as first movers will gain ground on their competition in the markets that matter: The markets for customers, talent, and capital.

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