In Pursuit of

There's much ado about corporate governance these days, but what's really being done? The world's most fervent watchdogs of corporate conduct believe that effective governance is less about boards and bookkeeping than it is about changing attitudes and behaviors—for good.

by Tricia Bisoux

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Before 2001, the word "Enron" referred to one of the largest energy companies in the world. After 2001, the term "Enron" forever entered the business lexicon as an instantly understood synonym for fraud, fiasco, and failure upon failures to play by the financial book.

The way many governance scholars see it, however, it was never a matter of *if* a failure of Enron's magnitude would happen, but *when*. Questionable off-book transactions, off-the-charts compensation, conflicts of interest, and managerial acts of self-interest and self-preservation have afflicted corporations for decades. Enron finally combined them into a perfect storm that would send the giant tumbling and the business world reeling.

"Enron wasn't a surprise," says Wayne Shaw, the Helmut Sohmen Distinguished Professor of Corporate Governance at Southern Methodist University's Cox School of Business in Dallas. "It was more a symptom of a long-term problem than the problem itself. That problem is that we seem to have lost control of the managers at the top of organizations."

The discussion about governance, of course, is also nothing new. The prototypical December 1992 Cadbury Report in the United Kingdom, written in response to controversy over directors' compensation at high-profile companies, made its recommendations long before corporate scandals became front-page mainstays. In it, the Cadbury committee promoted the now-familiar "comply or explain" guideline, which gives companies the flexibility to comply with governance standards or explain why if they do not. In his introduction to the report, Sir Adrian Cadbury expressed surprise that his committee's report received any attention at all from the corporate world.

"Neither our title nor our work programme seemed framed to catch the headlines," he wrote. "The Committee has become the focus of far more attention than I ever envisaged." Cadbury predicted, with uncanny prescience, that the report would be an important step in setting corporate governance standards. Since Cadbury, organizations devoted to governance have been launched everywhere, from Europe to India to Brazil. Scandals have inspired the U.S. Congress to pass the Sarbanes-Oxley Act of 2002, making good governance a matter of law.

Teaching the implications of corporate governance practices presents a challenge to business educators. It's one thing, say scholars, to teach the rights and wrongs of accurate accounting and the need for transparency. It's another to analyze matters of conscience and human nature.

The Lessons of Governance

For many educators, teaching corporate governance may seem like attempting to assemble a very complex puzzle with many pieces still missing. Compounding the problem, says Shaw of the Cox School, is that the business community itself can send mixed messages. Often, there are conflicts between the theories of good governance and its practice in the real world.

Good Governance

"I'll bring in a lawyer, or accountant, or member of an audit committee to give a presentation in my class and they'll stress codes of conduct. But then I'll bring in a CEO and he'll say, 'I don't have two board members on my board living within 250 miles of each other because I don't want them talking to each other,'" says Shaw. "I don't think the world has changed, because the CEOs haven't changed. And we shouldn't be surprised; many of our strongest CEOs are not great advice takers."

To cut through conflicting messages, educators might seek ways to give students firsthand and, if possible, long-term looks into board interactions and behavior. No student, intern, or lower-level employee will understand the implications of good corporate governance unless he actually participates in the process, says Mervyn King, chairman of the South Africa's King Committee on Corporate Governance that issued the 1994 King I Report and the subsequent 2002 King II Report.

Board participation, King emphasizes, is not the same as management. The fact that managers are frequently made directors with no transition between the roles, he believes, can often lead to executive-heavy boards characterized by poor governance. "Being a director and being a manager are two different things. A manager's job is to carry out the strategic plan of the board; a director's job is to reflect on all the facts and make decisions," says King. "When a chap who's been a manager for years is elevated to a directorship, he thinks he knows everything. In fact, he's bloody hopeless."

It's the educator's charge, says King, to prepare students for both the strategic responsibilities of management and the reflective responsibilities of directorships. King suggests that business schools and corporations partner to offer students what he calls "apprentice" directors' positions. Apprentice directors would attend board meetings, read the board's papers, and discuss the meetings with the directors.

After each board meeting, students and educators would discuss how the board arrived at a decision and why. This proposal requires corporate boards to be willing to accommodate students and share a portion of their interactions. Even so, such experiences would provide invaluable lessons in governance. "Students who spend a couple of years as apprentice directors," says King, "will be much better equipped when it's their turn to sit on the board than if they just walked in the door from an operational level."

As important as board-management dynamics are to corporate governance, the issue goes far beyond boardrooms to all levels of an organization. Governance authorities urge educators to take that into account as they work the issue into

their curricula. "Corporate governance isn't just about boards," says Marco Becht, professor of finance and economics at the Université Libre de Bruxelles and executive director of the European Corporate Governance Institute (ECGI). "It would be boring to have one course dedicated to the study of governance as it applies to boards."

Governance, in fact, spans all possible aspects of business, from the "hard" skills of accounting and finance to the "soft" skills of ethics and leadership. Its comprehensive nature would suggest its integration throughout a business curriculum. In addition, its involvement in three major disciplines—business, accounting, and law—complicates its treatment in the classroom even further.

Unfortunately, the legal component of governance can be especially short-changed in business school courses, states Charles Elson, the Edgar S. Woolard Jr. Chair in Corporate Governance and director of the John L. Weinberg Center for Corporate Governance at the University of Delaware, Newark. "Business schools that ignore legal issues in business do so at the peril of their students," Elson asserts. "Students should learn about anti-takeover defenses, fiduciary duties, effective oversight of boards—the legal issues that have huge impact on business performance."

The Curse of Complacency

Ironically, the flood of attention now directed to good corporate governance also has magnified two of its primary weak links: complacency and smugness. With so many codes in existence, from so many countries and organizations, there is a tendency for people to believe that the codes they have developed are, de facto, the best.

Prior to the scandals in late 2001, Becht saw what he calls "the smugness factor" of the U.S. at its peak. In particular, he refers to a conference on governance, where he says U.S delegates were, in essence, preaching the gospel of good governance.

"They told us that the U.S. system of corporate law, with its class action litigators and gigantic executive bonuses, was fantastic and that we in Europe were a bunch of primitives. I'm exaggerating a bit, but their message was, more or less, that the rest of the world had better wake up to these great inventions, because otherwise its corporate models would be eclipsed by the NASDAQ roller coaster," Becht recalls.

"Then, bang on, you've got the Enron crisis," he says. "There may have been a degree of *schadenfreude* in this; but I think the real lesson is that the smugger you feel about your governance, the more careful you need to be."

Since Enron, the U.S. has put in place many reforms—including Sarbanes-Oxley, the New York Stock Exchange listing requirements, and new SEC regulations. Even so, says Becht, U.S. corporations were anything but humbled by its scandals. "Their new message was, 'We've had our scandals, but look how quickly we've rebounded. Now we have all these reforms. The U.S. model is really the best and we must prescribe our medicine to the world,'" he says. "Then came the New York Stock Exchange affair!"

The U.S. may be bearing the brunt of criticism, but it hasn't been alone in its near-sightedness. The temptation toward superiority has been too strong for most countries to resist, says Ira Millstein, senior partner at the law firm Weil, Gotshal & Manges and the Eugene F. Williams Jr. Visiting Professor in Competitive Enterprise and Strategy at the Yale School of Management in New Haven, Connecticut.

"After Enron, many people in Europe were saying, 'Well, that's an American disease.' Then came the collapse of Parmalat," Millstein points out. "When they take a good look, I think they're going to find more than just one Parmalat, just as we did. We now know it's a universal disease."

The Global Picture

The next lesson of governance goes beyond simply steering clear of arrogance and requires a willingness to turn an eye outward, say these authorities. Every country has standards that can contribute to a greater understanding of best practices worldwide, and educators are being encouraged to have students compare and consider the proposed standards for other nations. Such study not only introduces students to different corporate structures and mindsets, but also to the reasons why governance standards differ from country to country.

Teaching a Western or U.S.-centric view of governance does business no favors, says Shaw of the Cox School. "For some reason, we in the U.S. seem to believe that we're the center of world trade; and, therefore, we expect the world to conform to our rules," he says. "But we lose valuable information by not looking at what other countries are doing under their own rules."

In Russia, for example, companies can actually be penalized when they make their operations more transparent to

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stakeholders, which complicates the pursuit of good governance, says Sergei Guriev, an assistant professor and vice-rector for strategic development at the New Economic School in Moscow and currently a visiting professor of economics at Princeton University in New Jersey. "Transparency is very costly in Russia. If a competitor learns details about its rival's operations, not to mention its ownership structures, it can cause problems," says Guriev.

To minimize taxes and to circumvent antitrust laws and other regulations, many Russian companies are owned by a web of offshore intermediaries. This, of course, encourages all of the activities that good governance shuns: tunneling, ignoring conflicts of interest, insider trading, transfer pricing, and off-the-book transactions. Guriev cites Russia's largest oil company, Yukos, as an example of Russia's challenge. Yukos and its now infamous former CEO, Mikhail Khodorkovsky, were once touted as exemplars of governance after the company's market capitalization improved tenfold due to its adoption of good governance practices. However, Khodorkovsky controlled 78 percent of the company's shares and was eventually arrested by Russian president Vladimir Putin, charged with tax fraud.

Under such circumstances, Guriev predicts that, in Russia, openness and transparency will most likely be imposed by external pressures to compete with international companies. Companies from abroad coming into the country or Russian owners who already operate in global markets will be the first to adopt such standards. "They know what's needed to compete globally," says Guriev.

The demands of the global market, in fact, will likely be the strongest incentive for companies to adopt good governance codes. The further afield they wish to operate, the more they'll have to prove to potential investors that they're on the up-and-up. Developing countries that want to attract foreign capital will have even stronger incentives, says Millstein.

"The world is all about the movement of global capital," Millstein asserts. "I've been working with the World Bank to try to get some of that capital flowing into less developed countries. The only way we can do that is to make sure that those countries' corporations are transparent and behaving somewhat like the rest of the world. Nobody wants to invest in a dangerous neighborhood."

In establishing a truly global system of transparency, however, the European Union may be the region of the world to watch. It already knows the challenges of reconciling differing codes firsthand, as it works to create a single market among separate governments. Its answer has been to establish the concept of a "governance passport." Like a passport for travel, a governance passport allows a company to operate and list on exchanges throughout the European Union, as long as it conforms to its own country's governance principles.

The practice could be a model for a global system of governance, suggests Becht. But first, countries will need to set aside mistrust and consider the validity of differing codes. "I believe the EU is a much better model for close globalization than the U.S. For example, the U.S. is rather homogeneous, while the EU is very heterogeneous, like the rest of the world," says Becht. "For the EU to make an overall governance model work will be a real challenge. But if it works, it could be a model for other parts of the world."

Changing Hearts and Minds

The most daunting task that corporate governance presents to business is perhaps the most elusive: changing attitudes, behaviors, and value systems. A system of unilateral decision making and a reluctance to hear "bad news" still prevail.

Seven Crucial Questions

No one approach to corporate governance is universal. What does not change are the questions that lead an individual to consider the full scope and impact of a corporate decision, says Mervyn King of South Africa's King Committee on Corporate Governance. He proposes a set of questions that he hopes educators will take into the classroom for their students to consider:

1. Do I have any conflict in this matter? If so, I must disclose it.
2. Am I basing my decision on all relevant facts, or on assumption and conjecture? If the latter, I must wait until the facts are in hand.
3. Is this a rational business decision based on the facts I have at this time?
4. Is this decision in the best interests of the company?
5. How will I communicate this decision to shareholders?
6. Is this decision socially responsible?
7. And, finally, would I or the board be embarrassed if this decision and its motivations appeared on the front page of a prominent newspaper?

The final question, says King, is perhaps the greatest gauge students and managers can use to encourage decisions based on good governance. "If someone had only asked these questions at Enron," says King, "the disaster might not have happened."

Some boards of directors still serve as "yes-men" to the CEO, or say no at their own peril.

Bengt Hallqvist, founder of the Brazilian Institute of Corporate Governance (IBGC) in São Paulo, has served on nearly 50 boards over 30 years. In his experience, many boards were ineffective at best; and at worst, they were irrelevant. "In most cases, I found the board was simply a formality. The management was rather powerful, so we just listened to what they had been up to, and they asked very little advice from us," says Hallqvist. "We met and talked about football for 50 minutes. Mostly it was a good lunch, a good dinner, and a complete waste of time."

"Five years ago, CEOs viewed boards as nuisances at best," agrees Shaw of the Cox School of Business. "We really need to change that mindset before we do anything else. So far, we haven't been very successful."

Nevertheless, there are hints of changes to come. Since its inception in 1995, the IBGC has worked closely with the Brazilian stock exchange, emphasizing good governance in all four corners of corporations, including the owners, boards, management, and auditors. The Institute has trained more than 1,000 directors in corporate governance. Of that number, most were from family-owned and mid-sized companies, not the top 400 Brazilian companies on the exchange. Still, Bengt sees their training as crucial in promoting best practices in governance at all levels of business.

"Those 1,000 directors have gone back to their companies and implemented some of the recommendations. They have really spread the gospel to mid-sized companies," notes Hallqvist. "In addition, I recently led a panel discussion with two of Brazil's largest family-controlled companies—one Brazil's largest supermarket chain, both listed on the stock exchange. Companies at that level will have great influence on Brazil's larger companies."

Becht of ECGI remembers a time when he would call a company's investor relations department to ask for a company statute and be greeted with silence. "They didn't even know what a company statute was. They would say, 'We don't deal with those. Maybe the company lawyer can help you,'" he says. "But if you call that same department today, they'll say, 'We'll e-mail it to you as a PDF file.' That's a dramatic change in culture. These days, investor relations personnel are well aware that corporate governance is part of the sales pitch."

Meredith Edwards, director of the National Institute for Governance at the University of Canberra in Australia, echoes the sentiments of many scholars who are calling for more studies on current governance practices to see what patterns are emerging. Research to date has dealt primarily with how present codes have been established. Edwards argues that it's now time to see what actually works.

"We need independent bodies that will monitor and evaluate how well 'comply or explain' systems are working," she says. "It's time to survey people and organizations from countries worldwide to find out how they're doing. How difficult is the practice of governance in reality, as opposed to the media hype? What have companies learned from it? What guidelines aren't working? What refinements are needed?"

As business schools attempt to teach corporate governance, they have struggled with the near-impossible task of "teaching integrity." Educators may not be able to teach values, per se, say many experts, but they can put students into decision-making situations and have them explore the impact of their decisions on the stakeholders of a company. Schools also can develop learning environments that produce students who are more willing to hear constructive criticism and bad news long before a crisis occurs. Then, these students will be more likely to see the extent of their responsibilities to the employees, to the shareholders, to the community, and above all, to the company.

Although the governance picture may now seem chaotic, many scholars predict that once countries start to look to each other for best practices, business may see a move toward fewer, more compatible systems. Moreover, they believe that the market itself will be the ultimate judge. It will compel good governance, even where it may not be welcome. "Corporations will be dealing with a more demanding, more educated, more cynical clientele," says Edwards. "Over time, companies will have to put more effort into involving stakeholders in the decision process in ways other than just having them attend the annual meeting."

Given the complexities of global governance, it's not surprising that few, if any, governance scholars expect resolution any time soon. What is clear, they say, is that good governance that promotes the accountability, transparency, and integrity of a company and its directors is imperative for a healthy global market. Constructive change is under way—but slowly. Z