

What IS Good Governance?

Governance has triggered great debate in the international community over how, which, and even whether codes of corporate conduct should be enforced. Most experts agree that coming to a consensus on best practices will be anything but easy.

Although the necessity of good governance is unquestioned, what actually constitutes good governance and how that governance should be enforced are very much under debate. The complexity of the issue quickly comes into focus with one visit to the Web site for the European Corporate Governance Institute (www.ecgi.be). The site includes an index of governance codes from 40 nations; lists of conclusions of committees ranging from Cadbury to King, Tabaksblat to Bosch; and rules and guidelines developed by the New York Stock Exchange (NYSE), the Organization for Economic Cooperation and Development (OECD), and countless other entities.

Each of the codes is intended to be a definitive guide for the intended audience. Taken together, however, the countless and varying approaches are anything but definitive.

by Tricia Bisoux

illustration by Stuart Bradford

Representing the findings of numerous separate nations and separate organizations, the myriad codes have inspired a vigorous and multifaceted discussion.

Two approaches, especially, have inspired a compelling question: Is governance an issue of ethics or an issue of law? Proponents of the “comply or explain” approach, first advocated by The Cadbury Report in 1992, argue it encourages good behavior while affording companies some flexibility—they either comply with good governance recommendations or explain to stakeholders why they choose not to do so. The spate of scandals has led others to assert that “comply or explain” may not be enough to force all corporations to adhere to governance guidelines. It may take something like the Sarbanes-Oxley Act to bring order to corporate boardrooms.

Conversations with four of the world’s authorities in governance illustrate the widely varying viewpoints on the issue. But they have consensus on one point. Underlying the national differences and legal minutiae is a common, attainable goal—to assure the accountability, transparency, and integrity of corporations and their management.





Rules Are Made to Be Broken

Mervyn King has been a leading force in South Africa's corporate governance development. As chairman of the South Africa's King Committee on Corporate Governance, he helped write the recommendations of the King I Report in 1994 and its update, King II Report, in 2002. He serves as chairman of financial services group

Brait South Africa, which has offices in Cape Town, Johannesburg, and locations worldwide. A legislative approach to governance, King maintains, will inevitably backfire.

Last year, I spoke in Las Vegas to about 2,000 delegates at the Institute of Internal Auditors. At the time, Sarbanes-Oxley was still hot off the press. I asked, "Is it better to 'comply or else' or 'comply or explain?'" That is, is it better to have rules or principles of governance? I said, facetiously, that Moses tried it and failed, and Sarbanes-Oxley wasn't going to succeed either.

Let me explain. The world has really caught corporate governance fever, which has resulted in this kind of quantitative approach to governance. Sarbanes-Oxley is only one example—there's the OECD, the New York Stock Exchange, the Global Reporting Initiative. Malaysia, Kenya, Hong Kong, every country is establishing its own guidelines. And it's correct that each country needs its own guidelines because each has its own special circumstances. But the question is, is quantitative governance the answer?

Whether you legislate, as in Sarbanes-Oxley, or comply or explain, as in King II, business success is not assured. All businesses will have failure. In business, you're dealing with risk-reward, and none of us is prescient enough to get it right 100 percent of the time. But when you have that business failure and you have practiced good governance, society will accept that because they've invested their money in a risk industry. But if you practice bad governance and you fail, you have scandal.

Moreover, if you had looked at Enron at the time, you would have thought, "What a well-governed company." It had an audit committee, a compensation committee, a nomination committee. The audit committee was chaired by a chartered accountant in the United Kingdom. It had a preponderance of nonexecutive directors, and it had 100 percent board attendance. But Enron executives were just "box-ticking," so they could say, "Yes, we are in compliance with the rules."

The Enron board was not applying what I call quality of governance. It did not accept the idea that the market is the ultimate compliance officer. Whether or not a company com-

plies with a particular guideline should be the choice of its board—when a board chooses not to comply, it needs only to explain its reasons to its stakeholders. If the stakeholders accept that, then so be it.

What is quality of governance? I think it's that immutable quality called "intellectual honesty." You can have all the bloody rules in the world, but you cannot legislate honesty. And I'll tell you, as a corporate lawyer, I've found it's much easier to get around a rule than a principle.

It's Time for Legislation

A prominent author and lecturer in the corporate governance debate, Ira Millstein is a senior partner at the international law firm Weil, Gotshal & Manges, and Eugene F. Williams Jr. Visiting Professor in Competitive Enterprise and Strategy at the Yale School of Management in New Haven, Connecticut. Millstein has worked closely with the OECD and the World Bank to develop codes of governance in developing countries. In an



opposing view to King's, Millstein believes that viewing governance as an ethical choice has led to far too many wrong choices. He maintains that the Sarbanes-Oxley legislation was necessary to tell corporate boards that "enough is enough."

I don't agree that we shouldn't legislate governance. We've had plenty of time to develop softer methods of

compliance. We have written codes of conduct and lists of best practices. If you look back over the years you'll find hundreds of them, promulgated by every corporate society in the world. And they didn't work. With those informal codes, we've had Enron, we've had WorldCom, and we've had 200 or 300 companies issuing restatements of their financial reports.

Congress passed Sarbanes-Oxley because so few companies followed rules of best practices. So, instead of *suggesting* that a company should have a majority of independent directors, we *require* that it has a majority. Instead of suggesting audit committees, we now require audit committees. Sarbanes-Oxley simply turned what you should do into what you must do.

Now, I no longer have to plead with and cajole people into following codes of governance. I can just point to the law and listing requirements. We all now have very assigned responsibilities. What Sarbanes-Oxley did, besides laying down rules, was to turn the paradigm back to the way it should be. It placed total responsibility for good corporate behavior and good fiscal reporting back to the board of directors. It makes

it very, very clear that the board is responsible for the behavior of the corporation. Instead of having imperial CEOs and managers who can do anything they want, we now have boards taking their jobs more seriously, digging in more deeply, and paying attention to their fiscal reporting.

There Is No One Way

Y.R.K. Reddy is the founder chairman of the Academy of Corporate Governance in Hyderabad, India, and founder chairman of Yaga Consulting, which is located in Hyderabad; London; and Lawrenceville, New Jersey. The Companies Bill 2003, a governance code for Indian business, is now being redrafted due to opposition to some of its content, including provisions that cap the age of directors at 75, prohibit a subsidiary company to have another subsidiary, and limit a company to making investments through only one investment company. India should work through the development of codes such as the Companies Bill according to the needs of the country, Reddy stresses, rather than submit to pressures from the West.



Discussion on the merits of the Companies Bill and various changes being attempted by the Securities and Exchange Board of India point to the need for greater validation that must precede such amendments. As of now, there is a distinct feeling that some amendments are more “knee-jerk” or “copycat,” following Sarbanes-Oxley, rather than iterative to a grand strategy more relevant to India’s specific requirements.

Should the global market ever agree to a framework of governance based on universal principles, that framework should not be based on country-specific points of governance. Governance, as it is being managed through the OECD principles, does not attempt to create such universal principles. Instead, these principles are steeped in a mire of assumptions that have little validation. The concept of stakeholders among Indian companies is indeed far wider than assumed by the OECD, which distinctly omits the community, consumers, and the environment.

The main challenge of governance facing Indian corporations is related to these differences in approach, quality, and integrity among some of the regulatory and governance institutions—these differences contribute to India’s low rank in Transparency International. Indian corporations will need to prove, through data and research, how state-owned enterprises have helped the late industrialization process in the country and continue to contribute to the development, even if the framework is different from that followed by the West.



Getting Back to Basics

Charles Elson is 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 in Newark. He is also “of counsel” to the Holland & Knight law firm and a former law professor at Stetson University College of Law, St. Petersburg, Florida. Good governance, he says, relies on managers knowing that the ends don’t justify the means.

We’re presently doing battle against the popular misconception that businessmen are crooks who think it doesn’t matter how they get results—a buck is a buck. We have to continually fight that belief in popular culture. We have to promote the idea that business isn’t corrupt and show that ethical behavior is the most effective and generates the greatest profit.

I think this belief was partially created by the political environment, at least in the U.S., where people believed that the ends justified the means. When we had our leading political figures saying that personal conduct didn’t matter if the results they delivered were good, that rationale leached into business. But we know that without ethical conduct in business, the whole system stops.

Ten years ago, before the scandals, those ends were achieved through accounting engineering that obscured what was going on behind the numbers. Such financial engineering was not viewed as particularly malignant by the market. It was simply viewed as something one had to do to make operations conform to accounting practice. Such financial engineering made it impossible to figure out from the numbers what was going on at the core of the business.

Good governance isn’t really innovative—it’s just going back to basics. It’s going back to the fact that the key to business is that operations drive accounting, not the other way around. Students in business school today need to realize that accounting is not just about the numbers, but the proper communication to the public of the actual operations of the business. They should realize that boards should represent the shareholders, and its directors must be financially independent of the management of the company. And students should realize that directors need to have long-term, personally meaningful ownership in the company to be effective on the board.

Finally, good governance is also encouraged by example. Those who teach must continually reinforce good codes of conduct by their own actions and the actions of business leaders who speak with students. We need to promote persistently the idea that ethical conduct is profitable. In the end, people flock to companies they believe will treat them fairly. 