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Good governance and the misleading myths of bad metrics

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In the aftermath of the well-publicized corruption and malfeasance in several large public corporations, especially at the executive and board levels, investors and analysts are searching for management tools to measure the vulnerability of firms to dishonesty, fraud, and corruption. While this effort to improve governance through uniform guidelines is understandable, at times boards and companies are reaching out for any life preserver that comes along. Some firms are capitalizing on this desperation by setting themselves up as corporate governance experts. In 1999, when William Donaldson was chairman of Aetna, he said prophetically, "I fear that there is a growing cottage industry of superficial thought about corporate governance."[1] The swelling number of governance consultants has made Donaldson's statement truer than ever. The vogue in the consulting world, in fact, is governance—supplanting business process reengineering, the "new economy," transformational leadership, diversity training, right-sizing, total quality management, and the like.

Some of what is being sold by the close to 100 governance training programs offered by consulting firms and universities is truly disturbing because it is often anchored more in clichés and myths than in careful research. In a recent review of academic studies on governance, the *Financial Times* suggested that many of the supposedly preventive practices advocated are not truly related to better performance and concluded, "Perhaps it is time the corporate governance activists came under the sort of scrutiny to which they subject listed companies."[2]

The Metrics Rating Services

The problematic nature of what is often being sold by commercial governance consultants is epitomized by the offerings of the powerful and feared governance metrics ratings services, the best known of which are Institutional Shareholder Services (ISS) and Governance Metrics International (GMI). While firms such as Moody's and The Corporate Library use a wide mix of criteria to evaluate companies, including their openly qualitative judgment, ISS and GMI rely more on crisp numerical scoring systems. Some even believe that it is dangerous for firms to challenge the influential ISS and GMI ratings services, given the attention paid to them by credit analysts, institutional portfolio managers, and liability underwriters.[3]

ISS and GMI look at public records to score firms on their governance effectiveness by using simplistic checklists of standards or metrics based heavily upon clichés and myths, rather than on genuine research. They also may cross the line from being independent raters to becoming active consultants for the firms they study in ways which lead to questions about their objective credibility. Finally and most importantly, their methods do not work; reliable, accurate governance ratings are not really produced despite all the charts and lists published. These three aspects of corporate governance ratings services—using evaluation standards based on Wall Street superstitions rather than research, potential conflicts of interest, and providing ratings that don't work—are discussed in the following sections.

Governance Expertise: Mixing Fact and Fiction in Measurement

Certainly the ratings services examine such worthwhile factors as financial disclosure, shareholder rights, related-party transactions, and executive compensation. These are sensible, research-supported dimensions to include in measures of the effectiveness of corporate governance.[4] But ISS and GMI blend these dimensions with superstitious ones to create checklists of highly stringent standards, regardless of the genuine research foundation to support them. They cite the collapsed firms of Enron and Worldcom as examples of poor governance without demonstrating how well these firms met many prominent structural dimensions of supposed good governance.

They perpetuate unfounded myths and clichés by downgrading firms for such reasons as failing to have a retirement age for directors and failing to separate the chairman and CEO roles. They claim that the downfall of many corporations has resulted from a lack of financial expertise on the board. Other reasons for poor ratings are failing to require that managers and directors have a formally set amount of equity holdings; prior history of service on boards of firms suffering financial distress; failure to have a formal retirement age, board size, and code of conduct; allowing a former CEO to serve on the firm's board; failing to have a separate chairman and CEO; and failing to have a supermajority of outside, independent directors. In sum, the ratings services evaluate the corporate governance of firms by mixing together empirically based standards and the myths and clichés of "the Street." Let us examine some of these myths and superstitions on which many corporations are measured, to see how wrong they can be.

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The Structure Myth

One problem is that certain studies not actually showing a relationship between board structure and performance are often cited as justification for structural reform, while true structural studies do not find relationships that matter between structure and performance. While a frequently cited McKinsey study suggests that investors were willing to pay an 18 per cent premium for a well-governed firm, such "good governance" was not defined in terms of any explicit board structure requirements.[5]

Millstein and MacAvoy studied the relationship between board independence and corporate performance to suggest that an active board made a difference. A board was deemed active if it met any one of the following criteria: (a) a non-executive chairman or lead director; (b) scheduled meetings of outside/independent directors without management present; or (c) substantial adherence to the well-known General Motors guidelines for corporate governance. This was thus not a study of the structural attributes of boards.[6] A recent study by Paul Gompers, Joy Ishii, and Andrew Metrick found that companies with strong shareholder rights had higher annual returns, profits, and sales growth than companies with weak rights. But again, though sometimes offered as substantiation for the need to reform board structure, this was not a study of structure.[7]

Finance studies by Sunil Wahal and Michael Smith suggest that even when shareholder activists have been able to change firm governance structures, the changes have not translated into improvements in operating performance.[8] Similarly, in research I have been doing with Sanjay Bhagat of Colorado and Dick Wittink of Yale on 1500 public companies, we are finding no support for a relationship between structural dimensions of board governance and company performance.

The Age Myth

There is no research suggesting that increased director age leads to impaired judgment. In fact, experience is often found to be advantageous in decision-making. Cognitive and developmental psychologists have mapped a strong correspondence between age, wisdom, and judgment on and off the job.[9] In particular, these studies have indicated an age-related strength in competency in the face of uncertainty and in perceiving others' intentions, as well as stronger communications skills. Term limits and age limits for board members are commonly discussed, but age-biased policies for board turnover lack genuine validation.

The Split CEO/Board Chairman Myth

The Conference Board recommended either splitting the CEO and chairman roles or using lead directors or presiding directors.[10] The metrics services also favor firms that divide these functions. And yet, many if not most of the highest-profile scandals in the US and Europe, (e.g., Enron, Worldcom, Vivendi, Adecco, Royal Ahold, ABB, Manesmann, Deutsche Telecom) involved firms that had separated the CEO and chairman roles, but the split hardly prevented subsequent scandals. Accordingly, there is no research that has established a link between the split leadership roles and firm performance.

The Financial Expertise Myth

A recent advertisement I received suggested a higher level of financial literacy as the solution to governance crises such as those experienced at Enron, Worldcom, the New York Stock Exchange, and Freddie Mac, despite the fact that these and many other struggling and collapsed firms had boards dominated by wide-ranging financial wizards including Ph.D. academicians in finance. Insufficient financial expertise has rarely been the point of vulnerability for firms suffering from executive corruption. Despite Enron's good fortune in having on the board an accounting professor and former Stanford Business School dean along with international bankers, former financial market regulars, and current financial service firm leaders, they claimed not to have understood their firm's activities in international financial markets. Thus they initially named a tainted executive as the successor CEO until he was forced out by public pressure several months later.

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Similarly, the Freddie Mac board included one of the world's leading financial economists, several prominent mortgage experts, and a former Big Four accounting firm CEO, yet still lacked confidence and felt compelled to nominate a knowingly tainted executive as CEO who better understood the mathematics of their market exposures.[11] He too was forced out by external pressure several months later. The Board of the New York Stock Exchange had twelve investment bankers, plus commercial bankers, mutual fund managers, and CEOs; yet they claimed they could not understand the finances of their own CEO compensation plan. Similarly, investor loss of trust in troubled mutual funds such as those of Strong Fund, Putnam, and Pilgrim Baxter did not occur because their boards lacked financial savvy.

The Director Equity Myth

One dimension or standard said to promote good governance is for directors to own significant amounts of stock in their firms, the thinking being that directors with an ownership stake will have a heightened incentive to govern well. There is research in support of this theory by Sanjai Bhagat, Dennis Carey, and Charles Elson.[12] In their study of 4874 directors from the 1994 proxies of 449 firms, their results showed a significant correlation between the amount of stock owned by individual outside directors and firm performance as well as an increased likelihood that CEOs would be terminated in poor-performing firms. Since this was not a longitudinal study, however, the findings are suggestive but do not prove causality.

Moreover, how much stock is enough, and does it matter if the policy is observed but not codified in a formal written mandate? Equity holdings by directors in firms such as Enron have been very high, with directors overseeing the loss of billions of dollars worth of stock that they personally owned or controlled. Furthermore, many great firms, such as UPS, where the average director owns millions of dollars in company equity, just do not require arbitrary formal levels of equity holdings in written policies and consequently suffer in the ratings.

The Former CEO Myth

Some ratings firms downgrade boards if the former CEO remains on the board, the fear being that the person will exert undue influence and perhaps have a negative effect on the independence of the current CEO. On the contrary, a former CEO on the board can provide valuable "ambassadorial service"[13] as is seen today in Intel's Andy Grove, Southwest Airlines' Herb Kelleher, Jim Kelly of UPS, and Microsoft's Bill Gates. Rather than intimidate or collude with their successors, they serve as invaluable public spokespersons and private advisors to the new CEO.

The Independent Board Myth

While the stock exchanges call for a majority of independent directors, they do not call for "supermajorities" as the governance metrics firms generally do. In the aftermath of its own governance difficulties, in late 2003 the NYSE also recommended that its own board be independent from its management and members, and from listed companies. A common standard used by firms rating corporate governance suggests that having a supermajority of independent, outside members with only one or two inside directors is a step toward good governance. The conventional wisdom has come to be that an independent board is preferable to a board made up mainly of company insiders.

Although an independent board of directors has many advantages, it is clearly not a panacea. Boards comprised mainly of inside members may have more knowledge of the business and more motivation to help it succeed. Several studies, such as those by Victor Dulewicz and Peter Herbert as well as by Sanjay Bhagat and Bernard Black, indicate that having larger numbers of non-executive directors may correspond with *worse* performance. According to Bhagat and Black, "There is no convincing evidence that greater board independence correlates with greater firm profitability or faster growth. In particular, there is no empirical support for current proposals that firms should have 'supermajority-independent boards' with only one or two inside directors. To the contrary, there is some evidence that firms with supermajority-independent boards are less profitable than other firms."[14] In fact, research by April Klein on all directors from S&P 500 firms suggested that affiliated directors are not puppets of management. She found a positive correlation between the percentage of insiders on board finance and investment committees and both stock market performance and return on investments.[15]

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Outmoded Standards: Attendance, Size, and Others

Other dimensions frequently measured, such as director attendance, codes of conduct, board size, and number of other boards on which directors serve, rarely matter as much as they may have in the past. For example, in several troubled firms such as Enron, director attendance had been nearly perfect. Similarly, the findings of research on board size are contrary to the beliefs of governance reformers and metrics firms who advance a template favoring smaller boards. In fact, David Yermack's study of 452 large firms found that the complex associations with other variables such as firm growth make it unclear if board size corresponds with higher or lower market values. Similar studies by Dan Dalton and Catherine Daily could not support the thesis that smaller boards are better performing boards.[16]

Ethics and Independence: Conflicts of Interest

Reports in such publications as the *Wall Street Journal* and *Fortune* have revealed how market-leading metrics firm Institutional Shareholder Services sells governance consulting advice to investors and to corporate management as well as to some firms they also evaluate, ironically thus potentially compromising their own objectivity and independence.[17] If ISS sees what they believe to be an improper transfer of shareholder wealth in your compensation plan, you have to become their client to find out what they do not like, in order to improve your scores.

Their major competitor, GMI, tries to avoid such criticism by maintaining that it makes its money by advising investors and not management. GMI states on its website, "We will not provide corporate governance consulting services to any company that is part of our research universe. . . . To do so would in or opinion impinge on our reputation and credibility." However, on this website GMI also describes their Comprehensive Rating of governance practices in a way which may encourage rated firms to become clients. This Comprehensive Rating is a "level of review possible only at the invitation of the company, which is required to pay a fee to GMI." It would be hard to imagine that *Consumer Reports*, JD Power, or the Academy Awards could maintain their credibility as independent evaluators with similar practices.

Efficacy and Accountability: Do The Governance Metrics Work?

ISS claims to have created governance metrics "that allow investors to quickly and accurately identify the relative performance of companies." When ISS launched their Corporate Governance Quotient in the summer of 2002, they trumpeted their prior low rating of Adelphia and stated that investors could have used their metrics to be wary of this coming governance fiasco. However, they did not publish the fact that they gave high scores to firms where similar train wrecks subsequently occurred.

For example, according to the ISS analysis of HealthSouth, its governance in early 2003 outperformed 64.3 per cent of S&P 500 companies and 92.3 per cent of its industry peers—just months before its own massive scandals were revealed.[18] In fact, ISS's proprietary evaluation praised HealthSouth's specific governance features such as: a supermajority of independent outside directors, nominating and compensation committees comprised solely of independent outside directors, annual election of the full board, no former CEO of the company on its board, the CEO does not serve on more than two other boards, there are between nine and twelve directors on the board, and all directors attended at least 75 per cent of the board meetings. Apparently measuring up well on so many structural dimensions advocated by ISS did not prevent the board's scandals. To the credit of ISS, they have begun to list top-ten performers in different size groupings with continual updating—but then of course that makes ISS accountability for past predictions tough to track.

Similarly, while competitor GMI's concerns over independence recently anticipated some serious governance problems at Adecco, their mistaken early 2003 positive assessments of such firms as Boeing, AMR, Merrill Lynch, Bristol-Myers, Delta, EDS, Citigroup, and Xerox as "Above Average" preceded the revelations of governance crises resulting in subsequent leadership changes and board overhauls of the qualities reviewed so highly by GMI. Their early 2003 "Average Ratings" of Healthsouth, Tenet Healthcare, and AOL all occurred just months before these companies generally made sweeping governance changes in response to the revelations of scandals and performance problems. Perhaps most disappointing of all were their "Below Average Ratings" of such widely admired, top-performing firms as Dell, Southwest Airlines, Wal-Mart, UPS, Starbucks, and eBay. Hopefully not too many investors or regulators relied upon these ratings as guidelines.

GMI has recently simply stopped publishing ratings on their website, thereby avoiding the same easy public accountability for significant miscalls. At about the same time, in September 2003 GMI released a "performance study" and heavily promoted it in the media, stating that they had found "a substantive link between investor-friendly governance practices and shareholder returns." Unfortunately, their study creates statistical confusion by comparing the handful of top-rated firms to 1500 others, resulting in problems of unmeasured within-group variance, regression toward the mean, and other distortions arising from comparing populations that are wildly unequal in size.[19]

The agreement between the ratings firms is not high nor are they always kind towards each other as evidenced by GMI's rating of Moody's, which also evaluates governance effectiveness. GMI protects itself by putting a disclaimer in its confidentiality agreement which states: "GMI makes no guarantees or warranties as to the accuracy or completeness of the GMI rating report or the overall rating or subcategory ratings." So much for confidence and accountability.

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Some newer governance ratings firms such as The Corporate Library are making far more cautious claims about governance links to financial performance and are looking beyond simple public documents and governance clichés about board structure to examine actual governance conduct in making their assessments and have produced more accurate assessments.[20]

The Missing Ingredient: The Human Side of Governance

Such attempts at improving corporate governance procedures as new legal and accounting mandates and the use of metrics have addressed only part of the governance challenge. At least as important are the human dynamics of boards as social systems where leadership character, individual values, decision-making processes, conflict management, and strategic thinking will truly differentiate a firm's governance.[21] Can fellow directors be trusted? Does management provide the full story? Is there enough time for advance reading and full discussion of materials? Is dissent encouraged? Are people well prepared? Does management allow themselves to be vulnerable? How are board members kept accountable for their preparation and decisions? How is assessment conducted so board members can learn and improve? Wayne Cascio's "Executives Ask" article earlier in this issue on boards as social systems sheds light on some of these questions.

In 2003 former Aetna chairman William Donaldson, now Securities and Exchange Commission chairman, captured the essence of the problem with the emerging governance industry's laundry-list approach:

> Such a "check the box" approach to good corporate governance will not inspire a true sense of ethical obligation. It could merely lead to an array of inhibiting, "politically correct" dictates. Instead of striving to meet higher standards, corporations would only strain under new costs associated with fulfilling a mandated process that could produce little of the desired effect. They would lose the freedom to make innovative decisions that an ethically sound entrepreneurial culture requires. . . .
>
> [Determining criteria for corporate governance] is not a one-size-fits-all exercise . . . we should go slowly in mandating specific structures and committees for all corporations. . . . There are vast differences in the function, structure, and business mandate of the thousands of corporations struggling with the issues of good corpo-

rate governance. . . . there is no one answer to these hotly debated questions. . . .[22]

Endnotes

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