Measuring the effectiveness of corporate governance

Trust is the foundation of sustainable development. As the world continues to get smaller, our mutual interdependence increases and we all need to be able to mobilise the resources and goodwill of others to achieve success. That can only be achieved through gaining their trust. Therefore, the ability to gain the trust of global financial markets and of all the stakeholders in the value chain is becoming the key to success.

The essence of good corporate governance is ensuring trustworthy relations between the corporation and its stakeholders. Therefore, good governance involves a lot more than compliance. Good corporate governance is a culture and a climate of **C**onsistency, **R**esponsibility, **A** ccountability, **F**airness, **T**ransparency, and **E** ffectiveness that is **D**eployed throughout the organisation (the 'CRAFTED' principles of governance).

Boards have the basic responsibility to ensure sustainable improvements in corporate valuations by providing strategic guidance and oversight regarding management decisions, as well as selecting and changing the management whenever necessary. Success can only be achieved on a sustainable basis, if boards behave as a role model for implementing the CRAFTED principles of governance in their own operations and ensure that the corporation follows these principles in making key decisions.

The board of directors is the most important element in corporate structures. The tone at the top determines the tune in the middle.*In particular, clear separation of management rights (taking initiative and implementation) and governance rights (guidance, approval, and oversight), is critical in minimising potential 'agency' risks of the management such as:
• fraud
• cronyism, building a personal fiefdom with company resources
• lethargy, focusing on excuses as opposed to results
• being too risk averse that may lead to overinvestment
• being too risk prone

Issues such as the composition of boards, their agenda and processes for decision-making, and how they **L**earn to continuously improve the governance of the corporation, critically influence the both the quality of decisions and of management.The main responsibilities of the board is to provide effective **O**versight and strategic **G** uidance for the management. The quality of their decisions is critically dependent on the quality of the **I**nformation they have. Establishing a **C**ulture that sets the right tone at the top is critical for establishing the 'trust' for the corporation with all its stakeholders (The 'LOGIC' of governance).

The success of the board depends on making sound judgments in numerous situations that involve balancing different interests:
• risk versus reward;
• short term versus long term;
• effective oversight versus motivating management;
• ethical considerations versus market practices; and
• competing interests of different stakeholders.

In short, good corporate governance is very important for sustainable development, not only for the individual company, but also for the economy as a whole. Therefore, the quality of governance should be continuously improved and good governance should be promoted. However, what is not measured, cannot be improved. Hence, there is a need for a model to measure the quality of corporate governance.

Most attempts to measure the quality of corporate governance focus on compliance-related issues. Numerous rating models also seem to focus on the inputs of governance, such as the composition of boards and the separation of the CEO and chairman roles. However, they do not pay sufficient attention to the quality of information, decision-making processes, nor link the effectiveness of governance to output measures such as the brand image, employee and customer satisfaction indices, or profitability and value creation. Also, most measures fail to deal with learning and development in governance.

First, what is more important than which demographic characteristics a board member possesses, is what kind of experience he/she has and what types of behaviour he/she portrays. Therefore, gender, nationality and age diversity are not sufficient to evaluate the effectiveness of a board. One should also evaluate the relevance of the experience of board members to address the main challenges the company is likely to face.

Another important issue is that the quality of the information that the board gets is a key determinant of its effectiveness. Whether relevant and timely information, presented in a context, with the benchmarks and alternatives identified, assumptions understood and stress-tested, or whether the potential effects of various alternatives on different stakeholders have been taken into account, would have a significant impact on the quality of the board's decision.

Third, the impact of a board's decisions on output measures should be evaluated, not just not inputs such as information quality. Governance is important for the sustainability of value creation. If the model that aims to measure effectiveness of governance does not evalute the linkages to output measures - not only financial performance, but also lead indicators such as customer, employee, or other stakeholder satisfaction - it would be missing an important dimension.

Boards should also be focusing not only on the business results, but also how business results are obtained. As an outstanding performance could sometimes be due to excessive risk-taking, resulting in a relatively good performance during a particular period, it may not be sustainable. Such an elaborate evaluation of management proposals requires an open and transparent culture, where members are encouraged to challenge assumptions and evaluate alternatives.

Also, as there is a time lag between decisions and their impacts, the board's performance should be evaluated over a period of time, not at a specific time.

Finally, the purpose of measuring the effectiveness of governance should be to improve it continuously. Therefore, assessing how a board learns and invests in developing its own performance should be an important dimension of the model.

Therefore, we have developed a model that tries to remedy these shortcomings. The essence of the ARGE Corporate Governance Model is to evaluate how the "CRAFTED" principles are applied to the "LOGIC" of governance.

The model aims to incorporate not only structural aspects of governance, such as the composition of the boards, but also behavioural aspects such as the evaluation of sufficient number of alternatives in decision-making, the quality of information that forms the basis of sound judgment, the culture of decision-making, the processes, and the results of oversight and guidance functions of the board of directors.

	Based on Definition	Scope	Implementation	Continuous Development	Sustainability
C - Culture	Values and Principles are defined	Values and principles are perpetuated with applications	Values and principles are disseminated throughout the organization	Implementation of values and principles are monitored to identify improvement opportunities	No leniency when values are breached
I - Information	Timely updated	Comprehensive (dimensions) and Comparable (trend).	Shared and consistent.	Best in class benchmarks are considered	Investments are made for information processes and sharing
G - Guidance	Based on information and consistent with the mission and principles of the corporation	Comprehensive (Dimensions)	Establishing the required communication structure for sharing the strategies and objectives.	Decision making with the assessment of various alternatives, results and risks.	Investments are made for incorporate learning into decision making processes
O - Oversight	Defined processes, principles and rules exist	Comprehensive (Dimensions)	Accountability	Weaknesses in internal control mechanisms are identified and remedied	Confidence to share with stakeholders
L - Learning	Limited examples exist	There are sporadic examples in different dimensions.	There are examples that are disseminated throughout the organization.	Determining the objective for development.	Rewarding learning and development.

The model also seeks to check whether if there is a sound, integrated approach to governance; whether the determined approach is deployed systematically throughout different processes and levels of the organisation; whether the approach to governance brings the desired results and that these are benchmarked with the best in class examples; and whether there is a continuous monitoring of results that feeds into learning and improvements.

The evaluation and backbone of the model stands on four main areas, three of which are inputs and the fourth, an output:

Inputs
• The right people
• The right team
• The right processes

Outputs
• Improvement in business results

The ARGE Corporate Governance Model provides a set of questions and best of class examples regarding the application of the 'LOGIC' of governance to the four dimensions of people, team, processes, and business results.

The model also looks at how continuous improvement processes are implemented in governance mechanisms. The model analyses the people, team and processes on the basis of corporate governance principles.

A self-assessment guide is developed based on the model. The guide attempts to check the coherence of the structure with the board's conduct and its continuous improvement processes. Questions are prepared to consider whether, in each dimension, a proper tone is set at the top; an effective information provision process is established; and a proper process is in place for appropriate guidance and adequate oversight.

Furthermore, the developments on these issues both over time and in comparison to benchmarks are considered.

Answers to these questions are rated according to **BaSICS** measurement that tries to identify whether there is a **Ba**sic definition against which performance would be measured, that the **S**cope is adequate, **I**mplementation is realised throughout the processes and organisation, that there is **C** ontinuous improvement, and an adequate system has been developed and resources deployed for **S** ustainability.

In short, this model could be utilised either as a self-assessment tool to measure and improve the effectiveness of governance, or as the basis of an award scheme like the European Foundation for Quality Management (EFQM) to promote the right kind of behaviours in the board.

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