HARCOURT BOARDROOM RESOURCES

GOOD CORPORATE GOVERNANCE MATTERS

Corporate governance is neither a fashionable buzz-word imported from the jargon of market capitalism, nor an arcane discipline about compliance only academics or regulators can get excited about. Good corporate governance, however organized, actually matters! Here are a few reasons why.

Enron was one of the success stories of the 1990s. The company dominated the decade with its innovations in the oil and gas markets, its skyrocketing share price and its whizz-kid managers. Suddenly, in less than three months in the fall of 2001, the company went from market star to bankrupt villain, also bringing down Arthur Anderson, the leading auditing and consultancy firm of the time. The Enron story quickly became the subject matter of Hollywood movies and Broadway plays, leaving aside the financial hardship it thrust upon its employees and investors. Over time, the full story of fraud and deceit became apparent: management had gone from aggressive to illegal business practices, and from ambiguous disclosure to outright lies. Where was the board during those 10 years of increasing deviation from ethical management?

The recent Olympus scandal in Japan shows that bad behavior is not limited to the late 1990s and the Internet bubble, nor to the United States and Europe. In this recent case, a permissive board, willingly or incompetently blind to fraud, brought about the collapse of a reputed and successful company.

These two examples are somewhat extreme. In most cases, there are neither lies nor fraudulent acts, and boards can focus on ensuring that processes are followed and businesses monitored. But the general point remains that the first reason why boards matter is that they set the tone for ethical behavior, and exercise control and oversight of a company's affairs and management. This role is increasingly important and complex as companies become more diversified and more international.

The second reason why boards matter is that they make essential decisions with long-lasting effects at crucial moments in the lives of companies. In times of crisis, boards are in the front line, and the quality of their decision-making can be a matter of life or death for the corporate entities they are the responsible for. Examples of boards taking very different decisions in the face of a similar crisis abound. The consequences of these decisions often differ dramatically. One classic case is the way the boards of British Telecom and of France Telecom reacted to the 2001-2002 Internet crisis.

Within a year of each other, both companies faced identical liquidity crises, after years of acquisitions at the height of the Internet bubble. Both boards reacted initially to market pressure and share prices in free-fall by firing their respective CEOs, but thereafter diverged widely in their responses. The British Telecom board bowed to demands from the financial community, and embarked on a distressed rights issue at a very high discount, a series of forced disposals and, finally, a break-up of the company into fixed-line telephony on the one hand, and mobile telephony on the other. Instead, the France Telecom board proposed to the financial market a drastic operational plan, which was deemed « aggressive but achievable », followed by the refinancing of some of its credit lines, and only when the situation had stabilized, did the company launch a highly successful rights issue at a standard discount, thus avoiding a break-up. Ten years later, British Telecom is a second or third-tier operator, whereas France Telecom is one of the top operators in the world, and their respective market capitalizations are in different leagues.

Obviously, one board thought through the issues properly and took risky but successful decisions, while the other's decision process was flawed and ended-up destroying not only significant value, but also a great company. As in the cases of Enron and Olympus, but for different reasons, governance mattered very much indeed! The quality of the decision-making process, the adequate balancing of conflicting goals, particularly the short-term interests of certain shareholders and the long-term needs of other stakeholders (employees, clients, other shareholders, etc.), the right judgment about the amount of risk a decision carries, in other words, the quality of the board's strategic leadership, is also what good corporate governance is about.

Some companies get it wrong on all counts and all the time. A classic example is Hewlett-Packard (HP), the soap opera of corporate governance. Every two to three years, this company manages to come up with a major corporate governance crisis, where dubious decision-making (acquisition of Compaq, acquisition of Autonomy, etc.) and allegations of unethical behavior (spying on the board, sexual harassment and falsification of invoices, accounting fraud, etc.) combine, leading to leaks to the media, a change of CEO and the partial replacement of the board, only to start all over again within a couple of years. Not many companies are capable of withstanding regular crises of this magnitude. The reason why HP, at least up to now, has managed to do so is probably because its divisions are run very independently, thus isolating somewhat the businesses from the mess at the top. But the loss of market-share, innovation leadership and market value, are testimonies of what bad corporate governance has brought about to this once-iconic company.

It is relatively easy to be convinced that good corporate governance improves business oversight and leads to better strategic decisions. However it is difficult to achieve in practice, particularly in the face of a major corporate crisis. Codes of « best practices » help, but go only so far: Enron had an exemplary board from that point of view, and it still did not do its job properly!

At the end of the day, a board is like a sports team: culture and courage, training and hard work, balance of competences and compatibility of personalities, all matter. And even if achieved for a period, good corporate governance is an unstable equilibrium: every difficult business decision will put it to the test.

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