

# — at the — TONE TOP<sup>®</sup>

Providing senior management, boards of directors, and audit committees with concise information on governance-related topics.

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## The Governance Benchmark

*There is a significant disconnect between our assessments of governance and true governance effectiveness. It's time to determine why our governance evaluations are often wrong and what we can do to fix the problem.*

We have entered an age of nonstop performance measurement. Throughout the world, teams of managers, auditors, and consultants are using disciplined, data-driven approaches such as Six Sigma, Kaizen, and Lean to evaluate business performance. The reason is simple: Running a company without measurement is like trying to improve your golf game without keeping score. You'll probably get results, but they are unlikely to be what you wanted. As management guru Peter Drucker pointed out, if you can't measure it, you can't improve it. That's why we use standards, benchmarks, evaluation forms, and scorecards to evaluate virtually every aspect of business performance – with one very significant exception.

Most companies still don't measure their overall system of corporate governance.

In a recent survey by The Institute of Internal Auditors and the Neel Corporate Governance Center at the University of Tennessee, Knoxville, a majority of participants reported no formal mechanism for monitoring or evaluating the full governance system. Only 21 percent of surveyed companies stated that they audit their full system of corporate governance on an annual basis.



## The Measurement Challenge

It is difficult to measure corporate governance. It encompasses all of the systems by which organizations are directed and controlled, and some of those systems are difficult to quantify. Governance is more than policies and procedures. It's about how we make decisions, establish objectives, and monitor their achievement. It's about working relationships and how we motivate, discipline, and reward behaviors. What's more, effective governance is constantly under construction. Regulations change, securities exchange listing requirements evolve, and stakeholder needs vary. There is always something to improve, if only we can identify it.

Unfortunately the evidence indicates that many of us are not as good at evaluating our organizations' governance as we'd like to believe. That's only natural. It's difficult to be unbiased about the organizations we control, and because of the Overconfidence Effect (see sidebar), it's likely that many of us are unrealistic about what our governance systems are accomplishing.



## About The IIA

The Institute of Internal Auditors Inc. (IIA) is a global professional association with more than 200,000 members in more than 170 countries and territories. The IIA serves as the internal audit profession's chief advocate, international standard-setter, and principal researcher and educator.

## The IIA

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## Ranking Our Governance: Success or Failure?

Although most of us lack formal mechanisms for monitoring or evaluating the full governance system, the problem is not that we don't rate governance at all. Various commercial rating agencies give overall opinions regarding governance. We have a host of award programs such as the Leadership in Governance, Excellence in Good Governance, and Global Governance awards. Proxy advisors use governance scorecards to make voting recommendations, and institutional investors use governance scores to evaluate information regarding ethical conduct and tone at the top.

The problem is that the scores and ratings aren't necessarily accurate. Some of history's most damaging governance failures have occurred at companies that were noted for good governance. Enron Corporation, for example, had an award-winning board of directors at the time of the company's implosion. Jeffrey Skilling, the COO and CEO, was a Harvard graduate who has been described as "incandescently brilliant." And when the Enron scandal took place, the company's code of conduct and "Vision and Values" messages were proudly displayed on everything from wall plaques to paper weights to coffee cups.

With its brilliant leadership team, well-publicized ethical code, and award-winning board of directors, Enron was the darling of Wall Street. Almost everyone assumed the company's governance was top-notch.

Almost everyone was wrong.

The lesson from Enron is that doing well on subjective scoring does not guarantee sound corporate governance or continued success. According to a 2018 [report](#) published in *Queen's Law Journal*, "When the empirical research is examined, there appears to be no relationship between corporate governance scores or ranking schemes and future corporate performance. These schemes also fail to identify companies that are likely to experience scandals or even terminate underperforming executives. This is the case whether we examine the work of commercial rating agencies, media outlets, "comply or explain" regulatory regimes, academic models, or Environmental, Social and Governance indices."

Despite these bleak findings, virtually all experts agree that effective governance is vital to the future success of American businesses. The issue is not that governance is unimportant; it's that there is a significant disconnect between our assessments of governance and true governance effectiveness.

The answer is not to stop benchmarking corporate governance. Running a business without performance measurement means trying to run a business blind to the facts. Instead, it's time to determine why our governance assessments are often wrong and what we can do to fix the problem.

## Why Governance Rating Systems Fail

Publicly available governance scores are determined primarily by comparing governance disclosures to a well-known code of governance. At first glance, this approach makes sense, but there are several reasons why it may be prone to failure.



First, the information gleaned from governance disclosures is incomplete. Disclosures provide important insights, but they never tell the whole story. Keep in mind that in The IIA/UT survey mentioned above, most participants said their organizations had no formal mechanism for monitoring or evaluating the full governance system. We can't disclose what we don't know.

Second, governance disclosures describe specific governance *characteristics*, but they don't shed much light on governance *effectiveness*. Disclosures about the number of board meetings, biographical information for directors, and executive compensation certainly deserve our attention. But the disclosures merely describe what governance structures look like, not what they accomplish. It's an unfortunate fact that a corporate board can be ineffective even if it is perfectly balanced and holds exactly the right number of meetings. Otherwise, anyone could be a director.

To make matters worse, many assessments simply compare disclosures to a well-known code of governance. Governance codes are vitally important for establishing minimum expectations, but it's impossible to achieve world-class governance merely by complying with one-size-fits-all minimum expectations. While the underlying principles of good governance apply to all organizations, a standard governance code cannot provide exact requirements that are an optimal fit regardless of industry, company maturity, size, complexity, or extent of international operations.

As noted earlier, most organizations don't assess the full system of corporate governance, so our assessments are incomplete. It's no wonder then that our assessments of corporate governance occasionally fail. Indeed, most assessments benchmark governance against minimum standards, so our performance expectations may be inadequate. And, perhaps most importantly, we have been evaluating governance characteristics rather than how we compare to the principles that are the basis of effective governance.

## A New Alternative



The good news is that a new scorecard is available that makes governance evaluation easier for U.S. public companies. The [American Corporate Governance Index](#) goes beyond publicly observable measures of corporate governance such as the number of board meetings or executive compensation disclosures. The index is based on governance principles that reflect viewpoints at leading organizations such as the National Association of Corporate Directors, Business Roundtable, Committee of Sponsoring Organizations of the

Treadway Commission, New York Stock Exchange, Organisation for Economic Co-operation and Development, and King Commission. Developed by The Institute of Internal Auditors and the Neel Corporate Governance Center at the University of Tennessee in Knoxville, the Guiding Principles of Corporate Governance are intended to describe the basis of good governance.

## THE OVERCONFIDENCE EFFECT

The Overconfidence Effect is a natural tendency for people to be more confident in their own abilities than is objectively reasonable. In his 2011 book, *Thinking, Fast and Slow*, Daniel Kahneman called overconfidence “the most significant of the cognitive biases.”

Virtually all of us are affected. [Psychology Today](#) reports, for example, that 93 percent of American motorists claim to be better than average drivers. In another recent study, a full 50 percent of surveyed business people said that, compared to their competitors, co-workers, and peers, they were in the top ten percent ethically.

As directors, we'd like to think that our decisions are unfailingly rational. But the same accomplishments that lead to director success may actually increase our susceptibility to overconfidence. A new research report from The Institute of Internal Auditors, [On Risk 2020: A Guide to Understanding, Aligning, and Optimizing Risk](#), reveals a disturbing pattern. The study found that surveyed board members were consistently more confident than executive management about their organization's capability to address key risks. For every risk category surveyed, board members rated capability higher than executive management did. For some types of risk, the directors' ratings were dramatically higher.

These discrepancies raise important questions about how boards build their views on the effectiveness of governance, risk management, and controls. That's one of the reasons governance benchmarks are invaluable. It is only through comprehensive reviews of corporate governance, including analysis of appropriate benchmarks, that we can make the transition from overconfidence to informed confidence.



To create the index, chief audit executives at a variety of U.S.-listed companies were asked a series of questions based on these principles. Why ask chief audit executives? Because many CAEs have made in-depth evaluations of governance. Approximately 75 percent of the times corporate governance is audited, the evaluation is performed by internal audit; and because auditors generally are independent of the governance structures they evaluate, they may be less susceptible to the Overconfidence Effect than directors or executive management.

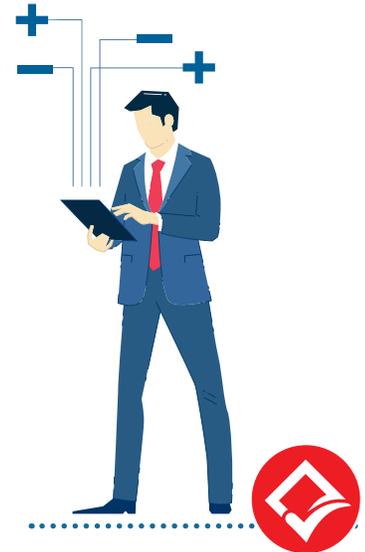
For example, one of the principles states, “The Board should ensure that the company maintains a sustainable strategy focused on long-term performance and values.” Audit executives were asked their level of agreement with statements such as, “Your company is not willing to sacrifice long-term strategy for the benefit of short-term interests.”

That statement received only 67 percent agreement – the lowest score in the survey. “Short-termism” might or might not be an issue at your organization, but if all of the survey questions are asked of auditors, executive management, and directors at your company, comparing their answers to the index will probably be enlightening. Comparing their answers to each other’s might also be eye-opening.

## The Path Forward

What’s measured improves. But meaningful improvement requires that we measure the right things systematically, thoroughly, and most importantly, using appropriate measurement criteria.

It is abundantly clear that corporate governance is key to long-term, sustainable success. When it comes to corporate governance, we can’t afford to fail. The path forward is clear. Organizations must monitor and evaluate their full systems of governance consistently and continually. And those evaluations must include careful consideration of benchmarks based on the underlying principles of sound corporate governance.



### Quick Poll Question

How would you rate the effectiveness of corporate governance leadership by your board and management?

- Poor
- Fair
- Good
- Very Good
- Excellent

Visit [www.theiia.org/toner](http://www.theiia.org/toner) to answer the question and learn how others are responding.



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