

OPINION

¶776 Governance rating systems – a long way to go

By Lynn Ralph, Managing Director, Cameron Ralph Pty Ltd, a consultancy which assists boards provide effective leadership, improve their performance and build positive reputations.

Two recent articles in Across the Board addressed the issue of governance ratings. In Issue 118, Jim Psaros ("Corporate Governance rating systems – what's the point?", 1 March 2005) made the case for the usefulness of ratings such as those with which he is associated through the Horwath Report. These are based, admittedly, solely on hard factors, such as committee structures and independence levels, rather than soft factors such as ethical and corporate culture, and the skills and characteristics of the management and directors. He argued that such assessments from outside the boardroom provided

objective information about governance practices to shareholders, which was better than relying on perception, or rhetoric from the companies themselves.

In Issue 120, the most recent GovernanceMetrics International ratings were summarised ("Westpac tops global governance ratings", 15 March 2005). They too are based on external factors. Their conclusions were that smaller companies are weaker in corporate governance, that the percentage of independent directors is increasing, and the number of combined Chair/CEO's are declining. Nothing surprising there. Larger companies can "afford" better governance, in every sense of afford. The pressure for more independents was always going to produce more, guess what, independents — at what "cost" is less clear. And even in the US the hype about splitting the roles of chairmen and CEO is finally making an impact — and on that you get no argument from me.

Nevertheless, I fear that these articles have missed the mark on a number of points.

Firstly, let's re-visit the question: why have ratings at all? I don't think we disagree on that. There can really be only one reason, and that is to assist investors to understand the degree of "governance risk" they are assuming when they purchase or hold a particular company's shares. Any governance rating must, if it is to be of any use at all, provide investors with information which would contribute to their decision to buy, sell or hold. I say "contribute" because governance risk is not necessarily a predictor of share price (let alone the only predictor). It is merely the extent to which a board's actions or inactions may contribute to a range of outcomes for the company.

The second issue is whether you can usefully rate companies on their governance merely on "hard" factors. Jim Psaros claims you can, as does GovernanceMetrics. Whilst he acknowledges that those things you can't measure from outside the boardroom (the "soft", people issues) do matter, he falls back on arguing that the "hard", measurable from the outside, factors, must also have some

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impact, and therefore one is justified creating a rating based on only the 'hard' factors. The ratings one is talking about are therefore what I will call "external ratings" — ratings based solely on published and observable information.

Seeking to judge companies by hard factors alone is what external ratings do, and it fails to recognise their limitations. Good governance is a complex interaction of people, processes, and structures set within the unique context in which the company is operating. It's not just about structural factors, like independence of directors, or having an audit committee. It's about finding the right mix of people, processes, and structures which meet the specific needs and challenges of that organisation — that is, being "fit for purpose". Such well-known companies as HIH and Enron did appear to have good governance when their structures were viewed from afar; it was only by digging deeper that the problems were observed.

Finally, the argument for having ratings is that good governance is beneficial to investors, and that ratings will drive standards higher. That argument assumes that the ratings are meaningful and reliable, and I have argued that external ratings do not meet that test. But that's not the end of it anyway. We all know that there are many types of risk which impact on a company's rate of return, and despite the best efforts of academics over the past 10-15 years, they have been unable to prove causality between so-called "best practice governance" (in fact, based on external factors alone) and long-term shareholder returns.

Don't get me wrong — I am absolutely certain that a good board adds value, and in many cases significant value, to a company. But we have all seen the many examples of companies which rate poorly in most of the current rating systems, but which nevertheless produce consistently outstanding results. Where substantial losses are incurred in a company, you can almost always trace it back to some aspect of poor governance, but I doubt that an external assessment of these companies' governance

would have predicted this (you know which companies I am thinking about).

You would expect me to say this — and my self interest is pretty obvious: there is only one way for investors to be confident that they understand the degree of governance risk they are taking — boards need to regularly undertake rigorous & independent reviews of their performance and be brave enough to publish the results.