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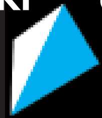

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THE VALUE OF SOUND GOVERNANCE

Governance - By the Numbers

Sound corporate governance creates value because it leads to higher levels of information integrity. As information integrity increases, so does the certainty that company reports are accurate, and that operations will produce consistent results into the future. This makes a company more desirable to potential investors, attracting capital and even commanding premiums - or better investment terms - for company owners and management. For example, according to McKinsey & Company, "…investors will pay as much as 28% more for the shares of well-governed companies..."[1]. And other research confirms "that better corporate governance is highly correlated with better operating performance and market valuation"[2].

Attention to corporate governance preserves value. According to a study of 1,600 firms conducted by GovernanceMetrics International, Inc., companies with the worst governance ratings over the past three years lost an average of 13% in investor returns per year compared with a loss of 1.8% for all companies[3]. The challenge for companies is twofold: 1.) to ensure your portfolio of operations have one standard for efficiency, financial reporting, and regulatory controls that are summarized and reported to senior management and the board, and 2.) to aptly communicate those summaries in the form of disclosures to investors. Such practice will decrease the likelihood of unintended process outcomes caused by fraud, operational failure, or lack of key-personnel depth.

Private and Public Regulations Align

New private company rules and regulations are putting public and private companies on the hook to increase disclosures to investors, eliminate conflicts of interest in deals, and formalize overhaul efforts to their governance. Reform applicable to private companies has materialized and will likely proliferate until the standards are in line with public company requirements. Recent initiatives in this area include efforts by the Senate Finance Committee, the American Institute of CPAs (AICPA), the United Nations Environment Program (UNEP), the GAO, various judicial rulings (e.g. Pereira v. Cogan), and certain Sarbanes Oxley sections.

Governance Assessment

Phase 1 - Risk Assessment

First, assess organizational risk. This involves understanding existing policy, process and procedural information, and analyzing current oversight mechanisms at a high-level. On the governance side, this means looking at the extent to which oversight activities are integrated and kept free of conflicts of interest. Regarding business operations and infrastructure, this means assessing key elements of control against four organizational characteristics: business and system complexity, existence and custody of assets, control structure performance, historical results of incurred risks and action plans. Recommendations in this phase identify areas for further detailed analysis.

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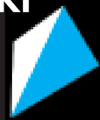
CENDROWSKI  CORPORATE ADVISORS
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Phase 2 - Operational Assessment

Second, analyze the reliability and adequacy of the operations. The goals in this phase are to address noted risks and improve the operating environment. Here, processes are deconstructed into discrete tasks where objectives must be met through coordination of manual, system, preventive, and detective controlling activities. Inspection of major asset categories, accounting, and financial reporting yields a prioritized gap analysis for decision makers. This way, where potential control improvements exist, informed decisions regarding the potential loss can be weighed against the actual costs of gap remediation.

Phase 3 - Transaction Assessment

Third, where key business activities are weak, conduct detailed analytical procedures on historical transactions to identify and quantify errors. Root-cause analysis is performed to determine whether non-conforming transactions are attributable to process design, control failure, fraud, or system integrity.

Time to Plan

Traditional due diligence limits organizational understanding to the financial outputs of a company. Little is revealed in terms of how those outputs came to be. Were the financial results a stroke of luck? Are they repeatable? Or were the financial statements manufactured in corrupt and fraudulent schemes?

By knowing more about the business behind the numbers, companies can make better funding, acquisition, and investor attraction decisions. More importantly, owners and financiers will have a basis for monitoring and reporting on their investments as they grow.

Sound governance and a resultant boost to information integrity are a must in attracting capital and protecting value. While the regulatory requirements in this area are in flux, private companies should use this time to learn more about best practice governance and internal control frameworks, process and control models, related information systems, and additional benefits that can be derived from such broad and in-depth business understanding.

Footnotes:

1. Roberto Newell, Gregory Wilson, "A Premium for Good Governance", The McKinsey Quarterly, 2002 Number 3.
2. Leora F. Klapper, Inessa Love, "Corporate Governance, Investor Protection and Performance in Emerging Markets", World Bank Policy Research Working Paper 2818, April, 2002; available from http://econ.worldbank.org/files/13267_wps2818.pdf; accessed 10 May, 2004.
3. James McRitchie, "Average is Best?", Corporate Governance, September, 2003; available from http://www.corpgov.net/news/archives%202003/September.html; accessed 12 May, 2004.

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