SCCO International

SCCO International // Volume 27

Beyond Corporate Governance

Good Governance Systems as a Factor for Competitive Advantage

by Gerhard Nenning and Konstantin Wrona

1 A radical solution is needed from within

The implosion of famous corporate names has shattered public confidence in management. In response to the series of corporate collapses legislative reforms have been put into place. These corporate governance guidelines are primarily aimed at pushing executives to more diligence in preparing and reporting financial information. Boards have also become aware of their responsibility and of the consequences of failure. These objectives are supposed to be achieved by the following levers: enlarging stakeholders' rights, promoting shareholder activism, strengthening the accountability of the board of directors, and ensuring compliance with the principles. Many countries have incorporated those aspects into their corporate governance requirements, even though the governance approaches differ significantly.

Welcome as these changes may be, they tackle the symptoms but don't cure the problem. True, a handful of companies have committed criminal acts – but this is just the tip of the iceberg. The real scandal is that almost every company bends the rules to some degree. It would therefore be shortsighted to rely on a set of formal guidelines such as roles, relationships and qualifications of the persons and institutions involved.

The internal dimension of corporate governance has been lost in the debate so far. It deals with the role of the internal governance system of a company. For this scope a more broader definition of Governance Systems needs to be applied: "The set of criteria and tools necessary to ensure, in accordance with the rules, sustainable value creation, strategic effectiveness and operational efficiency in an organization."

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To support the measurable improvement of the system's output quality, a radical solution "from within" is needed. The internal governance system consists of various aspects. In this paper we focus on serious issues related to the measurement of an organization's value as well as the strategic management and control of a company.

- >> **Goals:** What kinds of goals are set and how are targets established? What are the trade-offs and what are the priorities when business aims and financial objectives are in conflict?
- >> **Planning:** Which procedures are employed to identify the most valuable business strategies? How are planning alternatives prompted and evaluated? How are risks assessed?
- >> **Capital Allocation:** How are capital spending projects (for example equipment replacement, entering a new market, etc.) approved? And how, on the other hand, are decisions made to divest, downsize and outsource? Who is responsible for those decisions, and how are managers held accountable for delivering the promised results?
- >> **Performance measurement:** What set of metrics is used to keep track of results and to highlight important successes and failures? What is the hierarchy of financial and operational metrics, and how are they organized into an overall scorecard?
- >> **Incentive Compensation:** How is business performance measured and rewarded, and how are monetary incentives aligned with the long-term interests of shareholders?

In order to ensure that management is acting in the best interest of the respective organization, a compelling answer for these governance issues has to be found: Numerous examples of successful companies even in struggling industries show that the internal governance of an organization is an important factor for competitive advantage. This paper aims to offer useful hints for the development of internal governance systems.

2 The malady of governance

Internal governance systems comprise a variety of policies, procedures and levers which a management team can use to guide, control and drive its company's operations and strategies. Reality shows, however, that the standards, goals and terminology of existing governance systems are inconsistent and do not provide a common basis for the creation of value.

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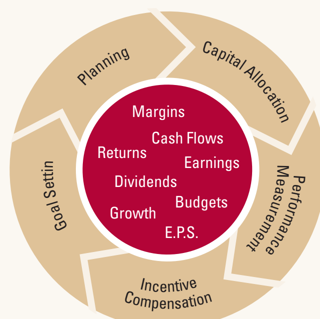
A Typical Governance System: Inconsistent standards, goals and terminology



Three factors, which we will call the "traps of abuse" stand out. First: the fact that external accounting standards are used for internal governing purposes. Second: The actual application of budgeting and capital allocation and third: The system of management compensation. The three factors are associated with the failure to provide the clarity, cohesion and accountability that are essential to drive the creation of value.

First trap of abuse:
External accounting and its implications for internal governance

The most frequently used General Accepted External Accounting Principles (GAAP) have no adequate relationship with increasing the value of a company. For example, neither domestic nor international accounting standards (e.g. IFRS) take into account the minimal interest rate that investors expect in return for the capital they provide. As a consequence, many managers will bask in the "profits" they have earned when the investment is barely above the rate of the borrowed capital interest. Unfortunately, this calculation leaves the providers of equity capital out in the cold.

Many governance systems attempt to offset the insufficient consideration of the capital side with relative indicators such as Internal Rate of Return (IRR), Return on Investment (ROI) or others. However, the problem is that these approaches neglect absolute size effects and fail to accurately reflect profitable growth. Rather, whenever the operative result allows, these indicators will invite the "inflation" of the profit by a steady reduction of the capital basis. This also explains the apparently unquenchable thirst of many managers for off-balance constructions. It should be common sense that capital assets have to result in appropriate profits as long as the company bears the corresponding economic risk. However, when accounting rules and imprudent business considerations dominate the allocation of economic ownership, the temptation is great to move exactly along

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those lines. The result of such efforts is that the capital asset disappears from the balance sheet, the capital basis shrinks, and the profit increases, even though the operative result remains the same.

What adds to these deficits is the variety of indicators used for governance: Operational performance usually is measured by external indicators such as earnings (e.g. EBITDA, EBIT) or margins, investments by the return they yield (e.g. ROI); capital allocation by cash indicators; corporate goals are often expressed in sales volume or profits; bonuses are typically based on the achievement of financial and operational budgetary goals. Last but not least, top management often centers its dialogue with investors around the next quarter's earnings (per share).

Second trap of abuse: The application of budgeting and capital allocation

Budgeting and capital allocation decisions do not occur in a vacuum. They are interlinked and highly dependent on the subsequent evaluation of the decision-makers' performance, and on the constraints top managers face when they reach out to communicate with investors.

Let's take a look at the process of a simple capital budgeting process that is quite common for companies: Suppose that an investment of €k 1,000 is to be assessed. The starting point is a projection on the future cash flows of the business (DCF Calculation) of which a project's Net Present Value (NPV) is calculated. Let's assume that it is positive for this project. If the project is expected to improve this year's operating profit from €k 20 to €k 80 and the annual return on investment, or ROI, from 2% to 6%, then it is a go.

In this case, the measures and motivations that count are totally inconsistent with the underlying DCF Calculation. Once the investment project is approved, managers know the investment will be buried in the balance sheet. When the projected earnings start to materialize, executives also start to realize that the companies' operating profits are likely to get a boost – even from many projects that in reality have a negative NPV (e.g. in cases where the projections had been all-too positive). Why? First, because earnings always rise when the project does not cover the associated cost of capital invested (in the aforementioned case, 8% times the investment of €k 1,000); the project is considered "profitable" when it simply covers current-period operating costs. Secondly, the problem with the standard Discounted Cash Flow (DCF) analysis is that it does not match the other parts of the management system, particularly the measurement system. In fact, the split between investment approval and performance measurement prevents a reasonable post calculation for projects. Once the performance is consolidated, nobody can examine the underlying assumptions.

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With this approach, operative managers consequently have a counterproductive incentive to get their hands on as much capital as possible – to help them to build their budgets, to build their businesses (in size) and to build their bonuses. Not surprisingly, capital always goes to the big divisions with the best track records, not the ones that can make the best honest case for added capital now.

Third trap of abuse: The system of management compensation

Given the backdrop of the counterproductive development sketched above, it is important to analyze the incentives that lead managers to specific behavior types: would the same decisions have been made and the same projects initiated if the decision-makers owned the company, or if they held an equal stake in the opportunities and risks of their decisions and the associated consequences?

Variable compensation has become quite popular in executive compensation schemes; the vast majority of European executives receive an incentive compensation portion. Stock options represent a widespread compensation tool. The effect is clear: managers are rewarded for opportunities, but pay insufficient attention to risks. This already establishes a basis for misguided incentives at more than 50% of all publicly traded companies, according to a recent survey. The higher the incentive of the stock option packages, the more the involved managers are rewarded for initiating projects and activities at elevated risks (associated with the expectation for higher profits). If the expected profits are generated, it has been worth it; if not, the option remains worthless. This means total gain or no loss, all or nothing. There are numerous examples of sales objectives that were meant to be implemented through external growth, but instead turned into value-destroying acquisitions.

Periodic bonuses are linked to the budgeted target of sales, earnings or any form of returns. Such a basis boots output at the expense of quality (value contribution). By looking more carefully at how the budget process itself drives compensation, the consequences for corporate behavior are quite obvious: Compensation is heavily influenced by political negotiations and individual "strategy". While investors and employees have to face the actual company success, management compensation is more a question of the distribution of power between executives and board. The result: goals that are considered easy to achieve are either likely to be elevated by the board or they just secure bonus for management. This process does not ask how to beat the previous year's performance. Every incentive to set ambitious goals in planning is impeded because the managerial compensation is likely to suffer.

There's more: Too often, incentives are linked to short-term performance. If bonuses are largely based on the results of one business year, managers may hesitate to invest in projects promising greater but longer-term success. They may even be tempted to manipulate accounting figures, stating results they cannot sustain in the long run.

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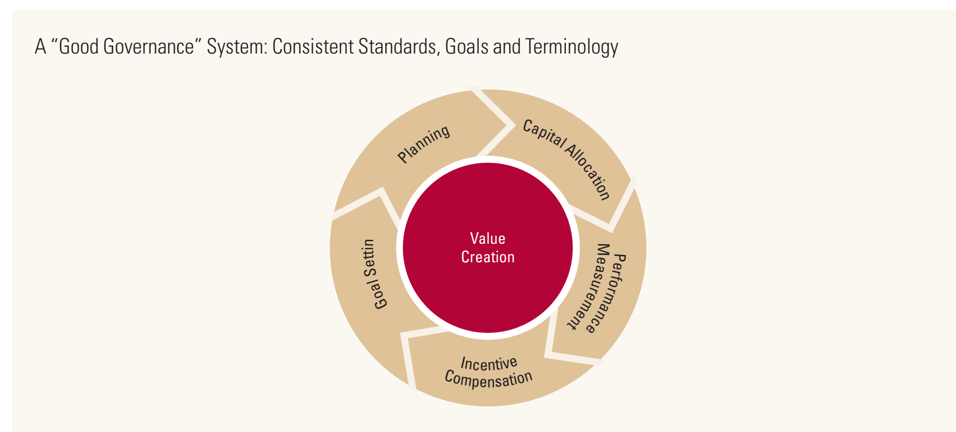
3 How to implement good governance

The key is to consider the governing objective – value contribution – as the center of corporate governance. This approach gives executives the information they truly need and uses consistent levers (in addition to publication and control regulations) to achieve responsible corporate management in the sense of prudent business practices.



A "Good Governance" System: Consistent Standards, Goals and Terminology

Performance Measurement & Goal Setting

A substantial prerequisite for the quality of corporate governance will be the way accountants are directed to measure the company's performance: by centering the mission on calculating and reporting "value creation" – profit the way that an economist measures it. A common indicator for "value contribution" is Economic Profit or Value Added. In contrast to book earnings, value contribution includes a charge for the use of all capital employed – equity as well as debt. Therefore, until a company earns a profit greater than its investors could earn on their own, the performance measure indicates that it really operates at a loss.

Ultimately, every strategy must be measured against the goal to create sustained value for the company: Boards and executive should therefore dedicate more attention to the company's true (or intrinsic) value – which is the present value of future value contributions – and less attention to share prices. The objective of internal and external communication, then, will be to ensure that the market's valuation is as close as possible to the company's true value. As a consequence, corporate and financial strategies will be logically connected. Corporate strategists will determine the vision, initiate the optimal mix of business approaches, and develop and oversee action plans – financial strategists will determine (and communicate) how the corporate strategy will contribute to value creation. There are three basic paths to value creation:

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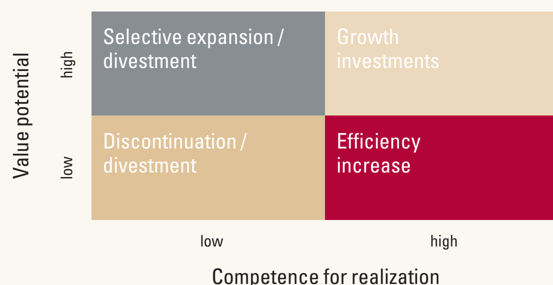
- >> **Profitable growth:** As long as the cost of the additional investment is lower than the profit generated by the business, the growth will create additional value.
- >> **Improving operating efficiency:** This includes all efforts where an investment will improve the company's returns.
- >> **Portfolio management:** The goal here is to free up capital in areas where it is locked up inefficiently. Once investors recognize that the activities initiated will promote an efficient use of capital, trust in the corporate management will grow.

Planning & Capital Allocation

The first requirement here is to overcome the obstacles of traditional budgeting: Severing the link between budgets and bonuses (see chapter 2) will eliminate the wrong incentives which have caused individuals to destroy value. The budget can then be used for its original purpose: to communicate the performance forecast and the resource allocation for the next year.

Capital allocation should be strictly aligned with the company's overriding strategic orientation. In practice, this means that every strategic option must be assessed against two criteria: First, will value contribution be possible at all, based on the inherent customer benefit and the market and competitive environment? Secondly, does the company have the capabilities required to realize this value potential?

Strategic Capital Allocation: Building Profitable Growth, Releasing Unemployed Assets



In a preliminary assessment, the three value paths discussed above can be allocated to certain combinations of value and realization competence: If high future value projections in a core business sector meet with a high level of competence (compared to potential competitors), growth invest-

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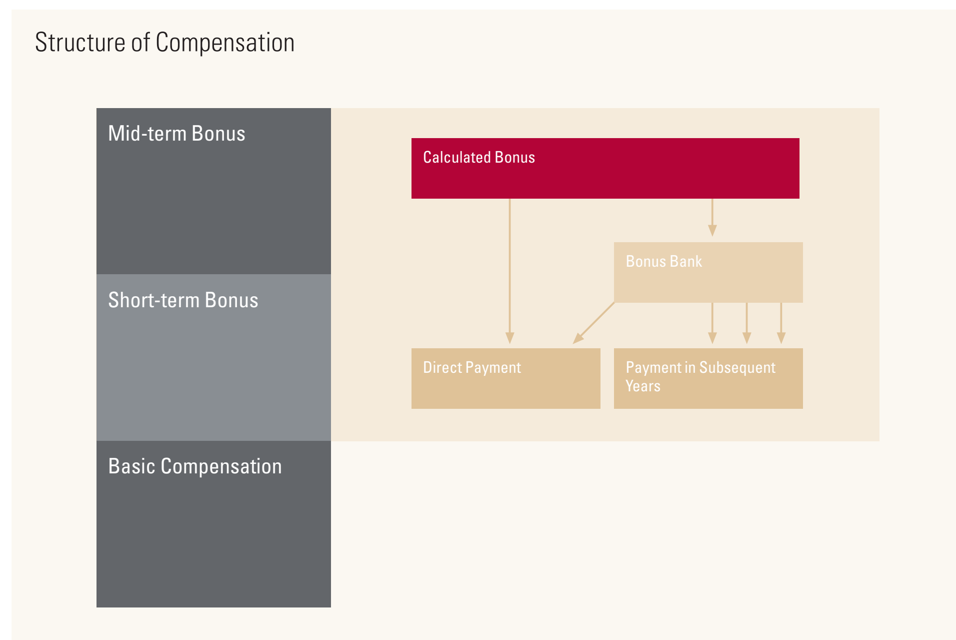
ments will likely be the path of choice. Low value potential, on the other hand, does not necessarily have to lead to the divestment of the unit in question: With a high degree of implementation competence, the company might be able to leverage this value potential by taking measures to increase efficiency. And in the reverse case – high value potential and low realization competence – the solution does not necessarily have to consist in competence building, as other market participants may be willing to pay substantial amounts for the high-value unit. Only if results are poor in both dimensions, there will be few alternatives other than divesting or closing down the unit.

Incentive Compensation

To encourage managers and employees to think and act like owners, the most effective incentive strategy is to pay them like owners. What this means is, above all, that bonuses must be based on actual value contribution (rather than a negotiated budget). This creates room for setting ambitious improvement goals. Secondly, managers' responsibility for entrepreneurial action must be emphasized by linking their compensation to business opportunities and risks. This means that value creation will be rewarded and the elimination of value will be sanctioned. Stock options as an incentive instrument clearly do not support this objective.

Structure of Compensation



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Another core requirement is that value creation (expressed as a clear improvement compared to the previous period) must be worthwhile at any point – regardless of whether the performance is still in the negative or already on a very high level. This means that the payment structure must be uncapped. Finally, in order to prevent an overly short-term focus and ensure sustained value creation, bonus payments must be tied to long-term value development. One way to do this is to establish a so-called bonus bank: Rather than being paid fully and immediately, annual bonuses are initially credited to a personal bonus account. A previously determined percentage of this balance is paid out every year, while the remainder carries over. Negative bonuses from bad years are entered into the bonus bank and are offset with the balance.

4 Proactive improvements pay out

Diligence is not just about disclosing more data, and is not centered on this issue. It is about providing a clear roadmap on how managers should make decisions that are in the best interest of their company. Since governance reforms have not gone to this length, more and deeper reforms are indispensable. In other words, the comply-or-explain principles may have to be expanded.

Companies that are serious about good governance should not stand back and wait: Rather, they should move to ensure the clarity, consistency and strategic alignment characterizing high-quality internal governance. There is no time to lose: First movers stand to gain ground on the competition.

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