Evaluating the Corporate Board

MOUNTING PRESSURE TO IMPROVE CORPORATE GOVERNANCE RESULTS IN NEW SCORECARDS.

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The frequency and magnitude of accounting failures and earnings restatements have increased dramatically in the past three years. Assorted experts have laid the blame on various policies, groups, individuals, and especially company boards and inadequate corporate governance.

Hoping to reduce the incidence of accounting failures and fraud, investors, creditors, insurers, and regulators are taking multiple approaches to improve corporate governance. In line with this, conscientious boards want to benchmark their companies' corporate governance against their peers. To that end, scorecards or yardsticks are available that evaluate boards and offer a benchmark for rating and comparing boards of directors and their practices.

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Because of pressure from various constituencies, Congress passed the Sarbanes-Oxley Act (SOX) in July 2002. Under the direction of the Securities & Exchange Commission (SEC), which is enforcing the Act's provisions, the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) have implemented new governance requirements for listed companies.

Further pressure is coming from the companies that provide liability insurance to the directors and officers of corporations. For several reasons, insurers have underfunded director and officer (D&O) policies, so, in order to correct this problem, the insuring companies have dramatically increased the prices of D&O insurance premiums. In fact, many large companies have seen their premiums increase by 200% to 400%. Also, in the September 16, 2002, issue of *Business Insurance*, Sally Roberts indicated that insurers are evaluating the composition of boards of directors and their compensation committees as well as the reasonableness of CEO compensation. In addition, insurance companies are using board scorecards to evaluate their risks in providing D&O insurance to a specific company.

BOARD SCORECARDS

Four rating services provide metrics that rank the quality of a firm's directors. Each rating service obtains most of its data from publicly available disclosure documents, but some, such as Institutional Shareholder Services (ISS), also seek additional information from press releases, news articles, and company websites. For a fee, most provide the rated companies an opportunity to review how scores are compiled.

We'll look at ISS, Standard & Poor's (S&P), Governance Metrics International (GMI), and The Corporate Library (TCL). Table 1 shows characteristics of the four major rating systems, and Table 2 outlines the categories used in each of the four scorecards.

Institutional Shareholder Services

According to Monica Langley in the June 6, 2003, issue of the *Wall Street Journal*, ISS carries the most clout. ISS started in 1985 by advising investors on how to vote on resolutions put before shareholders. In June 2001, it began rating companies in the Russell 3000 Index using its Corporate Governance Quotient (CGQ). ISS rates companies on a 0% to 100% basis relative to firms within their peer group and publishes firms' CGQ overall score and additional scores on each of eight categories. A total of 61 governance variables make up the eight categories. For example, 17 variables, such as member activities and response to shareholder proposals, make up the category of board structure and composition.

Table 1: **Characteristics of Corporate Governance Rating Systems**

RATING SYSTEM PROVIDER	INSTITUTIONAL SHAREHOLDER SERVICES (ISS)	STANDARD & POOR'S (S&P)	GOVERNANCE METRIC INTERNATIONAL (GMI)	THE CORPORATE LIBRARY (TCL)
NUMBER OF VARIABLES AND CATEGORIES USED	61 variables in 8 categories	Number not available. 4 categories	600 variables in 7 categories	Number not available. 6 categories
TARGETED CLIENT BASE	Companies being rated, institutional investors, other interested parties	Directors and officers of rated companies	Institutional investors and other interested parties	Institutional investors and other interested parties
COST	$10,000–$17,000 annual subscription fee	$75,000–$200,000 for review	$18,000 subscription–$50,000 comprehensive review	Variable hourly access rate and number of users (1–24) per year $3,000 to $80,000

Table 2: Categories Included in Governance Rating Systems

	ISS	S&P	GMI	TCL
NAME OF RATING	CGQ (Corporate Governance Quotient)	CGS (Corporate Governance Score)	GMI rating (Governance Metric International)	BER (Board Effectiveness Rating)
NUMBER OF SCORES	Overall + 8 categories	Overall + 4 categories	Overall + 7 categories	Overall + 6 categories
CATEGORIES*	1. Board structure and composition	1. Board structure and process	1. Board accountability	1. Board structure and makeup of skills
	2. Executive and director compensation	2. Financial stakeholder rights and relations	2. Executive compensation	2. CEO employment contracts and compensation practices
	3. D&O stock ownership	3. Ownership structure and influence	3. Ownership base and potential dilution	3. Outside director shareholdings
	4. Charter and bylaw provisions	4. Financial transparency and information disclosure	4. Financial disclosure and internal controls	4. Ownership
	5. Audit		5. Market for control	5. Accounting and audit oversight
	6. Takeover practices		6. Reputational and socially responsible investment issues	6. Board decision making
	7. Director education		7. Shareholder rights	
	8. Qualitative factors			

* Categories are listed according to similarity for comparison purposes rather than in order identified by service.

To find out the details of their scores, companies must pay a $10,000 to $17,000 subscription fee to ISS. The CGQ is published in ISS proxies of each rated company, which are used primarily by institutional investors. Thus, investors and other interested parties, for a fee, can use the CGQ as a distinctive element in investment decisions. You can find more detailed information at the ISS website at www.isscgq.com.

Standard & Poor's

S&P assesses a company's Corporate Governance Scores (CGS) based on the interactions among management, the board of directors, and financial stakeholders, but it emphasizes interactions with shareholders. The purpose of the S&P CGS is to enable senior management and directors to benchmark their own corporate policies. This is the most expensive rating service of the four. S&P doesn't publish these scores, but companies who pay between $75,000 and $200,000 for the reviews can use their scores as they choose.

After meeting with a company's management and directors and grading their responses based on the Organization of Economic Cooperation and Development Principles of Corporate Governance and other criteria, S&P assigns an overall CGS to the company plus a score for each of four separate components. They use a grading scale of 1 (lowest) to 10 (highest), unless a company refuses to provide meaningful information, in which case the company receives a 0. You can find S&P's 16-page "Criteria, Methodology and Definitions" from July 2003 under the section Corporate Governance Scores & Evaluations at www.standardandpoors.com.

Currently, S&P focuses on a firm's internal governance structure and processes, but in the future it intends to score individual countries within which a firm operates since various countries may have either weak or strong governance standards.

Governance Metrics International

Formed in April 2000, GMI began rating S&P 500 firms at the end of 2002. Using data from a variety of sources (public filings, news services, and others), GMI compiles a relational database of more than 600 metrics for each company and then sends the reports to the company for verification. Using company "corrected" information, GMI then creates a score of 1 (lowest) to 10 (highest) relative to other companies in the GMI universe that are being graded. GMI subscription fees start at $18,000 and increase to $50,000 for a comprehensive rating, which is a review initiated by a company's request to augment its rating.

Similar to the way ISS works, GMI produces an overall score and ratings on seven categories, but the number of variables is more than 600 rather than 61. The seven categories listed are somewhat different from those used by ISS but include many of the same issues. GMI's website is www.gmiratings.com.

The Corporate Library

The newest service, The Corporate Library (TCL), launched its online repository for corporate governance information in 2003. Nell Minow, a lawyer, shareholder activist, and editor, founded this system in 1999. She had been general counsel and president of ISS in its earlier days.

TCL's system differs greatly from the others. It uses different criteria than the others do, and where ISS, for example, may give a firm a very high grade, TCL may give the firm an "F." The key? TCL attempts to grade actions and policy implementation as opposed to policy making and what boards say they will do.

TCL's Board Analyst System rates 1,700 companies on corporate governance and boards' relationships among company management, their boards, and shareholders. TCL's Board Effectiveness Rating (BER) grading scale is "A" to "F," and it assigns an overall score and one on each of six key areas, as shown in Table 2. Ratings include individual directors' performance in terms of meeting attendance, willingness to question management decisions, stock ownership, and other boardroom actions. Minow is particularly interested in interlocking and cross-directorships, tenure, meeting attendance standards, and stock ownership.

Its ratings are primarily for sale to institutional investors, with subscription services ranging from $8,000 to $35,000. Because it doesn't accept fees from companies it rates, TCL advertises itself as the only independent rating system, and BER is the only one of the four systems to exclude the term "governance" from its rating name. The website is www.thecorporatelibrary.com.

WHICH ONE TO CHOOSE?

If a corporation embraces the scorecards, the next decision is which rating service to purchase, either for internal use or for evaluations of other organizations. There are some commonalities across the four scorecards. CGQ, CGS, and TCL look at board structure and CEO compensation. CGS and GMI include ownership structure and financial disclosure. CGQ, CGS, and GMI examine con-

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trol in terms of takeover practices or financial stakeholders rights. And there are notable differences. Only CGQ and BER include auditing. GMI is the only one to examine social responsibility.

These four services aren't the only ones that evaluate corporate governance and boardroom activities. For example, shareholder activists and institutional investors, such as TIAA-CREF, are developing their own rating systems for various purposes. According to the International Chamber of Commerce's website, TrueCourse's SharkRepellent.net uses 13 criteria to assess the takeover defenses a company has in place. Another organization, The Board Institute, developed a new internal board evaluation metric, which we'll describe later.

THE PROS AND CONS

The corporate scorecard may be worth purchasing for several reasons. First, a company can track improvements in its own governance practices. Second, board scorecards give companies another way to compete by adopting better standards of performance, which becomes a motivator for change and may demonstrate evidence of change at the higher echelons. High ratings will provide an additional marketing tool for investor relations departments. Third, meeting the letter of the law might increase the actual spirit of the law, particularly for proactive companies.

But corporate scorecards aren't perfect. First, as Langley mentioned in the June 6, 2003, *Wall Street Journal*, the rating services appear to have a conflict of interest. For some services, companies must pay to discover how they were scored, so they learn how to change their scores. Scorecards can appear to be a type of bribery when, by paying, companies find out how to improve their scores. The rating service then charges the investors fees for the scores, which results in the appearance of lack of independence.

Second, the subscribing company is often the one that must find any errors in the grading, which may result in costly and time-consuming use of company resources. One concern is whether the rating service or corporation being rated verifies the data. In many cases, a corporation's accountants and financial analysts will be the ones to review the data and provide the necessary corrections.

One final disadvantage is that simply improving the score doesn't mean the board actually performs better within closed meetings. Good corporate governance may be used to prevent business failures, but investors and others are really interested in success, so the ultimate issue is whether the corporation can make the leap from good corporate governance to good financial performance.

These scorecards are relatively new, so only time will tell the value of each one. Financial analysts and management accountants will certainly be involved in assessing the credibility and usefulness of these scorecards, and different groups may find different scorecards useful. Given this, a corporation may choose to pay for one or all of the scorecards, which is an issue for corporate accountants and investor relations departments.

BOARD-DRIVEN EVALUATION

Another scorecard is the *internal* board evaluation. The Board Institute developed a new Web-based, confidential index that directors complete. At the directors' discretion, those who work closely with the board may also complete it. The questions require both objective and subjective responses. The Board Index results, which cost $10,000 to

$20,000, are tabulated and provided to all the directors, along with guidelines for best practices and benchmarks developed from participating companies. The Board Index covers board structure and composition, role of directors, and leadership of the board.

The Board Institute is developing additional modules to evaluate board committees, such as the audit and compensation committees. Its website is www.TheBoardInstitute.com.

SOX AND STOCK EXCHANGE REQUIREMENTS

Among the new requirements in the Sarbanes-Oxley Act are greater independence of members of corporate boards of directors and increased accountability for accuracy of financial statements and adequacy of internal controls. SOX also imposes new requirements for a company's principal executive officer and principal financial officer, the audit committee of the board of directors, other directors, executives, principal stockholders, attorneys, and financial research analysts.

The most important SOX requirements related to corporate boards concern the audit committee, which must be composed of independent directors, one of whom should be a financial expert. The audit committee is to handle the contract with the auditors, has the power to hire other advisors, and must establish procedures to deal with accounting complaints and whistle-blowers.

Audit committees are also supposed to develop a written charter, discuss the financial reports, and meet separately with the external auditors, management, and internal auditors. If the external auditors experience any problems, they should discuss those with the audit committee members. Finally, companies are to develop corporate governance guidelines and codes of ethics and business conduct, and the audit committee should evaluate the company's risk management. Additional NYSE rules include allowing the audit committee members to receive higher fees than other directors in recognition of the greater work requirements.

Other SOX requirements related to the board of directors include prohibition of loans to directors and executive officers. Directors, officers, and 10% shareowners must report transactions in the company stock within two business days. These transactions must be posted at the SEC and the company's websites. Finally, directors and executive officers are prohibited from trading company stock during pension blackout periods.

Also, the NYSE and NASD exchanges have altered their listing standards to comply with audit committee independence rules. As in the SOX requirements, the audit committee is given oversight responsibility for the external auditors and other nonaudit engagements with the audit firm. Beyond SOX, the NYSE proposed rules requiring that a majority of directors be independent, defining independent to include no material relationship with the company in the previous five years.

How do scorecards relate to the Sarbanes-Oxley Act and stock exchange rules? The SOX and stock exchange requirements for directors focus on independence and audit committee supervision of the external auditor. The scorecards' criteria are much broader and incorporate other aspects of board performance, particularly financial results (CGQ/BER) and executive compensation. For example, the CGS scorecard looks at financial transparency and information disclosure, the GMI metric looks at reputation and socially responsible investment issues, and CGQ evaluates takeover practices and director education. While fulfilling SOX and stock exchange requirements is in keeping with the letter of the law, scoreboard ratings services appear to be increasing the stakes. Companies that earn higher ratings may, in fact, be responding to the spirit of the law.

THE ULTIMATE TEST

Good corporate governance doesn't necessarily guarantee good performance. It should reduce fraud and save corporations and shareowners money on D&O insurance, SEC fines, lawsuits, and perhaps business failure.

Shareholder activist Nell Minow told Lori Calabro in the March 2003 issue of *CFO* that, "The most important change will come from the market itself, when shareholders insist on better corporate governance." The ultimate test of improvements in corporate governance will be fewer earnings restatements and accounting failures, but a few years must pass before we can establish cause and effect. ■

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