Metrics of Corporate Governance

Regulators, investors, academicians, rating agencies and analysts are continually searching for tools that help to develop a pattern or metric that not only works as early warning signals but also gives insight into firms indulging in deception, fraud and corruption. But do these metrics really work? Let us look at some of the common metrics that the world of corporate governance uses as a measure of its effectiveness.

Big Four Auditor Myth

External auditors form one of the pillars of corporate governance of a company. Regulators and courts alike have designated auditors as one of the prime gatekeepers charged with ensuring that companies stay on the straight and narrow. Hence, the quality, size and expertise of auditors have become matters of public scrutiny. The world of audit firms presently consists of four big firms and other national level accounting firms and progressively smaller firms thereafter up to sole proprietors operating at local levels.

The 'big four' firms are Deloitte, PwC, E&Y and KPMG who carry out global operations in audit and professional services. Big four around the world audit a substantial number of publicly traded and private companies and therefore invest a lot of resources in developing auditing systems and conducting research for better processes. There is a perception that these firms through their high standards and rigour provide greater credibility to the financial statements they attest.

As a corollary, there is also a belief in the commercial world that smaller auditing firms are not in the same level of global reach and techniques as the big four firms and hence not in a position to carry out top end work spanning across geographies. Most large public companies by tradition employs a "Big Four" auditor and many companies, prior to an IPO, change their auditors from a domestic firm to one of the big four for greater acceptance of their numbers by global investors. Many private equity or venture capital firms include in the term sheet of investment, that the investee needs to employ a big four firm as its auditor.

But the perception about big four auditors creating higher levels of credibility of financial statements may not be entirely justified considering a recent analysis by COSO, the US body that revolutionised the understanding of corporate reporting and internal controls, that says ,"Fraud goes undetected by auditors of all types and sizes". Big Six/Four firms audited 79 percent of the fraud companies during the period of ten years they had reviewed.

The recent SEC ruling on the role of PwC in the Satyam fraud case questions the quality of work done not only in relation to audits of Satyam by the Indian affiliates of PwC but all other audits by the firm as well.

Given the level of size and ability to invest, a Big Four auditor provides, but necessarily not always, a backdrop of greater credibility. Hence the metric of a higher value just by having a Big Four auditor may not always be a prudent benchmark of corporate governance.

Sequential Quarter's Growth/ Analyst Calls Myth

Investors believe that companies that experience sequential quarter growth are on an upward trajectory of progress and thus a safe haven for investing money. Analysts predict future earnings and share prices of these companies and advise their clients to either buy or hold those shares.

Due to such market expectations, more and more companies try to meet or beat projections in order to grow market capitalisation and increase the value of options. The suspicion that consistently sequential quarter growth might have its origins embedded in earnings management has gained acceptance and popularity in recent times.

Many companies lay a huge emphasis on meeting expectations not realizing that there is no empirical evidence of any defined relationship between beating or meeting expectations and stock returns. (Study done by Kinney, Burgstahler and Martin, after analysing over 22,000 annual earnings). Over a period of time, companies may even get into bankruptcy and litigation when the fine line between earnings management and fraud gets breached.

SEBI has recently barred seven entities from dealing in the stock market after finding that they were involved in manipulating share prices of these companies on the day of listing of IPO's. Satyam had over many years manufactured earnings that never existed but all along had met 'guidance' figures.

Warren Buffet's sums up earnings management as 'Managers that always promise to 'make the numbers' will at some point be tempted to make up the numbers'.

Governance Ratings and Awards Myth

Several agencies have come out with a ratings methodology or criteria that claim to predict future performance of a company based on past or current governance metrics. Investors believe that governance ratings help to segregate their portfolios by identifying firms with good or bad governance and thereby reduce risks and optimise performance.

Is it possible to rate a company's governance standards or is it a myth? The myth factor gets more credence going by a study done by the Rock Centre for Corporate Governance at the Stanford School which examined more than 15,000 ratings of 6,827 separate firms from late 2005 to early 2007. The purpose of the study was to look for correlations among the governance ratings and five basic performance metrics: (namely restatements of financial results, shareholder lawsuits, return on assets, a measure of stock valuation known as the Q Ratio, and Alpha—a measure of an investment's stock price performance on a risk-adjusted basis.)

The results showed that there was no significant correlation between its Corporate Governance Quotient (or CGQ) ratings and any of the five metrics. Also the correlations were very small 'and did not appear to be useful'.

What about awards? Once again Satyam exemplifies this myth: it received the Golden Peacock Award for Excellence in Corporate Governance from the Institute of Directors in New Delhi in 2002 and again just few months before the fraud made headlines; Investor Relations Global Rankings (IRGR) rated Satyam as the company with Best Corporate Governance Practices for 2006 and 2007. Enron for years was voted as the most admired company in the world and won most of the global awards on corporate governance.

Ironically, governance metrics or receiving awards may end up forcing companies to tick the box when it comes to adopting corporate governance mechanisms, ignoring as it does the qualitative aspect of governance. Awards may be useful as an aspiration for companies to actually improve their governance mechanisms but often awards are a synthesis of limited public opinion about a company.

Metrics at best provide a standardized format about governance framework. To link metrics with effective corporate governance is probably oversimplifying a complex subject. For instance, the number of times the board of a company meets is a metric of good corporate governance. But it does not—indeed, cannot—capture the nature of discussions, value input of particular directors, how well prepared were the directors about board discussions and other value judgements.
And the reality is that there is still a long way to go before a truly workable model of governance metric is developed.

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