Critical Success Factors for Effective Corporate Governance

Winford E. "Dutch" Holland, Holland & Davis
Scott M. Shemwell, Oracle Corporation
Linda Wilson, Holland & Davis

Institute for Change Leadership

With the passage of Sarbanes-Oxley and ongoing reconciliation of reforms undertaken by the SEC and listing exchanges, the responsible legislative and regulatory institutions have assured growth for some parts of the economy lawyers, accountants, executive search firms, consultants, software companies, system integrators, conference producers, publishers and their supporting casts of thousands. The road to good intentions, governance-wise, is being paved with a host of new services and products aimed at helping public companies interpret, implement and integrate "good governance" in their people, practices and business processes.

But effective governance involves a lot more than just having ethically sniff-testable executives or the latest whiz-bang Sarbanes software. The Holy Grail of effective corporate governance getting it and using it to advantage requires some strategic rethinking of how the corporation relates to and serves a different set of customers: the investors. This article posits that effective governance requires a focus on both the company's traditional customers and its investor customers. Good governance is much more than ethical executive behavior; it requires that critical success factors be in place: the right company values, management competencies, ethics, governance processes, and information systems that feed from a comprehensive data base of single instance information.

Governance has never been more important for businesses than it is today.

Good governance counts in good sense and dollars and cents. Companies with good governance will have better access to capital. Governance is factored into credit ratings in the sense that it reflects and influences management behavior and their dealings with stakeholders.

"But simply adopting sound corporate policies is not enough to improve ratings, lower risk and gain market confidence. Companies need to rigorously implement these policies and develop long-term records to be consistently good corporate citizens; the benefits are obvious. Stock markets, shareholders and creditors will reward a company with higher liquidity by increasing share price premiums relative to its peers and making more credit available at a lower cost. Ultimately, the cost of capital will be lower for companies with good reputations for fair dealings, all other things being equal."[1]

"The end game of effective governance is positioning the corporation to succeed. The need to compete successfully, to attract capital and to provide a competitive return to investors is the market reality for all publicly traded corporations. And to succeed, they must attract capital at competitive rates and perform in an efficient and accountable manner."[2]

Commenting on surveys that indicated the value of good corporate governance, Nigel Payne wrote, "If companies could capture but a small proportion of the governance premium that is available, they would create significant shareholder value. Moreover, those companies that fail to reform will find themselves at a competitive disadvantage when it comes to attracting capital to finance growth. High governance standards will prove essential to attracting and retaining investors in globalised capital markets, while failure to reform is likely to hinder those companies with global ambitions."[3]

Companies with good governance will be worth more.

The overall governance capability of any company depends on tangible attributes that we call "governance critical success factors." This article examines these critical success factors and illustrates what a company will need to go through over time to develop them to a level that will enable effective governance.

For years no academic research showed a clear causal link between governance and financial performance. However, new research from faculty at the Harvard Business School offers new perspective to the subject. Using the incidence of 24 governance rules at 1500 large firms, researchers constructed an index to proxy for the level of shareholder rights at each firm during the 1990s. "An investment strategy that bought firms in the lowest decile of the index (strongest rights) and sold firms in the highest decile of the index (weakest rights) would have earned abnormal returns of 8.5% per year between 1990 and 1999."[4] The study also found that firms with stronger shareholder rights had higher profits, higher sales growth, lower capital expenditures and made fewer corporate acquisitions.

[1] "Building Investors confidence with Corporate Governance," Daniel R. Kastholm, Institutional Investos, Sept 2002
[2] OECD: Improving Competitiveness and Access to Capital in Global Markets
[3] Nigel Payne, Bcom(Hon) CA(SA) MBL, is General Manager, Transnet Group Audit Services. He is a member of the King Committee on Corporate Governance.
[4] "Corporate Governance and Equity Prices," Paul Gompers, Joy Ishii and Andrew Metrick, National Bureau of Economic Research Working Paper No. 8449 and forthcoming in the *Quarterly Journal of Economics*, Feb 2003

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A Global Investor Opinion Survey[5] undertaken by McKinsey & Company, in cooperation with the Global Corporate Governance Forum, found that over 75% of the 200+ fund managers polled would be willing to pay more for businesses with strong governance policies. Premiums averaged 12-14% in North American and Western Europe, and more than half of the North American investors polled said that governance issues are as important as companies' financials when deciding which stocks they invest in.

A company's overall governance capability depends on tangible attributes that we call "governance critical success factors." In the body of this article, we examine these critical success factors and illustrate what a company will need to go through over time to develop them to a level that will enable effective governance. But first, what is today's definition of governance and why is governance vital to the life of a firm?

Governance is now being more widely defined.

In the broadest sense, governance can be thought of as the mechanisms that ensure the efficient deployment of resources and distribution of wealth. The classic definition:

> Corporate governance is the set of rules, laws, and institutions that regulate the relationship between the shareholders and the managers of a corporation.

Modern interpretation has broadened "shareholders" to "stakeholders" to include employees and local communities, although the broadened term brings practical issues of accountability into question. Directors and officers accountable to "everyone" are in practice accountable to no one.

The Conference Board views corporate governance as "a management system to provide an essential framework for boards, managements and shareholders to define, manage and balance critical strategic performance measures. These measures go beyond the usual bottom-line indicators and deal with a wide variety of compliance, quality and environmental and human capital issues to enable a company's board and its management to assess whether a company can reach its strategic objectives. Thus, it not only mandates but also systematizes many of the things we have come to expect from good governance."[6]

The challenge of meeting expectations in general is already complex enough in a global economy, where corporations operate in a number of different legal, regulatory, cultural and business environments. Nevertheless the movement to improve the "fit" between corporations and the societies in which they operate will mean strengthening the governance structures and practices within corporations and their Relationships with owners and other interested parties. "Good corporate governance and corporate responsibility are no longer add-ons to markets; they are integral to them."[7]

Beverly Goldberg and John G. Sifonis, authors of Corporation on a Tightrope, propose a new perspective on governance. "Governance involves control, accountability, responsibility and authority areas that are often only vaguely understood or defined. It is critical to how well organizations perform, determining the nature of the relationships within the organization as well as between the organization's representatives and those outside. The dynamics of these relationships will determine how well an organization can shift directions in response to external events."[8]

And it's not about redrawing the org charts, changing titles or publishing new policies and procedures. It is about an updated definition and a more robust practice of corporate governance in which the board and all the company's managers work in concert so that all major stakeholder categories experience effective performance. But the practice of governance will be dependent on critical success factors that enable effective practice.

A new perspective for governance is needed.

"Corporate structures change fast, while financial innovation and globilisation all present new challenges to maintaining good corporate governance. The recent high-profile cases of governance failure and corporate misconduct have shown that corporate governance mechanisms sometimes have not kept up with these developments. Nor have company boards lived up to their responsibilities. We need to develop governance tools and incentive structures that are more robust in the face of rapid financial innovation, and procedures that leave no doubt a to the stakes involved."[9] In short, what is needed is a new way of looking at governance, a way that can build on what managers already know and can be put into action quickly.

A customer-oriented model of governance: Under several banners (e.g., service improvement, reengineering, process improvement, culture shift), corporations have spent the last 10+ years reorganizing -- strategies, workflow, information, financial data, job definitions, performance measures and even locations around the customer. From the top of the organization down to the shop floor, people can articulate how their work relates to serving the company's traditional customers the good folks who purchase the company's products and services.

Traditional Customer (C1) Model for the company's products and services: The model shown in Figure 1 is

[5] "Global Investor Opinion Survey: Key Findings," McKinsey Global Investor Opinion Survey on Corporate Governance, 2002
[6] "Governance As A Management System," Carolyn Kay Brancato, *Directors & Boards*, Fall 2001
[7] "Corporate Governance and Responsibility: Foundations of Market Integrity," Bill Witherell, *OECD Observer*, October 2002
[8] John G. Sifonis and Beverly Goldberg, Corporate on a Tightrope: Balancing Leadership Governance and Technology in an Age of Complexity, Oxford University Press, 1996
[9] "Corporate Governance and Responsibility: Foundations of Market Integrity," Bill Witherell, *OECD Observer*, October 2002

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familiar to employees worldwide. Through a chain of command, senior leadership charts a course aimed at designing, developing, producing, reliably delivering and servicing widgets (products or services) to targeted customers at competitive prices, collecting revenues and utilizing resources for optimal return on investment.

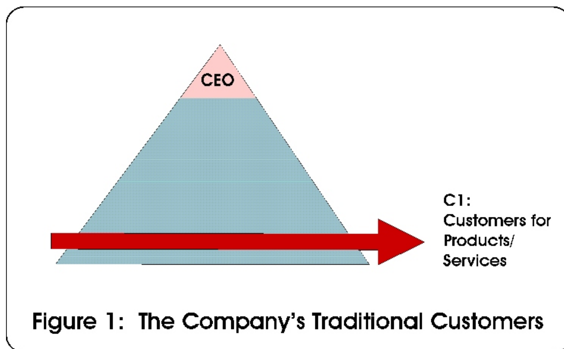

Figure 1: The Company's Traditional Customers

Whether the company is more hierarchical, with multiple divisional and departmental managers, supervisory levels and line level employees, or more flattened with minimal layers between senior management and line level employees, most everyone in today's process improved organization has the company's customers directly in their line of sight. We have sophisticated technologies to help us understand these customers and make decisions based on the cost: value associated with acquiring and retaining them. We research markets and segment customers; we build one-to-one lifetime relationships with them; we develop a deep understanding of their needs and expectations; we focus jobs around understanding and fulfilling customers' needs; we customize products/services for different segments; we measure their satisfaction with our products/services; we get input from them on new or improved products/services we darn near dream about them at night.

Dual Customer Model required for good governance: As it turns out, this "new religion" orientation to serving C1 customers only a 50% success story. That same laser-like focus needs to be applied to the company's other customers the good folks and institutions who buy company stock and corporate bonds. In a very real sense, one set of customers funds ongoing operations (the annual budget) while the other set enables the company to plan and allocate capital for future operations (the vision or rolling 3-5 year plan). The dual customer model, as shown in Figure 2, adds a second customer-driven focus:

> Designing, developing, producing, reliably delivering and servicing an economic investment for targeted C2 customers at competitive prices, collecting revenues and utilizing resources for optimal return on investment.

For example, a company that builds shopping centers in order to provide C1 customers

- *Affordable space in convenient neighborhood centers in areas of high residential density*

could present itself to C2 investors as

- *A conservative investment anchored in tangle assets that can be physically evaluated.*

While there is an actionable understanding of roles and behaviors in terms of the traditional C1 customer at multiple levels, the number of people in the modern corporate who have an actionable understanding of roles and behaviors in terms of the company's C2 customers are few … and these few reside at the very apex of the corporate hierarchy.

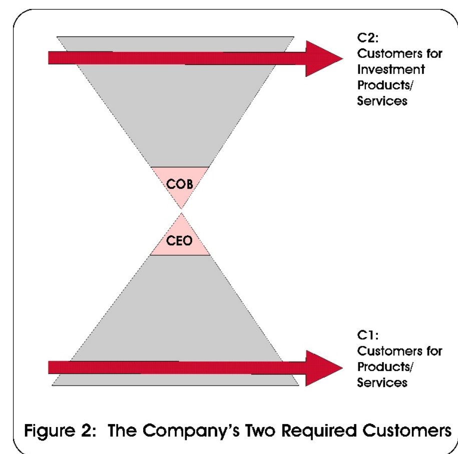

Figure 2: The Company's Two Required Customers

Corporate America may already be under-performing in communication and interaction with C2 customers. A 2001 survey by PricewaterhouseCoopers[10] examined the way that pharmaceutical and healthcare companies communicated with the markets. Results indicated a large gap between the companies' perception of their communication effectiveness and the market's assessment of their efforts. While most companies thought they were very proactive in their communications, only 8% of investors thought that the companies had an active dialogue with them, and 28% of investors thought that companies initiated contact only when they had new information.

The consequences are significant. Over the past year, buy-and-hold investors, a market-stabilizing force, have taken billions in capital out of play. As a whole, Main Street appears far from ready to risk savaged and salvaged cash reserves for another fling. And today's market volatility is unlikely to go away soon.

[10] "Transparency: Rewards Likely to Come from Greater Openness," Adrian Preston, *The Financial Times*, Nov 15, 2002

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Further demonstrating the law of unintended consequences, regulatory and accounting standards reform, intended to protect investors from corporate wrongdoers and wrongdoing, are serving to create more earnings surprises. Corporations are rethinking how they publicly handle forward earnings. Coca-Cola, Pepsi, AT&T and McDonalds have announced they will no longer project quarterly earnings per share. And analysts are so sensitive to increased scrutiny that they many are loathe to make any kind of bold warning calls that might be wrong (more lawsuits) or might be right (investigated for having inside information). These are dangerous waters being treaded, certainly unlikely to restore investor confidence in the short term.

Critical Success Factors for Effective Governance

Much of the central focus for governance reform is in the boardroom roles and responsibilities of directors and company officers and shareholder, auditing and compensation practices. In theory, a more independent board composition, clearer roles for directors and committees, and enhanced executive responsibility and accountability are supposed to prevent future misdeeds and scandals of the Enron, WorldCom, Global Crossing, Tyco, Vivendi and Marconi types.

Yet endless examination of these and other corporate failings demonstrate that what looked like good governance on paper was woefully lacking in practice. For the most part, blame can be shared equally between the stunning absence of business ethics among key corporate leaders and the absence, or at least weak execution, of boardroom governance processes. At an even deeper level, a company's overall governance capability depends on tangle attributes that we call "governance critical success factors."

The essential requirements for a governance capability are considerably beyond having an ethical and well-meaning executive team. Figure 3 illustrates what we believe are four meaningful and manageable success factors that, when present to a threshold performance level, will enable a company to have effective governance:

Governance work processes: specific, explicit work steps designed for effective governance

Information tools: tools that support governance work processes and that give managers the ability to manage those processes well

Integrated database: a real-time, accessible repository of structured, single instance data that generated by the day-to-day operation of the company

Governance leadership: including both competencies of management to use governance processes and tools as well as the company values and ethics practices to bound management behavior

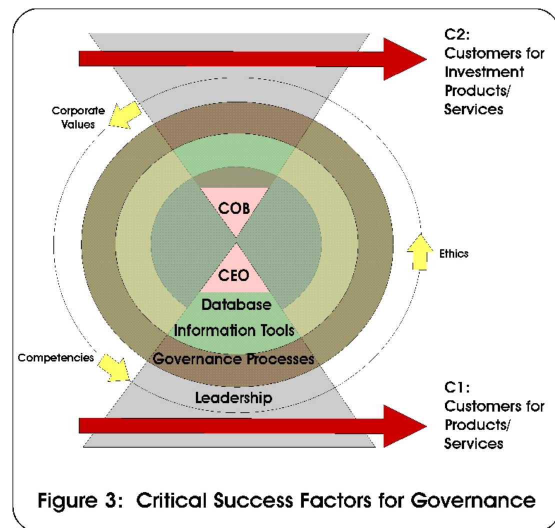

Figure 3: Critical Success Factors for Governance

The set of critical success factors are obviously interrelated, with each factor being necessary but not sufficient for effective governance. The following section is designed to explore in more detail these critical success factors.

Governance Work Processes

As discussed earlier, in most companies, processes for C1 customers are explicit and performance is actively measured and managed. In contrast, processes for C2 customers are generally a mixed bag, with some processes explicit, some processes implicit and some entirely unspoken. Seldom are the roles, responsibilities and execution of duties on behalf of C2 customers seem as processes to be proactively managed. What is sorely needed in many companies today is a dual approach to governance.

Governance processes may not need so much of a reformation as they do a transformation to deal with the rights and obligations of shareholders and stakeholders. For C2 investment customers, governance should address value creation through ownership and should delineate…

- The company's value proposition to investment customers
- Attributes of the company that support the value proposition
- Key processes for governance, including roles and responsibilities for people throughout the organization who impact the company's performance in delivering value
- Measures to evaluate performance on processes
- Measures to evaluate leadership performance

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- Results … and expectations for future performance
- Rights of shareholders and stakeholders
- How and how often performance audits will be done

Corporate governance could be considered as the set of organizational processes that leaders use to manage the performance of the company as a whole. As shown in Table 1, many basic processes for doing business with conventional customers (C1 focus) can also be translated for business with investment customers (C2 focus).

When viewed with the dual customer model, governance takes on a significantly different look than today's conventional public company organization chart. For corporate governance, Investor Relations, Corporate Communications, Public Relations, Compliance, Finance and Legal Services are key resource processes, but they are not at the heart of true governance. IT in the 21st century is in a position to provide critical and indispensable information tools that support corporate governance and business processes … and create significant competitive advantage for the company with both its C1 and C2 customers.

Without question, greater transparency is the goal of new regulations from Sarbanes-Oxley, the SEC and listing exchanges that require CEOs and CFOs to certify the accuracy of company information, to provide more immediate information on insider sales of company stock and to organize it in a way that is understandable to the average investor. In spirit, the intention is clearly to improve the accuracy, applicability, timeliness and overall quality of dialogue between the corporate and its investment customers.

But compliance with this legislation is not governance either. And companies that focus their search for good governance on "Sarbanes-Oxley processes" for getting executive signature may keep their executives out of jail, but these compliance steps alone will not be the vehicles that provide good governance with its better access to capital and increased company value.

Effective boards establish clear and comprehensive performance criteria and qualitative measures for the CEO … and for the board itself and its members. Many executive compensation plans have linked pay to performance, although in too many cases, an unintended consequence of

Basic C1 Processes	Basic C21 Processes
• Identify markets - groups of customers where the company's products/services might be sold	• Find capital markets that fit with the company's risk profile (e.g., High risk, conservative, fast growth, etc.) • Understand which markets will be responsive to the company's risk profile • Structure and communicate the tangible benefits for C2 customers
• Develop and package products/services that can be sold in those markets	• Define and package the attributes of the investment (as opposed to the product/service) so that the company appeals to the target investment markets
• Get orders (make sales) for the company's products/services to individual customers within those markets	• Determine the ideal forums for exchange with target investment markets (e.g., road shows, analyst meetings, webcasts, institutional advertising, investor conferences, etc.). • Orchestrate the exhange and prepare for the sales team (e.g., CEO/COB, CFO, IRO) for Academy Award winning performances
• Produce and deliver the products/services that fulfill the customer's orders	• Manage governance so that the company delivers on its promises to owners/markets (e.g., dividends, forward-looking earnings statements, strategy execution, business goals, corporate citizenship, etc.)
• Provide support to customers after delivery of products/services	• Meet or exceed C2 customers' expectation for business performance that is consistent with the company's investment profile • Within the framework of legal and regulated exchanges, adequate and timely information about significant trends, results and events that impact the company's ability to perform and/or position in capital markets

Table 1: Examples of Basic C1 and C2 Processes

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the linkage was less than scrupulous manipulation of performance results for the benefit of the linkees. The concept is still valid with a caveat. To ensure attention to the long-term health of the company, best practice boards, in working this process, find the right incentives to help leadership make the hard choices for the long-term prosperity of the business, using tools such as balanced scorecards to drive forward-looking performance in both financial and non-financial areas. Equity incentives are now being structured so that options cannot be exercised for some period of time, even retirement.

Outspoken investors will not sit by silently as compensation committees authorize outrageously out-of-proportion salaries or vote to lower the bar in order for CEOs of under-performing companies to receive their incentive packages. The "back-up" safeguard processes, for better or worse, are more visible than ever before. The number of proxy filings has grown significantly as owners seek to remove poorly performing directors and redress imbalances. And the number of shareholder lawsuits will keep corporate counsels and private attorneys employed for the foreseeable future.

Information tools that serve governance processes

A good number of governance processes and supporting processes require timely access to information and the capability to communicate on demand with one or thousands of people. In this sense, a company's Information Technology systems, processes and people are not only vital to efficient business operations, but a potential source of competitive advantage to be exploited for the firm's success with both C1 and C2 customers. "Excellence" is the minimum acceptable performance standard for governance work in corporations that expect to thrive in the coming years. "Immediately" is the only acceptable timeframe for corporations that wish to survive in the coming years.

Both regulations and trends have converged to move information technology and tools from the back office towards core business and governance functions. With both the CEO and CFO personally responsible for the accuracy of reporting to shareholders and regulatory bodies, information management takes on a materiality that is inconsistent with the back office mindset of the past. It is important for executives to have the appropriate information readily available as well as a new set of information management tools to better interpret the data. And now that companies have reengineered workflow processes, many are looking to streamline processes across the extended enterprise and its supply chain. Customer Relationship Management, Supply Chain Management and other Enterprise Resource Planning systems are among the tools of the extended enterprise.

Common rules for looking at the data: Central to any discussion around information technology is the role of data management. Increasingly, the data avalanche is swallowing corporate villages in its path. Many firms are starting to count their data at the petabyte (quadrillion bytes) level.

- "the typical American consumer now generates some 100 gigabytes of data during his or her lifetime, including medical, educational, insurance, and credit-historydata, says James Rothnie, chief technology officer at storage-system vendor EMC Corporation. Multiple that by 100 million consumers and you get a whopping 10,000 petabytes of data."[11]
- Sun Microsystems stated that it had shipped an aggregate of two petabytes of storage or the equivalent of 40 million four-drawer filing cabinets full of text.[12]

With an increasing amount of this data required to be on-line, availability and security are critical to operational efficiency. Many once defined *e-commerce* as the buying and selling of commodity products over the Internet. Today, we define *commerce* not as just procurement, but the full range of interactive processes throughout the extended supply chain as well as with internal controls such as travel and expense account management.

Organizations and their partners must share data if the full capabilities and efficiencies of the team are to be leveraged for competitive advantage. Effective decisions can only be made if all parties are simultaneously using the same data. Referred to as a "single instance" of the logical data set, this single version insures that regardless of where individuals are physically located, they are working together on the same data. This approach insures that…

- Decision support systems are consistent across the globe.
- Business intelligence is available to those that need it in a timely manner.
- Executive "dashboards" provide the information necessary for good governance.

The Internet is the fundamental data communications vehicle. Organizational information must flow across the wire if the value of network economics is to be gained by the firm.[13] When data is transmitted, either passively to customers accessing the corporate Web site or actively such as in collaborative project management, data must be secure. Online businesses require systems be operational 24x7. Revenue and customer-facing IT systems cannot be "down." Downtime translates into lost revenue in real-time and lost credibility for a long time. Who wants to do business with a company whose critical systems are not

[11] Whiting, Rick. (2002, February 11). Preparing for a Petabyte Future Tower of Power: IT managers brace for the inevitable petabyte-size databases. *Information Week*. http://www.ncr.com/repository/articles/data_warehousing/petabyte_future.htm
[12] http://searchstorage.techtarget.com/sDefinition/0,,sid5_gci212777,00.html
[13] Shemwell, Scott (1999, July). Economics of Networks: A Little Trivia About How the Knowledge Age Actually Works. New Millennium News. Author.

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available and where there is concern about the integrity of the transaction?

Flexible business intelligence tools: In its raw format, data is not very useful. Software applications acquire, process, analyze and present data in a format that is functional for executives. Business intelligence applications transform data into useful learning.

Executive dashboards are designed to provide information tailored to the needs of the specific individual and his or her role and responsibility in the firm. For example, the CEO requires information that is useful from a strategic perspective, such as assessing possible acquisition candidates, while the COO may use the same intelligence to enhance operational effectiveness.

Housing a single instance of the corporate data store while assessing it for different, but aligned purposes insures that a cost effective approach to information management adds value to the firm. Time lost transferring or transposing data to support different requirements not only increases IT costs, but potentially limits decision-making processes as well.

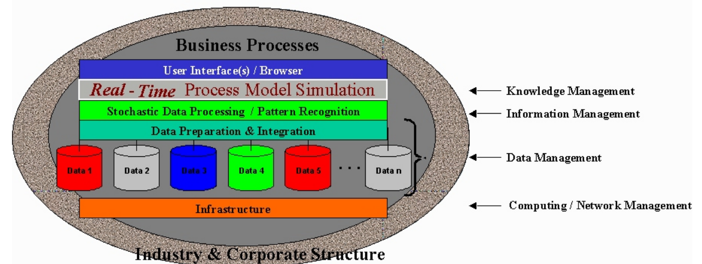
Flexibility is key to optimal corporate performance. The corporate world moves rapidly, and quick but good decisions are necessary to insure and sustain competitive advantage. Moreover, recent governance driven actions by regulatory agencies demand that business intelligence and reporting be accurate. Not only the financial reporting, but all aspects of the firm's operations including its supply chain and even customer base.[14]

Data structure and databases that support effective governance ... and cost controls

When the organization depends on single instance data availability for its operational excellence, failure is not an option. When the nervous system of the information economy is online, in real time, significant revenue can be at risk, not to mention the firm's reputation and possible exposure to litigation. In this environment, systems must work 24x7 and must be bulletproof both physically and logically.

Using a data architecture that integrates at the data middleware, as opposed to across applications, enables the extended enterprise to truly share data in real time. A single logical instance of the data enables all users, against appropriate security levels, to see a *single version of the truth*.[15] By amalgamating the enterprise data into an environment where all users can use the entire data mix as required to conduct their work, not only are IT costs dramatically reduced, but work process times are shortened and users are more informed decision makers. The end results: the stage is set for the organization to take out significant cost (20% or greater) while insuring better control and security.

The near future holds tremendous opportunities to further change the business landscape. Real-time and near real-time access to data and information brings the prospect of optimizing the entire business. This approach to "End Game Management" capitalizes on key technologies providing single instance data and content management data and information in context as interpreted by a knowledgeable individual/group to add significant economic value using gaming techniques and other simulation algorithms.[17]



Knowledge truly is power when it is properly utilized. In the near future, asset management will entail the use of sophisticated data acquisition, data reduction and statistical process to condition data to best capitalize on real-time business process models. Users will utilize advanced dashboard technologies to literally fly the organization. Asset optimization, from a business perspective, will include the use of market and economic data in addition to the operational data associated with the process.

If the economy is an information system, then companies must put into place the structure, process and enabling technology to reap economic benefits. "Off the shelf" information tools are available to structurally change the way organizations do business and do governance. As shown in Figure 4, by using the Structural Dynamics Management Model,[18] the full force of the Information Age will be brought to bear on business problems. The technology enablers are available today, and organizations that understand their value can achieve early adopter positioning at little risk. If your company is not doing or pursuing this capability, you may already be behind your current competitors. You may be playing a costly game of catch up with new firms that have built this capability into both their business and governance infrastructures.

Effective governance leadership

On a routine basis, the interests of the corporation's owners

[14] DiPiazza, Samuel A. and Eccles, Robert G (2002). Building Public Trust: The Future of Corporate Reporting. New York: John Wiley & Sons.
[15] "Spatially enabling Our Global Business," Jerry Larthe de Langladure. Paper presented at Oracle OpenWorld, 2001.
[16] "The New Business Imperative: Using the Internet to Boost Your Bottom Line," The Economist Intelligence Unit e-briefing, 2001
[17] "Understanding Structural Dynamics: Key to Success in the Knowledge Age, Scott M. Shemwell, 1999 monograph
[18] "The Value of Business Process Simulation," Scott M. Shemwell, 1997

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are represented by the Board of Directors. In the U.S., the roles of chief executive and chairman of the board (COB) are more often than not held by the same person. Generally, the company spokespersons to its investment customers are the CEO/COB, the CFO and on occasion other "C" level executives, with the support of the firm's Investor Relations group, external auditing, legal counsel, corporate communications and/or public relations groups. And generally the form of communication follows proscribed formats for reporting financial data, management outlook and issues before the shareholders, plus an opportunity for the CEO and executive team to review highlights of the year and give an overview of future plans. More recently, Internet technology has enabled wider C2 customer access to periodic teleconferences with analysts and institutional investors. Otherwise, the typical forums for interaction with investment customers are limited to periodic face-to-face meetings with major individual investors and the annual shareholders presentation.

Leadership Competencies: In his 1976 book The Unseen Revolution, Peter Drucker, in his usual provocative and prescient way, pointed out a key trend in the ownership of U.S. companies:

"If socialism is defined as ownership of the means of production by the workers -- and this is both the orthodox and the only rigorous definition -- then the United States is the first truly Socialist country.

"Through their pension funds, employees of American business today ... own at least 25% of its equity capital, which is more than enough for control. The pension funds of the self-employed, of the public employees, and of the school and college teachers own at least another 10%, giving the workers of America ownership of more than one-third of the equity capital of American business. Within another 10 years the pension funds will inevitably increase their holdings, and by 1985 (probably sooner) they will own at least 50% -- if not 60% -- of equity capital. Ten years later, or well before the turn of the century, their holdings should exceed around two-thirds of the equity capital ... plus a major portion -- perhaps 40% -- of the debt capital (bonds, debentures and notes) of the American economy. Inflation can only speed up this process."

Drucker's suggestion is tracking right on target. The most critical competency today's leadership can develop is the ability to relate to the firm's new owners the institutional investors and their representatives who are now showing up on the board. And the part of the corporation best positioned to help leadership do this? The Board of Directors. And the processes best positioned to demonstrate to the firm's owners that they are receiving due recognition during boardroom discussion and decision-making? Corporate Governance.

Successful leaders will utilize their boards more like arsenals, with directors carefully considered strategic elements in the arsenal. Each director will be a "strategy" for designated purposes as well as ownership's representative for corporate oversight. CEOs and chairmen will build boards like the corporation's ownership builds their investment portfolios with criteria, goals and future performance expectations in mind. Successful leaders will actively steward the implementation and execution of governance processes that serve to attract, protect and grow the firm's capital.

Corporate Values and Ethics: Simply put, values and ethics are the mostly-unspoken bases for the attitudes, actions and decisions of a company and its employees toward customers, partners, suppliers, competitors, regulators, local communities and other groups the company interacts with. Defining and formally explaining the corporation's values and ethics helps clarify for employees and customers this typically gray area. Most important to any conception of ethical behavior, of course, is how leaders act in terms of compliance to the rules of behavior. Setting minimal standards signals minimal importance in the scheme or things. Setting strict standards can be a powerful message, as long as the motivation is sincere and not an attempt to avoid even stricter standards. Violating any standards, or rewarding people who do, signals organizational tolerance and encouragement for such behavior.

As a foundation for governance, corporate codes of ethics must be put in place and communicated inside and outside the organization. Building these rules to both fit and formulate the company's culture involves discussion about the meaning of terms such as *ethics, values, integrity, compliance, trust, openness* and *"doing the right thing"* that starts with senior leaders. Once the rules or code of conduct is developed, compensation plans must be aligned and practiced so that adherence is rewarded and violation punished at every level. Implementation involves leadership interpretation so that each part of the organization knows what constitutes ethical behavior in the workplace and in specific jobs in essence, a social contract between the firm and each employee.

Again, the part of the corporation best positioned to ensure ethical "tone at the top?" The Board of Directors. And, again, the processes best positioned to demonstrate to the firm's owners that values-aligned business practices are indeed being practiced … and their mispractice punished? Corporate Governance.

Given the atmosphere of distrust among many investors and the highly publicized perp walks and prosecution of corporate wrongdoers, no corporation that expects to have

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successful relationships with C1 and C2 customers can afford fuzzy values or inadequately defended ethics … or their consequences.

Bottom Line: Better governance may well be the fundamental business driver of the decade.

“Corporate structures change fast, while financial innovation and globalisation all present new challenges to maintaining good corporate governance. The recent high-profile cases of governance failure and corporate misconduct have shown that corporate governance mechanisms sometimes have not kept up with these developments. Nor have company boards lived up to the responsibilities. We need to develop governance tools and incentive structures that are more robust in the face of rapid financial innovation, and procedures that leave not doubt as to the stakes involved.”[19]

Our point throughout this article has been that companies have two sets of customers … and that the high performance companies of this and future decades will be those with a “customer” focus on governance. It has taken awhile for companies to figure out that we can't just push products onto customers. We've learned the hard way that substantial and enduring effort must be made to understand and serve customers. Consequently, corporations spent much of the last decade mass customizing products and services, reengineering business processes, buying ever more robust hardware, implementing sophisticated software, and Realigning compensation with an eagle eye on their customers.

Corporate America is in the painful process of recognizing that the people and institutions involved the ownership of their companies need to be recognized as customers too customers for the company's investment products and services. Leaders will likely spend much of this decade reorganizing the “shape” of their investment products, orchestrating innovative ways to communicate with a mistrustful, ever more demanding marketplace, reengineering governance processes, buying compliance and reporting software and implementing powerful tools that improve information flow and decision-making, and realigning compensation with an eagle eye on serving their investment customers.

What's at stake in this effort? Bet-your-company, bet-your-career and even jail time issues about maximizing shareholder value, business continuity and security, transparency and internal control, regulatory compliance, liquidity and sustainability. Capital markets will continue to demand assurances that investments will be protected and stewarded appropriately. To survive and thrive, companies must now apply what they learned how to do with their C1 customers to their C2 customers … and learn how to maintain and balance a laser-like focus on both.

[19] “Corporate Governance and Responsibility: Foundations of Market Integrity,” Bill Witherell, *OECD Observer*, Oct 2002

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