PAPERS ON CORPORATE GOVERNANCE - SUMMARY

In the absence of sincere manifestation of interest at the top, little will happen below...

Joseph Juran
The Corporate Director – 1968

WHAT IS CORPORATE GOVERNANCE?

Corporate governance is a structural system of institutional policies, implementing rules and business controls that establish a framework under which corporations are managed and operate. This framework governs all actions of corporations from initial founding, through their period of entrepreneurship and growth, through their development into a mature structure for their administration and governance, and to the point of their exit of the market as an independent identity (by merger, dissolution or insolvency).

What is the current state of governance that Greenspan referenced? The current practices focus the decision authority on the CEO – the board of directors provides oversight while management provides advice and executes the final decisions (using authority that is delegated by the CEO). When all power is focused into one position, the question that is always raised is the degree of checks and balances to assure ethical conduct – do actions taken benefit all of the stakeholders and not just one dimension. This is a core problem as perceived by the reformers – they want to have a broader distribution of decision-making authority than the centralized focus in a CEO.

However, a board of directors fills a crucial role in the accountability chain representing interests of the owner-investors – both legal and moral owners (society when the corporation consumes public resources may be considered to have a moral ownership right to the corporation) – and operators who work in the business processes of the firm to meet its operational mission. The board does not exist to support staff – it serves to represent ownership provide a controlling voice. The owner-representative authority of a board of directors is executed as a single unit, prescribing organizational direction – providing limitations on the staff means to achieve an end without directing the specific means that the staff takes to achieve the desired results.

The governance process sets policy for corporate decisions using the principles of policy management [also known as hoshin kanri and policy deployment] – an approach that enables extensive empowerment to staff while preserving business controls necessary for accountability for shareholder-owners. The system of policy management includes both strategic direction setting as well as the deployment of the policy to the organization. It provides a moral and ethical foundation of values, a framework for exercising all of the management disciplines, an approach for precision in delegation of authority, as well as a long-term focus on the organization's purpose rather than on its operational actions. In this context, how is quality governance achieved?

While board members are usually intelligent and experienced persons as individuals. Yet boards, as groups, are mediocre. Indeed, boards have been the subjects of much derision:

- "Effective governance by a board of trustees is a relatively rare and unnatural act ... trustees are often little more than high-powered, well-intentioned people engaged in low-level activities."
- "There is one thing all boards have in common ... they do not function."
- "Ninety-five percent [of all boards] are not fully doing what they are legally,
- morally, and ethically supposed to do."
- "Boards have been largely irrelevant throughout most of the 20th century."

In the wake of the Enron debacle, there has been an intense call for more independence of boards, separation of CEO and chair roles, rigorous audit committees, as well as much more responsible accounting. Interestingly, almost all recommendations put forward involve enhancing the current features of boards. These recommendations offer a series of improvements that are defined by a set of 'best practices' that do not establish a system for governance.

When a set of disjoint best practices are integrated into a management system, this can create managerial confusion because they do not fit into a higher-level governance process. When a systems approach is not used for setting a management framework, board members and senior managers suffer confusion between their roles creating a conflict between strong board and management components of the business model that may, in turn, lead to either a situation where the management pre-empts the authority of the board or the board micromanages management. Neither alternative is a healthy situation.

What is a better way for boards to work? Boards must serve as "devil's advocate" and "sounding board" for management. Board members should refuse to engage in rubber- stamping executive initiatives or the micromanaging the activities of the business leaders. In general, boards must become far more enlightened and more competent as groups than they have been.

Gregory H Watson
President and Managing Partner Business Systems Solutions, Inc.
Corporate governance requires quality leadership;
ASQ World Conference con Quality and Improvement;
Seatle; May 15 -2005

One of the most basic principles of business success recognized by those of us who have spent our careers in corporate leadership is the great management value, the absolute organizational strength and the essentiality to economic and social responsibility of effective Corporate Governance.

Effective Corporate Governance is key to generating and supporting continuously strong and meaningful corporate profitability and growth in today's brutally competitive global markets. It is fundamental to a company's integrity throughout its human, customer, public and financial affairs that is the necessary condition for the genuine and lasting business growth of today's twenty first century organization.

And our experience shows that effective Corporate Governance is a key foundation for providing the all-important business operating results of:

- Empowering a company-wide culture of superior performance, and
- Providing and emphasizing consistent customer value leadership throughout all the company's products and services.

Armand V. Feigenbaum
President and CEO General Systems Company
The Impact of Corporate Governance;
ASQ World Conference con Quality and Improvement;
Seatle; May 15 -2005

Governance is in fact a whole, which involves different logical functions of the business: 1) overall strategic guidance of the company; 2) global company system oversight; 3) management of the company according to the general strategic directions, with the broad mission of generating maximum value for the company itself and its stakeholders in the long run; 4) monitoring for compliance with laws, regulations, ethical behaviors, environmental and social responsibilities. The above logical functions are quite often combined, particularly in the case of the smaller companies. In general, different kinds and degrees of overlapping are present in all organizations

Tito Conti
Managing Partner, Organizational Assessment Management S.A.A.;
A set of quality assessments aimed at improving corporate governance
ASQ World Conference con Quality and Improvement;
Seatle; May 15 -2005

WHAT IS QUALITY?

Quality is one way to describe the "goodness of the results" or outcomes accomplished by a corporation. With such a results focus, quality becomes a value proposition. How this value is developed, managed and captured is the work of the corporation's leaders and managers. In a simple model of business activity, quality is assured through the effective design of innovative goods and services for real needs in competitive markets and through the consistent production and delivery of these goods and services to their final consumer.

A competitive product design is based on understanding expectations of customers and serves as the basis for the market promise from the corporation. Once a promise has been made the act of consistent promise keeping represents the second dimension of quality – reliable performance against its promises made. In considering where this performance can go wrong there are three types of defects observable:

- A Type I Defect occurs when organization do not keep its promises to the market.
- A Type II Defect occurs when organizations do not design product to meet the expectations of its market or targeted customers.
- A Type III Defect happens when Type I and Type II defects occur simultaneously.

Gregory H Watson
President and Managing Partner Business Systems Solutions, Inc.
Corporate governance requires quality leadership;
ASQ World Conference con Quality and Improvement;
Seatle; May 15 -2005

WHAT HAS QUALITY TO DO WITH CORPORATE GOVERNANCE?

Quality is a substantive part of Corporate Governance. It is about how the Board really looks at corporate governance as a value-added principle of its business proposition.

Philip Amstrong
Former Head of the Global Corporate Governance Forum
International Finance Corporation

The plain answer is that quality is a concept that applies to any relation where people are involved, whether individual or collective (Conti, 2003). Corporate governance consists of relations - and important relations in fact - the most important being that between the board and the CEO.

Relations always imply material and immaterial exchanges, which are valued by the involved parties according to their needs and to their subjective - or inter-subjective, or objective - scales of value. In business relations, the main value that is normally considered is fitness for purpose (to what extent what we receive fits our purpose). That holds true for economic transactions, but also for business-related meta-economic relations (like the relations between the different governing bodies). Quite often the main quality problem in business relations is lack of definition of the expected values, followed by lack of delivery of the agreed upon values. Lack of definition often comes from inadequacy of goals or of agreed upon rules. Lack of delivery can be ascribed to inadequate control and to absence of systematic assessment. Rules of corporate governance are certainly the first point to address, since it seems that many huge problems have emerged around the world due to too much distraction from the rules. But beyond the primary need for rules, synergy and cooperation will be claimed here as the most critical success factors in corporate governance.

The second point that needs to be addressed is control, in relation to the application of the defined rules. Finally, the issue of how quality assessments can be applied to corporate governance, to check the effectiveness of the rules in achieving the planned results and to identify areas for improvement, is worth a specific discussion. The latter - assessment for improvement – is in fact the core theme of this paper; but first some basic points will be recalled – or proposed – to create the framework for the discussion.

Tito Conti
Managing Partner, Organizational Assessment Management S.A.A.;
A set of quality assessments aimed at improving corporate governance
ASQ World Conference con Quality and Improvement;
Seatle; May 15 -2005

Fred-Henri Firmenich is Chairman of the Board of Firmenich International, with Headquarters in Geneva, Switzerland. Is also member of the Board of the Sandoz Corporation and the Swiss National Bank.

He believes that a strong board makes a first-class management even stronger and that a professional board makes management even more professional. Being a multinational group, he states that local Boards should be an extension of the Group Board.

The Board should have more outside members than internal and, in addition to control management should participate in developing the vision, mission and major strategies, inter -acting with the executive management. The objectives should be proposed by management and approved by the Board.

The drawing of the line between the two bodies (Board and Management) should be care -fully done. A good quality Board does not invade the management functions.

The Board, according to Fred-Henri Firmenich, must have an informed and independent view of the company. A high quality Board should be the primary force pressing the company to the realization of. its opportunities and the fulfilment of its obligations to its shareholders, customers, employees and the communities in which it operates.

Dr. Marcos E.J. Bertin
Quality on the Board of Directors

According to Barnard, leadership has two aspects: technical leadership and moral leadership. Technical leadership is: "local, individual, particular, ephemeral. It is the aspect of individual superiority – in physique, in skill, in technology, in perception, in knowledge, in memory, in imagination." It is "subject to specific development by conditioning, training, education; significant chiefly in conjunction with specific conditions; relative; rather easily determinable, comparatively objective; essential to positive action; commanding admiration, emulation."

On the other hand moral leadership is "more general, more constant; the least subject to specific development; the more absolute, the subjective; that which reflects the attitudes and ideals of society and its general institutions. It is the aspect of individual superiority in determination, persistence, endurance, courage; that which determines the quality of action; which often is most inferred from what is not done, from abstention; which commands respect, reverence. It is the aspect of leadership we commonly imply in the world 'responsibility,' the quality which gives dependability and determination to human conduct and foresight and ideality to its purpose."

This aspect of leadership yields the highest expression of responsibility – "the power of a particular private code of morals to control the conduct of the individual in the presence of strong contrary desires or impulses." So, Barnard defines responsibility as an outcome of moral leadership: "the property of an individual by which whatever morality exists in him becomes effective in conduct." (Barnard, 1936, pp. 260, 263. 267)

Effective leadership of an organization requires as a foundation the relatively easier to develop "technical leadership" while requiring exemplary "moral leadership" to assure that the organization will endure. Thus, a Board of Directors must establish the moral framework for the organization: purpose and long- term vision or strategic direction.

However, quality in governance has to do more with two specific aspects: the process of governing and also the content or result of the governance outcome. In its previous work the International Academy for Quality (IAQ or Academy) has defined good governance as:

"'Good governance' describes quality in terms of the response of the organization to its guiding principles and strategic direction: does it do what is right, reliable and responsible to assure the desired performance within a context of holistic oversight that is provided through the system of business controls? Good corporate governance must focus on ensuring that corporations take into account the interests of a wide range of constituencies (stakeholders such as customer-consumers, investor-owner-shareholders, employee-associates, legal-regulatory, and communities in which it operates) and that the board of directors is accountable to both the company and its constituents." (Bertin and Watson, 2007, p. 18)

Thus, "good governance" must specify both the targeted outcomes (results to be managed) as well as the process by which it will obtain these results (business operating methods). While the Board does not specify the specific content of the process, it should be held accountable to assure appropriate methods are used to determine "what and when" the organization will respond to the "why and how" of its policy. Perhaps the biggest implication of this observation is that any commitment towards improving the quality of management in an organization must include improving the quality of its moral leadership and this must begin with the Board itself and its establishment of the cultural foundation that is deployed as the spirit of the organization.

Marcos E. J. Bertin
Bertin Quality Consulting, Buenos Aires, Argentina
Gregory H. Watson
Business Excellence Solutions, Ltd., Espoo, Finland
The Requirement for Quality in Corporate Governance
World Quality Congress, Budapest, Hungary
june 20-23, 2011

WHAT IS 'GOOD' CORPORATE GOVERNANCE?

Good governance is often observed in its absence – the failure of business leadership to provide adequate due diligence or responsible oversight. In recent years abuse of the top leadership positions of public companies has lead to escalating emphasis on issues related to shareholder responsibility, corporate ethics, and executive compensation. In response to the recent Enron – Arthur Andersen and the Worldcom crises, there has been a call for reform in administration of governance with an emphasis on increasing ethical behavior of management and avoidance of conflict of interest among the competing corporate stakeholders.

This interest has focused on corporate reform in both public and private sectors for the way that top executives and board members are held accountable. This call for transformation in the 'rules of governance' is projected to grow as dissatisfaction with the execution of governance provides justification to focus attention on the issue: what is good governance? Good governance delivers benefits to each organizational stakeholder – but the question that is debated is which stakeholder rights are most significant.

Good governance plays an important role in the process of assuring customer satisfaction with the management of business in all areas from the flawless manufacture of products and consistent execution of services. It also assists in assuring employee satisfaction with such issues as equitable distribution of fair compensation packages and security of the work environment. The way an organization is governed particularly assures the shareholders that management will make all decisions at 'arms length' and consider ownership's fiduciary interests as a priority. In short, governance defines the value context of the organization and shapes the direction of its mission while setting the long-term business perspective for ethical conduct and effective public responsibility. This paper focuses on the role of quality as a management practice for establishing and implementing processes that support good corporate governance and assure long-term, mutual success for all stakeholders in the modern corporation.

The role of business leaders and board members in this management system is to set the guiding policy and strategic direction that the organization will execute in the future, while the role of business leaders and their team of operational management is to execute the firm's strategic direction within the context of the board's delegated authority.

Based on this model of a business system 'good governance' is quality in terms of the response of the organization to the guiding principles and strategic direction: does it do what is right, reliable and responsible to assure the desired performance within a context of holistic oversight that is provided through the system of business controls?

Good corporate governance must focus on ensuring that corporations take into account the interests of a wide rage of constituencies (stakeholders such as customer-consumers, investor-owner-shareholders, employee-associates, legal-regulatory, and the communities in which the corporation operates) and that the board of directors is accountable to both the company and its shareholders.

Gregory H Watson
President and Managing Partner Business Systems Solutions, Inc.
Corporate governance requires quality leadership;
ASQ World Conference con Quality and Improvement;
Seatle; May 15 -2005

A fundamental determinant of effective Corporate Governance is the clarity and visibility of the responsibilities and ongoing activities of the company's Board of Directors. This requires, among other key demands, the specificity of the definition and assurance of the responsibilities and relationships within the Board and among its members and between the Board and the CEO.

And, because what is measured and evaluated well in corporate affairs will be managed and implemented well in corporate action, a basic demand for establishing and assuring such effective Corporate Governance is a clear, systematic and well-structured process for its measurement and evaluation. This report on *The Impact of*

Corporate Governance on the Quality of Management provides such a process for evaluation of a Board of Directors.

Armand V. Feigenbaum
President and CEO General Systems Company
The Impact of Corporate Governance;
ASQ World Conference con Quality and Improvement;
Seatle; May 15 -2005

WHAT CONDITIONS MUST BE SATISFIED IN ORDER TO HOLD BOARDS AND MANAGERS ACCOUNTABLE?

What does it take to hold someone accountable for the quality of his or her work? There are three necessary and sufficient conditions that must be met for management to be able to properly hold individuals as accountable for the quality of their work. All of these three conditions must also be met in the following sequence in order for them to operate:

- *Defined expectations* – Employees must have clear knowledge about the expectations of management – people must have good knowledge of the work they should accomplish and proper preparation in right way to perform work procedures (effective training) as well as the resources needed to get the job done (resources refers to material, equipment, information and time).
- *Capability to perform* – People must have knowledge of the standard of performance that they are being asked to attain and an objective measurement system must be in place to assure that the data is being collected objectively to evaluate this performance and provide the necessary knowledge required to operate the work process so people can effectively and efficiently address the set of expectations (and thereby assume the delegated responsibility).
- *Ability to self-regulate their own work* – People must have the ability to observe the work process measures and to make decisions about corrective action in order to keep their process operating according to the standard when they are not going to meet the original expectations for desired performance targets (and thereby exercise their delegated authority to manage within the limitations of control that has been granted to them).

When these conditions are met, then an individual may be appropriately held accountable for the quality of their work – this includes the board's initial delegation of authority to a CEO as well as the CEO's delegation of authority to the organizational management (this authority delegation is cascaded, with prescribed limitations, like the tree diagram that is the structure of the organization chart. A delegation diagram that is constructed using a decision tree format is one way to assure clarity in expectations for the limitations of the decision and fiduciary authority that has been entrusted to different levels of the firm. The effective delegation of authority and appropriate accountability for work are key elements of good governance.

Gregory H Watson
President and Managing Partner Business Systems Solutions, Inc.
Corporate governance requires quality leadership;
ASQ World Conference con Quality and Improvement;
Seatle; May 15 -2005

THE POLICY MANAGEMENT APPROACH TO CORPORATE GOVERNANCE

Policy management delivers strategic direction through breakthrough projects that deliver the long-term performance goals for achieving sustainable business strength while, at the same time, delivering an operating plan for achieving short-term performance through the daily management system of the organization.

Four steps (I) define policy setting (or establishment of the subjects for these strategic projects), (II) deployment (or propagation of these projects throughout the organization to engage the resources of the operational layers of management), (III) implementation (or integration of the results of change into the daily management system), and (IV) review (the monitoring and assessment of the results achieved from this process). These four steps define a business improvement cycle.

Throughout this process the actions of the board are focused on defining the policy while the management’s actions are focused on translating the board’s improvement policy into improvement projects and then deploying the improvements generated by these projects into full-scale implementation in the daily management process. Finally the executive and board conduct regular reviews of the policy to assure implementation reflects intent of the policy. Some specific actions across these four steps include:

- Identifying critical business assumptions and areas of vulnerability (board)
- Identifying specific opportunities for long-term improvement (board)
- Establishing business objectives to address the most imperative policies (board)
- Setting performance improvement goals for the organization (board/management)
- Developing change strategies to address business objectives (management)
- Preparing an annual policy implementation plan for the organization (management)
- Defining project charters for implementing each change strategy (management)

- Implementing the change projects (organization)

Gregory H Watson
President and Managing Partner Business Systems Solutions, Inc.
Corporate governance requires quality leadership;
ASQ World Conference con Quality and Improvement;
Seatle; May 15 -2005

THE BOARD TASKS

In his book Management Tasks, Responsibilities and Practices, Peter Drucker described three functions that must be performed by a Board of Directors:

1. The Board is a review organ to help management control itself: "a group of experience people, people of integrity, people of proven performance capacity and proven willingness to work who counsel, advise, and deliberate with top management." "Somebody has to make sure that top management thinks through what the company's business is and what it should be. Somebody has to make sure that objectives are being set and strategies are being developed. Somebody has to look critically at the planning of the company, its capital-investment policy, and its managed expenditures budget. Somebody has to monitor people decisions and organization problems and has to be the 'supreme court.' Somebody has to watch the organization's spirit, has to make sure that it succeeds in utilizing the strengths of people and in neutralizing their weaknesses, that it develops tomorrow's managers and that its rewards to managers, its management tools and management methods strengthen the organization and direct it toward objectives." (Drucker, 1974, p. 631)
2. The Board is a disciplinary body to assure management effectiveness: "An effective and functioning board is needed to remove a top management that fails to perform." (Drucker, 1974, p. 632)
3. The Board is a representative of the organization's constituency to assure that the results the organization delivers are aligned with their expectations: "The enterprise needs a 'public and community relations' organ. It needs easy and direct access to its various 'publics' and 'constituents.' It needs to hear from them and to be able to talk to them. The central fact is that the modern enterprise has a multiplicity of constituencies. The shareholders are one. But they are no longer the one, as traditional legal theory has it. The employees are clearly also such a constituency, but they are not, as the German trade unions (or the 'industrial community' laws in various Latin-American countries) assert the constituency. There are also the communities where a major company has its plants. There are consumers, suppliers, and distributors. All of them need to know what goes on in a major business, what

> its problems, its policies, and its plans are. The business needs to be understood by them. Top management needs even more, perhaps, to understand what these constituencies want, understand, misunderstand, see, question." (Drucker, 1974, p. 632-633) "The governing board of directors must be a board that represents the basic long-term interests of the enterprise. It must be capable of discharging its function as the review organ and as the supervisor of top-management performance." (Drucker, 1974, p. 267) [Note: The duties that are legally required of the members of the Board of Directors are owed to the company, and not to a specific constituency of the company (Baxt, 2007, p. 35)]

"The Board is an organ of review, of appraisal, of appeal. Only in crisis does it become an organ of action – and then only to remove existing executives that have failed, or to replace executives who have resigned retired, or died. Once the replacement has been made, the Board again becomes an organ of review." (Drucker, 1954, p. 179)

Drucker had a superficial approach to defining roles and responsibilities of the Board compared to that of Joseph M. Juran and J. Keith Louden. In his book Managerial Breakthrough, Joseph M. Juran identifies the need for a "steering arm" in the organization that acts with "unity of purpose" based upon the new knowledge that it generates during diagnostics of the organization's performance (Juran, 1964 p. 75-154) At the apex of an organization, this is a role of the Board of Directors. Juran and Louden define three key activities of a Board of directors: (1) setting strategic direction for breakthrough (Juran and Louden, 1966, pp. 46-57) (2) policy formulation, and (3) assurance of control (Juran and Louden, 1966, pp. 130-153). Organizations must identify what they mean by long-term as this identifies the region of specific attention from a Board of Directors. Most organizations define short-term as a period that extends from the current date about three years and many define long-term.as beyond this period. However, some companies are known to have declared long-term as a planning horizon that is 10-25 years from the current date and they may even distinguish what they focus on within this period (e.g., facility or real estate decisions are made on the 10-25 year horizon, while technology acquisition and partnerships are based on a 5-10 year horizon and new product development decisions are within the 5 year planning horizon). Policy formulation is the act of making explicit the "intent or direction based upon a philosophy or belief that serves to guide the actions of people within the company." (Juran and Louden, 1966, p. 52) "For all practical purposes the Board has no measurement machinery of its own." (Juran and Louden, 1966, p. 142) The Board must assure the integrity of the measurements provided by management and must also assure an independent auditor is used to evaluate from both internal and external perspectives (including the audit of the quality system and all other performance elements affecting materiality in an organization's performance results).

Typically, all the various constituencies of an organization are lumped together and called stakeholders. But, some stakeholders have a major financial stake in the company as well as a role in the company. In the case of effective Boards of Directors, Drucker notes that the most effective Boards had both of these components. (Drucker 1992) Thus, whenever the entrepreneurial role of the directors is weak, then the moral motivation toward responsibility of the directors may also suffer weakness. So, what does it take for an organization to have good governance?

Marcos E. J. Bertin
Bertin Quality Consulting, Buenos Aires, Argentina
Gregory H. Watson
Business Excellence Solutions, Ltd., Espoo, Finland
The Requirement for Quality in Corporate Governance
World Quality Congress, Budapest, Hungary
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PRINCIPLES OF GOOD CORPORATE GOVERNANCE?

Governance is based on three cornerstone principles: ownership, stewardship and accountability:

- *Principle of Ownership* – Ownership is a principle that describes the way an individual cares for a resource. Owners will establish a system of business control for preservation of capital and risk management methodologies for defining and operating with their personal comfort zone for potential loss of capital (or any owned asset) in order to achieve their desired level of return.
- *Principle of Stewardship* – Stewardship is a principle that directs a person to take responsibility for the management of resources that have been entrusted into their care by an owner. Corporate stewardship implies that the value of capital investments is preserved and enhanced by the actions of management. Stewardship impacts all business issues (e.g., social, health and environmental ramifications of the production methodologies as well as the use and eventual disposal of products). The primary roles in assuring stewardship in the life cycle of a product typically involve manufacturers, retailers, service providers, consumers and government. Stewardship acts on behalf of these participating communities to preserve value and exercise due diligence in the management of the organization's resources to achieve is purposeful ends.
- *Principle of Accountability* – Delegation of authority and resources from anowner to a designated steward brings accountability for how the authority is used and how the resources are deployed or consumed.

Gregory H Watson
President and Managing Partner Business Systems Solutions, Inc.
Corporate governance requires quality leadership;

The Organization for Economic Co-operation and Development (OECD), a non-aligned, non-governmental organization that was initially established to help manage the Marshal Plan, has also produced a set of principles that should define good governance:

Ensuring the basis for an effective corporate governance framework	The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities
The rights of shareholders and key ownership functions	The corporate governance framework should protect and facilitate the exercise of shareholders' right
The equitable treatment of shareholders	The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights
The role of stakeholder in corporate governance	The corporate governance framework should recognize the rights of stakeholders established by law or through mutual agreements and encourage active cooperation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises
Disclosure and transparency	The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company
The responsibilities of the board	The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders

Gregory H. Watson
Business Excellence Solutions, Ltd., Espoo, Finland
The Requirement for Quality in Corporate Governance
World Quality Congress, Budapest, Hungary
june 20-23, 2011

GIVEN THESE PERSPECTIVES, HOW SHOULD 'GOOD GOVERNANCE' BE OPERATIONALLY DEFINED?

The following modest proposal is made to operationally define 'good governance' in the context of corporate management. 'Good governance' occurs when all of the following conditions are met:

- *The board sets policy that defines the purpose and long-range vision* of the total corporation and places limitations on the methods and style that management may use to achieve its purpose [under conditions where shareholder requirements are known and defined as objectively measurable and auditable business objectives].
- *The board establishes framework for execution* of the way that the organization may elect to meet these business objectives (moral, ethical and legal boundary conditions that limit the actions of management) and describes this framework in terms of guiding principles or policies that the organization is obligated to apply.
- *The board deploys this policy to the CEO* for further delegation to the operational managers through the business management organizational structure.
- *The board reviews performance* against the objectives using an objective system of measurements that reflect the concerns of all major corporate constituencies.
- *The board encourages the CEO to self-regulate* the action of the organization in order to achieve the desired results.
- *When the organization is found to be operating outside its business control system that was been established by the board*, then boards must take corrective action to bring realign the organization [if they do not do so, then inaction will undermine the authority of the board that has been granted by the corporate stakeholders].

Gregory H Watson
President and Managing Partner Business Systems Solutions, Inc.
Corporate governance requires quality leadership;
ASQ World Conference con Quality and Improvement;
Seatle; May 15 -2005

GOVERNANCE FOR SME SUSTAINABILITY AND GROWTH

Significant changes in the global economic environment require major improvements in the governance of organizations. Such improvements are essential for SMEs led by an entrepreneur (or patron, in Spanish and French). These small businesses have a major impact on the economy as a main source of new jobs and are strong contributors to innovation. However, as a result of poor management and inadequate governance practices, SMEs experience a high rate of failure during their early stages.

Plenty of information is available on how to improve existing governance structures in SMEs. But very few resources focus on the initial stages of growth in a company with only a successful CEO (in this case, “chief entrepreneur officer”) responsible for what to do to develop good practices and assure sustainability.

This paper introduces IFC’s “growth-oriented governance model for SMEs,” a very effective tool for entrepreneurs around the world. It will be useful for business owners as well as governments, academics, and governance professionals.

I had the opportunity to advise SMEs in South America and in the United Arab Emirates, sometimes in one-day company seminars or with small groups of chief executive officers from different kinds of businesses. I was especially impressed with the excellent proposals on “what to do during the first year, to start with,” particularly in the groups of peers from different companies. It was noteworthy that all agreed that the recommendations must be good for their business at each stage of the corporate governance journey, which closely resonates with the main point of the IFC Governance Methodology.

For example, with some smaller companies, I found that it was initially helpful for the owner to have an adviser with whom to discuss ideas, as the methodology suggests. Just the process of presenting a project to an outside adviser usually significantly improves the entrepreneur’s own knowledge of the subject, and further improvement comes with fielding the adviser’s questions. This is one of the most basic methods for management improvement, and it paves the way for later establishment of a good board of directors for guidance and approval of strategies and plans.

The framework also addresses other major concerns that I observed in SMEs. For example, it helps small businesses improve company culture and guides family-owned businesses through the process of formalizing family engagement through bodies such as family councils.

Marcos E. J. Bertin
Bertin Quality Consulting, Buenos Aires, Argentina
Governance for SME Sustainability and Growth
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Good governance is important for the growth and sustainability of organizations of all types and all sizes—large, medium, and small. While it is widely accepted that "one size does not fit all" (for example, Arcot and Bruno 2006), there is far less research and guidance on good governance for small and medium companies.

Instead, most of the governance guidance currently available for SMEs amounts to scaled-down versions of governance solutions developed for larger, listed companies. This approach fails to account for a variety of unique SME risks, characteristics, and practices2 and thus has limited applicability in helping SME leaders fulfill their companies' purpose and potential. This is especially true in emerging markets where companies often operate with severe resource constraints.

For SMEs to benefit from the introduction of good governance, a fundamental shift in the overall approach is necessary. We need to help SMEs grow into governance organically by offering solutions that are fit for purpose as the company evolves from start-up to mature business.

This paper introduces the IFC Governance Methodology for SMEs, originally developed by a multiregional team of IFC governance specialists3 and based on an innovative approach:

- We started from the distinctive realities of SMEs at different organizational stages of growth.
- Then we identified specific challenges that SMEs need to overcome at each stage.
- Finally, we outlined governance-related tools and practices to help companies overcome these challenges and progress to the next stage of development.

Governance recommendations should not only help the company succeed at its current stage of development. . .but also help it create conditions for moving to the next stage.

For purposes of practical orientation and support we have defined four common stages or states that emerge in company evolution; these four stages not only are intuitively plausible, but they also resonate with IFC practical experience in SME-related governance consulting and advisory services:

Stage 1: Start-Up. Product/service development and market testing are the first priorities. The company thrives under the entrepreneurial and often authoritarian leadership of the founder. Resources are stretched, and little priority is given to organizational development. "Small and informal" works well—until scaling operations and sales growth become urgent necessities.

Stage 2: Active Growth. Need for growth through sales, people, and increasing complexity are the defining features of this stage. This growth remains largely organic, unplanned, and unbalanced, which works well until the company becomes so big or so imbalanced and unconnected that organic growth reaches its limit. Systemic organizational development becomes a necessity.

Stage 3: Organizational Development. Once the organization has grown in size and complexity, it becomes a priority to correct the imbalances and develop the organization through specialization, professional policies, structures, and staff. The focus is on the company itself.

Stage 4: Business Expansion. Additional capital is often needed to take the organization to the next level. When this capital comes in the form of equity, an increase in the number of shareholders necessitates more formality in the corporate governance arrangements.5 The company's governance starts taking on the characteristics of "classic corporate governance," including a board of directors.

Table 2: The Four Stages of SME Evolution

Stage 1 Start-Up Business	**Stage 2 Active Growth**	**Stage 3 Organizational Development**	**Stage 4 Business Expansion**
The challenge is to allow the founders to fully realize their ideas and apply expertise with flexibility and drive while minimizing risks from lack of discipline and myopic leadership. **Recommendations** focus on adopting informal mechanisms for incorporating external advice, implementing cost-effective systems for cash flow management, identifying core functions needed for further growth, and starting a gradual shift toward more inclusive management and longer-term strategy.	**The challenge** is that the company is still in the process of defining its strategy and business model, so the founder's role remains essential and retaining flexibility is paramount; yet focus on sales demands increasing organizational size, professionalization of functions, and delegation and decentralization of decision making. **Recommendations** focus on developing basic organizational structure and processes. The company should start defining its approach to operational and strategic decision making. The founder/CEO should learn to delegate and to consult with key personnel and external advisers before making important decisions. Internal controls should be introduced to promote accountability and to secure assets.	**The challenge** is that the company has grown dramatically in size and complexity; it has multiple centers of professional expertise, yet its structure and processes remain largely informal, often unbalanced, with blurred lines of authority and responsibility. The business needs to be professionalized while minimizing disruptions, bureaucracy, and staff tensions. **Recommendations** focus on governance practices that support the need for good administration, documentation of processes and procedures, structured decision making, and professional management. Overall, the decision making should become more decentralized and collaborative.	**The challenge** is to manage an expanding shareholder base by instituting a governance system similar to that of large organizations, but without hampering entrepreneurial spirit and creating a slowdown because of ineffective and costly bureaucracy. **Recommendations** provide support for building "traditional" corporate governance institutions and policies (such as a board of directors) to balance interests of various shareholders, to bring in new expertise and perspectives, and to support development of long-term strategy. External investors and professional boards require strong risk management, good internal controls, and reliable financial and nonfinancial reporting.

Transitions are not necessarily linear, unidirectional, sequenced, and deterministic. For example, the company can fail at any stage, or it can regress from a higher stage to a lower one.

In Stages 1–3, the catalyst for change is most often the increasing business complexity precipitated by organizational growth. In the later stages (Stages 3–4), the transition is usually stimulated by a significant change in ownership.

We stop at Stage 4, because this is where the company becomes sophisticated enough to start using "standard" corporate governance guidance for unlisted companies, which is already abundant.

Some of the recommendations in Table 2, especially at Stages 1–3, relate more to management than to what is traditionally understood as "governance." This is intentional. Certain management issues need to be addressed before governance can start to be effectively implemented. These might be called "pre-governance" issues, and they are an essential part of the SME governance agenda.

Table 3: Summary SME Governance Matrix

Key Governance Risks	Stage 1 Start-Up	Stage 2 Active Growth	Stage 3 Organizational Development	Stage 4 Business Expansion
CULTURE AND COMMITMENT TO GOOD GOVERNANCE	Core functions identified Articles of association adopted	Core positions filled Organization chart, key policies, and statement of basic business principles	Governance champion TORs for key positions Core processes documented A calendar of corporate events	Governance action plan Company secretary function Governance provisions incorporated in the articles of association and bylaws
DECISION MAKING AND STRATEGIC OVERSIGHT	Informal external advisers involved* Founder(s) make decisions in consultations with individual executives Authority limits of key personnel have been communicated	External advisers formally engaged Key decisions are made in collaboration with executives as a group Limited delegation of signing authority formalized Staffing priorities identified Business continuity plan for CEO and key persons	Continuous and structured outside advice is engaged Enterprisewide discussions on strategy, financing, staffing Executive/management (or similar) committee formalized HR policies to attract, retain, and motivate staff Succession-planning framework for key persons	A board of directors Board procedures ensure effective meetings and input from all directors Succession-planning policy has been approved by the board
RISK GOVERNANCE AND INTERNAL CONTROLS	Basic bookkeeping, cash flow management, and tax functions Cash sources, bank accounts are separate from those of the founder(s) Basic understanding of regulatory requirements and compliance	Basic principles of business conduct Basic business risks—including key-person risks—identified Processes in place for tax payments, records, and filing Controls on cash management	Detailed code of ethics and business conduct Objectives, strategic planning, budget, key performance indicators, and clear accountabilities A professional CFO A basic internal audit function Policies and procedures to monitor and mitigate strategic and operational risks Business units have clear authority, reporting lines, and guidelines	Effective internal controls systems (e.g., based on COSO) Independent external auditors Timely and secure recording and reporting for sales and accounts
DISCLOSURE AND TRANSPARENCY	Basic financial accounts prepared The same financial information and data are used for all purposes	Monthly bank account reconciliation disclosed to all founders Founder(s), shareholders, and directors periodically receive consistent financial and nonfinancial information The public profile of the enterprise has been developed	Financial statements in accordance with national accounting standards Point person for information sharing identified Key decisions are formally communicated to all staff Basic performance reports are presented to external advisers Key nonfinancial information is disclosed to the public	Financial reporting is in accordance with the IFRS for SMEs or U.S. GAAP (if having/seeking foreign investors) Financial statements are audited by a recognized auditing firm Periodic financial reports and comprehensive performance reports are provided to investors An annual report (or equivalent) is produced. Shareholders are provided with information on request
OWNERSHIP	The role and responsibilities of the founder(s) clearly established Basic understanding of roles of all founding family members Shareholder dispute resolution mechanism	The difference between non-family and family issues is acknowledged Awareness of family succession planning Annual shareholders' meetings	Clear distinction between the roles of the founder(s), family members, and managers Clear career paths for non-family executives Family succession plan Annual shareholders' meetings include discussions of key decisions made, dividends, and plans	Policies and mechanisms to regulate family members' ownership, employment, and other benefits All shareholders are regularly updated on company policy, strategy, and results Mechanism for resolving governance-related disputes

(continued on next page)

Table 3: Summary SME Governance Matrix *(continued from previous page)*

*Some jurisdictions require a board of directors at the time of company registration. Such boards are often just a formality. This Matrix does not assume the board to be effectively functional until Stage 4.

Vladislava Ryabota and Alexey Volynets (IFC),
Axel Kravatzky and Helen Carrington (Syntegra/Tailored Governance)
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A FRAMEWORK FOR CORPORATE GOVERNANCE RELATED QUALITY ASSESSMENTS

A comprehensive framework for corporate governance related quality assessments.

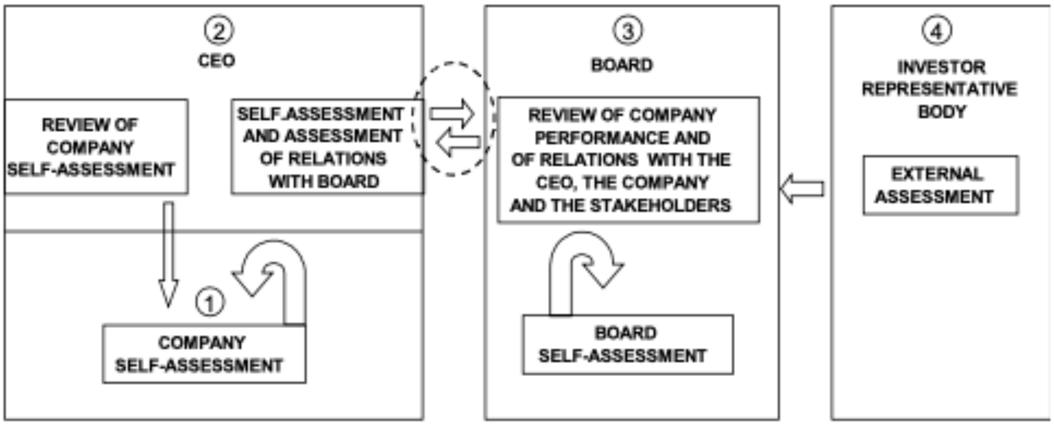

Figure 2 - A map of corporate governance improvement related assessments (1 and 2) completed with an external assessment (4) aimed at giving customer confidence about the state of corporate governance

To put board self-assessment in the proper light, the following information should be preliminarily available to the board directors, before any questionnaire is filled in or interview is made:

- The company's results in all areas of business and of stakeholder relations (shareholders, employees, business partners, the society)
- The results of the annual company self-assessment (validated by the CEO) to give evidence of organizational strengths and weaknesses in relation to the aforementioned results and to future goals. The extension from purely business and financial results to customer and stakeholder related results is important because it allows seeing reality from a different perspective. Critical analysis of the organizational architecture should be considered part of the assessment.

Beyond that, the self-assessment process should be based on:

- The board's annual objectives, defined at the beginning of the fiscal year.

- The results in relation to such objectives, with particular evidence of the relationship
- between what the board did and the relevant business outcomes.
- Corporate governance written rules and current practices, as well as external references and trends.

The assessment should focus both on the board's performance gaps (distance between board results and objectives) and goal gaps (inconsistencies between board objectives and company objectives).

Tito Conti
Managing Partner, Organizational Assessment Management S.A.A.;
A set of quality assessments aimed at improving corporate governance
ASQ World Conference con Quality and Improvement;
Seatle; May 15 -2005

BOARD SELF-ASSESSMENT EFFECTIVENESS

Having stated the above, a doubt arises: are we sure that defining board responsibilities, governance rules, best practice, self-assessment procedures, provides a reasonable guarantee against the occurrence of governance problems? Unfortunately the answer is no. The recent history of corporate failure seems to prove that just behaving according to the book does not guarantee success. As J. A. Sonnenfeld puts it in a recent Harvard Business Review article, the big companies that resoundingly failed in the recent past could all "pass the tests that would normally be applied to ascertain whether a board of directors was likely to do a good job" (Sonnefeld, 2002). "It's time for some fundamentally new thinking about how corporate boards should operate and be evaluated" continues Sonnenfeld " We need to consider not only how we structure the work of a board but also how we manage the social system a board actually is... Most of the remedies are structural: they are concerned with rules, procedures, composition of committees, and the like, and together they are supposed to produce vigilant, involved boards....The key isn't structural, it's social...What distinguishes exemplary boards is that they are robust, effective social systems". And then Sonnenfeld talks of respect, trust, candor, culture of open dissent...are these not values?

In fact, if compliance with rules is a necessary but not sufficient condition to avoid failures, it is not, by any means, a recipe for excellence. This paper started by saying that real quality is about value exchanged in any relation. Rules and procedures can, at their best, guarantee conformance. Excellent performance can be achieved only by small or large teams of people who share those values that are fundamental to create the team spirit and pursue the same vision. In such an environment, people are inclined to generate the reciprocally expected values and together, through a synergic effect, they are able to create and deliver high levels of value to customers and stakeholders.

That is why core values should be put in first place –followed by behaviors. Self-assessment, that aims at improving corporate governance and in particular board performance, should then start by addressing the issue of corporate values, to ensure that the company has not only defined but also deeply rooted a set of core values that have been identified as key to sustained success. Similarly, the board should guarantee that the company vision and mission are shared at all levels in the organization. Values should dictate ethical behaviors, and this is the key to generating the expected values in any company relation, the elementary roots for any quality outcome. Obviously, if it is part of the board's role to foster the value-based characteristics that make an organization excellent, the board itself should be the first to embody those characteristics. That is what Sonnenfeld's paper seems to imply when talking about "a virtuous cycle of respect, trust and candor….in which one good quality builds another" (ibid.)

To enhance the effectiveness of board assessment, the "soft" aspects (values and real behaviors) should be given great importance. Formal and mechanistic approaches should be avoided and a diagnostic (right-left) approach - starting from past result, focusing on performance gaps and searching for root causes - should be adopted.

Tito Conti
Managing Partner, Organizational Assessment Management S.A.A.;
A set of quality assessments aimed at improving corporate governance
ASQ World Conference con Quality and Improvement;
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BOARD SELF ASSESMENT - THE IMPACT OF CORPORATE GOVERNANCE IN THE QUALITY OF MANAGEMENT; AN APPROACH TO THE EVALUATION OF A BOARD OF DIRECTORS

Corporate Governance is presently being recognized as a key factor in the long-term success of Companies around the world. Good Governance implies the need to establish and operate within a framework of accepted core values. In this sense, best practices have been established in various international projects (Ref: 1, 2 and 3). We have developed a system through which a Board of Directors can be evaluated and its performance measured against these best practices. We use a matrix where key attributes are evaluated and the results are expressed in a simple, numerical way.

The evaluation process not only provides the status of Governance at a certain moment in time but also serves as the basis of information for the necessary improvement plans. The process we propose also constitutes an excellent feedback mechanism as the plans are implemented and measured. The matrix, being a graphical and clear representation of the board situation, also represents an excellent management communication tool.

The evaluation of the BOD is a key strategic decision of the Enterprise that will, over time, improve the Board's contribution to the Company. This allows the Directors to have a reference to be compared with. An improved Governance level will, in turn, improve the performance of the Company and shareholder value on the long term.

The proposed evaluation process constitutes the basis for the development of BOD improvement plans, with the matrix as a clear information tool which can help establish targets for each criterion.

Once implemented, the matrix will also help measuring the progress against those goals both as a total result as well as partially for each criterion. The score and the factors can be professionally selected accordingly to the board development status, geography, and time. We believe that this procedure can help to improve Corporate Governance at the Company, Region, and Country level in a complete, yet simple way.

Board Evaluation Criteria:

1. Mission and Principles
2. Board structure
3. Board operating procedures
4. Board & Management
5. Board & Shareholders
6. Board & Community
7. Board Contribution

Criteria Levels

1. Level 1: Understanding the need to improve Corporate Governance
2. Level 2: First concrete steps toward establishing best practices
3. Level 3: Implementation of best practices
4. Level 4: Leadership

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Marcos E.J. Bertin
CEO, Bertin Quality Consulting,
Buenos Aires, Argentina
Hugo Strachan
Director, EDDE, Univ. Argentina de la Empresa
Buenos Aires, Argentina
Board Of Directors Evaluation Model,
An approach to the evaluation of a Board of Directors
2008

EXTERNAL ASSESSMENT

Companies that adopt a reliable set of corporate assessments should welcome external assessments (or external audits) performed by acknowledged investor representative bodies. Furthermore, such bodies would certainly consider corporate self-assessment a very useful basis for their work.

Tito Conti
Managing Partner, Organizational Assessment Management S.A.A.;
A set of quality assessments aimed at improving corporate governance
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IAQ GOVERNANCE QUALITY INITIATIVE

The development of the Governance Quality Think Tanks is a good illustration of how IAQ operates. It was the insight of one academician that initiated this effort after several years of individual research and personal effort. In 1996, Academician Bertin delivered the first paper that identified quality in governance as an issue that should be pursued (Bertin, 1996). Subsequent to this speech he continued his research and in 2002 the Academy initiated a project to investigate this subject which resulted in the publication of a research report on governance quality (Bertin, 2005) which was later turned into a book that was endorsed by the Global Corporate Governance Forum and the Governance practice of PriceWaterhouseCoopers (Bertin and Watson, 2007).

In 2009, the Academy established the Governance Quality Think Tank, lead by Academician Bertin to increase its activities in this area. In recognition of his pioneering work in this area, the “Marcos E. J. Bertin Corporate Governance Quality Medal” was established by the Academy in 2008. This medal is awarded in two categories: one to a practitioner of governance quality (e.g., the chairman of the board of a company) and the second to an individual who has advanced the governance quality body of knowledge. Perhaps the most important development of the IAQ Think Tank has been the development of a methodology for evaluating board performance by Academician Bertin with fellow Argentinian Academician Hugo Ricardo Strachan. This method will be described in the next section of this paper.

QUALITY IN GOVERNANCE THINK TANK

PURPOSE: To contribute to the practice of Governance in all spheres but particularly incorporates through effective utilization of quality concepts for equitable and sustainable growth without causing harm to the Planet Earth.

ON THE BOOK CORPORATE GOVERNANCE – QUALITY AT THE TOP

Corporate Governance – Quality at the top is an excellent example of what can happen when a truly global team works together on a project to improve corporate governance worldwide.

We have distributed the draft of this work as part of the required reading for the World Bank/OECD Global Corporate Leadership Program among the participants found it both valuable and thought-provoking."

Ira Millstein
Past Chair, Private Sector Advisory Group
Global Corporate Governance Forum, World Bank – OECD

The Global Corporate Governance Forum commends the International Academy for Quality for its efforts to publish these practical guidance insights on corporate governance, that have been collected from leading experts and professionals around the world. We hope that this book will serve as a valuable knowledge resource for those companies and executives that seek to improve their competitiveness, applying corporate governance as a strategic means for reaching fundamental business goals."

Global Corporate Governance Forum

Corporate Governance - Quality at the Top describes a process for conducting quality assessments for Boards of Directors that are aimed at improving corporate governance as well as focusing on review of corporate govemance in terms of quality at the top. It benefits from utilizing the new focus on quality with a more powerfully productive role for its principles, methods, and disciplines. This book consolidates the reseach, experience, and insights of some of the most highly qualified and experienced quality and management experts who are all members of the International Academy for Quality. It provides an important resource and guide for the men and women who are committed to effective corporate governance and to application of principles and methods in terms that fit today's new governance demands.

Armand V. Feigenbaum
President and CEO General Systems Company