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A Systems Approach to Governance Programs

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Abstract

Effective corporate governance requires that all stakeholders be committed to its intent and purpose. Business governance plans are essential for achieving the corporate goals and objectives. Recent corporate scandals have indicated that governance has not been effectively managed. Governance plans are essential for ensuring business behaviors and practices are representative of ethical conduct. The model developed in this paper is a governance model that provides a practical, detailed, and innovative approach to corporate governance with a look to the standard Systems Design Life Cycle. The paper details how the need for a model was identified, then how a governance program would be designed, developed, tested, and finally implemented.

Keywords: Corporate Governance, Governance Program, SDLC, and Systems Design Life Cycle

Introduction

In June 2005, the former CEO and CFO of Tyco International were found guilty of stealing over $600 million from their company (Ex-Tyco officials, 2005). In July 2002, WorldCom filed the largest U.S. bankruptcy to date (Largest U.S. bankruptcies, 2005). Just seven months earlier, the fifth largest company on the Fortune 500 list, Enron, filed for Chapter 11 bankruptcy protection (Culpan & Trussel, 2005). Top executives at WorldCom and Enron were also charged, and Enron's accounting firm, Arthur Anderson, has collapsed in the wake of its role in the scandal.

Where is governance in all this? The CEO, the CFO, and the accounting entities are evident in these and other large-scale organizational failings, but little mention is made of the boards of directors or functional entities within the organizations. Governance requires commitment from all stakeholders and is essential for achieving corporate objectives. Boards of directors, external auditors, and shareholders comprise a formal governance system (DeYoung, Driscoll, & Fried, 2005) that should be supported by functional departments (Dahms, 2003). "Although the board has overall responsibility for the control environment, everyone who has responsibility for meeting an objective has responsibility for the risks associated with that objective and the controls to manage those risks" (Dahms, 2003, p. 26).

Governance plans are not new, but recent events indicate that in many cases, they have been more show than action. A plan does not ensure governance, people do. It is important to note that while greed seems to have driven many of the indiscretions evident in the large-scale scandals highlighted in the media in recent years, many ethical employees and directors of organizations face dilemmas simply because the landscape within which they operate is becoming more complex. The decisions are no longer obvious. For that reason, governance plans are essential to provide guidance, and the governance model (see Figure 1) provides as much balance and input from multiple sources as practical while ensuring good business as well. Multiple inputs help keep things honest, simplicity keeps things effective and transparent.

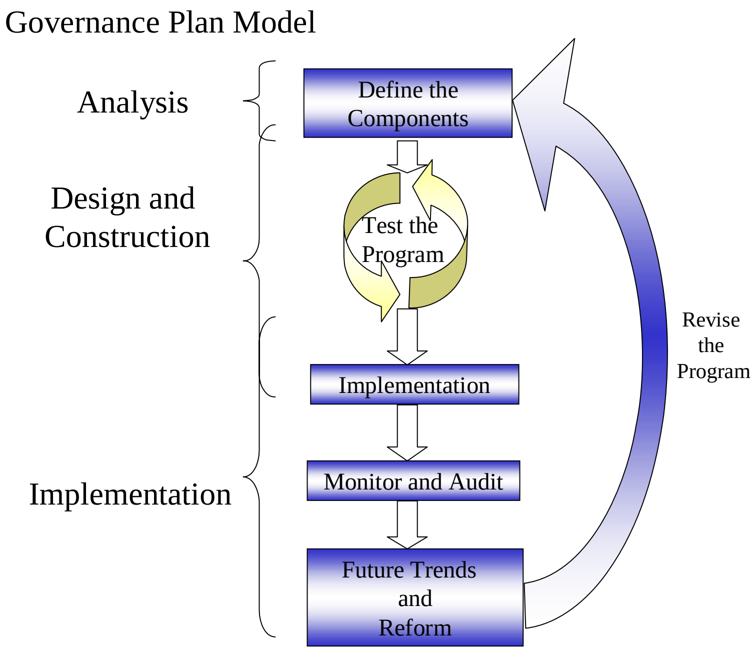

Figure 1. Governance Plan Model.

The governance model is similar to a typical systems design life cycle (SDLC) model (Plyler & Young-Gul, 1993), the components of which include four linear steps:

- Analysis, which leads to the definition of the problem and identification of the requirements.
- Design is the detail resulting from the analysis.
- Construction includes development and testing.
- Implementation includes installation, operation, and maintenance of the process.

The governance model consists of seven steps, but each fits into the SDLC model. The steps include:

1. Define the current need, part of the analysis phase.
2. Design the program, the design phase.
3. Develop the program, part of the construction phase.
4. Test the program, also part of construction.
5. Create an implementation plan, the first implementation component.
6. Monitor/audit the program, a feature of implementation.
7. Evaluate future trends and reform initiatives and revise the program, as needed, all parts of implementation.

The Program

An empowered and independent Board of Directors that is responsible to investors for protection of its interests in the organization is a key part of the governance model. In this model, the board is empowered by management and auditors, and responsible to employees, the community, and other entities for ethical business practices and corporate responsibility in addition to profitable business outcomes. The program includes a code of ethics, monitoring for compliance and intent, and

multiple sources of information to enhance decision-making and to maintain a high-level of integrity.
In the program, the following departments will provide specific information:

- Human Resources
- Legal
- Finance
- Marketing/Advertising
- Others as appropriate based on organization and industry

The governance program includes these players in the traditional notion, but stretches them into new responsibilities as well. Internal auditing, for example, will continue to conduct audits to ensure compliance and understanding, and they will stretch that role to include facilitation. Auditors must be extremely comfortable with the rules and regulations, understanding how and why they work, in order to audit their use, but auditors do not have to be imposing and unhelpful. Rather than pointing out errors and stopping at that, the governance program has internal auditors taking the next step. They will work with business units to help them understand how they can best implement the regulations within their business and how they can use the regulation to the organization's advantage whenever possible and ethical.

Accounting will also be proactive. Creative financing and accounting practices have a negative connotation to them, but these are new times and innovative, yet ethical practices will surface. When they do, the accounting team will review them and present those that have potential for ethical and practical use to the Board of Directors and executive leadership team. They will also present their own ideas as appropriate. In either case, the accounting team will provide a thorough explanation of how the practices can be employed and why they are better than what is currently in use, where trouble might arise, and any other pertinent information that will enable a well-considered decision regarding its use. No changes in any accounting procedure will occur without the Chief Financial Officer, Chief Executive Officer, and finance committee (or appropriate board representation) approval.

Marketing and advertising will use long-range predictive scanning to determine opportunities and threats associated with any product or service initiative. Armed with a tool, such as the Model for Assessing Adaptive Effectiveness (Figure 2), the department will look for long-range effects on the organization, the community, the customer, and the industry and share the results of its scan with senior management. Any product or service presented to the board will have scanning results as part of the presentation. The same method of scanning will be used to forecast upstream issues. For example, what happens if a primary supplier goes out of business; is there a secondary source and do we have an established relationship? Marketing, senior management, and legal will work together to determine not only cost benefit and political implications of actions, but ethical implications as well.

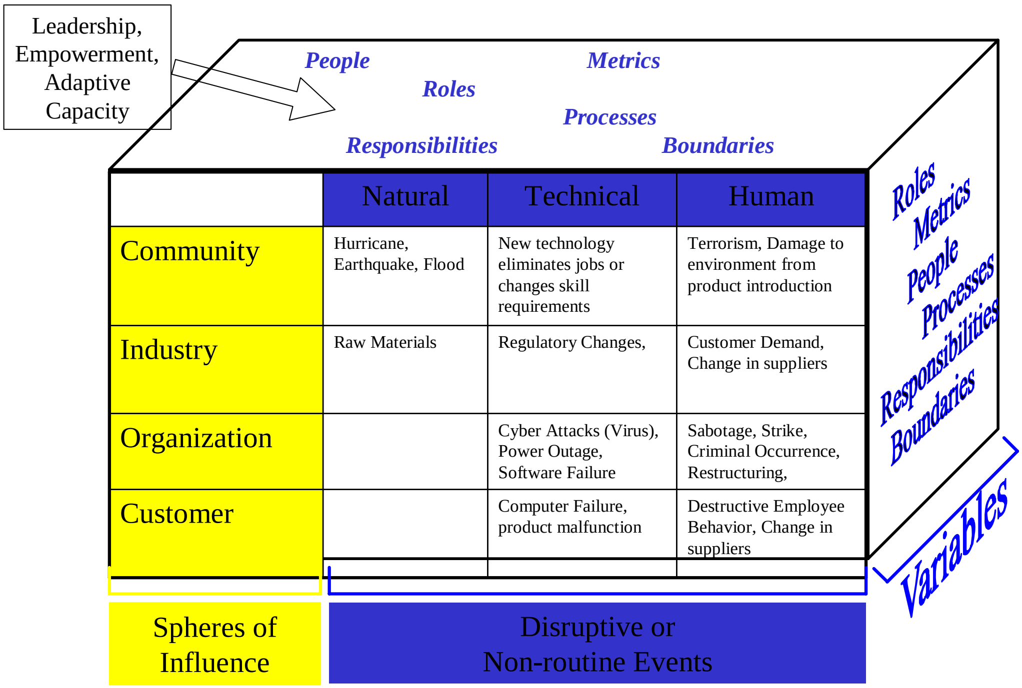

Figure 2. Model for Assessing Adaptive Effectiveness (MAAE), a tool used to categorize disruptive events, identify the variables likely to be impacted by lack of contingency planning, connect the relationships, and define the spheres of influence.

The legal department will play a similar role as finance from its vantage point. Legal will work with all departments to help them understand the rules and regulations and the intent of them. Legal will also work to simplify the language of complex laws and contracts that effect organizational business so that rather than getting lost in the law, employees, customers, suppliers, boards of directors, and senior managers can better understand the law. The group will also work internally and externally to create positive, mutually productive relationships such that all parts of the industry work together to create a productive, professional, and ethical enterprise. Finally, legal will act as consultants to the Board of Directors and committees to help assess the many pieces of information to ensure both the letter of the law and the legal intent. The very interdependencies of systems that enhance operation and strengthen an organization can also aid in overlooking a substantial piece of the picture or create a conflict of interest. The legal department will help to monitor those areas where overlap can create unique regulatory or ethical circumstance.

Human resources will continue to provide for employee relations, payroll, staffing, and training. The role will not stop there, though. Like the others, human resources will move into a proactive mode, leading the organization strategically by developing top-notch leaders and by working with other departments to capture knowledge essential to long-range planning. For example, human resources will work with senior management to create a development culture where senior management is actively involved in projects, assignments, coaching, mentoring, and other initiatives aimed at growing a leadership talent pool ready for internal opportunity. Another example might be human resource department leadership in determining the best strategy for moving into a new region. Optimizing the opportunity from a learning philosophy, an organization can move into areas with scouts who will learn things the organization needs to know: are there potential employees, what business practices and cultures might conflict with our values, what laws might conflict ethically or legally, what style of leadership would we need to start up? Human resources might actually be the first part of the organization to relocate, but not to take applications and train new hires on company policy. Instead, the department will have the strategic role of identifying the best way for the organization to move into the region.

The plan requires regular, written reports verbally presented by each department to the senior management team and to the Board of Directors. The reporting structure is intended to provide thoughtful consideration and accountability of information while simultaneously enabling thorough understanding through dialogue. Additionally, non-voting participation by senior management of the functional departments on the appropriate committee is required as a regular resource to that entity. The governance plan also requires regularly scheduled interaction between all senior managers, such as at a planning retreat or other activity that purposefully involves open dialogue about the activities in each department. The purpose is to open opportunities to improve business while simultaneously identifying potential threats and eliminating them before they become problematic.

Finally, the governance program requires very specific plan details be addressed in writing. The board structure, to include unambiguous roles and responsibilities of positions and committees shall be identified (Dahms, 2003; Totten & Orlikoff, 2004). Details about the number of independent board members required, the amount of time a board member can serve, on how many boards a member can sit, and which committees require independent directors are also addressed in writing (Dahms, 2003). The charters of requisite committees as determined by regulation are delineated as well (Totten & Orlikoff, 2004; Dahms, 2003).

Specific lines of authority of the board and management are written as part of the governance plan. Selection, compensation, orientation, evaluation, continuing education, and succession planning of the board and senior management are all delineated as appropriate for the specific organization (Dahms, 2003; DeYoung, Driscoll, & Fried, 2005; Totten & Orlikoff, 2004).

Other information that is specifically addressed as part of the governance plan includes an organizational code of ethics (Dahms, 2003), standard communication procedures, standard meeting and reporting practices, and the types of activities that require tracking and the procedures for tracking them (Dahms, 2003; Totten & Orlikoff, 2004).

Once the design is completed, a major milestone has been achieved, and the program can then continue to move forward. The governance model in this paper provides a design frame within which an organizationally specific governance plan can be developed. In the system design life cycle model (Plyler & Young-Gul, 1993) the testing process follows the development phase, and similarly in this governance model, testing is performed after the governance plan is developed.

Test the Program

The general purpose of the testing stage is to validate the various components that result from the construction phase; in this case, testing will serve to verify the components of the governance model. The testing process itself is generally a pyramid structure as testing begins with the smallest components in a *unit test*. Once unit testing is complete, components are combined into larger sections and testing continues in the *regression-testing* phase (Alicherry, Bhatia, Nagesh, Phadke, & Poosala, 2003).

In terms of testing general plans, William Baer (1997) highlights three main criteria; first, how does the current plan compare to alternatives? Second, does the plan contain all the required elements? Third, does the plan produce the expected results? These higher-level categories are the basis of the testing model used within this governance model. The testing model is used to test the governance plan. Figure 3 illustrates the testing model and introduces the basic components of testing in a graphic fashion.

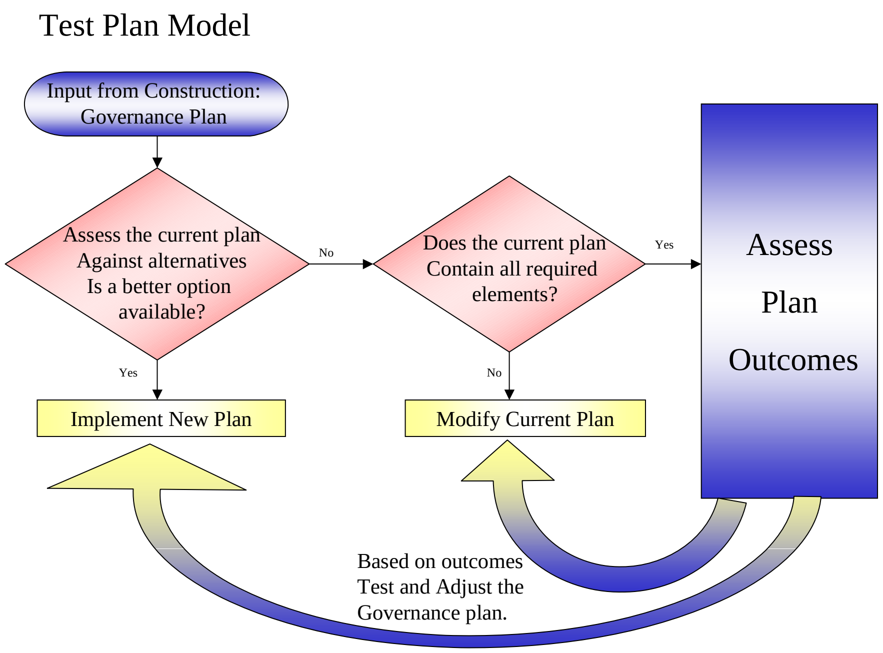

Figure 3. Model to test a governance plan consisting of the three major testing processes.

3.1 Steps of testing. The first criterion of testing a governance plan is an appraisal of the existing plan as compared to alternatives. For a governance plan, comparisons could be made to existing governance practices, to entirely different plans, and to modifications to the recommended plan. This process works to vet out plan weaknesses and replace them with stronger components.

The second criterion for testing a plan is to determine if the plan contains all the required elements. This component of the governance plan test would assess if all the agreed components were contained in the plan. For example, this test might assess board member independence, or that appropriate committees are established to monitor governance, if these committees regularly meet, and if the interactions are documented.

The final component is to validate the expected results. While the broad expected result of a governance plan is improved organizational governance, this specific goal cannot be directly tested until after the plan is implemented. As such, the test process for a governance plan is an ongoing cycle that continually tests and adjusts the governance plan.

A final consideration is who maintains responsibility for testing the governance plan. Responsibility for testing can be assigned to either an internal or an external entity. However, for the purposes of appropriate checks and balances, this test model would recommend both an internal and an external review. An initial internal review could be conducted with organizational resources; the company's internal audit function could conduct an audit review, or an independent internal committee could conduct a first pass assessment of the governance plan. By using internal resources, the organization can work to fine tune the governance plan. Internal resources would have a better understanding of the organization as well as an understanding of the potential high-risk areas that could require governance. Additionally, an internal review could be conducted at a reduced cost. Once the internal review is complete, an external and independent auditor could conduct a second detailed review of the governance process. This testing methodology would ensure an improved product with an independent review.

Ultimately, the governance program is a product (Baer, 1997) and this product must be continuously tested and adjusted to meet the objective of improved governance.
Implementation Plan

Once the components of a governance plan have been decided and the plan developed, testing will validate it, followed by implementation. The implementation phase generally describes the installation, operation, and maintenance of any plan (Plyler & Young-Gul, 1993). Figure 4 depicts the implementation model advocated in the governance program.

Implementation Plan Model

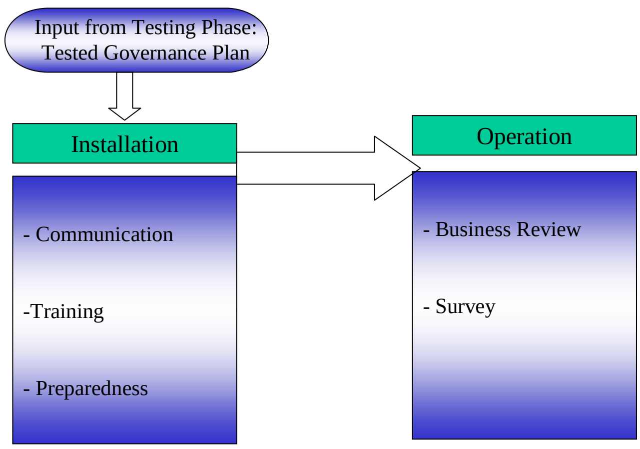

Figure 4. Implementation Plan Model including the phases of installation, operation, and maintenance.

The model for implementation highlights the three divisions of implementation, namely installation, operation, and maintenance.

Installation. Installing a governance plan means the successful delivery of that plan from inception to application. One of the key components of successful application of a governance plan is organizational acceptance of the plan. This means that all levels, including the CEO and executive board, will support the plan as well as the implementation effort.

The first component of successful installation is communication. At an early stage, all participants should be informed of the organization's vision to change and improve governance. Communication of the vision serves to ease tension and works toward accepting change. The second step for successful implementation is training. All levels of the organization must be made aware of the components and changes of the governance plan. They should be informed of the resulting impact of those changes to their function, and finally they should be made aware of what is expected of them (Rau, 2004). Ultimately, a successful installation will yield a new governance plan, which is supported and used by all levels of the organization.

Operation. Once the business governance plan is installed, the ongoing operation of that governance plan follows. The operation phase of implementation means that a functional plan is installed and in use by the organization. The operation process keeps the plan functional. In order to maintain the ongoing operation of the plan, several processes are applied. Within this area, the processes of business review and survey will work to keep the governance plan operational. The idea of the business review is a two-fold notion to question and determine the functionality of the governance plan. The first level of business review is at the departmental level such that all departments involved with the governance plan review the applicability of the plan within the department and externally to other departments within the organization. In conjunction with departmental reviews, the Board of Directors would conduct an organization-wide business review to evaluate the operating governance plan.

One tool available to any organization is the survey. Surveying employees and managers as part of the business review will provide valuable information about the operation of the governance plan from the persons tasked with using it.

The final component of the implementation model is maintenance. At this stage of the governance program life cycle, a complete and tested plan is in use throughout the organization and it is important to monitor and assess that plan in order to ensure effectiveness.

Monitoring and Auditing Business Governance Plans

Business governance plans and their effective implementation are the primary responsibility of the board of directors, while monitoring and recommending improvements to the plan is the internal auditor's primary role. A report from Crowe Chizek, a provider of assurance, consulting, and risk management, noted " . . . that the *IIA's International Standards for the Professional Practice of Internal Auditing* calls on internal auditors to evaluate and offer recommendations to improve governance processes and affirms their importance in risk management activities" (Whitley, 2005, p.21). Crowe Chizek has recommended the following steps for internal auditors to ensure management and the board are meeting their responsibilities:

- Assist the board with its governance of self-assessment.
- Provide the audit committee with best practices regarding internal controls and risk management.
- Seek out opportunities where compliance can be leveraged to reduce costs.
- Assess the organizational code of conduct and policies on ethical behavior to ensure they are updated regularly and communicated to employees.
- Annually audit the whistleblower hotlines and ensure that follow-up procedures and results are provided to the audit committee.
- Provide disclosure and transparency objectives in the yearly audit plan (Whitley, 2005).

The governance program will use a test and adjust model (see Figure 5) as an approach to monitoring the governance program. Each step outlined above will be tested and adjusted to ensure the plan is meeting critical performance measures. For example, if internal auditors test for the self-assessment of the Board of Directors, they will either continue to monitor if the process is working or they will make necessary adjustments if the process is not working. Upon testing each component and determining the component's effectiveness, the organization should see positive results from the monitoring process and effective organizational governance. If the results of an evaluation indicate critical performance measures are not successful, a test and adjust process will occur until established standards of performance are achieved. The model is not fixed or static; it is a work in progress. Based on the needs of an organization, the six components can be adjusted or replaced.

Monitor and Audit Model

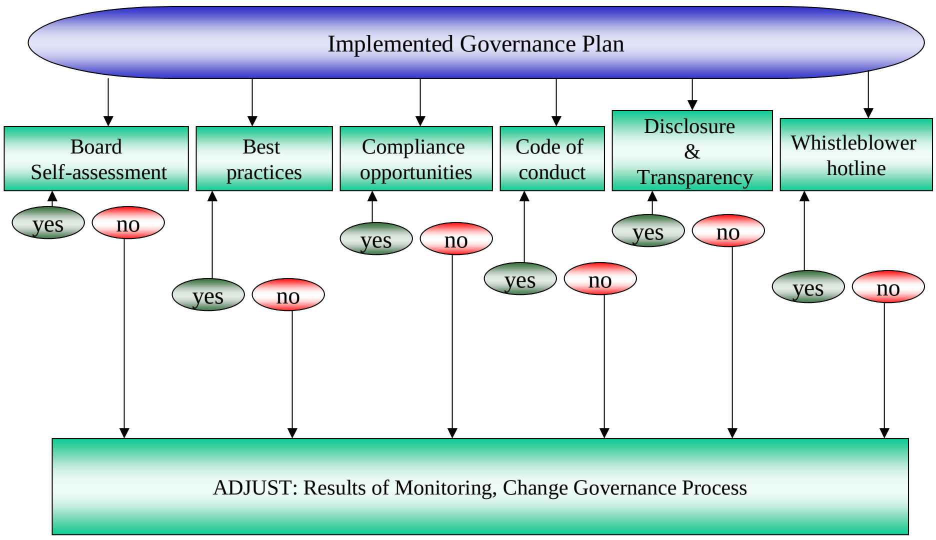

Figure 5. Monitor and Audit Model.

An annual review process should be in place to ensure that regulatory requirements are met and the governance plan is adjusted accordingly to meet changing standards and regulatory requirements.

Evaluate Future Trends and Reform Initiatives

Muel Kaptein (2004) conducted a first-time study of ethical business codes of two hundred of the world's largest corporations. Of the two hundred organizations studied, only 52.5% had business codes in place. The codes were inclusive of issues such as quality products and services, obeying laws and regulations, environmental protection, transparency, corruption, conflict of interest, and fraud just to mention a few.

The past decade has placed an increased focus on corporate social responsibility, governance, business ethics, integrity, and compliance (Waddock, Bodwell, & Graves, 2002). Recent corporate scandals and changed legislation have encouraged organizations to acknowledge the significance of ethical and responsible business practices (Waddock, Bodwell, & Graves, 2002). The authors recommend a code of business conduct as a means of ensuring organizations, management, and the board are meeting their responsibilities. They encourage the use of the following components:

- Accountability.
- Feedback.
- Stimulating work environment where the code is honored, implemented, and the roles are clearly defined.
- Periodic updates.
- A clearly defined purpose and intent.
- A code that is readily available, not held as confidential, is easily translated and understood, and is clear and concise.
- A foundation that expresses the organizational values.
- A presentation that represents the importance and seriousness of the code.
- Representative of the organizational environment.

The study conducted by Waddock, Bodwell, & Graves (2002) provides insight into some areas where organizations are falling short with regard to the implementation and maintenance of their business governance plans. They provide many recommendations and reform initiatives for organizations to work on to improve the success of their business governance plans. The governance program will evaluate future trends and reforms with another test and adjust model (see Figure 6). The governance plan will test to determine if the plan has addressed all reform initiatives.

Although business governance has become a focal point within business operations today and many steps have been taken to improve ethics and compliance, there is still room for improvement. Business governance is a work in progress.

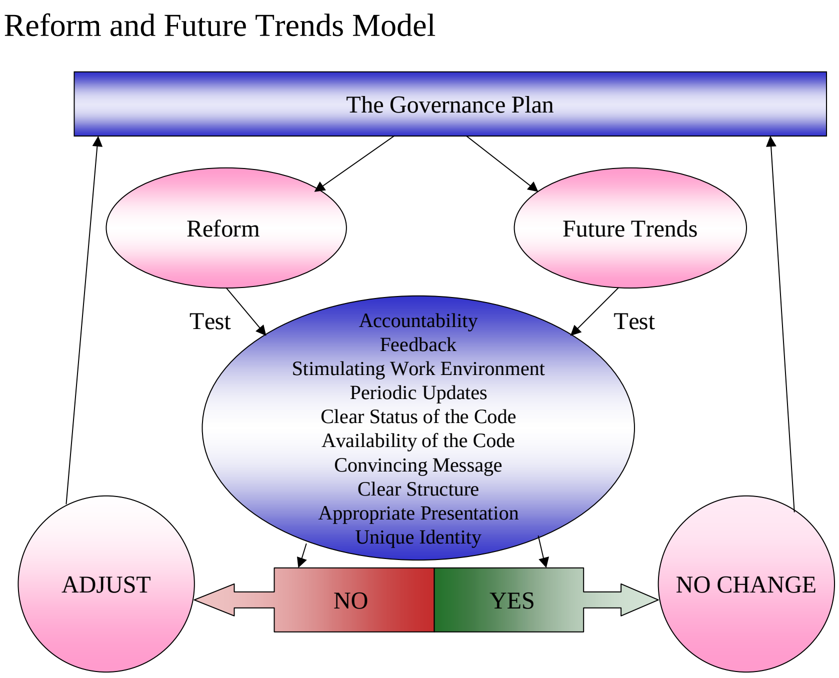

Figure 6. Reform and Future Trends Model.

Conclusion

The future trends and reform initiatives anticipated in business ethics appear to be simply more of the same, the creation of rules and regulations. Rules and regulations mandating policies and procedures seem to be the universal answer to unethical business behavior. Where does prevention factor in? Is it unrealistic to think that a preventive approach can be developed to save organizations millions of dollars? Recent corporate scandals have led organizations to spend millions of dollars on business governance plans. They are striving to improve their level of integrity, live by their values, and practice ethical behavior starting at the top. The goal is to establish a culture that exudes business integrity and accountability (Verschoor, 2004).

Progressive organizations value integrated governance, risk, and compliance (PricewaterhouseCoopers as cited by Verschoor, 2004). Use of this governance model can work to achieve such integration thus striking a balance between what is best for the organization and its stakeholders.

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