Journal of Banking,
Information Technology and Management
Volume 9 No. 1
January-June 2012

Performance Measurement for Accountability in Corporate Governance

Girish Kumar Rana & Rajesh D. Rana

Abstract

The recent spate of business scandals has placed a renewed emphasis on better corporate governance by raising the issue of accountability for business performance. The most common business performance analysis is based on financial measures and includes various accounting ratios. Since these measures often provide conflicting signals, which do little to establish responsibility and accountability, we compute a DEA based "income efficiency" measure of business performance. We analyze the pharmaceutical industry, which includes many multinational corporations with complex governance problems, over ten recent years, and the strategies that allowed firm efficiency rankings to improve or worsen over time are highlighted. Our analyses indicate that the inclines and declines in DEA efficiency rankings are related to the strategic choices made by the upper management, thereby lending credibility to the use of these rankings in performance measurement by the board of directors.

Keywords: *Performance, Accountability, Corporate Governance, Objectives.*

Introduction

Improving corporate governance has become a key objective in recent years for both academics and practitioners alike. More specifically, the issue revolves around board of directors in their role as monitors of a firm's top management (Sundaramurthy & Lewis, 2003; Carter & Lorsch, 2004; Demb & Neubauer, 1992; Goel & Erakovic, 2003; MacMillan & Downing, 1999). One key aspect of good and reassuring corporate governance is the assigning of clear accountability for firm's outcomes. In the performance of its monitoring role, a board of directors needs appropriate operational metrics to evaluate management's performance. Market-based measures are the result of both management performance, and external factors such as industry conditions and general stock market performance. Developing rankings that are based purely on metrics that represent areas which can be directly attributed to managerial decisions provide greater clarity to the board in evaluating managerial performance. Furthermore, since the rankings are for Estimating Technical and Scale Efficiencies in Data Envelopment Analysis." Management relative to competition, they provide an objective relative assessment of the quality of decision-makers (managers) relative to the competition. The monitoring function of the board essentially involves conducting a business performance analysis. Business performance analysis is often based on a set of accounting measures such as ROI and ROE, be it at the firm or industry level. While there is often more than one financial measure, including various accounting ratios used in measuring performance, there is no comprehensive index of financial and non-financial measures available at this time. Extant business performance measures have generally been criticized on two accounts; business performance is often measure-specific, meaning different measures could generate different and conflicting signals, and there is a preponderance of financial measures of performance. Predominance of financial measures has paved the way for performance measures that incorporate both financial and non-financial measures of performance. For instance, Kaplan and Norton (1992) have devised the Balanced Scorecard (BSC) as a response to the criticism of the preponderance of financial measures only. BSC is an improvement over traditional financial accounting based measures only. However, BSC does not solve the problem of conflicting signals generated by financial and / or non-financial measures, nor does it clearly assign accountability for specific financial outcomes. Another problem of looking at financial or non-financial measures of performance is that the end results can be generated by both value added as well non-value added (window dressing) means, and hence there is a need to develop measurement tools that distinguish "honest performance" from "less than honest performance." Data Envelopment Analysis (DEA) provides a comprehensive measure of performance and objectively assigns linear programming optimization weights to the various accounting and non-accounting measures embodied in the analysis. In this paper we focus on using and explaining DEA, emphasizing the use of objective financial measures as inputs. Furthermore, since the rankings are relative to competition, they provide a more objective and comprehensive assessment of the quality of decision-makers (managers) relative to the competition.

Summary and Conclusion

In this study we have demonstrated the usefulness of DEA in performance governance measurement by applying it to the pharmaceuticals industry. The novelty of DEA is to help develop a set of holistic business measurements both financial and non-financial that can be used to compare performance using a common metric. Our approach overcomes some of the difficult issues faced by the board of directors in comparing performance of the management to the best case scenario within the same industry. One direct contribution of our approach is in the area of evaluation of top management by a firm's board of directors. The board of directors usually faces a gargantuan task in evaluating the strategic managers of the company. They usually have to make assessments of managers' performance based on a conflicting set of indicators, and have to separate out factors that were under managerial control versus factors that were externally driven. In addition, assessments have to be made in a relative sense as compared to other firms ("benchmarks") in the industry. Our approach may be ideal to evaluate strategic managers (CEOs, General Managers, and Presidents), since it relates multiple performance indices to a meta measure of performance. Hence our measures could be of use as an aid to boards of directors who are usually faced with a problem of evaluating top management on multiple indicators which may not provide consistent information about performance. Given the current skepticism about the effectiveness of corporate governance, and given the issue of whether they have appropriate tools to evaluate top management performance, we believe that this project will provide the board of directors with appropriate decision aids in evaluating strategic managers.

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Dr Girish Kumar Rana, J.Z. Shah Arts and H.P. Desai Commerce College, Amroli, Gujarat.

Prof. Rajesh D. Rana, J.Z. Shah Arts and H.P. Desai Commerce College, Amroli, Gujarat.