Corporate Governance from Formality to Reality: Common Practical Challenges to Board Effectiveness

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Why focus on corporate governance?

- **Corporate governance** is intended to increase the accountability of managers, improve operations, and avoid disasters before they occur.

- Strong corporate governance helps maintain the confidence of investors, lenders, creditors, suppliers, and other business partners, so that the company can raise capital efficiently and build effective and profitable business relationships, locally and internationally.

- For a national economy to “move up the value chain,” with sophisticated businesses investing in technology and producing globally competitive products and services, companies must have governance that inspires confidence in their integrity, focus, efficiency, and reliability.

The problem with corporate management

- In 1932, Adolf Berle and Gardiner Means published ***The Modern Corporation and Private Property***. They argued that the central problem of governance stems from **separation of ownership and control** in modern corporations.
- To grow, corporations may need a broad base of owners or funders, who must necessarily delegate to management the day-to-day running of the company.
- But managers may serve themselves instead of owners, other stakeholders, and society. They may:
  - Seek excessive compensation or advantages for themselves or related parties;
  - Focus on short term results instead of long-term shareholder and product value;
  - Attempt to insulate themselves from replacement or accountability;
  - Cut corners on legal compliance, financial transparency and social responsibility;
  - Engage in fraudulent schemes to appropriate the value of the company.

Independent Boards as a solution? Maybe.

» *In theory*, an independent Board can monitor and check management to prevent self-dealing and help assure sound operation and strategic focus for the company.

» A sound system of corporate governance assures accountability of the Board to all stakeholders of the corporation, including shareholders, employees, suppliers, customers and society in general. The Board is responsible for assuring a fair, efficient and transparent administration of the company.

» But can Boards really fulfill this role?

Common challenges to Board effectiveness

- Throughout the world, in both the most developed and newer market economies, Boards face common challenges in monitoring and overseeing management. Some basic challenges are:
- Weak capacity/ expertise
- Lack of understanding of the Board’s role
- Lack of genuine independence
- Lack of information
- Lack of time
- Management resistance
- Weak incentives

Weak capacity/expertise

Boards are responsible for, among other things:

- setting the strategy and structure for the business;
- hiring, compensation, and evaluation of the chief executive;
- evaluating implementation of policies, strategies and business plans;
- financial reporting and relationship with the external auditor;
- internal controls, internal audit, and risk management;
- overseeing communications with shareholders;
- evaluating their own performance.

How can Boards attract and keep members with adequate expertise to perform these various and complex functions?

Lack of understanding of the Board's role

» The Board should provide effective, high-level oversight, but should not immerse itself in the minutiae of daily business operations, routine transactions, and other details.

» Less experienced Board members, particularly those who are presently or were previously managers themselves, may misunderstand their role and become overly focused on routine management decisions.

» How can Board members

Lack of genuine independence

- One source of competent Board members may be executives of other (non-competing) companies. But if companies in effect trade Board members between each other by recruiting each other's executives, Board members will not be genuinely independent.
- Board members and managers may have social ties or other informal connections with each other, even if members are formally independent.

- How can Boards assure genuine (not just formal) independence of members?

Lack of information

- Companies may generate mass amounts of data and information about operations, finances, compliance, and other issues relevant to Board oversight.
- While managers may be familiar with this information from their daily duties, it may be difficult for Board members to understand the scope of relevant information available, let alone obtain it in a digestible form to assist in their own oversight.
- How can Board members obtain adequate digestible information to perform their role?

Lack of time

» Management works full time. Boards only meet periodically during the year, and typically for short periods. Boards must spend part of their limited time together with various formalities.

» How can Board members hope to find sufficient time to understand operations and developments in the company and meaningfully exercise oversight?

Management resistance

» Management may not welcome genuine Board oversight and may resist, fail to implement, fail to inform, mislead or otherwise evade the Board’s direction.

» How can Board members overcome management resistance?

Weak incentives

» If Board members are paid too little, they may not want to spend the time needed to perform their function adequately. If paid a lot, they may not want to jeopardize their position by “rocking the boat.”

» There may appear to be little or no reward for rigorous performance.

» The easiest course is to follow the formalities of Board duties without digging deeply into the issues or challenging management.

» How can Board members be incentivized to challenge management?