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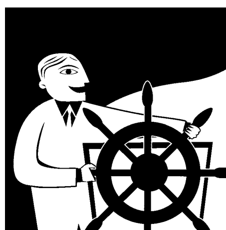
A Primer on Corporate Governance

In a Word Good corporate governance helps an organization achieve its objectives; poor corporate governance can speed its decline or demise. Never before has the glare of the spotlight focused so much on boards of directors. Corporate governance has emerged from obscurity and become a mainstream topic.



Notions of Governance

Direction and control are needed whenever people come together to realize societal and organizational goals. To govern is to do just that, to direct and control, by established laws or—preferably not—by arbitrary will. Its core underlying practices, where the former mode is used, are to specify expectations, delegate authority, and substantiate performance.

> *Different men seek after happiness in different ways and by different means, and so make for themselves different modes of life and forms of government.*
>
> —Aristotle

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Complex systems cannot be reduced; however, where society or an organization is multipart or too large for simple management, it usually moves for the creation of entities tasked with guiding related processes and systems in their host's evolving context of society, economy, environment, polity, and technology.

> *You can only govern men by serving them.*
>
> —Victor Cousin

It follows that governance, the activity of governing, is a multifaceted phenomenon; definitions of it can be subtle, challenging, and powerful at once.[1] With frequent overlap and resultant conflict, governance shapes affairs at global, national (including, for instance, state or provincial, municipal, and local), institutional, and community levels by means of the entities that occupy shifting (and frequently permeable) social and economic space there, such as government (including the military), civil society (including the voluntary or not-for-profit sector), and the private sector. (Public and private media play advocacy, entertainment, and advertising roles throughout.) All the same, most definitions of governance rest on three dimensions: (i) authority, (ii) decision-making, and (iii) accountability for conformance (assurance) and performance (value creation and resource utilization). Hence, regimes of governance determine severally who has authority, who makes decisions (and how other stakeholders make their voice heard), and the manner in which account is rendered.

A Short History of Corporate Governance

Until the mid-1990s, the term "corporate governance" meant little to most people except small groups of academics and practitioners.[2] But, with daily mention in the media for the last 10 years, in a globalizing world of organizations, it is now

[1]To note, governance is not synonymous with government: the first is a structured process (some say a set of responsibilities and rules about their practices); the second is an agent of that. Governance, then, is about how those tasked with governing exercise political authority and use institutional resources to manage affairs in interaction with stakeholders.

[2]In truth, concern for corporate governance is not totally new; it is as old as enterprise even if the study of the subject can only be traced to the 1930s. Business historians deem the Bubble Act of 1720 an early reaction to abuse of charters in the United Kingdom. (There are no doubt others.) But a milestone was reached in 1932 when, in the aftermath of the Wall Street Crash of 1929, Berle and Means (1991) reflected in *The Modern Corporation and Private Property* on the changing role of the modern corporation in society: through legal and economic lenses, they researched the consequences of separation of ownership and control (primarily stemming from the dispersal of shareholding in large corporations). In *Revolt in the Boardroom*, Murray (2007)

broadly understood as the processes by which the policies, strategies, and operations of organizations are regulated, operated, and controlled by boards of directors[3] to give them overall direction and control, and satisfy reasonable expectations of accountability and performance, including to those outside them.[4] It embraces regulation, structure, best practice, and, increasingly, the ability of boards of directors.

> *Whenever an institution malfunctions as consistently as boards of directors have in nearly every major fiasco of the last forty or fifty years it is futile to blame men. It is the institution that malfunctions.*
>
> —Peter Drucker

Corporate constitutions now owe much to the work of Adrian Cadbury[5]: in 1992, in the wake of corporate catastrophes in the United Kingdom, the Cadbury Report—titled *Financial Aspects of Corporate Governance*—concluded that similar fiascos could be mitigated by way of greater disclosure by management and

(Footnote 2 continued)

provides an engaging perspective on American corporations in the twentieth century, covering also the work of Adolf Berle and Gardiner Means and the early travails of crusaders such as Lewis Gilbert, Wilma Soss, Evelyn Davis, and James Peck, and delineates a new world in which the "shoulds" of corporate governance have become "musts"..

[3]A board of directors is a governing body of elected or appointed individuals who jointly oversee an organization's activities for multiple year terms. (Other names for such bodies are board of trustees, board of managers, or executive boards.) The functions of boards of directors are determined by the powers, duties, and responsibilities—typically detailed in the organization's by-laws. (By-laws usually specify how many directors a board will have, how they are to be chosen, and when they are to meet.) To govern the organization, basic functions of boards of directors are to establish vision, mission, and values; set strategy, structure, and objectives; select, appoint, and support the chief executive officer and assess his or her performance; delegate to management; promote effective organizational planning; make available adequate financial and other resources; provide proper financial oversight; ensure legal and ethical integrity; maintain accountability; determine, monitor, and strengthen organizational performance, and give account to shareholders for that; be responsible to relevant stakeholders; enhance the organization's public standing; evaluate the board's own performance; and recruit and orient new board members. These functions are largely discharged through meetings of boards of directors and their committees, during which discussions are conducted and resolutions are passed. (It may also be necessary for board members to consult management, personnel, clients, and other constituents outside of board meetings.)

[4]In a word, corporate governance concerns the way power is exercised over an organization.

[5]The Cadbury Report is the first code on corporate governance. It was followed by codes in Australia (the Hilmer Report, 1993); France (the Viénot Report, 1995); the Netherlands (the Peters Report, 1997); and South Africa (the King Reports, 1994 and 2002), among others.

better oversight by boards of directors. Proclaiming fundamental principles of openness, integrity, and accountability, the Cadbury Report made 19 recommendations addressing the structure, independence, and responsibilities of boards of directors; effective internal financial controls; and the remuneration of board directors and management. In 1999, the Organisation for Economic Co-operation and Development (2004) issued principles of corporate governance, revised in 2004, that made a point of underlining the legitimacy and importance of stakeholders as well as shareholders. (The organization also stated that there is no single model of good corporate governance.) Since 2001, in large part due to the high-profile debacles at Enron Corporation, Tyco, and WorldCom, attention to the governance practices of organizations has run rife. In 2002, the Federal Government of the United States passed the Sarbanes-Oxley Act to set new or enhanced standards for all US public company boards, management, and public accounting firms to restore confidence in corporate governance. Such legislation also marked the start of criminalization of corporate misdemeanors by board directors. In 2009, both the New York Stock Exchange and the NASDAQ Stock Market demanded that companies should have a majority of independent board directors.

> *Transparency is often just as effective as a rigidly applied rule book and is usually more flexible and less expensive to administer.*
>
> —Gary Hamel

In consequence or in parallel, all over the world, "comply or explain" codes on corporate governance emanating from securities commissions, stock exchanges, investors and investor associations, and supranational organizations have grown.[6] They vary in scope and detail but most tackle four fundamental issues: (i) fairness to all shareholders, the "owners," whose rights must be upheld; (ii) clear accountability by the board of directors and management; (iii) transparency, or accurate financial and nonfinancial reporting; and (iv) responsibility for the interests of minority shareholders and other stakeholders and for abiding by the letter and spirit of the law. Some see in current trends to balance the three critical anchors of the corporate balance of powers—shareholders, boards of directors, and management[7]—the

[6]A case in point is the code of best practice now adopted in the United Kingdom. First issued in 1998 and updated at regular intervals since then, the UK Corporate Governance Code (formerly the Combined Code) sets out standards of good practice in relation to issues such as board composition and development, remuneration, accountability and audit, and relations with shareholders (Financial Reporting Council 2010).

[7]The basic triad of shareholders, boards of directors, and management reflects the division of ownership, strategic management, and day-to-day operational management of an organization.

general evolution of a democratic model of corporate governance, sped by the revolution in communications (even if boards of directors still seldom appear on an organization chart).[8] Beyond manager-centered, hierarchical attempts to merely redistribute power,[9] recent reforms initiatives aim toward better governed organizations that have more robust, pluralistic, and adaptable decision-making processes.

A Scrapbook Collection of Gremlins

> *The difficulty lies, not in the new ideas, but in escaping from the old ones, which ramify, for those brought up as most of us have been, into every corner of our minds.*
>
> —John Maynard Keynes

Codes on corporate governance can surely help steer organizations but it helps to know where they are currently berthed. Corporate governance malfunctions owe to history and tradition, assumptions and perceptions, people and the values they hold, and an organization's existing governance framework.

[8]Notwithstanding trends, differences of opinion will likely continue to polarize debate. Should corporate governance be conceived from the perspective of agency theory or from that of stewardship theory? In addition to owing duty to shareholders, should boards of directors also be responsible to stakeholders? Should corporate governance be driven by principles or by prescriptions? Should the chair of the board of directors and the chief executive officer necessarily be different individuals?

[9]Examples include separating the positions of chair of the board of directors and chief executive officer, conducting (more) formal audits of management performance, appointing lead outside directors, and making the board of directors more accountable to shareholders. Usefully, Pound (1995) differentiates managed-corporation and governed-corporation paradigms. In the managed-corporation paradigm, the role of the board of directors is to hire, monitor, and when necessary replace management; in the governed-corporation paradigm, it is to foster effective decisions and reverse failed policies. The characteristics that conduce governed organizations are (i) expertise sufficient to allow boards of directors to add value to decision-making processes, (ii) incentives to ensure that boards of directors are committed to creating corporate value, and (iii) procedures that foster open debate and keep board members informed and attuned to shareholder concerns.

Table. Governance gremlins

• Cognitive dissonance about the mission of the organization	• Cognitive dissonance about its vision	• High turnover of the board of directors and chief executive officer
• Cognitive dissonance about the role of the board of directors	• Insufficient understanding by board members of duties and liabilities	• Tenuous understanding of financial statements
• Unresolved conflicts between board members or between the board of directors and the chief executive officer	• Insufficient understanding of roles of officers or how one becomes one	• The current practice or structure of the board of directors do not match the by-laws
• Confusion over conflicts of interest	• A superfluous number of committees	• Committees that are not engaged in inconsequential work
• A board of directors that is primarily run by the chief executive officer	• Rubber-stamping by the board of directors	• Micromanagement by the board of directors
• Analysis paralysis	• Insufficient strategic vista and competing priorities for the board of directors	• A board of directors that works well but focuses on unimportant issues
• Lack of unity once board members leave the board room	• Low attendance at board or committee meetings	• Ineffective board or committee meetings
• Information that is inopportunely or inaccurately presented to the board of directors	• Lack of clarity on role of the board of directors vis-à-vis staff	• Poor relationships with shareholders and stakeholders
• Insufficient involvement of or consultation with members of the organization	• Staff burnout or volunteer fatigue	

Source Author

Building Better Governance in the Public Sector

Momentously, more demanding notions of corporate governance—typically drawn from the principles of the Cadbury Report—are spreading to the public sector, arguably with more emphasis on conformance than on performance.[10] (However,

[10]In the United Kingdom, the Nolan Report of 1995 later adapted the three principles of the Cadbury Report to the public sector. Its seven principles of public life are selflessness, integrity, objectivity, accountability, openness, honesty, and leadership. These principles were to be reflected in each dimension of governance in the public sector, namely, standards of behavior, organizational structures and processes, and control.

where considerable diversity in governance structures is found,[11] for example, in agencies of the United Nations, the challenge is to devise systems that assure stakeholders services are in capable and honest hands, avoid the negative effects of excessive control and bureaucracy, and enable performance to be achieved and improved.) Naturally, clarity of objectives and identification of and reporting on appropriate performance indicators are vital to this process. (This is easier said than done: by definition, political choice impacts the selection of performance indicators.) Notwithstanding, building on the work of the Organisation for Economic Co-operation and Development, the United Nations Development Programme (1997) articulated in 1997 a set of nine principles of good governance that are somewhat better suited to public organizations than the organization's version and, with slight variations, appear in much subsequent literature. (The need for characterization may be less if one accepts that, in both the private and the public sectors, corporate governance is the application of some external standard to internal management processes; some way of holding management to account for their actions; structures that separate responsibilities, particularly where conflicts of interest might otherwise arise; a means to ensure the identification and safeguarding of the interests of a wider group of stakeholders; and a process to ensure that independent expertise is introduced into decision-taking processes at the very top of the organization (Merson 2010).) In 2003, the Institute on Governance aggregated the principles of the United Nations Development Programme to highlight legitimacy and voice, direction, performance, accountability, and fairness.

[11]Differences in governance between the private and public sectors pertain to organizational structure, regulation, agents, objectives, the origin of the governance model, authority, responsibility, independence, accountability, and reporting. Plumptre (2004) distinguishes salient elements of governance at international financial institutions. At the World Bank, for one: (i) the board of directors is chaired by the president (chief executive officer), a member of staff; (ii) the board of directors is subordinate to the board of governors—generally, governors are government officials such as ministers of finance or ministers of development; (iii) both the board of governors and the board of directors are accountable to shareholders; (iv) shareholders are governments, not institutions or individuals; (v) shareholders have very diverse values and objectives; (vi) the board of directors is in more or less permanent session; (vii) directors have weighted votes, unlike directors in the private sector who, by and large, all have an equal voice in decision-making; (viii) directors are selected by member countries based on criteria that may be quite different from those that increasingly apply to directors in the private sector, e.g., expertise, professional knowledge, contacts.

Sourcing and Inducting Directors

Managers may run an organization but the board of directors should make sure that it is run well in the right direction. To curtail corporate governance malfunctions, focus is being brought to bear on the core competencies of directors and their induction into the organization.

- **The core competencies of directors** Concern for both conformance and performance requires, respectively, that directors be equipped with short-term organizational efficiency and long-term organizational effectiveness competencies. The conformance-related functions of boards of directors demand abilities in supervision of management and accountability. Their performance-related functions call for aptitudes in policy formulation and foresight as well as strategic thinking. To help boards of directors become more effective, the Institute of Directors (2002) has suggested what personal attributes directors may need (i) strategic perception, (ii) decision-making, (iii) analyzing and using information, (iv) communication, (v) interacting with others, and (vi) achievement of results. The areas of knowledge it recommends directors be learned in are (i) the role of company director and the board, (ii) strategic business direction, (iii) basic principles and practice of finance and accounting, (iv) effective marketing strategy, (v) human resource direction, (vi) improving business performance, and (vii) organizing for tomorrow.
- **Induction of new directors** New directors must also be given the right preparation to do their job. A principle of the UK Corporate Governance Code is that all directors should receive induction on joining the board. (They should also regularly update and refresh their skills and knowledge). The objective of induction is to inform an individual in such ways that he or she can become as effective as possible in the new role as soon as possible. Obviously, directors vary in the extent of their preparedness. The essential point is that their induction should be planned with care, with a program of site visits and meetings with both major shareholders and management. (The UK Corporate Governance Code gives the chair of the board of directors responsibility for agreeing and reviewing a learning and development plan for each director.) New directors must be thoroughly conversant and competent in their knowledge of the organization, its business, and associated financials.

Evaluating Board Performance

If organizations are to survive and grow, their rate of learning must be equal to or greater than the rate of change in their environment. Comparison, reflection, and action are prerequisites to this. Thus, the ideal of the learning organization is as relevant to boards of directors as to the organizations they direct. To advance organizational efficiency and organizational effectiveness, they must become learning boards that simultaneously balance short-term and long-term, internally and externally oriented thinking. Admitting that the link between the performance of boards of directors and the organization may not always be perfect, boards of directors are ultimately accountable for the performance of an organization and should be judged accordingly. Therefore, there is considerable potential for self- and independent evaluations of boards of directors to improve corporate governance.

Naturally, an evaluation can serve many different purposes; three broad areas where the searchlight of review might be directed are processes and systems, participation, and performance.[12] In 2004, to cater to public sector needs, the Public Services Productivity Panel established in 1998 in the Treasury of the United Kingdom designed a comparable performance evaluation framework to cast light on structures and functions, actions and behaviors, and performance (Barker 2004).

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[12]Process and system evaluations are concerned with how the board and its committees operate, the role played by the chair, and the support provided to the board by staff. Participation examines the involvement of individual directors. Performance is concerned with the outcomes of board activity—this is where careful judgment must be exercised, as the issues can be complex (Plumptre 2006).

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