GOVERNANCE

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CG – science, craft or art?

'Governance is about the quality of management supervision, ensuring that the company is managed in the interest of shareholders and other stakeholders. Compliance is about adherence to rules and regulations which are a necessary, but not a sufficient, condition for good governance. Used in the context of a football game, governance describes the quality of the game, while compliance ensures playing by the rules.'

Dr Florian Schilling

Changing requirements and the future of CG

'The structures, memberships and practices of boards may need to change to ensure that they remain relevant and can continue to discharge their responsibilities, including providing the responsible, shared and transformational leadership required to cope with a changing and uncertain business environment.'

Professor Colin Coulson-Thomas

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CG – science, craft or art?

For over 20 years now a debate has been going on about what good corporate governance is. **Dr Florian Schilling** argues that depending on whether it is seen as a science, a craft or an art, very different conclusions can be drawn.

Science to outsiders

Outsiders such as academics, consultants and regulators tend to see corporate governance as a science. They seek a new perspective of corporate governance, looking for patterns and correlations to systematically identify causes and effects of good and bad governance, thereby freeing it from the habits and limitations of traditional boards and old boys' networks. According to this perspective, it is not necessary to sit in a board meeting to judge its quality, because there are quality indicators that can be observed and measured from the outside. If such indicators exist, then regulators can judge the quality of governance and define rules to prevent bad governance.

Craft to insiders

Insiders, the executive and non-executive directors (non-execs) who sit on boards, see corporate governance more like a craft than like a science. According to this viewpoint, good governance can only be recognised when experienced inside a boardroom, but neither can it be measured nor observed from the outside. Since insiders have to live with the daily challenges of good corporate governance; they are primarily interested in experiences and behaviours that have proven to be useful for boards. For them, the best apprenticeship for a non-exec is usually a successful management career, training executives for the real challenges of board work.

Mutual prejudices

Mutual acceptance of both viewpoints is quite limited; instead, prejudices are often cultivated and reinforced on both sides. Outsiders criticise conventional boards to be staffed with white old males defending their habits and privileges and refusing to appreciate new academic insights. Conversely, insiders criticise academics and consultants for having a purely theoretical view of what is really happening in boardrooms, and for overburdening them with unrealistic rules and recommendations that make boards less effective than they could be.

Both groups are competing for public recognition and acceptance; outsiders because it enhances their reputation and influence and insiders because they fear more regulation as a result of changed public opinion.

So far, outsiders are clearly winning this contest: just observe the worldwide trend for more regulation of corporate governance as well as the mushrooming terminology in which the debate is being conducted. Whoever defines the terms dominates the debate.

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Governance or compliance?

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However, both words describe different phenomena: *Governance* is about the quality of management supervision, ensuring that the company is managed in the interest of shareholders and other stakeholders; *Compliance* is about adherence to rules and regulations which are a necessary, but not a sufficient, condition for good governance. Used in the context of a football game, governance describes the quality of the game, while compliance ensures playing by the rules. The more compliance is equated with governance, the more the debate shifts from content to form.

Role of proxy advisors

This trend is strongly reinforced by proxy advisors, who primarily use publicly available information on compliance as the basis of their voting recommendations to institutional investors. Since these usually follow the recommendations of proxy advisors, companies are under enormous pressure to focus on compliance; irrespective whether these rules improve or hinder good governance. As a consequence, billion dollar investment decisions are based not on the quality of governance but rather on the level of compliance.

In addition, comply or explain options in many corporate governance codes can no longer be used when proxy advisors accept only full compliance as the basis of their voting recommendations.

Can corporate governance be measured?

After having carried out dozens of board reviews for European and US corporations in the last 15 years, I conclude that 'good governance' simply cannot be measured. I have yet to find a single quantifiable element that is a reliable indicator

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for the quality of the board, with the possible exception of the number of board meetings and the size of the board. Less than four board meetings and more than 20 board members are indicators of boards that do not work well. But beyond that obvious and very rough relationship I have found no other quantifiable, reliable indicators for the quality of a board. Therefore, every attempt to observe, measure and rate the quality of a board on the basis of publicly available information is misguided. The fact that in the last 20 years thousands of academics have unsuccessfully searched for correlations between indicators for the quality of corporate governance and stock price development suggests that there are neither reliable indicators nor significant correlations.

Blind spots of insiders

Insiders, who are sceptical of an increasing focus on compliance and ever more regulation, may see their view of good governance as a craft reinforced by this criticism.

Haven't they always said, that you better leave corporate governance to the practitioners, those who sit on boards and know how to run large corporations?

Why worry, if everything seems okay, comprehensive information material arrives in time, agendas are well prepared, all questions are answered and the board meetings are run professionally and smoothly? In such a situation both the professional experience and the instincts of board members indicate a well-functioning board.

It could be a typical weakness of a craftsman to focus on doing things right, instead of asking, if he is doing the right things.

Main responsibilities of the board

At this point it may be helpful to take a step back and ask, what the most important responsibilities of the board are and where non-execs can add most value?

By far the most important task of a board is the selection and appointment of the best possible management team. If the board successfully does a good job here, it has fulfilled its most important responsibility, even if it has not ticked all the compliance boxes. Conversely, even an over compliant board is useless, if it doesn't pick the right management team. ENRON is probably still the best known example of that.

Choosing the right CEO however is not a task that will keep the board permanently busy. Once a successful management team has been installed, there is no need to constantly question this decision of selecting the CEO. So what should the board do in between major appointments?

Most of the other board responsibilities are about supervising and controlling what the management does. If a good management team knows what it is doing, the non-execs in the board can add little value here. Specialists in the audit committee may debate the merits of different accounting methods but it is unlikely that any of this will have a strong impact on the future of the company.

What remains as a prime responsibility of the non-execs is one of the board's most important and most neglected functions: to provide a different perspective from management and act as an early warning system. While this may seem fairly obvious, it runs counter to the constant drive for professionalisation in the boardroom.

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Well-oiled machines

Corporate boards have a strong tendency to become well-oiled machines, where all the effort is being put into setting up the agenda, providing the necessary information and running the board meeting without surprises. Huge corporate staff does nothing but prepare for this event and most directors are satisfied with smooth board meetings as an indication of a well-functioning board.

The better organised and the more formal a board becomes, the more it loses its awareness of its own blind spots and deficiencies and the sensitivity for things that could go wrong. The usual suspects only have the usual suspicions.

We interviewed board members after spectacular company failures, which came as a surprise to the outside world and asked, if they saw that corporate failure coming. Many of these non-execs felt uncomfortable before the event and had a hunch that the company was not moving in the right direction: the CEO had his own agenda; monopolised the debate; the board was not given the full picture; and critical remarks or questions were not encouraged but either played down or sometimes even ridiculed.

In most of these cases the outside directors felt unable to raise such issues in board meetings because they felt alone

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with their concerns and the atmosphere discouraged the expression of doubts or reservations.

Dysfunctional alarm system

In other words, most boards have members with the awareness and judgement to sense when things are going wrong, but they lack the platform to voice these concerns at an early stage. If non-execs wait until they have the facts to prove their doubts, a lot of precious time has been lost.

You could compare this to an alarm system with smoke detectors that correctly detect fire and smoke, but whose signals are not processed by the system and therefore nobody acts when an alarm should be triggered.

So the challenge for a board is to create an atmosphere that not only allows but encourages board members to express doubts, reservations and uneasy feelings at an early stage – without fear of being isolated in a consensus driven environment.

Corporate governance as an art

Creating this kind of atmosphere is neither a science nor a craft it is an art, because it runs counter to the instincts of the professionals in the boardroom.

Imagine a theatre, whose success depends on the creativity of the artistic director and his ability to create an atmosphere in which the actors feel free to express themselves. While a professional commercial CEO may resent the creative chaos on the stage, he would be well advised to recognise that the main value to the company is added by a creative and innovative ensemble and create a structure that ensures professional management of all administrative issues while leaving room for creative chaos on the artistic side. If he loses sight of the main purpose of the theatre and follows his professional instincts to structure and rationalise the performance on stage, he might well end up with a perfectly organised theatre going bankrupt because nobody would be interested in seeing its performance any longer.

To use the comparison with the football team again, the compliance focus is about playing by the rules, the focus of the practitioners is about choosing the right players and training them and the 'art focus' element is about helping creative and unconventional players succeed.

This may seem fairly obvious but it is an enormous challenge for boards to create and maintain this kind of atmosphere. It is in the DNA of successful managers of large corporations to avoid surprises and create professional, smooth and efficient processes. So the natural tendency is that the professional and formal elements expand at the expense of the informal, 'amateurish' elements.

Role of the Chair

The board Chair has the main responsibility for creating this kind of informal atmosphere, if the Chair doesn't want it, it just doesn't happen. It does however take a strong Chair to achieve this, since it is not without risk.

The typical well-oiled machine guarantees the Chair the respect from his peers and prevents him from surprises. There are still Chairs that focus only on the formal aspects of chairing a board. Such Chairs know all the rules and bylaws and thus are very skilled at going through the motions, but they never get into substantial business discussions. As long as the business is good, such boards can create the impression that they function well. However, once the business environment changes, they will encounter greater difficulties in anticipating new challenges and risks and are therefore likely to react too late to a crisis.

A Chair that wants to emphasise the informal, unconventional elements described above has a more difficult job, since discussions may take unexpected turns, not every item is well prepared, time-keeping is more of a challenge and the more conservative board members may not like such a creative and some sometimes chaotic atmosphere.

The best prerequisite to start such a process is either a crisis, which the company and the board have just survived successfully or an outside review of the board, making it aware of its deficiencies. Once a board has decided that it wants to change its focus from the formal to the informal elements it can build on the experiences of other boards that have successfully gone through such a transformation.

A Chair that is undeterred by these challenges and focuses on the art of corporate governance may not be popular in the short term – but can take comfort in the knowledge, that it will earn the respect of other board members and will prepare the company for more difficult times.

Florian Schilling's has a Master's degree and a PhD in Economics from Freiburg University and an MBA from INSEAD in Fontainebleau. He has worked in strategy consulting, executive search and for the last 20 years has focused on board consulting.

He pioneered the concept of external board evaluation in Europe carrying out board reviews for major European corporations, ranging from ABN Amro to Zurich Financial and including companies like Deutsche Bank, EON, and Unilever. The focus of his work is not on compliance but rather on the underlying patterns and structures that define or limit a board's effectiveness.