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978-0-521-60634-9 - Boards, Governance and Value Creation: The Human Side of Corporate Governance
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Excerpt
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1 Investigating boards of directors

It is my intention in this book to present the human side of corporate governance. A landmark book about boards of directors was written in 1971 by Professor Miles Mace of Harvard Business School, with the title *Directors: Myth and Reality*.[1] His key observation was that there was a disparity between board task expectations (myths) and actual board task performance (realities). Mace placed the human side of corporate governance in this disparity. He recognised that this human side helps us explore the discrepancy between myths and realities. By understanding the human side of corporate governance, in this book we will:

- explore how boards can contribute to value creation;
- highlight behavioural and ethical dimensions of corporate governance; and
- present a coherent and unifying framework for exploring boards.

This book is about boards and value creation. Accountability and creating accountability are key concepts in the discussion about the board and value creation. Accountability is concerned with value creation, and creating accountability is concerned with bridging the gap between board task expectations and performance. The focus in this book is on how boards of directors can contribute to value creation.

Regularly these days, almost on a daily basis, we read in the press about boards and governance issues. Generally we read about malgovernance, cases in which boards are not doing what they are supposed to do. Institutional investors have increasingly turned their attention to corporate governance and boards of directors and their work, and during the 1990s many countries saw a mushrooming of codes of best corporate governance practice. An ethical dimension is often included in these codes. In this book I intend to highlight the behavioural and ethical dimensions of corporate governance. The focus on the human side of corporate governance will help us understand arenas for board ethics.

It has been clearly demonstrated in the ongoing debates that many of the actors, including board members, investors, the public in general and even business scholars, have only a limited understanding of the dynamics of boards and their governance. Concepts that are used in one context are, all too often, just copied and implemented in other contexts. Often there is confusion with respect to theories, concepts and contexts. A cohesive, coherent and unifying framework is missing. This makes it necessary to clarify some of the main concepts related to boards and governance, and to position these concepts in a context, and in relation to each other. The presentation of a unifying framework or structure may be considered to be both a strength and a weakness of a book such as this one. It is a strength insofar as it brings together aspects of corporate governance and board literature into a single view, but it may be difficult for the reader to combine all the different concepts and perspectives. I also run the risk of upsetting defenders of 'holy cows' in several different disciplines. Here I have to concede that I am not equally familiar with all the various disciplines and approaches that contribute to the understanding of boards of directors. These challenges have helped provide guidelines for the presentation and outline of the book.

An integrative framework will be used as a presentation guide throughout the book. Practical questions from ongoing debates will be addressed, and concepts, theories and research results will be presented. In this chapter the guiding framework is introduced. It is a framework for exploring the behavioural perspectives of corporate governance. The main contribution of the framework is the focus on actual board behaviour and the board's working style. The so-called 'black box' of actual board behaviour is opened. The book and the framework are concerned with how boards may contribute to value creation. Contingency and evolutionary perspectives are also central to this discussion.

A framework: the value-creating board

Reviews of research articles may give us a framework with which to analyse boards and governance. More than fifteen years have elapsed since Shaker Zahra and John A. Pearce showed in their seminal article that there are needs to use mid-range theories, including measures of a set of board attributes going beyond board composition.[2] However, in practice these needs are rarely met. In their follow-up, state-of-the-art article Jonathan Johnson, Catherine Daily and Allan Ellstrand divided research about board-financial performance links into three research traditions by focusing on various board tasks; control, service and resource dependence.[3] The main differences between the three traditions are the theoretical perspectives employed. The hypothesised relationships may vary, but board composition is generally measured by the same variables, as are most of the financial performance variables. The various tasks are reflected as theoretical board task expectations, and actual board task performance is rarely measured. Johnson, Daily and Ellstrand concluded that it is difficult to find relationships between board composition and financial performance in any of these traditions. For future research they suggested that boards should also be seen as social constructs.

Opening the black box

Actual board behaviour and the dynamics within the boardroom have in most research been considered as something of a 'black box'. Andrew Pettigrew argues in a 1992 article that the work of boards of directors was one of the most under-researched management topics, and because this research was still in its infancy there were few theoretical, empirical and methodological guideposts to assist researchers through this minefield.[4]

Daniel Forbes and Francis Milliken present, in a timely contribution from 1999, the board as a social construct and employ cognitive theories to understand boards.[5] They emphasise the need to open the black box, and they present a model of board processes. They argue that the board should be understood through the attributes of board composition and its members, the board's working style, and the board-level outcomes. They assign attributes to boards in the same way as for any other decision-making group, including preparations and the use of knowledge and skills, effort norms and cognitive conflicts. While Forbes and Milliken argue for understanding and measuring processes inside the boardroom, Pettigrew argues in favour of considering the board as an open system, and suggests that studies of board tasks should not be separated from studies of power in institutions and society, or from studies of the composition and attributes of top management teams.[6] He concludes that various research directions of managerial elites should be integrated, and that we must understand the dynamism in relations both inside and outside the boardroom.

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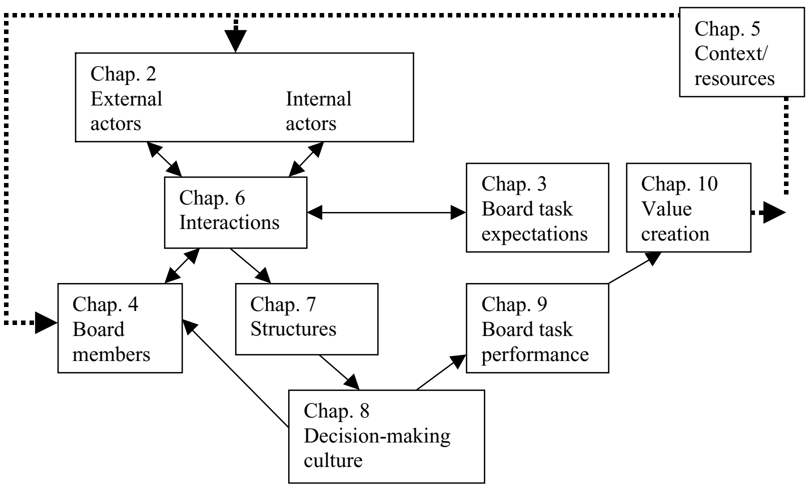
In a review article from 2000 I show the importance of using a contextual approach to understand boards.[7] Research into boards and the development of codes for boards and good governance is more or less based exclusively on research and concepts developed in the United States from Fortune 500 firms with institutional ownership. However, most firms are in fact small, most firms are family businesses, and most firms are located outside the United States.

This brief summary provides the following behavioural input for the evaluation framework:

- a need for mid-range theories and studies to replace input-output research;
- a need to bridge the gap between assumptions from board task theories and actual board task performance;
- a need for cognitive approaches to understanding the board's decision-making and actions;
- a need for research on the interaction among the board members and the larger set of stakeholders inside and outside the boardroom; and
- a need for board research that differs from the contexts of large US corporations.

In this framework, the firm is seen as a bundle of resources and relationships. Moreover, in this framework corporate governance is defined as the interactions between coalitions of internal actors, external actors and the board members in directing a corporation for value creation.

Overall guiding framework for this book



In this book and in the framework I integrate four main approaches to understanding boards and governance. These are:

- the discussion about board effectiveness and value creation;
- the exploration of behavioural perspectives on boards and governance;
- how various types of contextual factors influence boards, governance and value creation; and
- the importance of evolution and learning (these are all illustrated in the framework).

The framework has nine boxes and several arrows. Each box corresponds with a content chapter of this book. The arrows linking the boxes indicate how the content chapters of this book are linked. The framework may appear complex, but it is possible to include more concepts and relationships. I have here, however, tried to keep it as simple as possible. More arrows could have been included, and some of these possibilities will be discussed in the various chapters.

The chapter sequence follows the logic of intermediate steps from input to output. I first present the actors and their board task expectations (chapters 2 to 4). The interactions between the various actors are then presented (chapter 6). The board working style, including structures and processes, follows in chapters 7 and 8. Board task performance and value creation are presented in chapters 9 and 10. Context and resources could equally well have been placed at the beginning or at the end; they feature here as chapter 5. The main concepts from the bulk of board literature have already been presented and defined by then, and it makes sense to present the context in relation to them. Chapter 11 includes cross-chapter summaries.

Main concepts

A large number of concepts are presented in the book, and they are clearly related at many levels. I present them in different chapters, however, and the various chapters build on each other, as indicated above, in chronological order.

In chapter 2 I present concepts about the actors (internal, external and board members) and various corporate governance definitions (managerial, shareholder supremacy, stakeholder and firm definitions). With these different definitions corporate governance may be seen as a struggle between ideologies, and new paradigms for governance are suggested. In chapter 3 I present concepts related to accountability and various board task expectations. A typology of six groups of board tasks relating to control (output and internal), service (networking and advisory) and strategy (decision control and collaboration) follows, and finally in that chapter board task theories are sorted under four different headings (aunt, barbarian, clan and value-creating). Chapter 4 is about the board members. Both the demand side and the supply side are presented. The main concepts in this chapter are the characteristics, competence, compensation and composition of the board members.

The context and resources are presented in chapter 5. The main concepts in this chapter are resources, CEO tenure and characteristics, national and cultural differences, industrial environment, firm size, the firm life cycle, and ownership. In greater detail, these are: resources; CEO tenure, ownership and TMT competence; national, geographical and cultural differences, variations in stakeholder pictures and variations in legislation, including one-tier versus two-tier systems; differences in industries and competitive environments; firm size, including the comparison between large Fortune 500 corporations and SMEs; firm life cycle phases, including start-ups, growth firms, mature firms, firms in crisis and firms at different thresholds – as, for example, with initial public offerings (IPOs); ownership structures, including ownership dispersion and types, different kinds of family firms, institutional investors, venture capitalists (VCs), business angels and corporate ownership (including subsidiaries).

In chapter 6 I present interactions and steps towards a behavioural theory of boards and governance. The main concepts in this chapter are actors and arenas, trust, emotions, power and strategising. The main concepts in chapter 7 are rules, codes, norms, structures and leadership. Also included are concepts such as committees, the CEO work description, board instructions, board evaluations and 'away days'. In chapter 8 I present concepts related to the board as a team. The main concepts are criticality and independence, creativity, cohesiveness, openness and generosity, preparation and involvement, and cognitive conflicts. Various paradoxes and vicious and virtual dynamics are also presented.

Chapter 9 is about actual board task performance. Among the concepts presented are board strategy involvement, output control, quantitative control, behavioural control, qualitative control, reputation building and networking, advice and counsel, and mentoring and collaboration in strategic decision-making. In chapter 10 I present internal and external value creation, and the board's contribution in value creation through the whole value chain. Important concepts include corporate financial performance, corporate social responsibility, mergers, divestments, process innovation, product innovation and organisational innovation, and domestic and international market venturing. The main concepts in the concluding chapter (chapter 11) are board ethics, the 'value-creating board', balancing, and the human side of corporate governance.

Value creation and board effectiveness

The outline of this book is based closely on the framework. Governance, value creation and board effectiveness are the starting points. These concepts are introduced in chapter 2 and discussed at board level (chapters 3 and 9), as well as at corporate level (chapter 10).

Corporate governance and board effectiveness are concerned with accountability and about who and what really count. I present corporate governance definitions in which alternative value creation concepts are discussed. Corporate governance is defined here as the interactions between internal actors, external actors and the board members in directing a corporation for value creation. Accountability thus goes beyond controlling managerial opportunism on behalf of distant shareholders. A broader stakeholder picture is introduced (in chapter 2).

The actors may be categorised in different groups. External actors, internal actors and the various board members constitute such groups. However, the framework does not state clearly who the external and internal actors are, as this may vary depending on the context. The owners in a family business context may, for example, be classified as internal actors.

Firm-level outcomes relate to short- and long-term value creation in the firm as well as to the distribution of the firm's values among various stakeholders. Value creation is, in addition, more than just value distribution. Value creation occurs throughout the whole value chain, and board accountability thus also includes a large set of board tasks.

'Governance' and 'corporate governance' are both used as terms. Here I consider 'governance' in a broader sense than specifically 'corporate governance'. 'Governance' may relate to more levels in the corporate hierarchy, and it may relate to organisations that are not corporations. Boards in small firms, medium-sized firms and large firms, as well as boards in various other types of enterprises, are addressed in this book. 'Corporate governance' is therefore not a term that it is correct to employ in all situations. I will, however, still use it when the presentation relates to the ongoing corporate governance debate. In this book the term 'governance' is used in relation to boards; 'governance' is used when accountability and effectiveness are discussed, and the board is one of several tools to provide good governance.

Actors, behaviour and the human side

In this book I open what is often characterised as the black box of board behaviour, and I present behavioural perspectives on boards and governance. Strategic processes are emphasised more than strategic contents.

This book is about the human side of corporate governance, and it is based on a behavioural perspective with regard to boards and governance. A behavioural theory of boards and governance will have assumptions about the limited rationality of the actors and the fact that decisions are made by coalitions of individuals.[8] The behavioural assumptions are different from those that are found in the neoclassical understandings, and in most of the agency-theory-based input-output studies of boards of directors.

The framework indicates that there may be a wide disparity between expectations from traditional theories about board tasks (chapter 3) and actual board task performance (chapter 9). The behavioural perspectives presented in the chapters about the board's working style explain why we have this difference. The framework indicates that the interactions (chapter 6) among various actors or groups of actors with varying and changing power influence the decision-making and actions taking place in the boardroom (chapter 8). This influence can be directed through formal and informal structures (chapter 7), such as leadership, formal instructions, informal rules of the game, committees, efforts, norms, codes of conduct, etc. The changes and variations in the power of actors are indicated in the learning loops.

Contexts and resources

A contingency perspective for understanding boards and governance will have as its starting point the realisation that there is no single best way of designing boards and governance systems, but that not all ways are equally good.[9] When designing boards and governance systems we must take into account the actors and the context. The actors are not only the board members but also the whole range of internal and external stakeholders or actors. Earlier in this chapter I defined corporate governance as the interactions among the various actors who have various stakes and power in a corporation. Their stakes relate to the value creation and distribution of the values of the corporation. Their power will vary in nature and intensity in accordance with the variation of contextual factors, as will their knowledge and use of various governance mechanisms.

The corporate governance discussion has largely been shaped by the situation and developments in the United States and the United Kingdom. Much of this discussion has been about the board and how boards contribute to corporate financial performance – for example, should a firm have more outside board members, and should the CEO also be the board chairperson? In continental Europe the discussion has to a large extent been centred on whether or not a two-tier system is better than a one-tier system. A two-tier system exists if the board has to delegate the responsibilities for daily operations to executives chaired by a CEO or an executive board. The Anglo-American and the European discussions both concern accountability. Core questions raised in both discussions include what constitutes effective boards (including board tasks, board structures and leadership), how independent and knowledgeable board members are, and what the board's decision-making style is. In this book I concentrate more on the commonalities than the differences between the two discussions, but at the same time I clearly emphasise how boards and governance systems should fit contingencies and the context.

Since 1995 we have seen a fast-growing number of studies and publications on comparative governance systems, governance in different countries, and governance under various systems – such as economies in transition. Recent corporate scandals also lead scholars to use alternative perspectives in understanding governance and to search for alternative organisational forms. Stakeholder perspectives on corporate governance have received increased attention.[10]

The contextual factors that are most often identified in corporate governance research are:

- the firm's resources;
- the CEO and TMT's tenure, attributes and background;
- national, geographical and cultural differences;
- the industry and environment of the corporation;
- the firm's size;
- life cycle variations, including the importance of crises and the configuration of corporate resources; and
- the ownership dispersion and types, including family ownership.

The contextual factors are more fully described in chapter 5. The various contextual factors may have several aspects. In the firm's production system some of the contextual factors constitute input resources and some are the results of or directly influenced by the firm's outcome. Some of the contextual factors are tools for designing governance systems in addition to shaping the context for corporate governance.

The basic approach in this book is that governance designs must be tailored to the particular situation and needs of each firm. The discretion and thoughtfulness of the actors, and in particular the board members, are thus challenged.

Evolution

Understanding boards involves understanding dynamic processes, including various types of evolution and learning. This dynamism is illustrated in the arrows and loops in the framework diagram.

The dynamism of actual board behaviour and corporate governance is rooted in various learning and influencing loops.[11] These processes and loops exist at various levels:

- societal;
- institutional;
- organisational;
- group; and
- individual.

This evolutionary perspective is illustrated in the framework diagram by means of the arrows. The evolution at a societal level is illustrated through the changing awareness, concepts and rules of cor-