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Why an effective board is vital for a company

It should monitor top management, and decide on strategy, executive pay and succession

By **Loizos Heracleous**

EFFECTIVE corporate governance is an idea whose time has come. Adam Smith's concerns in his *Wealth of Nations* about the seemingly unlimited life, size and power of limited joint-stock companies were well founded; the world's largest corporations now wield greater economic power than many countries; their decision processes are largely non-transparent and are accountable to no one other than impersonal stock markets.

Globalisation and the integration of financial markets have given large multinationals an unprecedented reach and influence in the affairs of the countries and regions in which they operate.

Well-publicised abuses of corporate power in many countries through commercial fraud, environmental pollution or various other types of questionable and negligent practices through ill-will or sheer director incompetence have led in recent years to much disquiet among the stakeholders. These include institutional investors, politicians and the public at large.

The influence of institutional investors in particular is growing. Such investors are willing to pay a premium for stocks of companies they deem to have good corporate governance, and are becoming more active in monitoring governance issues.

Some institutional investors such as Calpers publish annually their list of worst-performing investments, and publicly call for corporate governance reforms in underperforming companies.

But directors are often not aware of their legal duties and the penalties they face in the discharge of their duties. Around six in 10 directors surveyed by the National Audit Office in the UK, for example, had not even heard of the Company Directors Disqualification Act 1986.

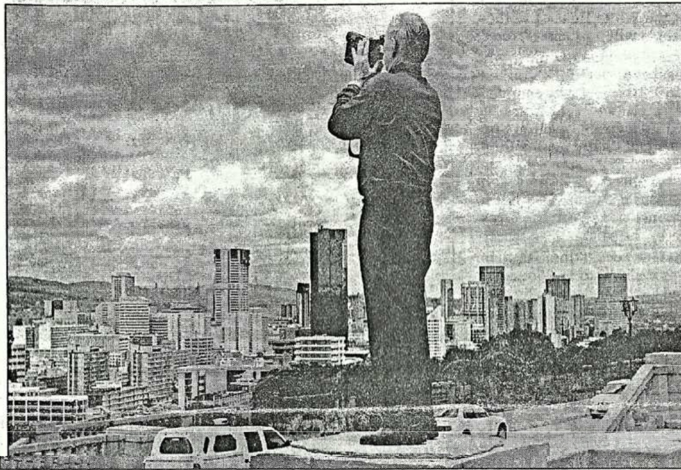
Of those who had heard of it, only half believed that disqualification arrangements were unsuccessful in deterring unfit directoral conduct; and nearly three-quarters believed that arrangements for disqualification were unsuccessful in putting unfit directors out of action and in protecting the public.

The Companies Act 1985 (UK) renders directors potentially liable for about 200 possible offences.

It is important to note that delegation of responsibility, or ignorance of transactions entered into by the company, are not adequate defences for a director, which is a point of special relevance to non-executive directors. Directors have unlimited liability under Commonwealth law.

In addition, one can be deemed a "shadow director" and be liable under the legislation even if he or she is not formally appointed a director. This is relevant to advisers of directors, and executives of holding companies who give instructions to the directors of their subsidiaries. Over 3,000 company directors have already been disqualified in the UK on grounds of being unfit to be a director, or upon conviction of an indictable offence, under the Company Directors Disqualification Act.

Boards of directors are ideally expected to monitor and discipline top management, and to be actively involved in such issues as executive succession, executive compensation, takeover defences, and strategy formation and change. UK studies show that directors generally take such strategic responsibilities seriously.



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The big picture: *directors can adopt a more strategic overall view of a company's business*

But the studies also show that corporate board activities do not usually correspond to the ideal view.

Directors are often not actively involved in strategy formation but at best rubber-stamp the CEO's decisions, and usually try to avoid "rocking the boat". Board performance has been found to be deficient. This is especially in the areas of director and board evaluation, which is rarely if ever carried out, and director selection, where there are no systematic processes for identifying and selecting the most suitable candidates, instead relying on the personal networks of the chairman, CEO or other directors.

Surveys also show that three-quarters of chairmen in the UK believe their company boards could be more effective, and four in five chairmen and CEOs in the US believe board training in director competencies should be mandatory. This gap between ideal and actual states is unfortunate, given the "scientific" evidence that the firm's strategy and organisation are much more important factors for company performance than even the industry context.

This highlights the potentially high value-added and wealth creation that effective boards can achieve by being astute in strategic functions.

Directors' limited time available for performing their role, and in the case of non-executives, insufficient in-depth knowledge of the company's workings, does impose limitations on what they can realistically be expected to achieve.

On the other hand, detachment from daily operations in their role as directors and the adoption of a "helicopter view", or seeing the big picture, bring the advantages of potentially more effective strategic thinking.

Their experience in other organisations and contexts, in addition, can lead to a more holistic view of the issues than in the case of operational managers who spend most of their time on daily fire-fighting.

Even with time limitations, boards can thus still make a critical contribution in long-term policy formulation, strategic thinking and planning, as well as supervising management and being accountable to stakeholders.

Frameworks and models exist which can help boards address these vital functions by allocating their time in a thoughtful and focused manner, such as the "learning board model", "strategic audits" for boards, or tools for developing directors through personal coaching.

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Scientific knowledge is still in its early stages when it comes to what makes an effective board; but important considerations are how the board is structured, how it carries out its deliberations, and what the outcomes of these deliberations are.

The Institute of Directors in London produced as early as 1973 its first *Guidelines for Directors*, now in its sixth edition, and in 1995, its *Good Practice for Directors*, based on extensive research.

Many international organisations and countries have either recently produced or are now considering codes of good practice for directors.

These codes are often contentious; the OECD's 1998 code, entitled *Draft OECD Principles of Corporate Governance*, for example, has been criticised as being too focused on returns to shareholders at the expense of other stakeholders.

The Commonwealth Association for Corporate Governance produced about four months ago its *Draft Commonwealth Code and Guidelines for Corporate Governance*, based on 10 commercial, legal and social duties of directors.

We are still in the early days of a turbulent but exciting and far-reaching journey in corporate governance.

This is one of a series of articles from members of the Economic Society of Singapore. The views expressed are those of the author, who is a lecturer at the National University of Singapore's Faculty of Business Administration