Reconnecting the Board to the Company

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During the twentieth century, the focus of corporate governance shifted from shareholder empowerment to board reform. Most people will agree that while board reform produced endless debate and discussion, it achieved very little on the ground. Indeed the twentieth century was in many ways the low point of corporate governance worldwide.

But I am optimistic about the twenty first century for two reasons. First, the much maligned and much hated Sarbanes Oxley Act in the United States (and similar regulations elsewhere in the world) have changed the focus of corporate governance yet again. This time, the focus has shifted from reforming the board to strengthening its internal processes. I believe that this stands greater chance of success and that by reconnecting the board to the company, it might reform and empower the board in ways which decades of debate about corporate governance codes did not achieve.

Second, there is now evidence that shareholder empowerment which we had regarded as unworkable during much of the twentieth century could now be beginning to work once again. In the twentieth century, shareholder empowerment became irrelevant because of the fatally flawed nature of governance in the investment institutions that are the principal shareholders in much of the corporate sector. It was useless to empower some of these institutions because their flawed governance structure made them inadequately focused on maximizing the value of the companies that they invest in. Now we are seeing genuine change here, both with the growth of a new breed of investment institutions and with fundamental change in the behaviour of the old institutions.

Shareholder empowerment

For nearly two centuries after the first emergence of the joint stock corporation, the focus of corporate governance was exclusively on the three pillars of shareholder empowerment – shareholder democracy, minority rights and disclosure. The whole of early company law was devoted to this and to very little else.

For centuries, shareholder democracy was all that there was to corporate governance, but it did not work too badly. Talking about one of the largest and most corrupt multinationals of his time (the East India Company), Adam Smith, the father of economics, had this to say:

> "Frequently, a man of great fortune, sometimes even a man of small fortune is willing to purchase a thousand pounds share in India stock merely for the influence which he expects to acquire by a vote in the court of proprietors. It gives him a share, though not in the plunder, yet in the appointment of the plunderers of India ... Provided he can enjoy this influence for a few years, and thereby provide for a certain number of his friends, he cares little about the dividend, or even the value of the stock upon which his vote is founded" (Adam Smith, 1776, *Wealth of Nations,* Book V, Chapter I, Part III, Article 1st).

However repulsive this situation may appear to us, we must not miss the fundamental point underlying Adam Smith's description – a well functioning market for corporate control compensates for a lot of other sins and ensures that the shareholders get their reward. Another important point that emerges from this example is that fragmented shareholding does not of itself dis-empower the shareholder. The East India Company was one of the early instances of a large corporation where separation of ownership and management was clearly visible. Yet "even a man of small fortune" could make his vote count.

Unfortunately, over a period of time, we have made it more and more difficult for shareholder democracy to work. In some countries like the United States and Japan, poison pills and cumbersome proxy procedures have dis-empowered the shareholder to a great extent. Countries like India have escaped this trend. But in almost all countries including India, the twentieth century witnessed the rise of investment institutions that either do not vote at all or vote with incumbent management. Most mutual funds around the world fall in this category. The erstwhile development financial institutions in India were also notorious examples of this phenomenon. Empowering such shareholders is utterly pointless.

Within the government itself, power and prestige have gradually shifted from company law administrators to securities regulators. The evisceration of shareholder democracy has therefore been accompanied by a rise of ever more detailed disclosure requirements. This has been extremely useful to minority shareholders whether they choose to exit or to enforce their limited minority rights through litigation. But it is far less useful to large shareholders who seek to exercise their control rights.

During the early years of this century, we are seeing evidence that we may be putting the unfortunate legacy of the twentieth century behind us. Private equity funds and hedge funds have internal governance structures that are far better aligned to the interests of their owners. Since these institutions charge management fees that are linked to the investment performance of the fund, fund managers have a much stronger incentive to seek the highest possible return from their investment. This inhibits the cosy relationships that traditional investment institutions had with incumbent management.

Board Governance

Twentieth century corporate governance was fixated on board reform. But this fixation yielded little tangible results because of the prolonged atrophy of the board. The twentieth century board lacked the expertise, information, power and incentive to discipline incumbent management.

During the last decade or so, all this has changed. Shareholder litigation and regulatory intervention have created the incentive to act. Governance codes have helped enhance the expertise of the board at least in financial matters.

But the key element is information which is of course the source of real power. As long as the board lacks real information, its vast statutory powers are utterly meaningless. It is this more than anything else that has stymied the functioning of boards. If we are able to remedy this, we will see the emergence of a board that is immensely more powerful than the twentieth century board.

People often tell me that the board will never be able to perform any serious oversight because it simply lacks the time and expertise to do so. I do not agree. In a large multinational, the CEO also gets very little time to look at the performance of a particular subsidiary in a particular country and probably lacks the expertise to understand it too well either. The CEO depends on internal processes that ensure that accurate and relevant information is available and that problems are escalated to appropriate levels in the organization that can address them. History tells us whenever organizations have lacked these internal systems, the full time CEO with all the trappings of power and authority has been as ineffective as the board that meets only once a quarter.

Indeed once we look at it objectively, the CEO's oversight of divisional heads is in many ways as difficult as the board's oversight of the CEO. The divisional head knows more about his or her division than the corporate head office and can be counted on to defend divisional autonomy jealously. As the medieval legal maxim put it, a king is emperor in his kingdom (*rex in regno suo imperator est*). Yet top management does manage to exercise oversight over divisional heads. What enables this to happen is strong internal processes and reporting systems. These systems not only ensure that the top management gets all the information it needs but also provide assurance of the reliability and accuracy of this information.

Unfortunately, the board does not have the equivalent of these tools when it comes to exercising oversight over the top management. It is this lack of systems and processes that has distanced the board from the company and rendered it ineffective. The board can become effective only if this changes. It is only by strengthening internal processes that we can reconnect the board to the company and make it effective. Recent regulatory initiatives are attempting to do this though it is too early to say how effective these would turn out to be.

Internal Processes in the Modern Corporation

It is quite clear that the modern corporation is quite difficult to manage and govern. Several convergent trends have contributed to this phenomenon. First is that value addition is shifting from goods to services and it is more difficult to monitor the quality and efficiency of services especially when we attempt to do so from the rarified heights of the board room. Second, wealth creation is becoming increasingly dependent on intangible assets and intellectual property . It is relatively easy to walk around a factory and convince oneself that the physical assets are all still there. It is far more difficult to do the same when it comes to intangible assets and intellectual property. Walking through a research laboratory does little to convince oneself that the systems and processes for protecting and enhancing intellectual property are working properly.

All this means that oversight in the modern corporation needs to focus less on stocks than on flows. The value of an intangible asset is defined by the cash flows or other benefit flows that it produces. Safeguarding such an asset is fundamentally a question of monitoring and safeguarding these flows. This makes oversight and governance more difficult.

Going back to Adam Smith's example of the East India Company, it is worth recalling that the governance problems in that company were so severe because it was an "asset light" company whose business was all about flows rather than stocks. The key "assets" of the East India Company were its monopoly trading rights and its right to collect taxes in India. Its physical assets were negligible as it did not even own the ships on which it plied its trade. The East India Company never developed adequate systems and processes to safeguard and control its intangible assets and the cash flows from these assets. Two centuries later, the ability to monitor benefit flows from intangible assets remains the major oversight problems for most companies today.

Sarbanes Oxley

I am surprised by the near consensus among managers and investors today that the Sarbanes Oxley Act was a misguided reaction to the governance scandals of 2001 and that its benefits are not commensurate with its costs. There is even a tendency to give companies the benefit of doubt when they are unable to comply with the internal control requirements of Section 404 of this Act.

For example, in August 2005, Refco Inc came out with its IPO and stated in its prospectus:

> "... our independent auditors reported to us that we had two significant deficiencies in our internal controls over financial reporting. ... One significant deficiency was ... the need to increase our existing finance department resources to be able to prepare financial statements that are fully compliant with all SEC reporting guidelines on a timely basis. The second significant deficiency was ... our lack of formalized procedures for closing our books. ... we are in the process of enhancing our financial reporting capability by hiring additional internal audit and finance personnel and developing formalized closing procedures, including through the implementation of software upgrades throughout our operations." (Refco Inc. Prospectus dated August 10, 2005, page 23).

Investors completely ignored this risk factor and lapped up the offering of Refco shares. Two months later, Refco disclosed that $430 million of debt previously stated to be from a third party was actually owed by its chief executive. Within a week, a business previously valued at $3.6 billion had collapsed. Its collapse could be directly traced to the lack of internal controls disclosed in the prospectus and ignored by investors.

The Refco example suggest that Sarbanes Oxley is on the right track after all. Running the modern corporation without sound internal controls is like driving a car blindfolded. It is in the best interests of company management itself to improve internal controls. In the process, it also reconnects the board to the company and makes the tasks of the board one step closer to being doable.