# Reconnecting Directors to The Company

Only by strengthening internal processes can managements ensure the board will do its job, says **Jayanth R. Varma**

In the 20th 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 20th century was, in many ways, the low point of corporate governance worldwide.

But I am optimistic about the 21st 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) has 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 a greater chance of success. By reconnecting the board to the company, it might reform and empower the former in ways which decades of debate about corporate governance codes did not achieve.

Second, there is now evidence that shareholder empowerment, which was regarded as unworkable during much of the 20th century, could now be working once again. In the 20th century, shareholder empowerment became irrelevant because of the fatally flawed nature of governance in 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 maximising 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, corporate governance lay 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 very little else.

For centuries, shareholder democracy was all that there was to corporate governance, but it did not work too badly. The East India Company was one of the early instances of a large corporation where separation of ownership and management was clearly visible.

Unfortunately, over a period of time, we have made it increasingly difficult for shareholder democracy to work. In some countries like the United States and Japan, poison pills and cumbersome proxy procedures have excluded the shareholder to a great extent. Countries like India have escaped this trend.

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But in almost all countries – including India – the 20th 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, there is evidence that we may be putting the unfortunate legacy of the 20th 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 performance of their funds, 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 company management.

Corporate governance in the 20th century was fixated on board reform. But this fixation yielded few tangible results because of the prolonged atrophy of the board. The 20th century board lacked the expertise, information, power and incentive to discipline incumbent management.

### Board Power

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 20th century board.

People often say that the board will never 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 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 organisation that can address them. History tells us whenever organisations have lacked 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*).

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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 tools when it comes to exercising oversight over 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 initiatives are attempting to do this, though it is too early to say how effective they will be.

### The Modern Corporation

It is clear that the modern corporation is quite difficult to manage and govern. Several convergent trends have contributed to this phenomenon. Firstly, 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 rarefied heights of the boardroom.

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. Walking through a research laboratory does little to convince one 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 the East India Company, it is worth recalling that governance problems were 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 problem for most companies today.

It is surprising to note 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. Running the modern corporation without sound internal controls is like driving a car blindfold.

It is in the best interests of company management itself to improve internal controls. In the process, it also makes the company board's job doable. ■

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