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Why Is It So Hard For Boards To Govern?

by Steve Boivie, Michael Bednar and Ruth Aguilera

Corporate boards of directors have become the "go to" entity whenever a new government oversight or monitoring requirement is imposed—and the "where was the board?" scapegoat every time a corporate scandal erupts. Does this mean our board members are lazy, inattentive, or inept? Or could it mean we demand that boards perform a job they were never designed for?

When something goes horribly wrong at a firm, who gets the blame? Increasingly in today's business world, the answer is the board of directors. This tendency to blame boards when things go wrong appears to be quite prevalent. A quick news search of recent corporate failures reveals headlines such as: "Board sleeping at the wheel," and "Where was the board?" Boards are frequently portrayed in the media as a bunch of yes-men (or women) who fully acquiesce to whatever the CEO wants.

If we view the job of the board as primarily one of oversight, then perhaps this tendency to blame the board is understandable. Yet we need to ask ourselves as investors, regulators, consumers and other members of economic life, is it really fair to pin the blame for corporate failures on the board? Can we even reasonably expect that boards will be able to effectively provide ongoing managerial oversight? Trying to answer these questions served as the motivation for our review of academic research on boards. What we discovered calls into question some of the fundamental assumptions that are commonly held about the role of the board.

For many years the board was viewed in academic circles largely as a powerless group that gave in to the interests of the CEO. This view of the board persisted for quite some time among those who studied boards until the rise of agency theory in the mid-1970s. Agency theory outlines the problems that can occur in an agency relationship, where one party (the agent) represents the interests of another party (the principal).

One of the key assumptions in the agency perspective is that managers may often have different interests than shareholders and, because of this, they need to be carefully watched over. For example, managers might be more focused on securing their jobs than on trying to maximize value for the shareholders. This same rationale provides the driving force behind most work on executive compensation as executive pay is largely seen as a governance tool that can help align the interests of managers with those of shareholders.

Due in part to the influence of this agency perspective, the primary role of the board of directors is often seen as the monitoring of executives. Monitoring means exercising oversight and control of executive actions and ensuring that shareholder interests are protected. Research in this vein is based on the assumption that ultimate oversight and authority rests with boards.

Most boards are filled with smart, successful, conscientious and powerful people, who seem to care deeply about the firms that they help to oversee.

It is the board's responsibility to be more than just a sounding board for management, but they must also oversee and monitor their decisions. This view of the board as the primary monitoring mechanism of management has formed the underlying logic behind almost all academic work on boards in the last 40 years, as well as many practical actions like corporate legislation and stock exchange regulations.

This view of boards is one of the major reasons why boards get the blame when things go poorly at firms. However, just because theory argues that this is what boards should do, it does not necessarily mean that this is a reasonable expectation.

Furthermore, our research and experience with board members caused us to think that this view of what boards should do may be too extreme. When we have met with individual directors and interviewed them, we have been struck by the fact that most boards appear to be filled with smart, successful, conscientious, and powerful people. From our own interviews with numerous directors, we come away with the perception that most directors care deeply about the firms that they help to oversee.

The disconnect between our personal experience with boards and portrayals in the press of incompetent or shirking directors left us with a puzzle that we wanted to address. We decided to undertake an extensive review of the academic literature and use that inquiry to offer a new perspective on what role we should reasonably expect the board to fill. We sought to examine both the conceptual theories behind board behaviors as well as the empirical evidence. We reviewed approximately 300 research studies that examined the monitoring role of boards.

This research suggests that perhaps scholars have focused on the wrong questions with regards to understanding the effectiveness of board monitoring. Much of the scholarly research that we reviewed examined how different board structures are likely to facilitate increased monitoring by the board and ultimately enhance performance.

However, we were left with the feeling that perhaps the right question should not be centered on what the best structure for board effectiveness is, but instead whether it is even possible for the board to properly fulfill its oversight role. This question is important because, if the board is designed to fail, then we need to stop blaming directors and start asking different questions such as: "What can we expect boards to do well?"

In the course of our research, we identified a number of barriers that can prevent effective monitoring by boards. Boards have to process information to be effective. These barriers can inhibit the board from effectively obtaining, processing, and then sharing information. Further, these barriers appear to be pervasive, and they seem to make it unreasonable to expect boards to act as an effective watchdog of management. More precisely, we argue that there are ten important barriers that inhibit directors from being effective monitors.

Active CEOs are coveted board members, but with such a demanding job, are most CEOs going to be able to devote the necessary time and attention to their board duties?

Individual director factors arise from the individual challenges that outside directors face as working individuals, given that they have cognitive and time constraints.

☐ ***Outside job demands.*** Directors are successful and busy people with many competing demands for their attention. The more demands a person has on his/her time or attention, the harder it will be to monitor managers. Active CEOs are often coveted board members, but being a CEO is extremely demanding. With such a demanding main job, are most CEOs going to be able to devote the necessary time and attention to their board duties?

☐ ***Similarity of outside job demands.*** If a director's job is similar to the firm, it will be easier for that director to apply what he/she knows to understanding the firm. Often, though, boards have directors with little or no experience in that same industry. Consequently, it will be harder to monitor executives if a director has little direct understanding of the success factors in a given market.

☐ ***Complexity of outside job demands.*** Research has shown that it is more challenging for managers to oversee highly diversified firms. A firm that is in multiple industries requires a larger body of knowledge to oversee. So when a director is an executive at a highly diversified firm, they are going to have less

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spare time and attention for their role as a director.

Group factors are barriers that come out of the natural processes that occur when people work together in groups and teams. Group effectiveness requires extensive trust and important skills such as the ability to concisely share information, to communicate effectively, and more.

☐ ***Board size.*** As the board gets bigger, the costs of coordinating the group increase. In addition, on large boards, it is difficult for directors to get to know each other well. They are less likely to develop trust, and there is a greater likelihood that some directors may tend to coast on their duties.

☐ ***Meeting frequency.*** Groups have trouble being effective if they do not meet together frequently. Most boards meet less than once a month. This can make it very difficult to develop effective decision-making processes and information-sharing skills.

☐ ***Diversity of directors.*** Although most firms are trying to increase the diversity of their board, there is a cost to diversity. Groups that are diverse take longer to make decisions and develop trust. Diverse teams also sometimes fall prey to common decision biases.

☐ ***Norms of deference.*** Many groups develop unwritten rules or norms. One that is common is that a director should defer to the CEO about what items to discuss at meetings and how to voice concerns. These unwritten rules make it very difficult to monitor executives without making a bad impression on other directors.

☐ ***CEO power.*** CEOs have a lot of influence over what happens in the board meeting. Powerful CEOs often control the agenda, access to the money or resources needed to hire new directors, and more. This makes it more difficult for directors to monitor effectively.

Firm factors are barriers which arise from the very nature of the firms on which directors serve.

☐ ***Firm size.*** It is hard for a group of part time directors to oversee a company that has billions of dollars in revenue. Large firms have more moving parts and more ways things can go wrong. It is also quite difficult to make changes at big firms, which may make it harder for the board to be influential.

☐ ***Firm complexity.*** When a company operates in multiple product and geographic markets, it is harder to oversee and understand. The modern globally diversified firm is incredibly complex, and puts an extremely high burden onto a part time director to understand all of the necessary information to monitor executives.

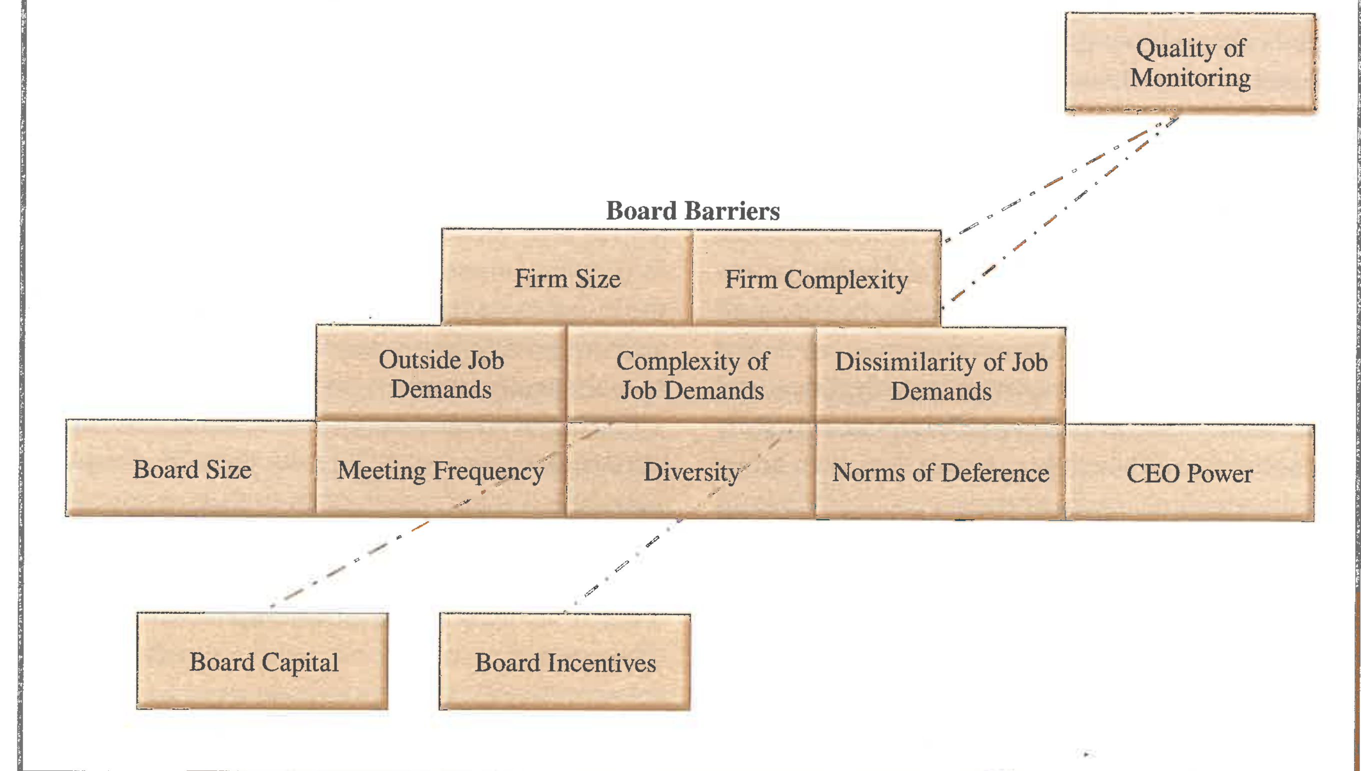
We may need to change our thinking about what we can reasonably expect boards to do well.

As you can see, there are many different reasons why it is incredibly difficult for boards to monitor like we expect them to. We do not believe boards are by default lazy, ill-intentioned or incompetent. Instead, the contemporary structure of boards makes it almost impossible even for the most qualified and competent directors to monitor executives effectively.

However, if boards cannot monitor effectively, does that mean they are worthless? Not at all. It does mean that we may need to change our thinking about what we can reasonably expect boards to do well. It also might mean that we need to stop believing that the agency theory view of boards, where boards are the watchdogs of management on behalf of shareholders, tells us everything we need to know.

So, given that we are arguing that boards cannot effectively monitor on an ongoing basis, what do we believe boards can do well? There are three main roles that boards can fulfill effectively. The first is to set the right tone at the top of the organization. The second role is as a collective body that gives advice and counsel to management. The third role is as an oversight body in times of crisis or critical events, such as replacing the CEO or overseeing an acquisition.

Part of the problem facing boards as the primary watchdog of management is the fact that information disparity between management and the board is so great. This information asymmetry has only been exacerbated as boards have become more and more independent, with many boards having the CEO as the only inside director.



Even if boards are not well positioned to oversee the details, they can and should set high expectations for the firm. This is true with regards to performance, but perhaps more importantly for business ethics, corporate culture and more generally how business gets done and how value gets created and distributed among the different stakeholders. How the board reacts when misconduct is suspected or even when seemingly minor ethical lapses occur, can either put a halt to a potential scandal before it begins, or set the stage for future, more costly mistakes.

Directors can be effective when serving as advisors and counselors for the management team. Directors often have decades of experience in varied industries. This knowledge can be an incredible resource for executives—when used properly. Indeed, knowledgeable directors can help the firm, especially when their knowledge matches what the firm is going through.

In a similar way, if a CEO knows and trusts the directors, he/she will be more willing to seek out their advice outside of board meetings. Directors can also ask important questions and work to make strategic actions better and more relevant. Although we mentioned the costs of diversity above, it can be valuable if the board works to develop trust and communication among directors.

The second way directors can be effective is by banding together and overcoming the barriers above in short-term bursts. For instance, when a firm is considering an acquisition, directors can devote considerable time and attention to that one particular decision. Most of the barriers above can be overcome with a dedicated burst of effort. We cannot expect this to occur in an ongoing fashion, but many important outcomes occur in this kind of punctuated situation.

We expect similar types of focused attention when the board needs to replace the CEO. If the board realizes that a major part of its job is to provide focused attention in short bursts such as these, then directors may see this as a much more realistic way to view

the way they allocate their time and attention to their duties as directors.

Boards should recognize their own limitations, and put mechanisms in place to minimize the obstacles.

In addition to shifting focus towards these other roles, boards should recognize their own limitations, and put mechanisms in place to minimize the obstacles that we outlined. For example, boards must understand and recognize potential group biases and recognize that they are as susceptible to dysfunctional dynamics as other workgroups. Boards that are fully aware of this will honestly examine their own group dynamics and put in place processes and procedures to make sure that there is appropriate debate about issues and that each director has sufficient opportunity to contribute expertise on relevant issues.

Understanding these barriers may also influence who gets nominated and ultimately elected to serve on a board. Just because a potential director has impressive credentials does not mean that he or she will be a good fit for the board if their outside job demands curtail the cognitive capacity to devote to the role. Considering these outside demands should be an important part of the director selection process.

In conclusion, maybe we need to shift our view of what a board's job is supposed to be. We must stop hoping for the impossible and instead focus on reorienting our expectations. Modifying our view of the board as an impartial watchdog may be difficult and even scary, but it may be necessary if we want to realistically improve corporate governance.

Further, if we give up this view, there are still corporate governance problems out there. For instance, none of our solutions do much to curb opportunistic CEO compensation. However, if we keep hoping that boards will do the impossible, then we will never work to develop better or alternative solutions for these issues. ■