The Pros and Cons of Good Governance

Despite the costs, there are notable advantages.

BY DOUG RAYMOND

Are best practices in corporate governance worth it? Why should boards struggle to implement policies and procedures that may be uncomfortable, expensive and inefficient?

Pundits often suggest that strong governance can boost stockholder returns and studies periodically seek to support to this idea with pronouncements such as "companies with strong governance outperform those with weak governance by 7.4% per annum," states a report titled *Internal Governance Characteristics, Time-Varying Agency Costs and Stock Prices*.)

The SEC, stock exchanges and many institutional investors also appear to have bought into good governance as a pathway to stronger shareholder returns. But some have sharply criticized such analyses, and at least for the moment, there doesn't seem to be strong empirical support for the claim that good governance produces increased shareholder returns. Despite the lack of quantifiable benefits, there are some notable advantages of good governance, including promoting efficient and effective responses to corporate misfortune.

The current governance regime includes state and federal laws and regulations, the various requirements of the stock exchanges, and recommendations and policies of institutional investors and their advisors. These prescriptions are extensive, intrusive and expensive.

To start, the median annual compensation of a director at a Fortune 500 company is now more than $250,000. Governance imposes other financial costs, including the expense of engaging outside experts and consultants, and non-financial costs such as the time and other resources spent in the name of "good governance." At many companies, management now spends days to prepare for board meetings, time that might have been devoted to operations or sales growth.

Beyond these, there can be other costs. Some have criticized that too much board interference impedes the entrepreneurial spirit that has animated many successful corporations. After all, many directors believe that their role requires skepticism in assessing management's plans and avoiding risks wherever possible. This skepticism and risk aversion can delay, thwart or dilute the implementation of management's grand vision.

In recent years, similar concerns have motivated founders, particularly in the technology sector, to use two classes of common stock when taking their companies public, allowing them to retain control over their boards.

So, if good governance produces inconclusive market returns, is costly and can dampen the entrepreneurial spirit, why is it good business? Despite its costs, good governance has some notable advantages in addition to facilitating compliance with SEC or stock exchange requirements.

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First, for every brilliant entrepreneur building a "unicorn," there may be one or more imperial CEOs persuaded of their infallibility. As with the Auriga, the Roman slave in antiquity whose job was to whisper into the victorious general's ear that he was not a god but mortal, a well-functioning board can help management keep an appropriate sense of perspective. One of the advantages of greater board diversity is that it helps management identify unexpected blind spots and unanticipated implications of a proposed course of action.

Second, a strong board is invaluable in a crisis, when crucial decisions must be made on short notice and "gut" reactions are often wrong or inadequate. Many public examples exist in which the first response to a corporate crisis needed to be significantly modified, creating situations that a well-functioning and fully engaged board possibly could have avoided.

With good governance comes the ability to respond effectively to corporate misfortune. If a board has had experience working collaboratively together to consider and anticipate potential risks, and has talked through the range of possible responses, the directors are better equipped to respond rapidly and effectively to significant and unanticipated challenges.

In addition, a board that makes a significant investment in good governance practices sends a strong signal to investors, regulators, employees and other constituencies that it values fairness, careful deliberation and building consensus before acting. This can create valuable goodwill that can prove important, if, for example, an unexpected accounting issue arises, or if the corporation is seeking to hire new senior officers or faces a public misstep.

These advantages of strong governance practices are especially important today with the instantaneous and 24-hour news cycle, and the increased levels of investigations and litigation against companies, arising not only from "traditional" areas, but also data privacy, #MeToo, sustainability and other issues crowding the front pages of newsfeeds and social media.

Strong and effective corporate governance has never been just a laundry list of "best practices." Rather, boards should engage in a thoughtful dialogue with management and other important constituencies to determine how best to ensure effective board governance in their particular circumstances. Boards should cultivate directors who can think creatively about which governance practices make the most sense for their specific situation and can balance encouraging and supporting management with providing a healthy dose of perspective. It takes talented directors to recognize how best to tailor the governance regime to the specific corporation and think ahead regarding potential issues.

Good governance may not boost your company's P/E ratio, but in good times and especially in bad times, it will lay the groundwork for meaningful and effective decisions by those running the business and can mitigate downside risks. Additionally, it demonstrates the decision makers' commitment to be fair to the company's various constituencies. All of this makes for good business. ■

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