

The Information Future of the Corporate Board

Joshua B. Bellin and Robert J. Thomas



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Research Note

Institute for
High Performance
Business

April 2008

Corporate governance is in the news again. Following the high-profile reversals in the financial-services industry, pressure on boards from shareholder activists and regulators to somehow prevent such meltdowns has increased. As a recent Business Week commentary proclaimed, "Long gone are the days when a director could get away with a quick rubber-stamp of a CEO's plans."¹

But boards won't be well positioned to take on greater responsibilities unless they can have access to the right information at the right time. Despite the growing availability of information about publicly traded companies—for example, via electronic filings and financial analyses on

the Internet—directors traditionally rely solely on information that comes from management when they make boardroom decisions.

This condition of dependence results from what we term "information asymmetry." And if boards are to effectively fulfill their duties, they may well want to shift the balance by seeking—with management's blessing—both more information and information from independent sources. Shouldn't boards be looking to reduce their dependence on management for the very thing that they are expected to examine, assess and oversee: information about management's performance and the company's risks? This question is

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especially pertinent during those inflection points when financial projections are missed by a wide margin, when foreseeable risks knock a company off kilter, or when management action damages corporate reputation. Surprisingly, perhaps, information asymmetry attracts little attention from shareholder activists and regulators and elicits little concern from directors.

In this research note we explore different dimensions of this question, including how information promotes or inhibits boardroom independence, where this issue falls on the corporate governance agenda, and the situations that make information asymmetry especially salient.

This is the first in a series of research notes that will address the use of information to enhance boardroom decision-making and corporate governance in general. Upcoming notes will focus on legal and regulatory scenarios in which information asymmetry might become an even greater concern in the near future, and on the role that technology—for example, in the form of instrument panels or dashboards—could play in corporate governance in the future.

Independence in the boardroom

The corporate governance crises of the early 2000s, followed in their wake by the Sarbanes-Oxley Act and other initiatives, reshaped the landscape of corporate governance in the United States. Since then, there have been measurable changes to the structure and

composition of the typical corporate board, with greater numbers of independent directors holding boardroom seats, populating key committees and, as lead independent directors, assuming some duties of the chairman when the latter is also an executive. One recent study revealed that 74 percent of directors in the United States are now independent.² These developments are seen as highly desirable by shareholder rights advocates such as RiskMetrics Group and others who believe that the more independent boards are from management, the more effective they will be at protecting shareholder interests.

Directors themselves are increasingly enthusiastic about these changes. According to recent surveys of board members, directors overwhelmingly see greater numbers of independent directors as one of the most important developments improving the quality of corporate governance.³ Likewise, directors are increasingly asserting their independence: surveys reveal that a large majority of directors believe their boards act independently of management, voicing contrary opinions and taking action when they believe it is necessary.⁴

Information in the boardroom

Despite these developments, the manner in which information is used in corporate boardrooms is both an overlooked and underappreciated aspect of board independence.⁵

As one recent study on corporate governance underscores, “the board’s ability to provide meaningful oversight and useful advice is determined by the quality, timeliness and credibility of the information it has. And it’s clear to us that most boards have a long way to go in this area.”⁶ A major fiduciary

responsibility of boards is to protect shareholder interests, and it is debatable just how effective they can be when their only source of information is the group they are supposed to oversee. (See “Agency Theory and Information Asymmetry.”)

Directors are often largely dependent on management for information. Management typically chooses the information to share, and the corporate secretary bundles it into board books and ships it to directors shortly before a meeting. One recent survey found that more than two-thirds of directors lacked access to independent information channels.⁷ Other surveys have shown that independent directors are, perhaps not surprisingly, less satisfied with the financial, operational and strategic information they receive than their non-independent counterparts.⁸ Directors also have trouble searching out specific information or manipulating scenarios within the materials they are given. In one recent survey, only 30 percent of directors said they received documents electronically, which at the bare minimum would allow them to search and pinpoint specific information in a large document. Fewer than 10 percent could obtain information through an online board portal.⁹

Another factor that calls attention to the importance of boardroom information to effective governance is the emergence of a new class of shareholders, such as hedge funds and sophisticated institutional investors. By using publicly available data alone, along with highly advanced analytics, these shareholders may be able to garner a more thorough

Agency theory

The notion that corporate boards should be independent from management derives largely from agency theory.¹⁵ According to agency theory, management owes allegiance to a company's owners or shareholders, not to a broader set of stakeholders inside and outside the firm. The theory holds, however, that an inherently self-interested management team will—if left unchecked—pursue priorities that may be at odds with shareholders' best interests. To counter

this potential problem, boards of directors must monitor management's performance and use levers such as executive compensation to encourage value-creating behaviors. As such, in order to safeguard shareholders' best interests, directors should not be closely associated with management.

In addition to justifying the independence of directors themselves, agency theory also addresses the role of information. The theory suggests that management at all times knows more about the business than do the company's shareholders, and this information asymmetry is one of the key factors that allows management to pursue goals that are divergent from shareholders'

interests in the first place. It follows, therefore, that to be truly effective in protecting shareholders' interests, a board of directors needs to overcome this information asymmetry – in other words, it must have a firm grasp of the business and the risks it faces.

understanding of a company's performance and risks than the typical board itself can. The vice chairman of a large financial services company explained in a recent interview that this development may put more pressure on board members: "You would expect the board member to have known [as much as the investors] because [the information] is available to people who are willing to dig." These external forces make it even more important for board members to know the companies they serve.

Information and the governance agenda

It remains a question whether access to more and better information will emerge as a priority on the corporate governance agenda. While it may seem that directors should want greater access to informa-

tion, they don't necessarily see it that way; in fact, they overwhelmingly claim to be satisfied with the amount and quality of information they already receive.¹⁰ And compared with structural changes such as the shift to appointing a majority of independent directors and establishing fully independent board committees, information in the boardroom is often lower on the agendas of regulators and activist shareholders who seek to guarantee board independence from management.¹¹ One governance expert we spoke to expressed a common view: directors can get a clear sense of a company from 25,000 feet, and past scandals arose not because information was lacking, but because the board was not sufficiently independent.

Why are many stakeholders in corporate governance seemingly content with the information currently provided to corporate boards?

First, directors, managers and the corporate counsel may be cautious when it comes to altering the dynamics of the manager-director relationship. Enhanced information in the boardroom might encourage directors to aggressively challenge management's assumptions and projections, thereby undermining a spirit of mutual trust and openness. Moreover, the relationship could even become adversarial, with board members reacting more like managers than overseers.¹²

Second, exposure to more information may pose difficulties for directors, as we discovered in a recent focus group of directors. Adding more information to directors' required reading—whether in the form of additional details on financial figures, third-party analyst

reports, or peer comparisons—may overburden directors. Furthermore, the focus group also underscored that directors do not always have the specialized skills and knowledge required to understand and interpret additional information. For example, a tool that made it possible to test different strategic scenarios or financial maneuvers may be beyond the competence of some board members, or it may offer too much information for them to be able to absorb. Finally, altering the method and format of information delivery—for example, switching from physical board books to an online portal—might raise concerns about directors' computer literacy and the security of the platform.

Third, boardrooms are often defined by certain cultural norms that are slow to change. In our conversations with directors, we heard numerous times how the culture of a board can determine its propensity to ask management for additional information or clarifications. One board member revealed that it is typically the new directors, especially those who were recently in management, who are more likely to request further details – often to the consternation of more experienced directors. Barring new regulatory guidelines on information, or internal crises that may serve as an immediate prompt for change, it is unlikely to expect most boards to closely examine the role of information in their decision making.

Information for non-routine decision making: inflection points

Ultimately, the question of how much and what kinds of information should make their way into the boardroom may be most salient when unexpected events arise. When a surprising or unexpected decline in financial performance is reported, for example, or a potentially material ethical lapse is revealed, directors may not be able to rely solely on information from management. They may feel compelled by duty and law to seek sources of information that are free from management's interpretations, analyses and biases.

As the recent write-downs and resulting CEO resignations in the financial sector suggest, boards must be prepared for exactly these types of circumstances. A Wall Street Journal article by a former bank executive, for example, suggested that bank boards shared a significant amount of the blame for the sub-prime mortgage crisis: "The handwriting has been on the wall for some time," the executive asserted, "and bank boards have made little effort to read it."¹³

Management and boards can both benefit when boards are prepared with the right information to prevent or address crises and other unforeseen circumstances. Rather than treating the board primarily as a monitor that should be exposed to only the most relevant and "processed" information, management may instead want to see the board as a strategic adviser on an array of topics. (See "Information asymmetry and directors' dashboards.") Surveys show, in fact, that directors are keen to serve this role and to engage management in discussions of strategic risk.¹⁴

A boardroom information research agenda

Based on the extensive interviews we have conducted with directors, executives, shareholders and regulators, we believe that information in the boardroom is commonly underemphasized when it comes to discussions of effective governance. Managers and directors alike face tough choices as they decide on the quality and quantity of information that the board receives, and how the board can use that information in ensuring best governance practices. In further research notes, we will be exploring the regulatory pressures for change in corporate governance practices, as well as the existing technology for sharing information in the boardroom.

Information asymmetry and directors' dashboards

Information asymmetry is a feature of most bilateral relationships. Each side has knowledge of itself and situations it faces and knowledge about the other side (and the situation it faces). Equally, each side has blind spots: things it doesn't know about itself and things it doesn't know about the other. The nature and quality of interaction between parties is always affected by how much they know about each other – about each other's interests and objectives, fears and aspirations, for example. (See Figure 1.)

The relative size of the quadrants, in the figure below, says a great deal about the quality of their interaction. For example:

- Open discussion or review is possible when each side reveals what it knows to the other.
- Boards fulfill their role as advisor when members share insights and experiences with management.
- Disputes are possible between management and the board when the line between management's knowledge (for example, of operations) is challenged by the board's quest for further discussion or review.
- The danger zone is the space where neither management nor the board have knowledge about a situation (for example, competitor behavior, legal or ethical terrain).

When management enlists the board as a strategic advisor—that is, when it expands the range of discussion or review to include business strategy, competitor behavior, and how strategy is being translated into operational changes—it has the effect of reducing the potential disputed territory.

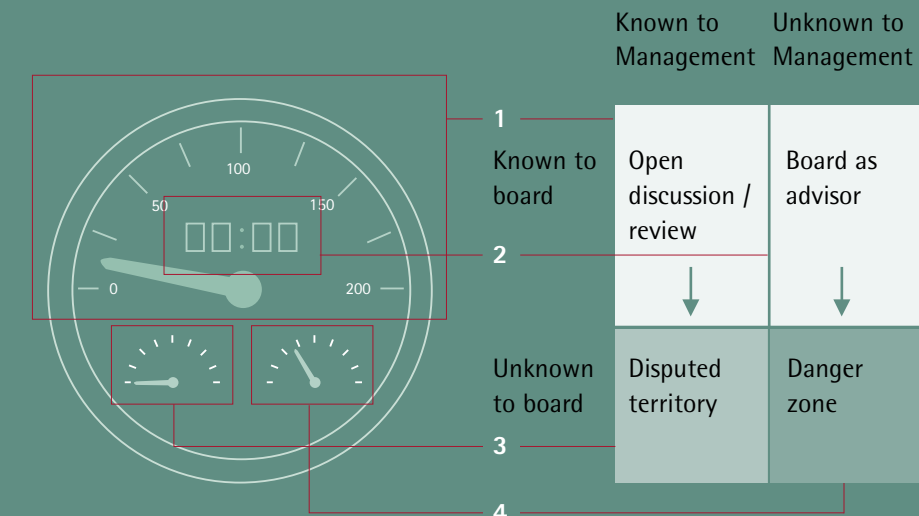
With an expanded range of topics on which it can provide insight and experience, the board helps reduce management's blind spot and, in the process, reduces overall risk.

The objective of a "directors' dashboard" would be to increase the ability of the board to access both external as well as internal information and, thus, to make more effective decisions. (See Figure 2.)

Figure 1

	Known to Management	Unknown to Management
Known to board	Open discussion / review	Board as advisor
Unknown to board	Disputed territory	Danger zone

Figure 2



1 Conventional measures of financial performance augmented by balanced scorecard

2 Board commentary and advice augmented to include experiences in strategy and execution that bring greater insight to management

3 Enhanced reporting of emerging internal issues that the board ought to know about and provide counsel on

4 Enhanced reporting of emerging external issues that both management and the board ought to take into consideration

About the authors

Joshua B. Bellin is a research associate with the Accenture Institute for High Performance Business in Boston. **Robert J. Thomas** is the executive director of the Institute for High Performance Business.

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Notes

- 1 Nanette Byrnes and Jane Sasseen, "Board of Hard Knocks: Activist shareholders, tougher rules, and anger over CEO pay have put directors on the hot seat" *Business Week*, January 22, 2007; p. 37.
- 2 RiskMetrics Group 2008 Board Practices Study. See http://blog.riskmetrics.com/2007/12/riskmetrics_groups_2008_board.html (accessed March 5, 2008).
- 3 "The State of the Corporate Board, 2007: A McKinsey Global Survey," *McKinsey Quarterly*, Special Supplement, June 2007; p. 9.
- 4 "What Directors Think," *Corporate Board Member*, 2006 Special Supplement; p. 12.
- 5 Voluntary guidelines and codes of best practice are thorough in defining what they mean by independence, and while a number of them mention the need for accurate, timely and relevant information in the boardroom, they are not specific about sources of data or formats of presented materials. See Holly J. Gregory, "Comparison of Corporate Governance Guidelines and Codes of Best Practice," Weil, Gotshal & Manges LLP, October 2007; pp. 23-24 and 43-44.
- 6 Richard Hardin and Judith A. Roland, "Board Work Processes," in David Nadler, Beverly Behan and Mark Nadler, eds., *Building Better Boards: A Blueprint for Effective Governance* (San Francisco: Jossey-Bass, 2006), p. 86.
- 7 "2004 USC/Mercer Delta Corporate Board Survey Results," March 2005, http://www.oliverwyman.com/ow/pdf_files/un_Board_Survey_2005.pdf (accessed March 5, 2008).
- 8 "The State of the Corporate Board, 2007: A McKinsey Global Survey," p. 3.
- 9 2007 Public Company Governance Survey, National Association of Corporate Directors, 2007; p. 41.
- 10 2007 Public Company Governance Survey; p. 40.
- 11 Eugene Fram, "Governance Reform: It's Only Just Begun," *Business Horizons* 47, no. 6, 2004; p. 13.
- 12 Jay Conger, Edward Lawler and David Finegold, *Corporate Boards: New Strategies for Adding Value at the Top* (San Francisco: Jossey-Bass, 2001); pp. 83-84.
- 13 Peter Hahn, "Blame the Bank Boards," *Wall Street Journal*, November 28, 2007.
- 14 "What Directors Think," p. 5.
- 15 See Kathleen M. Eisenhardt, "Agency Theory: An Assessment and Review," *Academy of Management Review* 14, no. 1, 1989. See also Rakesh Khurana, *From Higher Aims to Hired Hands: The Social Transformation of American Business Schools and the Unfulfilled Promise of Management as a Profession* (Princeton: Princeton University Press, 2007), pp. 317-26.

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