

# Directors' Perceptions of Board Governance and Operational Effectiveness

With Yo-Jud Cheng, Boris Groysberg, and Rajesh Vijayaraghavan

# Motivation

THE WALL STREET JOURNAL.



## GE Powered the American Century— Then It Burned Out

How the company that was once America's biggest, the maker of power turbines, the seller of insurance, the broadcaster of 'Seinfeld,' became a shadow of its former self

### THE BEST PEOPLE

The GE board of directors had long been one of the world's most prestigious corporate appointments. When Flannery took over as chair from Immelt, the members included a dozen current or former CEOs, the dean of NYU's business school and a former chairman of the SEC.

...

For 36 years under Immelt and Welch, the board had largely followed the chairman's lead. One newcomer under Welch was so surprised by the lack of debate that the director asked a more senior colleague, "What is the role of a GE board member?"

"Applause," the older answered.

# Research questions

- How do directors perceive their board's:
  - Internal operational performance & governance?
  - Effectiveness in its various external governance responsibilities?
- Are director perceptions of board operational performance and internal governance related to their assessments of its external governance effectiveness?



# Prior research on governance effectiveness

- Examines relation between
  - Firm financial performance or observable board actions, and
  - Observable governance characteristics, e.g., shareholder composition, board composition, director traits. (Adams et al., 2010; Hermalin and Weisbach, 2003)
- But limitations:
  - Board characteristics are endogenous (Hermalin and Weisbach, 2003)
  - Internal board dynamics likely important, but unexplored given data limitations (Adams et al., 2010; Lorsch, 2017; Sonnenfeld, 2004)

# Data

- Survey of board directors
  - Wide range of questions based on prior research and practitioner assessments of best practices, and beta tested
  - Responses collected from Oct. 2015-Jun. 2016 (7.1% response rate)
  - Analysis limited to directors of US, public firms (577 observations)
- Qualitative data
  - Qualitative survey questions
  - 75 interviews with directors

# Mitigating survey limitations

## Survey limitations

- Selection bias
- Response bias
- Difficult to infer causation

## Efforts to address

- Sample directors and boards generally comparable to BoardEx population
- Use marker variables subject to respondent bias, but theoretically unrelated to main constructs (Guise et al, 2015)
- Use qualitative and interview data to better interpret quantitative responses

# Board governance effectiveness constructs

## Risk management oversight

- e.g., compliance, asset stewardship, financial planning, cybersecurity, tone at top

## Strategy guidance and appraisal

- e.g., M&A, innovation, alignment with CEO on strategy, internally aligned

## Management evaluation and selection

- e.g., compensation, CEO evaluation, CEO succession planning

# Variation in responses

## High ratings

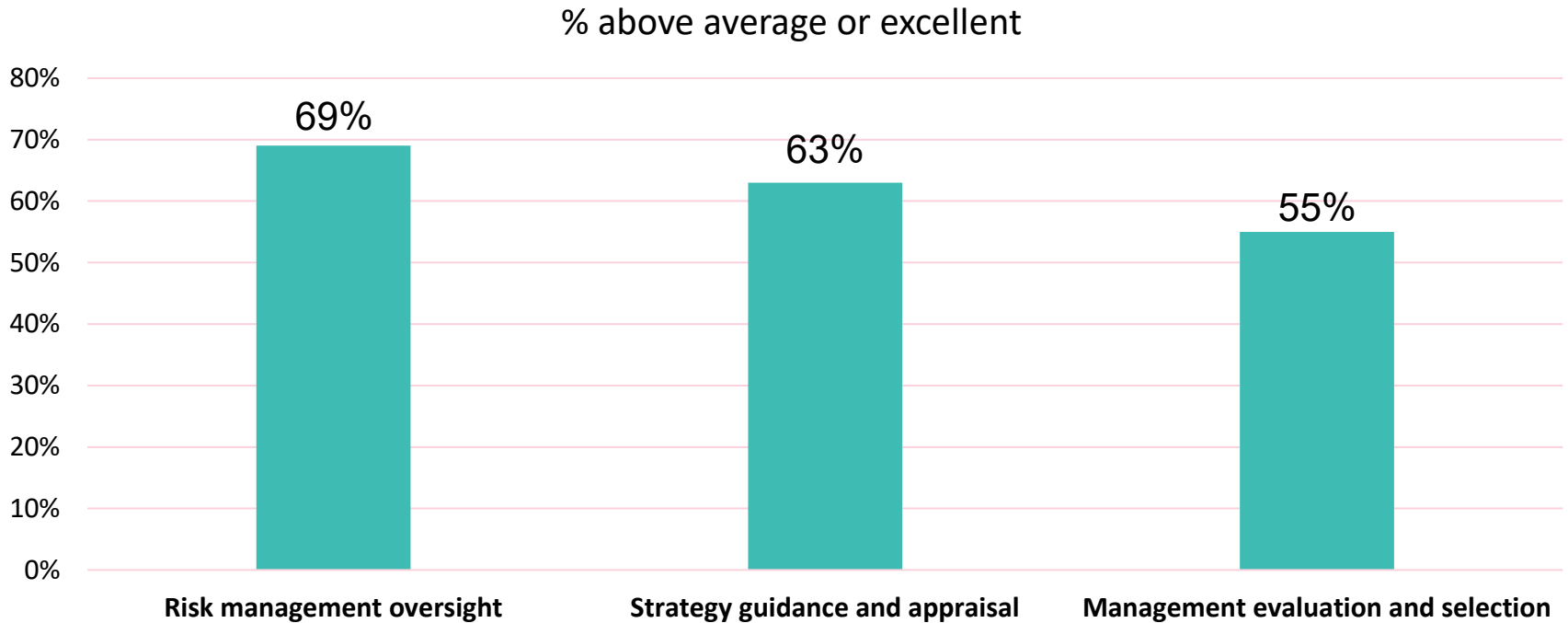
- Steward of company's assets: **94%**
- CEO-board sets right tone for company: **87%**
- CEO/board aligned on vision and strategy: **86%**
- Directors aligned on vision and strategy: **85%**

## Low ratings

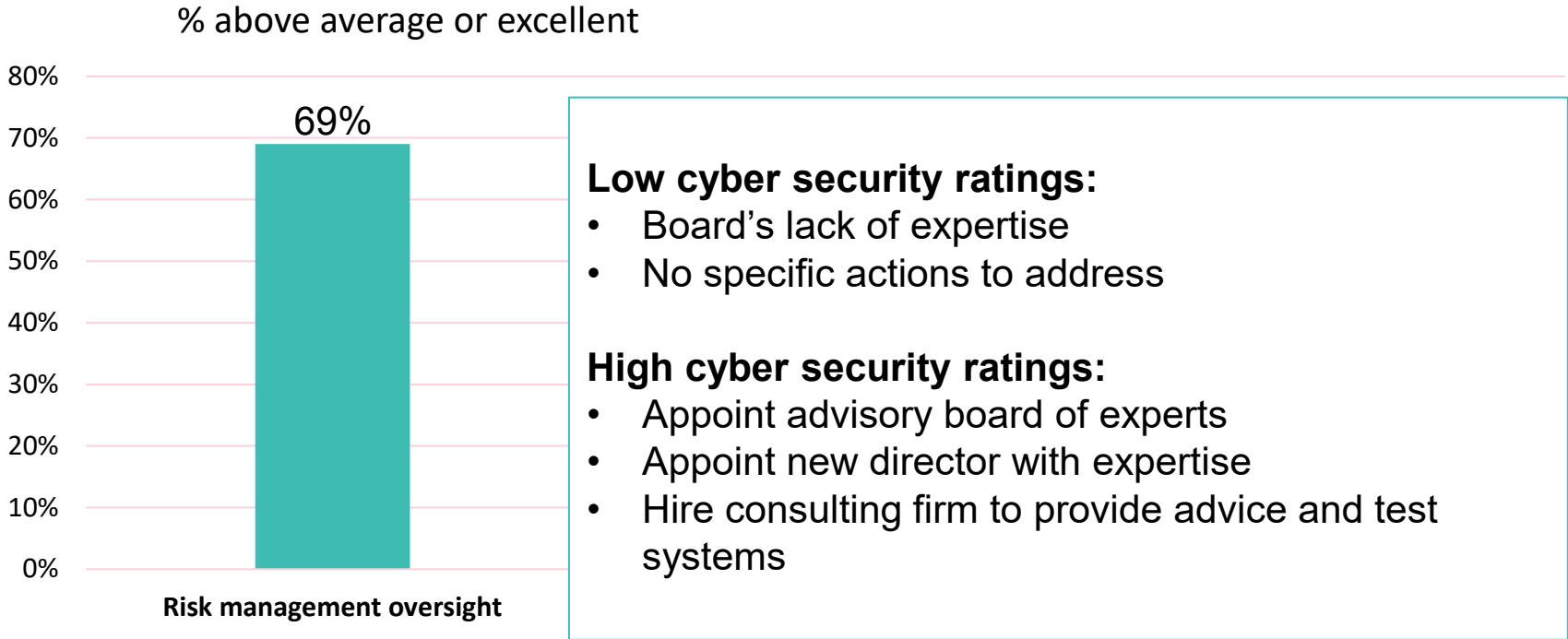
- M&A: **52%**
- Technology: **47%**
- CEO succession planning: **47%**
- Innovation: **44%**
- Talent management: **43%**
- Global expansion: **40%**
- Cybersecurity risk management: **31%**



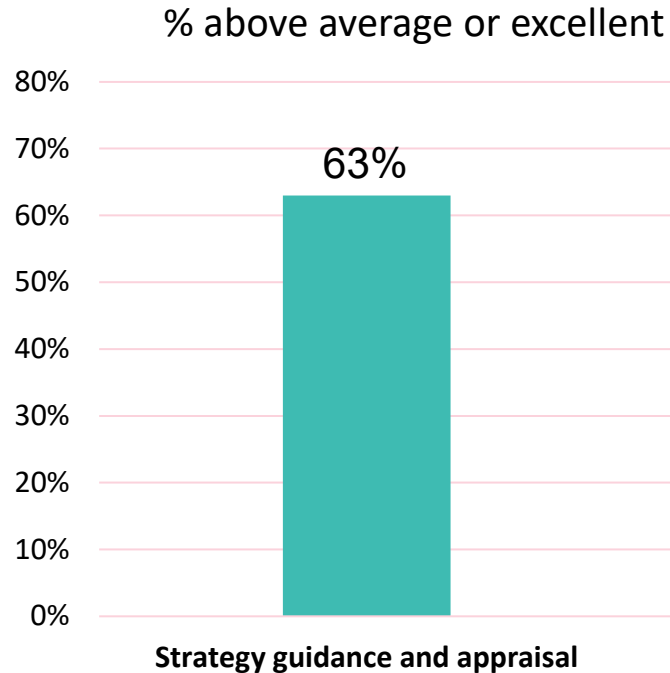
# Summary statistics



# Qualitative responses



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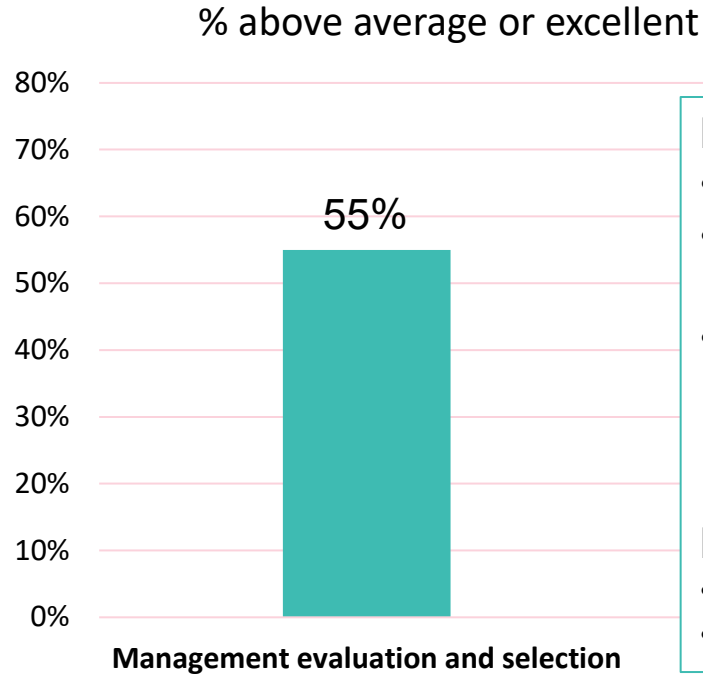
## High M&A ratings

- We reserve time to talk about the firm's strategy at every meeting. This helps the board be better prepared for reviewing acquisitions.
- We regularly go through companies that management are interested [in] and why those companies fit the strategy.

## Low M&A ratings

- Management never spent time we needed to help us understand the strategy. As a result, with all the time pressures that arise in acquisitions, where you are expected to approve a proposed deal quickly, the board would simply go along with whatever management recommended. There was no real discussion of whether the deal made sense.

# Qualitative responses



## Low CEO reviews & pay ratings

- CEO reviews and compensation “highly political”
- CEO active in setting compensation, causing discomfort among directors.
- Predefined criteria for the variable part [of compensation] seldom applied and the decision is more of ‘yes, he deserves it’

## Low succession planning ratings

- We never talk about the subject
- A powerful CEO is making it difficult to find a successor

# Independent variable constructs

## Internal board operations and governance

- Director engagement (e.g. prepared for meetings, engaged in meetings)
- Interpersonal relationships (e.g. CEO communication with board, collegiality)
- Board meeting management (e.g. time mgt., independent thinking, open and candid discussions)
- Internal governance (e.g. skill composition, onboarding, addressing problem directors)

## Other characteristics (following prior research)

- External influences; board characteristics; respondent characteristics; company characteristics

# Variation in responses

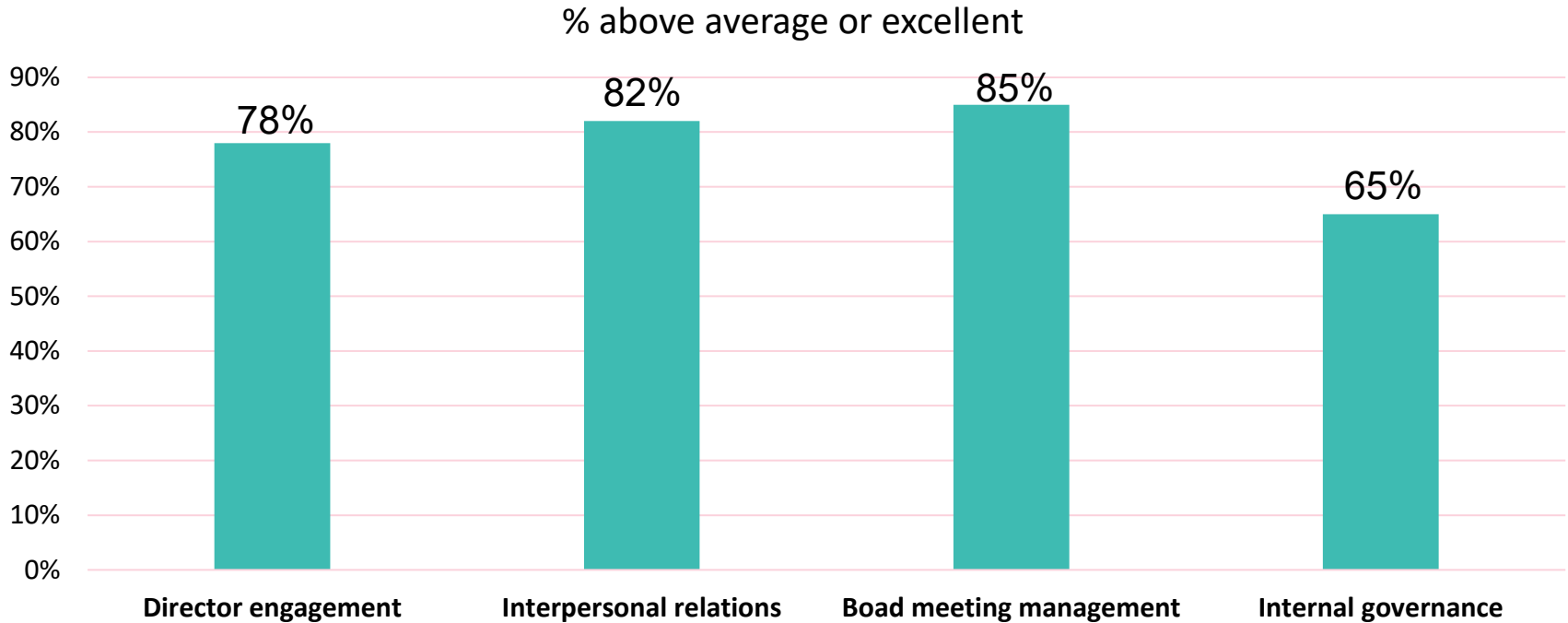
## High ratings

- Agenda reflects priorities: **96%**
- Committees work well: **96%**
- Voice heard on board: **95%**
- General board meeting effective: **94%**
- Candid discussions: **93%**
- Directors prepared for meetings: **92%**
- CEO communication with board: **87%**
- Executive sessions: **86%**
- Collegiality: **85%**

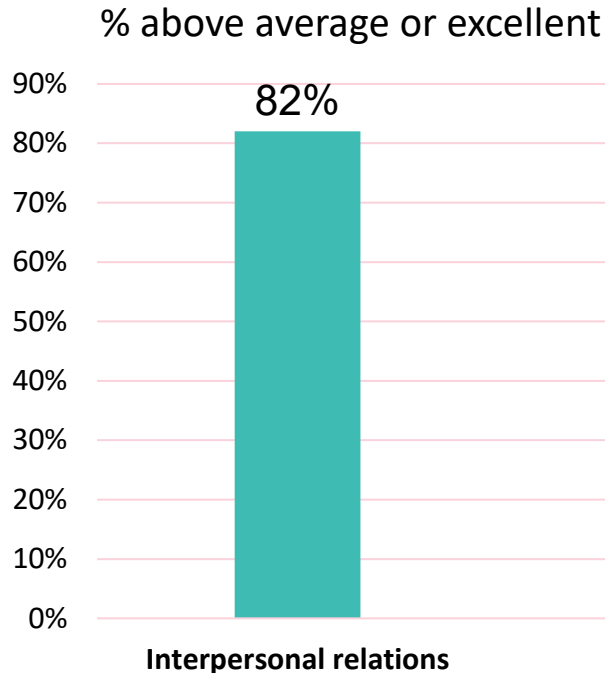
## Low ratings

- Time management: **60%**
- Addressing problematic directors: **59%**
- Engaged between meetings: **58%**
- Training for new directors: **58%**
- Relations between SH and non-SH directors: **55%**
- Evaluation individual directors: **44%**

# Summary statistics



# Qualitative responses



## High rating responses

- Collegial board environment where directors enjoy working with each other, increasing willingness to share knowledge, learn from others, and exchange ideas.
- CEO lays groundwork for relation with board by providing transparency about 'real' situation within organization, so board has candid and complete information.

## Low rating responses

- Too much 'me' and way too little 'us'
- Boardroom a challenging environment often influenced by big egos, low self-esteem and self-awareness, and politics.
- We have not been effective in dealing with a highly aggressive CEO
- We put too much trust in [the] CEO and management team.



# Board governance & operations relation

## Dependent variables

Risk management oversight

Strategy appraisal & guidance

Management evaluation & selection

## Independent variables

Director engagement

Interpersonal relations

Board meeting management

Board internal governance

Firm variables

Board variables

Respondent variables

Halo marker (Enjoyment from serving on board)

# Main results

- Board operations and internal control variables consistently positive & significant, either included one-by-one or jointly.
- Examples of economic impact. 1 unit increase (on 1-5 Likert scale) :
  - Board meeting mgt. ratings associated with 1.1 std. dev. increase in RM rating.
  - Interpersonal relations ratings associated with 1.0 std. dev. increase in strategy guidance and appraisal rating.
  - Internal governance ratings associated with 0.9 std. dev. increase in management evaluation and selection rating.

# Robustness Checks

- Different marker variable (serving on board has enhanced professional reputation)
- Individual survey questions
- Use variables constructed from factor analysis
- Examine US/private, non-US/public, non-US/private samples
- For subsample, explore board ratings & actual subsequent company performance.  
Firms with lower:
  - Strategy appraisal ratings had higher goodwill impairments
  - CEO succession planning ratings more likely to appoint outsider
  - CEO evaluation ratings had lower % stock-based remuneration

# Summary

- Most director respondents rated board governance effectiveness highly
  - Risk management oversight highest, followed by strategy guidance and appraisal, then management evaluation and selection
  - But exceptions: overseeing cybersecurity risks; strategy guidance on technology, innovation, global expansion, and M&A; succession planning and evaluation of future management talent.
- Ratings of board operations and internal governance also very high:
  - Exceptions: evaluations of individual directors, addressing problematic directors, and training for new members
- Perceptions of board governance effectiveness strongly associated with ratings of boards' internal operations and governance

# Opportunities for future research

- Areas where respondents identify variation in board effectiveness
  - e.g. oversight of cybersecurity, technology, innovation, global expansion, M&A, succession planning and evaluation of talent
- Areas where qualitative responses reveal typical board challenges
  - Check box response to regulatory oversight
  - Short-term performance pressure vs long-term strategy
  - Balance between oversight and advice, versus managing
  - Understanding complex business models and organizations