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Photo by Bruce Millar

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Igor Filatotchev, Professor of International Strategic Management at Kings College London, talks about the importance of context and complementary practices to ensure corporate goverance delivers maximum value to organisations.

Interview by Darilyn Kane

At the request of the UK Government you recently spent time evaluating the development of corporate governance over the last ten years. What did you find?

We wanted to develop a broad view of corporate governance, so we had a team that represented sociological, econometric and strategic aspects. We were looking for evidence to support the assumptions that have been made about what drives effective corporate governance. For example, do firms that have implemented current recommendations about the best board structures perform better? What we found was that there was no real empirical evidence linking current guidelines to performance outcomes. One of our main discoveries was that work on corporate governance has been "under contextualised". It has neglected the influence that diverse environments have on the effectiveness of corporate governance practices. The major focus of research on governance has been on large mature companies, mostly in stable environments. It has been driven very much from the financial perspective with a focus on control and not much attention to other capabilities such as learning and growth. So we have guidelines, and in some cases legislation, based on financial aspects of large, corporate organisations. These may be ineffective in different types of organisations – what about start-ups in high tech industries?

Can you describe the model that you have developed?

Effective governance can be reached through different paths. Rather than advocate a particular definition or measure of effectiveness, we developed a framework that highlights the importance of context. There are three major factors in this framework. *Costs* are the values of inputs to corporate governance. The most obvious are systemic or direct costs of governance, for example new rules under Sarbanes-Oxley raise litigation risks that have lead to increases in expenditure on directors' insurance policies. There are also less explicit costs, such as the impact of corporate governance practices on the strategic priorities of the firm and its ability to exploit business opportunities. The opportunity cost of meeting the short-term share price expectations of investors may be a lack of focus on longer-term growth opportunities. There may be costs incurred through having to disclose proprietary information to those outside the firm. There may also be costs that are related to the reputation of the firm. Firms that are more vulnerable to these costs, such as auditing firms and food companies, may try to reduce them through compliance with voluntary standards or national codes.

Any corporate governance practice may have systemic, opportunity, proprietary or reputational costs associated with it. The benefits of the practice should be looked at in conjunction with the firm's ability to meet the cost. A mature Fortune 500 firm may incur high systemic costs to meet the requirements of board independence, but may also have a high capacity to absorb those costs and receive benefits through the enhanced confidence of investors. A small venture firm may find it difficult to meet the high systemic costs of appointing independent directors and also increase their proprietary costs through having to share strategically sensitive information with outsiders. Both the level of the cost and the effectiveness of the practice will vary across different firm environments.

Contingencies recognise that the role of corporate governance will differ based on the external and internal resources that are critical to a firm. During the life-cycle of a firm – start-up, growth, maturity, and decline – there should also be a shift in the balance of the resource and entrepreneurial versus accountability roles of corporate governance. For example, in an entrepreneurial firm that is tightly controlled by a founder-manager, the level of accountability to external shareholders tends to be low. The resource and knowledge contribution of board members will be more critical than the monitoring role that they would play in a more mature firm. An IPO would offer the firm greater access to financial resources, but will come with an increased demand for accountability to the investors and other stakeholders. To be effective in meeting the interests of different stakeholders, corporate governance needs to adapt to different monitoring, resourcing and strategy roles based on contingencies, such as where the firm is in its life-cycle. There is no universal "best way" for all firms at all stages.

The third element of the framework, *complementarities,* suggests that different "bundles" of corporate governance practices will be more effective than isolated "best practices". For example, the combination of performance incentives for executives, board independence and the market for corporate control can align internal and external incentives where there is dispersed share ownership. But this would be ineffective without other complementary practices such as information disclosure that allows the market to price shares accurately and audits to ensure the quality of the information. Recent US corporate governance scandals illustrate what happens when these elements fail to reinforce each other. Managers increasingly influenced auditors and non-executive directors, links between executive pay and performance broke down and the market for corporate control was subdued. The important point here is that the effectiveness of particular governance practices cannot be viewed in isolation.

Governance for small business

In the New Zealand context, there are many small to medium enterprises, and they are often owner managed. What role can corporate governance play in these firms?

It is never too early to be thinking about corporate governance. It is not just about what happens on large Boards, it is about good business practices at all levels. Companies should be transparent and accountable even when they are privately owned. A firm that is at the beginning of their life cycle may be growing fast in a very dynamic environment. It might quickly outgrow the capacity and knowledge of the original founder. Then they would need to look outside for someone who has experience in managing a high growth business. This is, in fact, putting the first governance structures in place. As the company becomes bigger and more complex they might develop a structure with a CEO, Development Director and a Finance Director. It is critical to have the human capital in place to deal with growth and it may even be best for the firm for the original founder to step down. They might focus on development or become an independent board member. There are some good examples of this in high profile companies. Look at Google – the company was developed by two very entrepreneurial young people, but now it is managed by a professional CEO. This can be very complex as it can be difficult for the founder to allow others to be involved in the decision making process or even hand it over completely. This is the reason that some initially successful businesses never realise their full potential – the founders are unable to relinquish control.

How do cost, contingencies and complementarities interact in relation to good governance practices?

These three elements interact with each other and the firm's environment, and may add to, subtract from or multiply each others' effects. A practice that raises costs may be beneficial in helping a firm to adapt to contingencies or it may complement other practices. Conversely, attempts at saving costs by limiting one practice may undermine other practices by destroying complementarities.

What are the implications of this framework for corporate governance policy?

We use this framework to argue that there is no single best way to achieve effective corporate governance and that a more contextualised approach should be taken to developing policy. Recent corporate governance scandals have lead to a focus on reforming governance systems. There is debate over the "hard" and "soft" law approaches. The hard law approach, such as the Sarbanes-Oxley Act, seeks to strengthen governance through legal rules that set minimum standards and have severe penalties that cover a wide range of organisations. This has been criticised as rigid and costly. The soft approach, such as the UK Combined Code, is based on the principles of comply-or-explain. This has been criticised for weak enforcement and lack of mandated minimum standards. The jury is still out. The UK allows more scope for contextualising and this may explain why other countries have tended, on the whole, to follow the UK approach. It may be a factor in the tendency for a growing number of firms to prefer listing in London rather than New York.

What should a business founder look for if they are seeking outside inputs to corporate governance?

It will depend on the capacity of the original founders and whether they are able to lead the company though the stages of its growth. Commercialisation involves a multitude of different activities: cash flow control, investor relations, marketing. These are specialist functions, and it is unlikely that the original inventor of a new business has all of the characteristics and knowledge that is needed to grow the business. The earlier this is recognised in the business life-cycle the better. But equally, there is no point in creating a twenty-strong board, which will need to be compensated, in a small start-up when it is not yet clear whether the concept is justified and the product has any future. So it is a very delicate balance between costs, where the business is in the life-cycle and complementary practices.

What changes could a company that is looking for initial investment expect to make to their corporate governance processes?

Very often venture capital or private equity firms demand that a director be put on the board. Their focus would be oversight, to help with decisions in strategic areas and to provide advice in terms of business practice. It is important to have access to financial capital, but it is also important to know how to put that capital to good use. Developing business contacts and making the connections with a network of customers and suppliers can often be achieved more quickly by bringing people in from outside who have established networks.

As more investors come on board, the director's role would move more towards contributing knowledge and ensuring that systems are in place so that the company is accountable to those investors. Once the business has survived the challenges of the growth surge and established itself with legitimacy and market share, the next issue is to make sure those who are running the business are not abusing their power and objectivity would become more important. As the company environment changes, the governance system would begin to change to include accountability to a broader range of interests. It is very important to realise that we are not talking about something that is set in stone – "the company should have five directors and five non-executive directors". That may be a good mix, but it will depend upon where the company is in its life cycle.

Private equity partnerships are featuring strongly in the New Zealand market currently. What do you think about this from a corporate governance perspective?

The true impact of private equity is highly debated in the UK at the moment. One view is that they are very good at focusing on cash flow and at identifying and tightening up slack. They are very hands-on investors with a wealth of industry links and support systems that can actively help the companies to improve. This view recognises the value-adding capacity of private equity. The contra argument is that they achieve huge returns by saddling companies with debt and lowering their resources, and that the financial risk associated with this type of transaction is substantial. There is a lot of focus on the success stories but there are situations when they fail quite dramatically.

From a governance perspective one of the issues is who the private equity interests are accountable to. They are structured as limited partnerships and have finite horizons. From the beginning their focus is on exit through trade sale or listing, so they are not really long-term investors. When they see an opportunity they will exit, regardless of the situation of the company, so very often they leave behind the shell of a company that is saddled with debt.

I think there is a need for serious research on what the governance roles are for private equity companies or funds themselves. Who they are accountable to and what their objectives and decision making processes are. Because they are private, by definition, there is not much in the public domain. In the UK there is growing pressure to be more transparent and open to public scrutiny. The general trend is towards clear guidelines – if you are going to go around buying and selling these companies, it is time for you to have some accountability.

To what extent do you think the value of corporate governance is generally recognised?

Governance is often viewed as something that is imposed by investors to restrain managers, and this has lead to negative connotations. Particularly for small companies who sometimes would rather do without it if they could. I think the dual perspective, which also sees governance as a very important organisational resource, is more valid. It is not just a system of controls and checks but a very important source of information. Unlike IT facilities or cash reserves, the effects of this resource are not linear. For example, directors are often very powerful individuals who can contribute a great deal to the company.

At Kings College we have had a number of University spin-outs and the most successful of these were the ones that actually understand that corporate governance is important to run a really good business, rather than just enforcing controls and checks on their entrepreneurial behaviour. One of these companies has now listed on the stock exchange. The founders understood their limitations very early on and were quite positive about developing proper corporate governance. This really benefited the company and they are now viable market players. Of course they lost power and a lot of their say in company matters, but they benefited as shareholders. It depends what is seen as important – personal ambitions or the success of the business.

In the modern economy, corporate governance has a number of functions that go beyond the traditional approach of protection of wealth through control and monitoring. Governance shapes the entrepreneurial leadership, and the chain of entrepreneurial acts that occur through the life cycle of a firm. Effective corporate governance, aligned with the context of the firm, can actually create a competitive advantage.