CORPORATE GOVERNANCE

A Guide to the Big Ideas and Debates in Corporate Governance

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Corporate governance has become a topic of broad public interest as the power of institutional investors has increased and the impact of corporations on society has grown. Yet ideas about how corporations should be governed vary widely. People disagree, for example, on such basic matters as the purpose of the corporation, the role of corporate boards of directors, the rights of shareholders, and the proper way to measure corporate performance. The issue of whose interests should be considered in corporate decision making is particularly contentious, with some authorities giving primacy to shareholders' interest in maximizing their financial returns and others

arguing that shareholders' other interests — in corporate strategy, executive compensation, and environmental policies, for example — and the interests of other parties must be respected as well.

These debates have taken on a new intensity in the face of changing capital markets and mega-forces such as climate change, income inequality, digitalization, and rising populism sweeping the globe. The past few years have seen a proliferation of statements, proposals, and revised codes of corporate governance such as the "New Paradigm," the "Common Sense Principles," the "King IV Report," and the "2018 UK Corporate Governance Code," to mention just a few. While some of these statements reaffirm conventional doctrines and practices, others call for efforts to better align the activities of corporations with society's interest in a building a more inclusive, equitable, and sustainable economy.

This article does not attempt to catalogue all of these proposed changes, or to cover every aspect of corporate governance. Its purpose is to describe some of today's key debates and to identify the main areas in which changes are being called for. We hope this distillation will be helpful to corporate directors and other readers who may be grappling with the issues presented either now or in the near future. How these debates are resolved will have profound effects on how business operates across the globe. The article focuses on the governance of publicly traded companies rather than state-owned or private corporations, but many of the debates and proposed changes to public company governance are relevant for those types of corporations as well.

CORPORATIONS

The nature and purpose of the corporation

The corporation is one of society's most important institutions and its dominant form of business organization. Some corporations wield economic power rivaling that of many nation states. Yet the nature and purpose of the corporation—and, by extension, the purpose of corporate governance—has long been a matter of debate. For at least a century, there have been two dominant schools of thought, one holding that the corporation is a "legal fiction" designed to facilitate what is essentially a private agreement among shareholders, and the other holding that the corporation is a "real

entity" enabled by law to serve the needs of society. The former view gives primacy to the rights and interests of shareholders, while the latter seeks to balance the interests of shareholders with those of other stakeholders and gives greater weight to the interests of society at large.

The debate between these two views arose at the dawn of the 20th century. Following the adoption of general incorporation statutes in many jurisdictions in the late nineteenth century, those wishing to create a corporation no longer had to petition the state for a charter. Instead, they could form a corporation simply by filing the requisite forms and paying the associated fees with the relevant government authorities. The ease with which corporations could be formed thus reinforced the sense that incorporation was largely a matter of private agreement among shareholders. However, the subsequent rise of the giant railroad and manufacturing corporations and oil trusts of that era led to widespread concern about these increasingly large concentrations of capital and their impacts on society. These developments fueled the emergence of new thinking on the nature of the corporation as a palpable presence with power and influence–what scholars termed a "real entity"—and provided evidence that the "legal fiction" theory did not fully capture the significance of these large organizations.

By the 1930s an institutional view of the corporation moved into the mainstream and the notion that corporations are influential actors in society with responsibilities not just to shareholders, but also to employees, customers, and the general public gained credence with some respected business leaders and academics. But the debate shifted again with the emergence of neo-classical economics and a stagnant economy in the 1970s. A view of the corporation as the property of shareholders once again took hold, and was soon developed into a full-blown theory of corporate governance based on the idea that managers are the agents of shareholders who own the corporation and expect it to be run for their benefit. According to this theory, known among academics as "agency theory," the duty of managers is to maximize returns to shareholders and the role of the board is to monitor and reward management to ensure that it does just that.

Today, the debate continues but with a new sense of urgency. In Europe and the US, fewer companies are going public but the influence of large, listed companies has been amplified by legal developments expanding the rights of corporations and by increases

in corporate spending on lobbying, political contributions, and even charitable activities aimed at securing political influence. At the same time, governments are increasingly unable to address the significant and growing problems plaguing societies around the globe, and corporations are seen as having untapped potential to help mitigate these problems. While some academics and many in the financial community continue to hold that the purpose of the corporation is to maximize the wealth of its shareholders, and should be governed to that end, others call for a more robust definition of corporate purpose.

In the UK, for example, The Purposeful Company Taskforce has urged companies to be more explicit about their purpose, defined as "how they contribute to human betterment and create long-term value for all their stakeholders," and called for laws requiring companies to write their purpose into their articles of association. The U.K. Corporate Governance Code was revised in 2018 to charge boards with establishing the company's purpose, values, and strategy. In France, the new Pacte Law requires that companies be managed to further the "corporate interest" rather than the interest of any particular stakeholder and provides for companies to write their purpose ("raison d'être") into their by-laws. In the US, leading institutional investors have been calling on corporate boards for several years to clarify their companies' purpose and contribution to society.

Perhaps the most noteworthy development in the US is the Business Roundtable's new statement on corporate purpose issued in August 2019. The 181 CEOs who signed the statement declared their commitment not just to shareholders but to all stakeholders, thus reversing the BRT's previous espousal of shareholder primacy and the view, expressed in their 1997 statement, that the corporation's purpose is to generate returns to its owners.

This debate may appear to be purely theoretical and best left to academics, but its practical implications are far-reaching. With investors, regulators, and the public calling for greater clarity of corporate purpose, boards and managers will want to give this issue serious consideration and take steps to confirm that they have a shared understanding of their purpose in governing and leading.

Questions for Boards and Managers:

- Effective corporate governance starts with a shared concept of corporate purpose, but what is the purpose of a corporation?
- What is the purpose of corporate governance?
- How does the understanding of corporate purpose differ across regions and cultures?
- Do corporate directors and officers of your company have a shared understanding of the company's purpose and their own purpose as board members and leaders?

SHAREHOLDERS

The role of shareholders

Shareholders provide companies with equity capital and are vested with ownership rights to the shares held. While shareholders are often referred to as owners of companies, this description overstates the rights of shareholders. Legally, in most jurisdictions, shareholders are entitled to own and sell their shares, and vote on certain corporate matters as specified by law and the corporate charter. The definition and exercise of ownership rights vary greatly across companies and especially across countries. The most common shareholding structure follows the one-share-one-vote principle, with each share of equity ownership providing a proportionate voting stake to the owner. However, many companies have multiple classes of shares that give some shareholders (typically founders and their families) greater voting rights. The technology sector in the U.S. in particular has seen a growing number of companies with multiple voting classes creating concern about the appropriateness of such voting control and the rights of minority or non-controlling shareholders in such companies.

The nature of shareholding and ownership concentration has also seen significant change especially in U.S. and European capital markets. One secular trend is the growth of index funds, Exchange Traded Funds (ETFs), and other such passive investment funds. Between 2007 and 2017 in the U.S., over $1.3 trillion flowed into passive investors with an almost similar outflow from traditional actively managed equity mutual funds. Over the same period, the holdings of the top 10 shareholders in the largest 500 U.S. companies that comprise the S&P 500 index rose from 21% to about 30%, a change driven largely by greater ownership of the passive investors. This shift in ownership raises questions about the role of passive index investors in the stewardship

of companies where they hold very significant stakes. The large passive owners and others, especially pension funds, are exhibiting greater engagement with companies. A measure of such engagement is the over 700 shareholder proposals that are filed every year during annual shareholder meetings to influence companies to pursue a range of actions especially concerning executive compensation, shareholder rights, and environmental and social concerns. But the shape of such engagement is evolving as both investors and companies develop tools of engagement.

The rise in passive ownership has been accompanied by an increase in activism by hedge fund investors that take large stakes in companies and push them to adopt strategies and capital structure favored by the hedge fund. Between 2005 and 2017, there were between 200-300 such public campaigns every year against US-listed companies, not counting the many such efforts being conducted privately. During this period, an increasing number of campaigns were waged in other parts of the world as well, particularly in Europe but also in Asia. Such activists are often criticized for forcing companies to take short-term actions such as increasing share buybacks or spinning off divisions, though the empirical evidence on the consequences of activism is mixed with evidence of both costs and benefits. Overall, the rise of ownership concentration, greater shareholder engagement, and hedge-fund activism point to an era of greater shareholder influence over companies. These developments raise questions about the accountability of shareholders, particularly those who seek to influence corporate actions, and about the prevalent model of shareholder value maximization as the goal of good corporate governance.

These developments also raise questions about the responsibilities of institutional investors to the retail, or individual, investors, who are the ultimate owners or beneficiaries of the institutions' holdings. Although institutional investors style themselves both as stewards of the corporations in which they invest and as fiduciaries for their own customers and clients, some commentators question whether they can play both or, indeed either, role effectively given the inherently conflicting interests involved and the nature of the passive investors' low-cost business model. The reliance of many institutional investors on proxy advisory firms to guide their voting on important corporate matters has also raised questions about their capacity to act as stewards and about the influence of proxy advisors who, themselves, have no stake in

the votes they recommend. The proxy voting system and the process by which shareholders are permitted to put forth proposals for a shareholder vote have also become matters of contention, with some arguing that the criteria for permissible proposals should be loosened, and others arguing that they should be tightened. In the U.S. and other jurisdictions, regulators, lawmakers, and others have begun to examine these matters more closely.

In this context, boards and managers would be well-advised to have a thorough understanding of their companies' shareholder base and a deliberate approach to shareholder engagement. They should be prepared to be challenged by activist investors, and their overall governance arrangements should strike an appropriate balance of power among shareholders, the board, and management.

Questions for Boards and Managers:

- The past four decades have seen a significant increase in the rights and powers of shareholders in many countries, but how much power should shareholders have, to what extent should that differ among different types of shareholders, and what is a satisfactory balance of power among shareholders, boards, and management?
- Is your company's board knowledgeable about the company's shareholders and does it have an effective approach to shareholder engagement?
- Can institutional shareholders and asset managers be effective stewards for the asset owners whose funds they invest?
- What explains the increase in shareholding concentration and share turnover in recent decades?
- How will artificial intelligence affect investing and the role of different types of investors—active and passive, short-term and long-term—in corporate governance?

BOARDS OF DIRECTORS

The composition and role of boards

The board of directors is the corporation's governing body. By law, the board is vested with authority to manage the corporation's business and affairs, and the board's members have a fiduciary responsibility to act in the best interests of the corporation

and its shareholders. Boards are thus collegial bodies in the traditional sense that their members share authority and responsibility, and have both individual and collective accountability.

Boards typically delegate much of their authority to an executive team that carries out the day-to-day operations of the corporation's business. However, some board duties cannot be delegated, and boards vary widely in the extent of their involvement in the business. The board's core functions typically include selecting, monitoring, advising, and compensating the chief executive; monitoring the company's financial structure and declaring dividends; deciding on major transactions and changes in control; monitoring the company's financial reporting and internal controls; and overseeing the company's strategy, performance, risk management, and compliance with relevant legal and ethical standards. It is sometimes supposed that a sharp line can be drawn between governing and managing, but that line is neither sharp nor fixed. Even a board that normally focuses on high-level governance matters may find itself drawn into management issues when the company is in crisis or distress.

The structure and leadership of boards, like the processes for selecting their members, vary widely by law and custom across jurisdictions. One visible and frequently noted difference is between unitary or single-tier boards, like those in the U.S., and two-tier boards such as those in Germany where companies typically have both a management board and a supervisory board. In the U.S., companies are frequently led by a single individual who serves as both chairman and CEO, whereas in other jurisdictions, the roles of chairman and CEO are more often separated and held by different individuals. In some jurisdictions, such as France or Hong Kong, it is customary for directors to be elected for multi-year terms on a staggered basis; in others, all directors are voted on annually. The laws and norms of some jurisdictions require boards to include a certain number of directors elected by employees or other constituency groups, or to have a defined mix of shareholder and employee representatives. Processes for nominating directors also vary, as do the roles and composition of board committees, although many jurisdictions require boards to have audit, remuneration, and nominating committees with at least a majority of directors who are independent.

Despite such differences, the past few decades have seen several trends in board composition that cut across jurisdictions. One is a growing presence of female directors who, once rare, are now mandated in some countries to be at least 40% of the board's total. The overall percentage of female directors remains low relative to their numbers in the workforce, but the pace at which female directors are being added appears to be accelerating and surveys suggest that adding women to boards has been beneficial for those boards. Another cross-region trend is an increase in the percentage of directors who are "independent," in the sense that they have neither commercial nor family ties with the company or its management and are thus presumed to have a higher or more reliable capacity for objective judgment. Over the past decade, boards have become more independent, and independent directors have become more likely to meet in "executive" session separate from the management members of the board. Across the globe, high-performing boards are seeking to improve their effectiveness through more systematic self-assessment and succession planning, and by adding members with a more diverse set of skills, perspectives, and backgrounds.

Even though the functioning of boards is generally thought to have improved in recent decades, questions remain about the ability of boards, especially those of large public companies, to do the job expected of them. Dueling interpretations of the board's fiduciary duty only complicate the challenge. In 2018, for example, the UK Government announced new regulations clarifying the duties of pension fund trustees to consider the environmental, social, and governance risks and opportunities in the investment process. By comparison, the U.S. Department of Labor recently issued a bulletin urging pension fund fiduciaries to be cautious in considering environmental, social, and governance factors when making investment decisions. Although these pronouncements were both directed to pension fund fiduciaries rather than company directors, the underlying issue is one that company directors face as well and that is likely to be a source of ongoing tension in the years to come.

Questions for Boards and Managers:

- As corporations have grown more complex, the demands on boards have increased accordingly, but is your company's board up to the task expected of it today?
- Who should serve on boards and does your board have the right composition?

- Does your board have in place processes to ensure its ongoing effectiveness and renewal?
- Are the existing mechanisms for holding directors accountable sufficient?
- How is the interpretation of directors' fiduciary duties likely to evolve in terms of both the factors and time frame to be considered?

MANAGEMENT

Selecting and rewarding corporate leaders

Corporations are complex organizations whose functioning depends on leadership and day-to-day management. Ensuring that such leadership and management are in place is perhaps the most important job of a company's board of directors. This job involves specific tasks such as appointing the company's chief executive, evaluating the executive's performance, and deciding on executive pay, as well as planning for executive succession and, sometimes, removing an executive from office.

In recent years, the board's job has become more difficult in part because the CEO's job has become more difficult. As companies have become larger and more complex, and the pace of change has accelerated, the traditional activities of corporate leadership have become more challenging. In addition to market and competitive pressures, today's corporate leaders face an array of adverse forces ranging from heightened investor activism and volatile capital markets, to increased social and cultural diversity, mounting social and environmental challenges, political and regulatory uncertainty, and disruptive technologies changing industries across the globe. Despite these challenges, average tenure for departing CEOs at large US companies was 10.8 years in 2017, up from 7.2 in 2009, according to The Conference Board. However, boards are increasingly turning to outsiders rather than inside candidates for CEO appointments, especially in industries undergoing disruptive change, and the percentage of CEO successions attributable to ethical lapses, though small, has increased significantly in the past few years.

The heightened demands on corporate leaders have reinforced the importance of succession planning and raised questions about the qualities needed by today's executives. Many commentators say that traditional models are outmoded and that

companies today need leaders who are equipped with a broader set of skills and capabilities and who are more diverse. Indeed, the vast majority of large-company CEOs are male—just 4.8% of the *Fortune* 500 had a female CEO in 2018. While some indicators suggest that boards are becoming more vigilant about succession, a 2018 survey of U.S. directors by PwC found that only a third thought their company was doing an excellent job of succession planning for the C-suite.

One of the board's most fraught tasks is developing an appropriate compensation package for the CEO and top management. Typically, this task is delegated to the board's compensation (or remuneration) committee. Deciding how and how much to pay is particularly challenging. The past few decades have seen a dramatic rise in CEO pay relative to corporate performance and to the pay of the average employee. According to the Economic Policy Institute, the CEO-to-worker pay ratio at the 350 largest U.S. companies increased from 20-to-1 in 1965 to 312-to-1 in 2017. The rise has been attributed to an increase in the proportion of stock-related pay awarded to CEOs and to the widespread adoption of benchmarking which ratchets pay upward as each board seeks to ensure that its CEO's pay is above the average for the selected peer group. Some commentators defend the rise in executive pay as justified by the increased complexity and difficulty of the CEO job or by the returns generated for shareholders, but others see it as unmerited, excessive, and unfair. A number of jurisdictions have enacted "Say-on-Pay" laws that give shareholders a periodic vote on executive pay. These laws vary in their particulars but the evidence to date suggests that they have had little impact on executive pay levels, other than to slow the rate of growth in a few jurisdictions. A more recent effort to curb CEO pay growth in the U.S. requires companies to disclose the ratio of CEO-to-median employee pay on an annual basis. In 2018, the proxy statements of most U.S. public companies included this ratio for the first time.

Another challenge for boards is selecting performance measures and setting targets for variable awards under annual bonus and long-term incentive programs. Despite critiques of the "pay for performance" paradigm that underpins these programs, including studies linking aggressive targets to excessive risk-taking and destructive short-term behavior, the paradigm continues to shape the way boards approach executive pay. Proxy advisory firm ISS reports that Total Shareholder Return (TSR)

remains the leading metric used by S&P 500 boards for their long-term incentive programs. Other widely used metrics are earnings, returns, sales, and cash flow measures.

At the same time more boards are also setting targets using non-financial metrics related to innovation, quality, culture, or other dimensions of corporate strategy, including social and environmental performance. The prevalence of these measures is difficult to gauge but they appear to be gaining ground. A 2017 study of 600 large U.S. companies by the sustainability non-profit Ceres found that about 8% linked executive pay to sustainability metrics beyond compliance with law, compared to just 3% in 2014. Recent amendments to France's Afep-Medef Corporate Governance Code include a recommendation that criteria related to corporate social and environmental responsibility be integrated into executive compensation plans.

Critics of the prevailing system for selecting, evaluating, and rewarding corporate leaders point to the closed nature of the selection process, the narrowness of standard performance measures, the undue influence of executives whose own forecasts are used to set targets, the excessive complexity of many plans, and the outsized and sometime perverse rewards granted even to those who clearly fail at the job. Whether valid or not, these criticisms raise a set of questions that every board should consider in carrying out its responsibility to ensure that effective leadership and management are in place.

Questions for Boards and Managers:

- What kinds of leaders should boards be appointing as CEOs of today's corporations—and how should boards evaluate and pay these leaders?
- Does your company's board have an effective process for executive succession?
- How much of the value created through corporate activity should be distributed to shareholders and the leadership team as compared to the company's rank-and- file employees?
- Are you satisfied with your company's executive compensation program?
- What are the attributes and skills that will be needed by business leaders of the future?

RESOURCE ALLOCATION AND STRATEGY

Investing for today and tomorrow

Corporations perform many functions in society one of which is mobilizing financial capital and allocating it to investment opportunities. Typically, senior managers work with other members of the organization to carry out this activity, while the board plays an oversight role. In some situations, however, decisions about how to use the company's resources rest with the board, either by law or under the company's by-laws—for instance, whether to approve a major investment, declare a dividend, or authorize a share buyback. In theory, managers and boards allocate resources in a manner that advances the company's strategy, which itself is the result of a forward-looking process of identifying worthwhile opportunities and analyzing them in light of the company's distinctive capabilities and in view of the anticipated changes in the market, competitive landscape, and wider economic, political, regulatory, and social environment. The company's internal resource allocation process takes place within a capital markets context in which investors of various types are also deciding how to allocate their resources and whether to buy (or sell) the company's stock.

When corporate resource allocation is done well, companies are able to evolve and renew themselves over time, while at the same time producing a continuous flow of products and services that meet the needs of their customers and a continuous flow of profits that can be re-invested in the business or paid out to shareholders. In practice, however, resource allocation is extremely difficult, especially when it involves comparing businesses with different strategic characteristics, investments with long time horizons, or innovative projects with uncertain pay-offs—to name a few of the common challenges. The difficulty is compounded by pressures from shareholders with differing objectives, time horizons, and tolerance for risk. As a consequence many managers give short shrift to strategic and human complexities when making resource allocation decisions and instead rely on standard financial tools such as discounted cash flow analysis. Costs and benefits to third parties—so-called "externalities"—have not traditionally been part of this analysis. Thus, factors such as an increase in carbon emissions or potential risks to customers or employees are not typically considered in making these decisions.

In recent decades, this process and the resulting allocation of resources have come in for heightened scrutiny. As seen in numerous reports—by organizations such as The Aspen Institute, FCLTGlobal, The Conference Board, and others—a major concern has been “short-termism”—the idea that managers and boards are overly focused on generating near-term returns at the expense of investing in the future. It is said that boards and managers, under pressure from the capital markets, are investing too little in people, research, and innovation; paying too little attention to the longer-term human, environmental, and social costs of their resource allocation decisions; devoting too little time to understanding how evolving macro-trends are likely to affect future strategy; and too willing to cut expenses aimed at meeting future needs, such as training, research and development, and brand building, in order to boost current earnings and meet investors’ short-term expectations. Indeed, academic research suggests that many managers are willing to forego profitable investment opportunities if pursuing those opportunities would mean missing analysts’ quarterly earnings expectations, even by a small margin. The growth in share buybacks in recent years has also been cited as further evidence of a bias toward short-term shareholders and declining corporate re-investment though academic opinion on this point is divided.

Whatever the verdict on the significance of short-termism in the aggregate—which also remains a matter of debate among academics—surveys indicate that for many boards and managers the tensions between near-term expectations and longer-term needs are acute. Such tensions are to some extent inherent in the job of governing, but the debate about short-termism suggests that the tensions can perhaps be better managed and somewhat mitigated through better oversight over strategy, more clarity about time frames, and improved communication with investors. The Coalition for Inclusive Capitalism’s Embankment Project, which seeks to develop metrics that will allow companies to better communicate their ability to create value over the long term, is one of several efforts focused on this issue. But the debate also suggests the need for more radical innovation in how companies develop strategy and allocate resources. A first step is for boards to better understand these processes, the time frames that guide them, and the extent to which they include human, environmental, and social considerations. These matters raise questions of business judgment that boards and executives will increasingly be expected to address.

Questions for Boards and Managers:

- How prevalent is corporate short-termism and are companies investing enough in the future?
- How does your company's board determine what time horizon to use in setting strategy and making investments?
- To what extent do capital markets pressures and conventional valuation methods affect how resources are allocated?
- To what extent is your company's board asking managers about the human, environmental, and social impact of critical investment decisions?

CORPORATE PERFORMANCE

Defining and measuring performance

As fiduciaries, boards of directors are expected to keep a close watch on corporate performance. But what is corporate performance and how should it be assessed? Providers of capital, the prototypical users, seek performance information so that they can compare across opportunities to identify the best use of their capital and ensure effective ongoing stewardship of their investments. Other users may have different purposes – for example, a lender wanting to ensure timely payment of interest and principal, or a corporate center allocating resources to various divisions. The board itself needs this information to assess the success of corporate strategy or to decide on executive compensation. Still others, such as a potential customer or employee, or a local community deciding whether to grant a zoning variance will likely have yet other needs. Such a variety of sources of demand for corporate performance information means that no one definition of performance or a simple measurement system will suffice.

When it comes to corporate financial performance, investors typically look to stock price measures (such as Total Shareholder Return or TSR) and accounting numbers (such as Return on Equity or Return on Assets). TSR, which is a direct measure of how much shareholders have benefitted, has become a significant determinant of executive compensation especially in the US. TSR provides an easy benchmark of relative performance across companies and over time. However, if stock price is driven by biases of investors especially of those who are short-term shareholders, then TSR is less

useful as a metric of long-term value creation, the elusive benchmark against which any performance metric ought to be assessed. Measures based on accounting metrics are less subject to investor horizon concerns but are considered backward looking and subject to managerial manipulation. Moreover, accounting rules (codified as generally accepted accounting principles or GAAP) are slow to keep pace with rapid changes in business, technology, and organizational complexity. As a result, more managers are turning to alternative (non-GAAP) measures, such as adjusted income or cash operating return on assets, in an attempt to better describe the unique aspects of the business that are not captured by the conventional metrics.

Differing time horizons for assessing performance add further complexity to the challenge. Many stakeholders demand periodic assessment and reporting of performance, but operating and investment cycles do not conveniently correlate with calendar quarters or years. What then is the appropriate horizon? In most jurisdictions, listed companies are legally required to report their financial performance annually, and in many cases quarterly or at least half-yearly. But other users, such as boards of directors, have the option of measuring (and compensating) performance over longer horizons. Recognizing that no single metric (whether based on stock price or summary accounting metrics) or time horizon, is sufficient to capture the richness of business outcomes, some companies have adopted a dashboard approach based on ideas such as the balanced score card, for example, to measure interim outcomes rather than the ultimate objectives. This approach measures shorter-term indicators that will eventually lead to better overall outcomes. For instance, a company that relies on a strategy of long-term technological superiority, can measure and reward more immediate outcomes such as patent filings or the hiring and training of knowledge workers. This approach requires managers to develop a causal theory of drivers of performance, and to measure and motivate achievement of the intermediate drivers of performance that should eventually lead to long-term success.

In addition to measuring financial performance, companies are also being asked to measure their social and environmental performance on various dimensions ranging from diversity and inclusion, to customer privacy and supply chain conditions, to human rights and carbon emissions. This demand is driven in part by investors and others who believe that a company's social and environmental performance is related—

causally or otherwise—to its long-term financial performance, and in part by those who believe that social and environmental performance is important in its own right or required as a matter of corporate citizenship for the healthy functioning of society and the broader economy. Although some academic studies purport to show the financial benefits of strong social or environmental performance, the overall evidence of a linkage is inconclusive and the matter is unlikely to be resolved by academic studies given the many ways of measuring these different types of performance and the many factors that influence how companies perform on each of them. More promising are efforts to explore the relationship between specific social and environmental factors, often referred to as "sustainability" factors, and financial performance. The Sustainability Accounting Standards Board (SASB), for instance, is seeking to determine which environmental and social factors are financially material on an industry-by-industry basis.

Corporate performance measurement remains an exciting area of innovation and debate, both in terms of the appropriate measures and the appropriate horizon of measurement. Companies are experimenting with broader disclosure of strategy and drivers of long-term success while recognizing that investors and other stakeholders often prefer summary metrics and shorter-term outcomes as a way of identifying trouble early. How best to define and measure corporate performance—and over what time frame—are first-order questions that should be on every board's agenda.

Questions for Boards and Managers:

- How should boards and others evaluate corporate performance—over what time period, for whom, from whose perspective, and by what measures?
- How much weight does your company place on the company's stock price as compared to the achievement of strategic objectives, operating metrics, or corporate citizenship goals?
- Does your company incorporate impacts on third parties and society into the assessment of corporate performance?

CORPORATE OVERSIGHT

Overseeing risk and ensuring accountability

The board's responsibility to oversee corporate risk is widely recognized, but interpretations of what this responsibility requires vary widely. Traditionally, it was seen as quite limited. For example, under the law of Delaware, legal home to more than 60% of the *Fortune* 500, boards were initially responsible just for addressing violations of law that came to their attention, and the focus was mainly on accounting, financial reporting, and antitrust violations. In the 1990s, the duty was expanded to require boards to ensure that management set up information and control systems to monitor for such violations, but still with an emphasis on accounting and financial misconduct. Although boards' legal duties of oversight have changed little since then, public expectations have continued to evolve as businesses have grown larger and more complex, and the consequences of corporate failure more far-reaching.

Indeed, boards today are expected to oversee an extensive and ever-expanding menu of risks. In the wake of the 2008 financial crisis, the boards of banks and financial institutions were taken to task for paying insufficient attention to excessive financial risk. The recent spate of behavioral complaints against senior corporate leaders has raised questions about board oversight of executive conduct and caught numerous boards off guard. On a different front, various companies have suffered serious breaches of cybersecurity that have exposed a lack of preparedness and resulted in significant reputational damage; others have been tripped up by data privacy concerns and are facing political and user backlash. Environmental disasters, labor abuses in the supply chain, mistreatment of customers—these are other examples of the new breed of risk management issues that are consuming the attention of boards.

The broadening menu of risks has created a challenge for traditional practices of internal controls and is testing the ability of boards to provide adequate oversight. Since the financial crisis, the internal audit and risk management functions have received significantly greater attention especially in banks and financial institutions. All large banks in the U.S. now have a risk committee of the board and a chief risk officer function, reflecting the realization that a robust risk function is strategically important for sustainable growth and profitability. Similarly, in other industries, boards have adopted new risk oversight protocols or enlarged the mandate of the audit committee beyond traditional audit and internal control matters to include the oversight of other risks. Some, like the banks, have created a dedicated risk committee while others have

assigned particular categories of risk oversight to various other committees, such as conduct risk to an ethics and compliance committee, or supply chain risk to a sustainability committee. Boards have also sought to educate themselves about cyber risk and made cyber a defined area of board oversight.

Recurring cases of large-scale employee participation in reckless or illegal behavior—such as the mortgage-lending scandals leading up to the 2008 financial crisis or the diesel emissions scandals at several large auto makers—have created a growing recognition that organizational culture is a key factor in driving risk. This insight has led to efforts by various supervisory bodies and professional organizations to educate boards about organizational culture. Reports by groups such as The Group of Thirty (G30), the UK Financial Reporting Council, and the US National Association of Corporate Directors (NACD) reveal what decades of academic studies have shown: that an organization's culture and the risks associated with it cannot be understood in isolation or managed solely through traditional control and compliance mechanisms since it is a multi-faceted phenomenon resulting from numerous factors. Among the most important are the example set by the company's leaders; the company's business model and strategy; and its various systems for making decisions, hiring and motivating employees, and rewarding performance. Overseeing risk thus requires boards to go well beyond their traditional monitoring activities and to develop new ways of gauging the pulse of the organization. This task is being aided through advances in data science and computing abilities that are allowing digital compliance tools and predictive analytic capabilities to be used to help with risk management, especially in banks and financial institutions.

Most directors today recognize the importance of robust oversight, but it is unclear whether boards, as they are currently constituted and operate, are up to the task. The increasing size and complexity of companies, the expanding array of risk areas, and the difficulty boards have in getting the information needed to exercise effective oversight all bode poorly for a positive answer to this question. To be sure, other institutions, some internal and some external to the organization, also provide oversight. Large investors, proxy advisors, regulators, the media, NGOs, the general public—all play a role. However, it is doubtful that these institutions can substitute for boards and, indeed, it could be argued that these institutions can be effective only if boards

themselves are effective. In the coming years, boards can expect increasing pressure to strengthen their risk oversight capabilities while at the same time driving the kind of entrepreneurial innovation needed for sustainable growth and profitability.

Questions for Boards and Managers:

- Increasingly boards are expected to go beyond their traditional role as overseers of the company's accounting and financial controls and to ensure that systems are in place to protect against all manner of misconduct, dysfunctional cultures, security breaches, and breakdowns in corporate responsibility. But how realistic are these expectations and by what standards should board oversight and corporate behavior be evaluated?
- Does your company's board have the structures, processes, and information needed to carry out its oversight responsibilities?
- What is the role of other parties in ensuring responsible corporate behavior and protecting investors, customers, employees, and the public from injury and loss caused by corporate acts and omissions?

CORPORATE REPORTING

Defining standards for reporting and disclosure

Boards of directors play an important role in ensuring that investors and the public receive accurate and timely information about corporate activities and performance. In some areas, such as accounting and financial reporting, disclosures are highly regulated and standardized, and the board's role, through its audit committee, is largely to ensure that the company's reporting adheres to the relevant standards, and to make accounting policy choices as permitted under those standards. In other areas, such as disclosures about the CEO's health, potential future investments, or the company's sustainability efforts, boards must rely on their own business judgment and assessment of the information's materiality in deciding whether and when disclosures are appropriate. In recent years, boards and audit committees have faced an increasingly complex set of reporting and disclosure challenges.

One set of challenges has arisen from the globalization of capital flows. Prior to 2002, regulators around the world required domestic companies to report their financial performance using the country's own locally codified accounting and financial reporting standards, such as the U.S.'s generally accepted accounting principles (US GAAP). In 2002, however, the European Union (EU) adopted the International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB) as the common standard for all companies traded in the EU. By 2018, 166 countries had adopted IFRS, albeit to different degrees, and the IASB had become the recognized accounting standard setting institution for most of the world. While the US has continued to require domestic listed companies to follow US GAAP in preparing financial reports, non-U.S. companies listed in the US are permitted to report using either IFRS or US GAAP. In an ongoing effort, the US Financial Accounting Standards Board (FASB) has been working with the IASB to harmonize US GAAP with IFRS and to develop a common set of global accounting standards that enable investors to compare the financial reports of companies across the world. In the interim, boards and auditors face vexing issues that arise, for example, when a company that reports under IFRS acquires a company that reports under GAAP.

Another set of challenges has arisen from the spread of mark-to-market or fair value accounting for a growing number of asset classes. In contrast to historical cost accounting, the dominant methodology for measuring value, fair value accounting aims to measure the value of corporate resources and value created using current market prices. Fair value accounting originated as a way of making financial statement numbers more timely and relevant, especially the values reported for tradable securities and the many new financial products developed in recent years to manage risk, such as hedges, forward contracts, futures, swaps, and options. However, fair value accounting also gives managers greater discretion to determine values, particularly when market prices are not readily available, and thus makes greater demands on auditors and audit committees to ensure the integrity of reported figures.

Similar issues are posed by the emergence of new business models arising from rapid innovations in technology. The challenges are perhaps most apparent in the medical sciences (e.g., the growth of biotechnology) and digital technology (starting with the internet and accelerating with the growth of mobile computing, the cloud, AI, and data

science revolution). New business models enabled by these technologies—online platforms and bundled products hosted in the cloud, among others—are outpacing the development of performance measures that capture their true economic value. Companies have responded by producing measurements and reporting figures that arguably better reflect their businesses but that are inconsistent with conventional reporting metrics. While non-conventional measures may have merit, they also obviate the benefits of uniform measurement rules, make it more difficult for users to draw meaningful conclusions, and call for greater vigilance on the part of boards and audit committees.

In parallel with these new challenges, companies have faced heightened demands to provide various types of non-financial information, especially about their social and environmental impacts. These demands range from calls for specific types of disclosures—about climate-related risks, conflict minerals in the supply chain, political spending, or various pay ratios, for example—to calls for comprehensive periodic reports on companies' social and environmental performance. Over the past few decades corporate social responsibility (CSR) reporting, also called sustainability reporting, has evolved from an *ad hoc* activity undertaken by a few select companies to a routine practice at many of the world's large businesses. Although there is no legally mandated framework for such reporting, many companies have adopted the standards put forth by the Global Reporting Initiative (GRI) which cover a wide range of topics from human rights and workplace equity to environmental compliance, anti-corruption efforts, and customer privacy. The proliferation of sustainability topics has prompted various efforts to narrow and systematize the field. Perhaps the most ambitious has been the push for integrated reporting, launched in 2009 by the International Integrated Reporting Council (IIRC). The IIRC has put forth a reporting framework that integrates financial and non-financial information through a value creation model based on six "capitals": financial, human, social, intellectual, natural, and manufactured.

The long history of generally accepted accounting principles suggests that it is likely to be some time before sustainability or integrated reporting becomes standardized and widely accepted as a part of doing business. In the meantime, boards and companies will face difficult decisions about reporting and disclosure on both financial and non-

financial matters. Although the merits of transparency are evident, and the availability of accurate and timely information is crucial for the effective functioning of markets and society, gathering and reporting on corporate-wide information can be costly. As demands for more extensive reporting and disclosure continue to escalate, boards and companies will be challenged to find more efficient and more meaningful ways to respond.

Questions for Boards and Managers:

- Companies and boards are increasingly called on to provide more and better information about their activities, but how much and what types of reporting and disclosure are optimal?
- What should companies, boards, and their advisors disclose and what standards should govern those disclosures?
- What's your assessment of your company's reporting and disclosure practices?
- How can transparency be enhanced without compromising competitively valuable information or creating unfairness in the market?

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