FLAWS IN GOVERNANCE

We know from Part I that internal and external governance mechanisms exist to protect stakeholders, and in practice often work as intended. Occasionally, however, they break down as a result of some flaw, such as a failure within the board of directors or the executive suite, ineffective internal controls or corporate policies, and inadequate regulations. Any of these might lead to a corporate problem. In some cases several shortcomings might appear at the same time, increasing the possibility of a more extreme outcome, such as an excessively large and unexpected loss, a liquidity crisis, financial distress, or even bankruptcy.

Governance flaws generally develop slowly, over an extended period of time. It is unlikely in the modern corporation that an aspect of governance can suddenly fail and lead to immediate distress or liquidation. Even a company like Enron, which encountered liquidity difficulties in late September 2001 and filed for bankruptcy two months later, had sown the seeds of its destruction long before its relatively short collapse period. Indeed, problems related to controls, oversight, and behavior – and the culture that permitted these to exist – started at least five years before the company’s ultimate demise. If governance flaws are relatively slow to develop, directors, managers, auditors, creditors, and regulators theoretically have the opportunity to spot problems and take corrective action. While this often happens, sometimes it does not, perhaps as a result of comfort with the status quo, unwillingness to challenge executives, satisfaction with returns being generated in a bull market (“the rising tide carries all ships”), insufficient technical skills, and so forth. These behaviors must be corrected in order for governance flaws to be detected and acted upon.

Those deeply involved in governance matters, including board directors and regulators, are well aware of problems that can arise. Consider the
results from a 2002 McKinsey survey (conducted after Enron, Tyco, Adelphia, Swissair, Daewoo, et al.), where board directors commented on potential shortcomings and problem areas:

- 21 percent had no mechanisms for assessing executive compensation practices or financial/operating risks, and a further 30 percent felt their mechanisms were ineffective.
- 37 percent had no CEO succession plan in place, and a further 27 percent felt that their plan was inadequate.
- 19 percent had no formal plan for dealing with risks, and another 24 percent felt their plan was ineffective.
- 45 percent felt their companies should, but did not, have an annual director re-election process.
- 60 percent felt their companies should, but did not, have formal board evaluations, and 66 percent thought they should have formal director evaluations.
- 42 percent of directors felt they had only “some” knowledge of how the company’s business creates value, 36 percent felt they had only “some” knowledge of the major risks facing the company, and 47 percent felt they had only “some” knowledge of competition and strategy.
- 60 percent of directors did not independently observe the activities of the company’s chief risk officer, 39 percent did not observe internal auditors, and 28 percent did not observe chief legal counsel.
- 43 percent of directors were dissatisfied with board oversight of external counsel.
- 25 percent of directors would decline to serve again because of liability concerns.

Perhaps most revealing is the fact that 90 percent of directors felt that governance improvements were needed: 74 percent wanted more responsibility assigned to the CEO, 73 percent wanted more responsibility assigned to audit committee review of risk, 73 percent wanted a lead independent director, 70 percent wanted a ban on external auditor/consultant business, 69 percent favored a split in the CEO/chairperson roles, 52 percent favored the creation of a board-level risk management committee, and so forth. These director-level findings are not surprising when we examine the nature and extent of flaws that can impact the typical corporation, regardless of industry or location. Indeed, the potential problems we cite in this section (and which we illustrate “in practice” in Chapters 7 and 8) can be found in any