BOARDS OF DIRECTORS THAT WORK: IMPROVING THE DECISION-MAKING PRACTICES

Abstract

This article discusses how to improve decision making practices of boards of for-profit organisations that utilise corporate governance structure. Based on bibliographic research, the article argues that the company should decide on the optimal board structure and size, and work to establish good relationship between the Chief Executive Officer (CEO) and the board. The board should be aware of biases and limitations that may impact on board as a whole and on individual director such as lack of integrity, arrogance, dominant personality, selfishness, greediness, abuse of power and personal interests that may undermine the decision making process, and reduce the quality of decisions. Age, skills, knowledge and experience should be considered in the process of appointment of directors. Board processes should be improved over time and they should include directors and CEO evaluation.

Key words: board of directors; decision-making process; corporate governance.

INTRODUCTION

Corporate governance matters for the success of all type or organisations, including public, private, for-profit, and not for-profit organisations. Crowther and Seifi (2011) state that corporate governance attracted a lot of attention probably since the mid-1980s, and, after big corporate scandals, it became central to most companies. The demand for transparency and accountability in the utilisation of shareholders' funds and the growing awareness of the need for good corporate practices to attract investment capital to achieve organisational strategic goals over the long-term also contributed to become corporate governance an increasingly interesting subject.

While there is a burgeoning literature on board decision making, and continuous debates that provide guidance on decision making practices for corporate bodies, lots of corporate scandals and failures occur worldwide. In some cases, the main responsible for these situations are the boards of directors. Many companies still have boards with inadequate structures and sizes; some boards use decision making practices which lead to decisions that do not contribute effectively to enhance the company's performance. There are many examples of poor decision making by boards worldwide. The case of Enron Corporation in the United States of America was well-publicized from 2001, when, according to Healy and Palepu (2003, p.3) "Enron's image was in tatters and its stock price had plummeted nearly to zero".

The objective of this article is to analyse how to improve decision making practices of boards of directors given that they are the key decision bodies in most organisations which use a corporate governance structure.

A lot of literature, for example Colley, Coyle, Logan and Stettinius (2004), supports that businesses that have sustained success during long period of time had boards that governed the affairs of the businesses effectively. In the case of companies that performed poorly there is an indication that the boards had not addressed effectively the issues confronting their businesses. This shows that the decisions made by the boards may contribute to continuous improvement or undermine the performance of the companies.

METHODOLOGY

In this study was used exploratory research. According to Gil (2002), the objective of exploratory research is to provide greater familiarity with the problem, making it more explicit and allowing the formulation of hypotheses, thus, ensuring the improvement of ideas or the discovery of intuitions. The research procedures involved both bibliographical and documentary research on decision making by boards of directors. Gil (2002) and Martins (1990) say that bibliographical research is developed using books and scientific articles. The documentary research is similar to bibliographical research but the two forms of research differ in the nature of information sources. Gil (2002) says that documentary research uses materials that have not received significant analytical treatment from several authors such as photographs, recordings, research reports, company reports and statistical tables.

In this research were used several scientific articles, books and research reports related to the topic, published worldwide. In the study were collected, selected, analyzed and interpreted the existing theoretical contributions of the best practices on decision making in for profit organizations that utilize corporate governance structure.

The key question was: how to improve decision making practices of the board of directors to bust the performance of the company? To answer this question, the following questions guided the research: (i) Which types of major decisions a typical for profit board is asked to make? (ii) Which structural aspects of corporate governance mitigate against good decision making? (iii) What are the biases and limitations impact on both individual and group decision making? (iv) How boards may overcome the structural, individual and group decision making limitations and biases to improve their collective decision making?

In the next sections of this paper are given the answers found to the questions presented.

MAJOR BOARD DECISIONS

The decisions usually made by boards of for-profit organisations are related to the following issues (COLLEY AT AL.; KIEL & NICHOLSON, 2004):

(a) Strategy formulation - the board of directors has responsibility in establishing the company strategy. The role of the board in establishing the strategic direction of the company has changed over time. Currently, the company strategy is a joint product of management and board of directors. This means that the board must provide real value to corporate strategy formulation by moving away from just approving actions to producing strategy (KIEL & NICHOLSON, 2003). Stiles (2001) says that in terms of strategy formulation, the board is expected to make contribution at corporate level, helping the management to define the corporate level objectives.

(b) CEO selection, monitoring, mentoring, evaluation and removal - the selection of a CEO is one of the most important and risky decisions a board of directors makes in the life of any company (LORSH & KHURANA, 2000) and it is an opportunity to influence the direction and performance of the company, and also to build relationship between the board

and CEO. The selection of the CEO should be based on a job description. The CEO should have strategic vision similar that of the board (KIEL & NICHOLSON, 2003). The most recommended source of CEO candidates is the company itself but candidates from outside the company may also be considered (LORSH & KHURANA, 2000). Another issue to consider is related to succession planning. A contingency plan and long-term progressive development process of the future CEO should be established. The board should also decide whether the retiring CEO should remain in the board after he or she retires. Retaining the former CEO brings advantages to the company because he or she has knowledge of the business but the former CEO ties to management may be a problem. Also, the retired CEO may create difficulties to the new CEO especially when the new CEO wants to make considerable changes (COLLEY AT AL., 2004).

(c) Advising and networking - the board provides advice to CEO and facilitates the access to resources required to the company. Also, the board brings skills, knowledge and experience to the management (CARVER & OLIVER, 2002). The importance of the board in this case may be highlighted especially when the business environment is changing rapidly and adjustments in the business strategy and operations should be made, and the management may require more inputs from the board, and directors should make crucial decisions to keep the company in business, avoiding adverse impact on company operations. Boards are also important in developing networks with other organisations and individuals in the external environment of the company such as suppliers and customers. Networking enables companies to know the business environment, to get access to outside resources, and it can be used as a way to build reputation. The board, especially the chairman, may establish networks with several public and private organisations, government institutions, and individuals (KIEL & NICHOLSON, 2003).

(d) Monitoring of organisation performance - ensures that the firm strategy is being implemented as planned, the company is complying with legal obligations, and the shareholders expectations are met (HOULE, 1989; KIEL & NICHOLSON, 2003). Monitoring allows the board to make crucial decisions when there is a deviation in the strategic direction of the company, and the company performance is weak. Also, the board may rely on performance monitoring to determine changes in the management of the company. To implement an adequate performance monitoring of the company the board should decide on key indicators and look at monitoring in a board perspective using sophisticated tools such as Balanced Score Card, and deciding on indicators that are verifiable, valid, global and communicable, looking at short and long term goals of the firm (KIEL AND NICHOLSON, 2003).

(e) Compliance of policies and practices - companies must comply with the laws, regulations and codes of practices related to its operations. Breaches of laws, regulations and codes of practices may impact adversely on each individual director, on the board or on the company as a whole. The board provides accountability to stakeholders for the actions of the company. This means that the board is held responsible for the compliance of the company (KIEL & NICHOLSON, 2003).

In this context, the board should decide on adequate compliance system of the laws and, on how the management and the board should be protected. The board is also required to oversee the process of identification of relevant laws, formulation of internal policies, controlling and implementation of adequate actions when deviations in the compliance occur. In Australia, for example, most companies are required to comply with the Corporation Act, Taxation Law, Trade Practices Act, State OHS Legislation, Anti-discrimination and Equal Opportunity Legislation and Superannuation Requirements (KIEL & NICHOLSON, 2003).

(f) Risk management - supports better decision making because it reduces the degree of threat of the company by critical events; risk management involves the definition of optimal level of risk that the company should bear to achieve its goals, and it should be implemented at business, legislative, people, and disaster levels. The board should assess the exposure of the company to risk and set appropriate policies to mitigate threats and ensure its compliance in the company (KIEL & NICHOLSON, 2003).

(g) Policy formulation - the board should establish policies governing the company to ensure consistency and harmonization of firm operations. The management may draft some policies but they should be made available to the board for consideration, revision and approval (HOULE, 1989).

(h) Communication with stakeholders - in general, the board and management communicate with stakeholders via annual reports and annual general meetings. Using these tools, the board and management provide the stakeholders with relevant information on performance, remarkable events and challenges of the company.

BOARD OF DIRECTORS COMPOSITION

Board composition impacts on decision making process and quality of board decisions. Several companies have executive and non-executive directors. Some companies include independent and alternate directors.

The number of directors varies according to the size of the company, type of organisation, and organisation structure. Variation in the number of directors in the board may be determined by the circumstances facing the company. If the board is too small cannot provide adequate policy guidance or assistance to the agency with which it is connected (HOULE, 1989). Goodstein, Gautam and Boeker (1994) studying the effect of board structure on strategic changes initiated by organisations found that large boards tend to initiate fewer service reorganisations. Organisations with diverse boards are less likely to initiate strategic changes than those with homogenous boards. That is, diversity may act as a barrier to change due to the difficult in coordinating a more diverse decision making board. Hickey and Ryan (2003) based on UK Government Report on non-executive directors, state that where members of a group have diverse skills, knowledge and experience, quality solutions to problems are found because strong debates within the group are likely to occur but they warn that diversity may lead to lower cohesion, less trust and high turnover within the group. Diversity may prevent the board to make strategic changes.

Another issue to consider is the board tenure. Forbes and Milliken (1999) assert that directors working together for a long time are likely to have high level of cohesiveness, lower level of cognition conflict as they acquired enough knowledge and skills, and sound shared understanding on company issues. In contrast, if the board members have worked together for short period of time are likely to have more diverse perspectives on company issues and this situation may affect the board decisions.

Executive and non-executive directors

The role of inside and outside directors on board performance is a significantly vexed issue. Outside directors are considered as a source of additional skills, expertise, experience, and new contacts to the company (KIEL & NICHOLSON, 2003) but these directors may lack the amount and quality of information to assess managerial competence and the desirability of initiatives. The inside directors are crucial to preserve the contractual relation between the company and its management because they are participants in the decision process and have access to information necessary to truly be effective in controlling decisions (BAYSINGER & HOSKISSON, 1990). The same authors point that in the case of conflict of interest, inside directors ties to the CEO may compromise their effectiveness as decisions controllers when managerial opportunism is the cause of financial losses. Outside board members are more likely to be objective and independent, and more capable to resist self-interested efforts by inside managers to influence board decisions. They emphasize that corporate boards with high proportion of outside directors are more likely to resist the payment of greenmail. These considerations suggest that companies should balance the number of inside and outside directors and set clear roles for them.

BIASES AND LIMITATIONS ON DECISION MAKING PROCESS

According to Nadler (2004) the challenge for directors is not regulatory compliance. Good corporate governance lies in the working relationship between the board and management, in the social dynamics of the board, and in the competence and constructive involvement of each individual director. Cairnes (2003) believes that what drives the board of directors and the company down is the dysfunction within their social system, meaning that the human social relationships are the main determinant in the decision making process and procedures in the companies.

Decision-making process requires judgement. When impartial judgement is required, unconscious biases may occur in a manner that proportionate the self-interest of the judge, confusing what is personally beneficial with what is fair or moral. Many decision are made without following the rational decision making process. Rather, people tend to rely on heuristics in making decision that can lead to severe errors (BAZERMAN, 1998; HAMMOND, KEENEY, & RAIFFA, 1998). These authors state that this is what frequently happens in many boards. Sometimes, self-interests over the company resources become priority to some managers and directors and the decision making process is flawed and not rational. Many boards do not consider all alternatives when the decision is to be made and no criteria to select alternatives are set. Consequently, the board displays malfunctioning in the decision making process to exercise judgement on the appropriate policies, strategies, and controls to ensure a healthy and sustainable business.

Biases that impact on the board as a group

Groupthink is the tendency of groups of people working together over a period of time to make poorly reasoned decision. Groupthink interferes and limits rational decision making especially in highly cohesive groups (BAZERMAN, 1998). Janis (1972) as cited in Garratt (2003), says that there are many biases in the decision making process that can lead to underperformance or affect the board activities:

(i) The illusion of invulnerability - this bias takes place where the company and the board have been working for long time and things seem to go well. Hick and Ryan (2003) say that the members of a group such as board of directors become extremely optimistic so they ignore obvious dangers and take very high risk. Hayashi (2001) says that the dangerous ingredient is the tendency towards overconfidence. Garratt (2003) cites the example of British

Telecom which went to private sector maintaining public sector mindset where was like a monopoly supplier. As a result, the company had difficult to cope with the competition.

(ii) Collective efforts to rationalize – in this case the board displays a strong bias towards alternatives that perpetuate the status quo even when evidences suggest that the directors should consider seriously their policy or strategy assumptions (HAMMOND AT AL., 1998; POUND, 2000). The directors tend to perpetuate, irrationally, the previous unsuccessful actions (BAZERMAN, 1998). For instance, the Enron board ignored twice the warnings from auditors concerning high-risk accounting practices and the board allowed the chief financial officer (CFO) to participate in off-balance-deals (BYRNE, 2002; LAVELLE, 2002).

(iii) The shared illusion of unanimity – this bias is a result of a mixture of self-censorship, lack of critical questioning and review, and the board is capable to take decisions that no present director agrees (GARRATT, 2003).

(iv) Pressure for dissenting directors – dissenting directors are excluded or questioned about their loyalty to the board, so they cannot contribute effectively in the process of decision making (GARRATT, 2003; HICKEY & RYAN, 2003), and their experience is despised even when is useful.

(vi) Self-censorship of deviations from apparent group consensus – this bias is caused by a kind of board policy in the decision making process. The decisions are made quickly without comparative data and appropriate level of discussion about the issues in place. The directors do not exercise their rights and deliberately do not question proposals even when they are aware of the need for that action. Cairnes (2003) says that in many cases directors are asked to ratify rather than approve proposals.

Biases that impact on individual director

There are several biases that impact on individual director on the board. Some directors display lack of integrity, dominant personality, arrogance, selfishness, greediness, abuse of power and personal interest. These directors do not understand personal weaknesses and they do not have a strong enough set of values to deplore unadvisable acts and participate in a respect manner in the decision making process (COLLEY AT AL., 2004).

According to Kiel and Nicholson (2003) there are several sources of biases and personal power but the position power, the information power, and the expertise power seem to be of particular importance. For example, some CEOs use position power to enfeeble the board and conflict arises when the board tries to stop a CEO pursuing a strategy that seems to harm the company. Sometimes the abuse of power is associated to information possessed by the CEO that was not made available to the directors, who in this case, are in a frailty position. The same authors state that in some situations, the decision making process is affected by corruption, lack of leadership, director's ties to CEO. In addition, many directors have lack of experience and training to support duties, and others are not well informed upon the affairs of the business while the duty of care requires directors to understand the business and the major issues it faces. Consequently, some directors cannot make reasonable judgement and make useful contributions on the board.

CHAIRMAN /CEO RELATIONSHIPS AND BOARD–CEO TIES

Some companies have combined the chairman and CEO roles and give it to the same person allegedly because companies need strong leaders and the combination avoids CEO and chairman rivalry. While this may be true, some people support that these jobs constitute a distinct conflict of interest for anyone holding both positions (COLLEY AT AL., 2004) and it can lead to abuse of power and interference in the board decision making process. For example, the chairman should evaluate the performance of CEO and if these jobs have been combined and performed by the same person it means that the CEO should make self-evaluation.

Another issue is the participation of CEO in board and committees meetings. The participation of CEO may interfere in discussions and board decision making process. An examination of regarded worst boards, as classified by Lavelle (2002), allows to point some CEO interference in boards of some companies: the board of directors had meetings only when CEO was present (Conseco); The CEO was hand-picking the directors due to lack of nominating committee (Dillard's); and the CEO was a compensation committee member (Apple). These examples suggest the need of separation of management from the governance roles and definition of CEO authority to improve the board decision making process.

This is supported by several studies on corporate governance that point that many boards lack independence from management and this dependence brings about board passivity in the decision making process, compromising board effectiveness in strategy making process, and also undermining the controlling and monitoring functions of the board.

Baysinger and Hoskisson (1990) point that the general trend in today´s organisations is to separate the two roles, pointing an independent chairperson. This is based on agency theory that supports that in organisations may occur conflict of interests between shareholders and managers because managers are likely to deviate themselves from the interests of the shareholders. The separation of CEO and chairman roles enables the board, with its legal authority, to hire, fire and compensate to management, and hence it safeguards the interests of shareholders and the capital invested.

The lack of separation of CEO and chairperson roles may impact negatively on the quality of board decisions because the CEO may act opportunistically and influence the board to make decisions that are not in favour of the company strategy and goals (BAYSINGER & HOSKISSON, 1990). However, Westphal (1998) points that increased board independence may have a variety of negative effects on strategic decision making because of reduction of positive and cooperative interaction between the management and outside directors.

Finally, it is clear that although some benefits may arise from the combination of the CEO and chairman roles to the same person, and CEO-board ties, the board should be aware that decision making process may be undermined, implying that the board should check its processes over time in relation to these issues.

IMPROVING BOARD DECISION MAKING

Board structure

Boards should include executive and non-executive directors. When necessary, independent director should be hired. The number of directors has significant influence on board decision making process. Baxt (2002) says that a public company must have at least three directors. According to Kiel and Nicholson (2003), in Australian public companies, boards of six to eight directors are common and they seem to operate very well. The same authors recommend for boards to have at least two (preferable three) external directors. Data from Hanson, Dowling, Hitt, Ireland and Hoskisson (2003) show that in some countries such as Germany and Belgium the average board size is fifteen. Kiel & Nicholson (2003) recommend that boards should be diversified at the level in which the decision making process is improved and board diversity requires consideration in the skills and experience needed in the company.

The director's age is also important. Sonnenfeld (2002) states that age is an asset for the company. However, boards become less effective when the average age of the members rises. Many boards have directors who are sixties, and board members who are seventies or over are less valuable.

The selection of the board members is the work of nominating committee, and it should never be delegated to CEO but his or her inputs should be considered as the CEO may have good idea of the required skills. The selection of directors should consider the qualifications, experience and other relevant requirements such as integrity, ability to listen within an open mind, the willingness to engage in a constructive discussion with other board members should be considered of the candidates (SALMON, 2000).

The board culture and board committees are two important issues to consider when the board structure is discussed. Regard to board culture, the board should engage itself in a culture characterized by candour and willingness to challenge one another's assumptions. Openness and participatory culture are desirable in the board (NADLER, 2004). Sonnenfeld (2002) states that respect, trust and the capacity to challenge one another's assumptions and beliefs are important for boards to improve the decision making process. In relation to board committees, the board can delegate some policy or issue to a committee that will complete a detailed study and engender recommendations to be shared with the entire board for decision. The board of directors committees allow the board to make maximum use of their expertise especially for complex issues and when time and efficiency issues are taken into consideration (COLLEY AT AL., 2004). Committees may also be used for evaluation and monitoring of board's work. To allow committees to be effective, the board should set clear duties for each committee and the reports of each particular committee should be part of board minutes. According to Lorsch (2000) committees should be made up of outside directors. The following committees can be found in many boards: committee of outside directors, executive committee, compensation committee and governance committee (COLLEY AT AL., 2004).

Governance relations

The chairperson and CEO roles constitute a distinct conflict of interest for anyone holding both positions. In US corporations, chairperson is also CEO (HANSON AT AL., 2003; SALMON, 2000) but a lot of literature suggests the separation of the two roles with appointment of a non-employee chairperson (COLLEY AT AL., 2004) or appointment of an outside director who will work with de chairperson (SALMON, 2000). As supported by Crowther and Seifi (2011), keeping the board independent from the management is one of good corporate governance aspects. The chairperson and the CEO should set and agree from the outset the role of each one, and the agreement should be put in writing and sent to the board for approval. The chairperson and CEO must have close work relationship (HARVARD BUSINESS REVIEW [HBR], 2000).

Board processes

(i) Board meeting and board agenda - according to Kiel and Nicholson (2003), board meeting is the director's chief source of information and the key venue for decision making. To get sound outcomes from the board meetings, the meetings should be planned, conducted orderly with the active participation of the attendees. The meeting agenda should be prepared to make clear the issues that will be discussed, the priorities and the time allocated to each issue. As stated by Houle (1989) care should be taken to keep the agenda of the board meeting from becoming too full.

Location, venue and participants of each meeting should be set. Directors should take responsibility for the success of the meetings, arrive in time, listening to contributions of other members, and participating actively. The company secretary is responsible for record taking. The chairperson should lead the meeting and ensure the active participation of all members (KIEL & NICHOLSON, 2003).

(ii) Board papers - are sources of information for board meetings. To make the meeting productive, directors should be provided with the board papers in advance, generally seven days before the meeting (KIEL & NICHOLSON, 2003; WARD, 2000). Board papers include agenda, previous meetings minutes, correspondence, financial reports and other relevant documents. In many companies, the preparation and circulation of the board papers is responsibility of company secretary.

(iii) Board minutes - records the decisions and deliberations of the board (HOULE, 1989), the people who attended the meetings and the collective decision making process (KIEL & NICHOLSON, 2003). Keeping the records of decisions avoids future confusion, conflict, and repetition of earlier discussions. Ward (2000) states that minutes should be a record of what was decided, not the verbatim discussion but Kiel and Nicholson (2003) say that minutes must contain precisely the wording of the resolutions approved by the board and the board should decide on the detail required in the minutes. Companies and boards may adopt basic minutes, extended minutes or full reports.

(iv) Board and CEO evaluation - board evaluation is important to assess the board performance and to check how effectively the board is contributing to achieve the organisational goals. Board evaluation requires the definition of the evaluation purpose, evaluation frequency, and establishment of the measures to use, to check the performance of the board. It is also important the definition of who will be evaluated, who will be asked in the evaluation, which techniques will be used, who will conduct the evaluation, and what will be done with the results obtained from the evaluation. The evaluation can be carried out by the chairperson, a non-executive director, or independent expert using quantitative or qualitative methods, depending on who is being evaluated (the board as a whole, independent directors or CEO) and the nature of data to be gathered and the context in which the evaluation is conducted (KIEL & NICHOLSON, 2003). For example, peer evaluation, self-assessment, the evaluation by the CEO, and the evaluation by the chairperson may be combined in the evaluation of each individual director (CONGER, FINEGOLD, & LAWLER, 2000).

The evaluation of CEO has significant importance to the company life as it helps the CEO to improve his or her management practices and to improve the relationship with the board over time. The evaluation of the CEO should be aligned with replacement or succession plan, and CEO development and mentoring.

FINAL CONSIDERATIONS

The article argues that boards of directors are the key decision making bodies in most organisations that use the corporate governance structure. The functioning of the boards deserves a lot of attention and studies as the decisions made by boards may contribute to continuous improvement or undermine the performance of these organisations. Directors should be clear about their roles and the level in which their contributions are expected in the companies.

The quality of the board decisions depends on structure, size and processes of the board. Governance relations, biases and limitations may affect profoundly the quality of decisions made by boards.

The selection of directors should consider the age, skills, knowledge and experience of candidates to board members. The selection of CEO should be made carefully, based on job description and strict criteria in order to pick the best candidate from inside or outside the company.

The evaluation of both board members and CEO is essential to the life of the company, as its results help to point what should be done at board and management levels to contribute for continuous improvement of the company performance.

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