Episode 10 Insights into Corporate Governance

Length of recording: 39 minutes

Transcription notes

GB:	Gautam Basu
VS:	Vikash Sinha
S:	Speaker(s)

wo-	an unfinished word
(word)	an uncertain passage in speech or an unrecognized speaker
(-)	an unrecognizable word
(--)	unrecognizable words
[pause 10 s]	a pause in speech of at least 10 seconds
, . ? :	a grammatically correct punctuation mark or a pause in speech of less than 10 seconds

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[*intro music*]

S: The Operations Leadership podcast with Gautam Basu provides insights for today's business leaders on creating value through operations improvement, process excellence, digital innovation, and organizational leadership.

GB: Our guest for this episode of the Operations Leadership podcast is Vikash Sinha. Vikash is an assistant professor at the Aalto University School of Business in the management accounting department. He is considered a subject matter expert in the areas of risk management, internal controls and corporate governance. In this interview Vikash will discuss some of the principles, practices and structures around corporate governance, why corporate governance is especially important in these times and last but not least, why operations leaders should pay attention to corporate governance. If you like what you're hearing in this podcast series, we kindly ask you to subscribe. Enjoy.

[music stops

GB: Hello Vikash, how are you and welcome to the Operations Leadership podcast.

VS: Hi Gautam, nice to be here.

GB: Great. Alright, maybe we can start with a general question, maybe a little bit about your background and what got you interested in the topic of corporate governance and risk management?

VS: I'm assistant professor of management accounting at Aalto university school of business. I hold a PhD in industrial economics and management from KTH royal institute of technology and a PhD in management economics and industrial engineering from Politecnico di Milano, Italy. My research research focus during my PhD years has been on risk management, internal control and corporate governance. I was mostly interested in the packing sector while I did my research. And that comes from my own professional background. I have almost 8-9 years of experience in financial services consulting, especially on automation, risk-management and also risk-measurements. You know when in banks, you deal with risk-management, it's pretty institutionalized and there are a lot of regulations that you have to take care of. And the anecdote is, every time I did some consulting, I found that we talk about risk-management but it's such a complex thing that people really don't understand what risk-management is. And then when you go to the board level, then definitely boards are concerned about strategy and other aspects more than risk-management. But this is where the entanglement of the two topics became interesting for me during my PhD. Because in my own experience I understood that boards devote a lot of time making strategy, talking about big issues and big pictures but they really do not understand the small things that they should. Of course their time is limited, but then understanding what is happening in the firm is important for strategizing. Going back to the classic old saying, if you have a strategy, you want to make such a profit then you have to take such a level of risk. Though, I would say that in recent years focus on risk-management and internal control is increasing and boards have been pushed to do this by regulators.

GB: If I understand correctly, risk (--) [04:06], is this primarily the audit committee that is looking at these risks on a corporate wide and that kind of touches the intersection between corporate governance and internal audit and risk-management, is that correct?

VS: True that, just a small argument here that, we have to understand that financial services is the place where a lot of good corporate governance practices have emerged. If you normally look at banks and financial services and insurance firms, the audit committee is looking at something called retrospective risk, what has happened and then many firms also have what I would call risk committees that are looking more more at prospective risks. And then of course as we discussed, risk is a fundamental part of your strategy. How you make profit depends on what kind of risk you are willing to take. So of course both in general have to look at macro economic conditions. Firms internal resources, health, financial as well as what kind of capital you got and what you can make out of it.

GB: Okay, interesting. I guess the listeners of this podcast are primarily more from the operations side, so could you explain to us what actually is corporate governance? What are some of the key principles, practices? Maybe some stakeholders with corporate governance and why is it important?

VS: Thank you, this is a very interesting question but let me take it in parts. So coming to what corporate governance is, I would say corporate governance is about structures, institutions, rules, practices, processes that are all designed to direct control and manage a firm. And what is the purpose of this directive controlling or managing is; firms achieve their purpose, and then that purpose is implemented properly as strategy and shareholder values are reserved. Now when I talk about shareholder value, this is what some people will call an old paradigm where owners or principles of the firm, their profit making motives were more important. And now we'll see an emergence of stakeholder perspective (--) [06:55] where owners are one stakeholder. Then you have governance, especially when there are a lot of regulations. Then you have society at large, some people will claim the environment is a stakeholder and I will come back to this stakeholder question later. But the second part that you asked, what are the key structures and principles, so the key structures are, if we think at any public or private firm, you have shareholders who meet during practices such as annual general meetings and then talk about important issues. So this is one element of how owners participate directly in limited liability companies. And more and more regulations are coming here and more practices are emerging. These shareholders in some way appoint the board, because in the annual general meeting you confirm the board. And a lot of people when they think about corporate governance, they relate it to the board. But board is another element. And board works as we discussed a little earlier, in different committees. Audit committees on retrospective risk, risk committees for prospective risk and then you have compensation committees which has become very important because executives' compensation are an important way to guide whether they are following what the board wants. What the board wants is what shareholders want. And these days of course, I will come back to the question of stakeholders a little later. And of course executives themselves; chief executive officers, operational leaders like chief operating officers, financial officers and these days information officers, they are also an important part of this corporate governance paradigm. Now what are the differences between these elements is, the day to day management is done by CEO, CO, CIO. And depending on the firm, there is a certain level of independence here or the CEO assumes a top level position. Most of the firms, larger firms, smaller-medium size enterprises these days as well, have boards. And a little earlier I talked about boards being, board practices emerging in the financial sector but really what is happening today is, these practices are diffusing into other sectors. When regulators are seeing that some of these practices are good, we have to take this into account. Then coming back to practice and rituals, which are always there in management practices, so shareholders have these annual general meetings and the recent trend is, they not only approve board appointments, certain issues, but these days there is something that is coming back to shareholders is; say on pay. It's a very important aspect where shareholders can have a say on what should be the level of compensation and bonuses for top executives. Now again here, this regulation is being implemented and it's rudimentary in different parts of the world and there has been some evidence that it works. The second ritual that is emerging I would say is, and which is linked to sustainability is, shareholder activism. So you have activist shareholders who are pushing agendas. Just to clarify, American firms tend to have more dispersed ownership if you exclude the high tech sector. High-tech sector is a new phenomenon which has more concentrated ownership, also different kinds of share classes where owners have 18% share but 17% voting rights. So voting rights is what matters and this is designed through financial instruments and ownership equity that, okay it's A-class share and it has more voting right than the percentage of shares. If you look at it, traditionally if we look at Finland, Germany, you have had families that owned very large corporations. Not to say that there are not such corporations in the US, but that's a traditional difference. You have more dispersed ownership in the US, less dispersed in Europe, though these differences if we look at the high-tech sector, US companies are also (vary). And this is where activism is also important because minority shareholders can form a block of 5% and then push their agenda. So these are rituals that are emerging in shareholders. When we think about boards, irrespective of all the structure and committees, they have basically three things to take care of. Two of them are what they discharge as their duty all the time, one is steering the strategy, being a sounding board for the CEO and also being-, and that's where the relationship between CEOs and boards. Just to clarify here, if you think about a dispersed ownership where no 1% owns 5% of the firm. Then definitely, CEOs have more power because then boards will have representation of different shareholders. But if you have a concentrated board, then you will have more representation of family or concentrated owners. So this difference is important because if you have more dispersed ownership, CEOs get more power. If you have more concentrated ownership, the owners want to keep the power, so the CEOs have less power and that is visible in the board as well. Boards normally discharge duties of advising for strategy. Steering, depending on what kind of board it is. Monitoring is an important aspect and it's emerging a lot I would say these days. Given all these scandals that we see around us, (wire-card field), and if you look, the board did not take action. If we go back to concentrated ownership which is mostly in Japan; Toshiba had a scandal in 2015 but the scandal was running for several years and it was a financial misrepresentation scandal. Given the culture in Japan, boards were ineffective. So that's another thing, we will discuss it later, you might have, and I will come back to it, what people are pushing for independent boards. So the more independent board members who do not have something in common with the share-owners or something, they are independent of managers, they don't have that relationship is very important. it's been pushed around. But still, boards can fail. Think about it, normally boards meet 4 times a year and committees meet separately 4 times a year, 6 times let's say. Which means they have a very limited time and they can take into account a very limited set of issues. So that's where privatization matters. And that is driven by managers themselves, so they can influence the agenda. Because internal company information when you monitor a firm is very important. And third is I would say special actions, especially when firms go bankrupt or the one to expand, they hire board members that have especial expertise. For example, if a company is going bankrupt, they want to structure their capital. Then it would be very interesting for them to have somebody who is embedded in the financial industry. So board members can bring their network. Another example, if a company wants to expand to India, then they will try to hire somebody who is knowledgeable about that market in india. So then they would get some resources, the network of the board members as well. So this is in brief practices and rituals, the board meets 4 times, they get an agenda which should actually not be vetted all the time by CEOs. Of course CEOs have a lot of say but I think good boards also meet other leaders and we will talk about it, operational leaders, internal control heads, chief financial officers and sometimes without the CEOs so that they get an independent view of the firm. Coming back to this idea of shareholder versus stakeholder view, this is becoming very very important. EU corporate governance, guidelines, the new ones that they are going to propose are going to take this into account and there is a risk of having stakeholder view as well. The grass looks greener on the other side. Because we know from a lot of research and practices that if you give multiple targets to CEOs or even COOs, you can't measure all of them. Some of the task will be simple, like have you responded to clients, if we talk about COO or CEO; have you attended the meeting, have you formulated a strategy, these are simple. But what is the content of that strategy, how have you implemented it? It's a complex thing to measure. So we already know that if CEOs are given, and they have complex tasks, it's very difficult to control them. So given that they will have multiple goals to achieve, they will have a lot of discretion and a (levy) to say that we did our best. Also if you think about sustainability issues, they cannot be measured perfectly, they are like economic externalities, we do some action and something happens, we cannot measure all the things that happen and that's where sustainability and science about sustainabilities. So I think there are good things about it, the stakeholder view that employees should be happy unlike in Amazon or you should take care of the environment unlike fossil fuel companies but I'll come back to these as well. All these are also general topics and general things we tend to generalize. Not necessarily all firms are bad, I think they're trying to a lot of good things but things (--) [18:09]

GB: Good. You touched upon it a little bit but maybe something around this ESG, environmental social and governance, I understand this is quite a hot topic at the moment, and I guess it refers basically to a set of standards for a company's behavior. That's primarily used for socially conscious investors to screen potential investments, so I think this touches on some of the things you mentioned already but, could you tell us about the importance of ESG, especially from a corporate governance perspective in recent years?

VS: Here we have to also understand one aspect that corporate governance is about (monitoring), board is about monitoring the actions of the executives. Now you have other monitoring mechanisms which I will call external monitoring mechanisms that (--) [19:03] which were there for example, financial analysts, they collect information, find the financial health of the firm. In similar fashion, you have ESG ratings which are becoming very important and you have MSCI, a firm that does (-) owned by Thompson,Reuters and maybe other firms are rating ESG environmental, social and governance aspects. Also you have to understand here, another external monitoring mechanism that is becoming important on top of this, if you think about ESG is and I will come back to why this is important are investigative journalists. The whole wire-card scandal was investigated by Paul Murphy from financial times. If you look at a lot of ESG issues, these investigative journalists went to Bangladesh, looked at the condition of people there or the Foxconn factory in China and the news broke out that Apple is talking about sustainability but they're actually not following it. So ESG is extremely important for boards, why? Two reasons; one is, of course it harms their firm, if they don't take into account, firms will have reputational damage. Given how society is moving, it's not happening today and there are reasons for it but there may be younger generations that may not buy products of firms that have bad ESG ratings or they're in the news media. The other thing it matters for directors themselves and CEOs themselves because with tarnished reputation or (-) or even CEOs which play an important role in the supply chain issues as I touched who are your suppliers. Are your suppliers not using slave labor?, and all these ideas. That's where this becomes important for operational leaders, board members, CEOs, all kinds of (leaders), reputation matters because you wont get a job.

GB: Yea, that's interesting. Examples of good versus bad and you mentioned some of the poor corporate governance, you mentioned Foxconn, this wire-card, what are some examples of good corporate governance that you have seen in your, either career or academic research? Can you name a few cases? And what distinguishes good versus bad?

VS: First of all, it's very easy to identify bad corporate governance. There are hardly any firms listed in the US, the large firms that haven't had any scandal. That goes back to the idea that I was raising with you, are boards really capable of monitoring everything? Because they have limited time, the information they get sometimes is diluted by executives themselves and this of course depends on different parts of the world but there have been a lot of scandals in so-called developed countries as well. Which kind of points to; can we really distinguish between a good and a bad corporate governance? Because if we distinguish it by outcome, that there should be no fraud, there should be no reputational damage to the firm, it would be difficult to say that any firm has a very good corporate governance, but still, there are certain things and practices that can make a corporate governance good. Presence of more independent directors, motivated directors,- because you can be independent but you may be not motivated to discharge your duties. Devoted directors, which means they have time for your firm. There are cases where people sit on 12 boards. So are they able to monitor the firm? Or are they even able to advise the firm? They have so many duties. So what I will say here is, 4 characteristics that directors need, and I will go to the director level because I think boards have a very important role in good corporate governance. So you should have independent directors, you should have directors who are not busy, they have time for your firm. You should have motivated directors and the fourth characteristic is, they should be competent in different areas. Some should know finance, some should know strategy, some should be from different industries. For example, banking companies, they struggle a lot from operational issues, they have a lot of operational risk which is about fraud. They can benefit from hiring operational leaders in their boards to understand why processes are important. In other ways I would also say that some firms could benefit from hiring people who know finance. But financial literacy of directors was an issue in the 1990s, today is really not an issue, most of the MBA courses that people go through, they have some literacy about what financing is. So operations therefore are a very important aspect for banking. I will give an example here of that corporate governance, what was the problem with British Petroleum when deep horizon happened in 2010? or Boeing 737 max failure happened recently, CEOs were rewarded for financial performance and if we look at both these industries, they should have operational excellence, they should have safety culture and if you look at their independent investigation report by different agencies; environmental protection agency for British petroleum, or FAA unreluctantly have an investigative report on FAA. All these point to the issue that safety culture was completely undermined and these issues are very important because these firms- oil rigs are such a sensitive part of engineering and you are in deep water systems where it's very difficult to amend engineering failures. So therefore what matters is safety culture. So how can I say sitting here that these firms have issues with safety. Deep water horizon was the only case which became so popularized but there were tonnes of safety failures and they were reported by occupational safety hazard agencies in various operations of BP. So that was the culmination of several symptoms. So therefore BP could have benefitted from having a board member who understands safety issues. Same thing with Boeing, you are in the aviation industry, of course the conditions there were very right for Boeing to make bad decisions because it's a duopoly between Airbus and Boeing. Of course you have some smaller farms in Brazil like- but they don't compete in the segment, these two firm companies. Airbus has done extremely well with their new model, so therefore Boeing had a pressure to launch their product and then they gave financial incentives to the CEO Dennis Mullalberg to go ahead and do it and then operational issues were undermined. So the good and bad thing depends on, as I will just touch upon it is, in which sector are you operating. And boards are an important aspect of it.

GB: And I think you touched upon it, here is a question I would really ask is, because most of our listeners are some more from the operations background. So, if you think about things like corporate governance and you think about operations or supply chain oriented work which most of our listeners do, do you think (--) [27:59] some of these corporate boards include more operational experts. You mentioned the deep horizon, work at BP and also the Boeing, so there's probably some supplier and safety issues there that kind of touches more on the operational side. So what is your view on, why corporate governance is very relevant, especially in the operations leadership perspective and do you think that it would be beneficial for corporate boards to include folks with more of an operational background?

VS: Absolutely. My answer to this will be absolutely. If we look at the (-) sectors of the economy where time and again frauds are uncovered; banking, high-tech, fossil fuel companies, manufacturing, it's becoming marginalized. Engineering excellence firms, that's where all these issues are happening, BP is an example, but BP is the only example. You know before the advent of media, there have been cases from Exxon Mobil and all these fossil fuel firms, they had a lot of oil spills in Nigeria and different parts of the world and nobody knew about it. And why did they have this? Because they hadn't had good operational leaders on the board who could question the CEO about whether your operations are working well or not. Same thing with finance industry, by own experience there, it suffers from what I will say “operational myopia”. They just don't understand that back-end processes. These kind of things matter. Until and unless we understand that we have to have a strong process, you don't have checks and balances. So operations are becoming very important. Now also take at look at the current condition in which economies are working or the global political situation, so one issue is definitely COVID pandemic, if we think about it. It has increased sovereign debt of governments. Now what problem does it create, if governments already are heavily indebted, they can't make policies where they can rescue any corporate that is going to fail in this macro-economic condition especially when we are almost-, we haven't yet achieved the peak of recession, different analysts will talk about it. Maybe in next two quarters we will be at the peak and then inflation will start going down. Then if you also think about the war in Russia which precipitated the idea of a multi-polar world, decoupling from China is an important issue that should have a supply chain in one country because during COVID supply chains were affected. So where do you settle these suppliers. Where do you find these new suppliers from? So all these issues are becoming very important and in the next five years will play a very important role in determining which firm becomes successful and which firm goes down the drain. So therefore I think at this point operations are of very important aspects that firms need to take into account. I will give another example and that example I would say; look at the tech firms and their CEOs, even the bigger ones like Google or Microsoft. These CEOs also have engineering backgrounds, product development background, product ownership which if you think in terms of IT is their core product and core operational aspect. And they understand it well perhaps, that's why they're doing better. Therefore, I think it's a moment where boards should recognize the importance of operational excellence because we are also-, if I say we are getting into recession and inflationary conditions where efficiency of operations in general will matter apart from all these supply chain issues. So you can't guide CEOs on that until and unless you have a nice or well developed operational leader in your board.

GB: That's good to hear. We always like to hear things from other disciplines like accounting and finance that operations are also important. Maybe one last question and that's; how do you see corporate governance evolving in the next five years or so?

VS: It always difficult to predict future but definitely the trends are very clear. People, investors, society, they demand more accountability and transparency from firms and therefore some responsibility to a certain responsibility and transparency will fall on boards. Now whether it is a good thing or bad thing, it's very difficult to comment but definitely burdening boards with a lot of liabilities and questions that they need to consider will make board work heavier. If I look at Finland, you definitely have a new kind of profession emerging. Because people want to take care of their career. You have people who have a lot of experience in big pharmaceutical firms, big firms, financial sectors, consulting and they call themselves board professionals. So they sit on boards and that's the only thing they do. And they already have gained experience so they don't need to become CEO of another firm and board members are getting compensated which means that there is a scope of devoted board members, motivated board members, competent board members who can push the agenda of the future which is about stakeholder welfare. So these things will definitely become important. I would also say that the board diversity of-, and again when I talk about diversity I would like to clarify that I'm a big believer of substantial diversity compared to symbolic diversity that we have two minorities, 10 women, rather than that we say that, oh we have 10 women, nothing against minorities. If we have 10 women and out of which some of them are great experts on sustainability, some others financial experts and some come from different parts of the world because there are different cultural elements attached to it. and why I'm saying this is important is, the welfare of stakeholders will also matter for the welfare of shareholders. Because economy and business are embedded in society and therefore if there are risks in societal aspects or political aspects, it will be transferred to businesses because you are working under a systemic risk condition. Just to give you an example, there have been studies that have found that municipal bonds that municipalities raise debt on, so municipal bonds raised by municipalities that are under threat from climate issues, for example they can get submerged, they are coastal areas, they have higher coupon rates. Which means that they have to pay more interests and then there are also research on mortgages that at the same distance from the beach, if a home has future potential of being submerged under the sea and the other one hasn't, 7% discount is the price for such firms in the US, such houses in the US. So this kind of climate issue is going to affect the financial soundness of firms. So they're become important. The bad news is, as we discussed, we don't yet understand how smaller actions affect climate and what kind of climate will emerge in future. Of course in broad principle, we understand that there are issues, we can measure what will be the sea level rises and what kind of coastal areas will go down, we understand it to a great extent. I'm not saying we don't. But I still think that there are a lot of things that we don't understand in this area. Therefore as when issues come, we will have to take them into account. That will make boards work burdensome. That will give more levy to CEOs. So I don't know if we are moving in a good direction or bad, it's very difficult to say but these are kind of trade-offs and issues that will affect the board work. Plus, I think that governments are hell-bent on pushing too much regulation and there is enough debate on whether regulation is good or not. Because regulation can also result in tick-boxes. We have done this and therefore we are no more liable for any problem that happens.

GB: Okay, great. Well, thank you so much Vikash for your time. it's been a very interesting-, maybe a not so common theme for operational leaders, so definitely appreciate your view on these important topics of corporate governance.

VS: Thank you Gautam.

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GB: That's it for this week’s Operational Leadership podcast, we hope you enjoyed it, and until next time.

[*outro music ends*]