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One Size Does Not Fit All

In a well-researched and documented paper, David Larcker and Brian Tayan of the Rock Center for Corporate Governance at Stanford University have demonstrated the ringing truth of the oft heard "one size doesn't fit all" criticism of the stylized corporate governance principles promulgated by organizations like Institutional Shareholder Services, Glass Lewis, Council of Institutional Investors and many major institutional investors.

The authors' points are best summarized below:

1. The debate on corporate governance today suffers from two shortcomings: a tendency to overgeneralize and a tendency to use central concepts without clear and accepted definitions. Would the caliber of discussion improve, and consensus on solutions be realized, if the debate on corporate governance were less loosey-goosey?

2. The quality of a company's corporate governance system is widely considered to be a critical factor in its future success. However, many of the structural features commonly associated with good governance (such as board structure, share structure, etc.) are not shown to have a consistent relation with performance, and many of the organizational features that might lead to superior performance (such as leadership quality, board oversight, culture, and incentives) are not well studied or understood. After decades of research, why can we still not answer the question, "What makes good governance?"

3. The board of directors plays a central role in governance quality. Nevertheless, a gap exists between what outsiders think a board does and what they actually do. Furthermore, outside observers, including shareholders, have very limited insight into the factors that would help them understand the quality of oversight that their board provides. How can our understanding of board quality improve without betraying the confidential information that a board discusses?

4. CEO compensation is a highly controversial issue, primarily because most members of the public do not believe that CEOs deserve the level of compensation they receive. The root cause of this appears to be that despite extensive disclosure in the company proxy, most stakeholders—including shareholders—have considerable difficulty determining the relation between pay and performance. Why is it so difficult to answer the basic question, "How much should the CEO be paid?"

5. Large corporations are routinely criticized for being too short-term oriented and not taking into account the interests of important stakeholders, such as employees, customers, suppliers, and the general public. At the same time, most senior executives claim to manage their companies with a long-term horizon and to pay considerable attention to the needs of their most important stakeholders. Are companies really short-term myopic? Is there large-scale evidence for this claim? Can a company really maximize shareholder value without optimizing stakeholder needs?

In large measure this "must-read" paper relegates much of the academic support for stylized "good governance" based on so-called "empirical evidence" to the trash can. It will play a major role in the coming political debates over corporate governance.

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