Mind the Gap: Expectation Discrepancy in Board Work Practices

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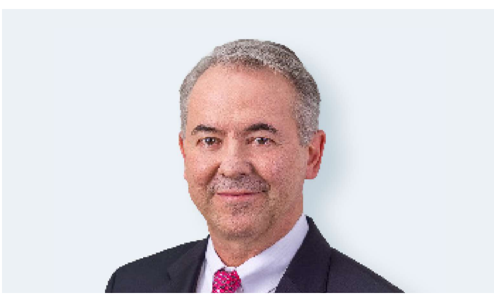

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«Many people believe that corporate boards [...] should be so closely involved in the affairs of the corporation that they can ensure nothing can go wrong.»[1]

1. Introduction

The collapses in the financial crisis and recent corporate scandals have shown that the working practices and responsibilities of boards have their limits. The cases since the turn of the millennium, e.g. Enron, Swissair, Worldcom, Parmalat, Purdue, Wirecard and Luckin Coffee (and many more), have made this particularly clear. Corporate governance is an all-encompassing and ever-changing area of the organizational life cycle.[2] If lessons are to be learned from these scandals, all governance aspects should be critically reflected and improved. One thereby often speaks of «good practices». Keeping up with such practices is the responsibility of the board of directors. The board as an equal collegiate body, is accountable for making strategic decisions that are value creating and value connecting.[3]

Picking up on the 2023 revised Swiss Code of Best Practice, a guiding principle for «good corporate governance» is that the board should act in the «interest of the shareholders as beneficial owners and/or risk capital providers of the company, but also in the interest of the other stakeholders».[4] Where there the boundaries of board responsibility begin and end, however, remains blurred and is in the current debate often part of a critical viewpoint.

1 Cole, S. (2012). Mind the Expectation Gap. The Role of a Company Director. Australian Institute of Company Directors. Derived from http://www.colecorporate.com.au/uploads/2/2/3/9/22398254/mind_the_expectation_gap_-_white_paper.pdf.

2 Sutter-Rüdisser, M. & Horber, F. (2021). Die Nachhaltigkeit als neues Standbein der Corporate Governance. NICG - Board Dynamics, 2021-1, S. 44-45.

3 Forstmoser, P. (2015). Corporate Social Responsibility, eine (neue) Rechtspflicht für Publikumsgesellschaften? In: Waldburger et al. (Hrsg.), Law & Economics, Festschrift für Peter Nobel zum 70. Geburtstag (S. 157 ff.).

4 economiesuisse (2023). Swiss Code of Best Practice for Corporate Governance. Abgerufen von https://www.economiesuisse.ch/sites/default/files/publications/swisscode_e_web.pdf.

The critical viewpoints are a consequence of the fact that much of board work and board performance is still undefined and «silent» in law and practice (so called black box).[5] In the public dialogue following the corporate scandals, this has led to wrong expectations. One such source of confusion is the difference between duty, responsibility and accountability:[6]

- Duty implies a legal obligation with liability consequences in the event of non-compliance;
- responsibility means that facts must be assumed and taken into account in the performance of duties;
- accountability requires disclosure and acquittal to shareholders and stakeholders for performing its role.

To reduce these irritations, it is therefore important to improve the understanding of the role of boards, which is largely related to priority task-setting (board standpoint) and perception (stakeholder standpoint).[7]

According to the arguments presented, we note that there is a gap in understanding,

- why there is no consensus on what boards really do (keyword «black box»); and
- why it is crucial to understand and communicate roles in depth (keyword «value creating and value connecting»).

This article is therefore an attempt to follow up on Stiles and Taylor's study of the actual roles and responsibility of boards.[8]

By describing the underlying tensions arising from responsibility and role expectations, this article aims thus to present the cause of such a «reality-problematic» and to derive recommended practices for board members on how to overcome the resulting multidimensional challenges.

2. The Gap: Expecting the Unexpected

Following the traditional view of the board, three role dimensions are primarily addressed: control and monitoring role (supervisionXxx, review, protect), strategy role (guide, support, challenge), and service role (representation, coaching, affirmation).[9] Board work in practice, however, is more complex. Today, the board performs tasks that go beyond the legal requirements of corporate law – tasks that result from regulatory requirements, tasks that result from stakeholder demand, and tasks that the board imposes on itself. For grasping such multi-faceted nature of board work, it is insufficient to cluster them solely into three categories. Following Biddle and Thomas, theory and role explanations must thus go beyond a traditional viewpoint and should explore why individuals adopt and perform a set of roles in a system and how they justify their actions to various stakeholders.[10] Role categorization should therefore assume that actions are the result of role expectations (demands on conduct of role behavior) and role characteristics (demands on personality and appearance). Something that thus «redefines the role of the individual in the system».[11]

5 Brennan, N. (2006). Boards of Directors and Firm Performance:is there an expectation gap? Corporate Governance, 14(6), pp. 577-593.

6 Cole, S. (2012). Mind the Expectation Gap. The Role of a Company Director. Australian Institute of Company Directors. Abgerufen von http://www.colecorporate.com.au/uploads/2/2/3/9/22398254/mind_the_expectation_gap_-_ white_paper.pdf.

7 Gehrig, B. (2019, 17. Januar). Die fünf Prioritäten für Verwaltungsräte. Neue Zürcher Zeitung. Abgerufen von https://www.nzz.ch/wirtschaft/die-fuenf-prioritaeten-fuer-verwaltungsraete-ld.1348257.

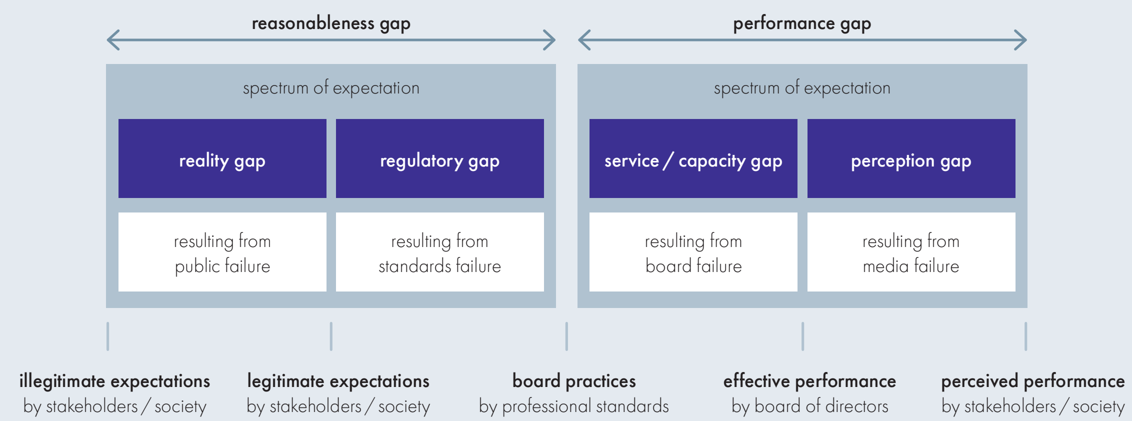
8 Stiles, P. & Taylor, B. (2001) Boards at Work. How Directors View their Roles and Responsibilities. Oxford University Press.

9 Zahra, S. A., & Pearce, J. A. (1989). Boards of Directors and Corporate Financial Performance: A Review and Integrative Model. Journal of Management, 15(2), 291– 334.

10 Biddle, B. J., & Thomas, E. J. (1966). Role Theory, Concepts and Research. Wiley.

11 Borwick, I. (2006). Organizational Role Analysis: managing strategic change in business settings. In J. Newton, S. Long, & B. Sievers (Eds.), Coaching in Depth:The Organizational Role Analysis (pp. 3–28). Taylor & Francis.

Figure 1: The Expectation Gap



Applying this quote to the reflections we make in composing the board of directors, it becomes clear why actions expected of the same person in two different organizations may be inconsistent.[12]

This phenomenon is known as the expectation gap. In principle, the expectation gap is a term originating from the diffuse expectation of the auditor and its audit procedures.[13] Adapted to the board domain, the expectation gap is defined as the sum of situations when stakeholder's understanding of the expected versus effective quality of board scope and purpose (reasonableness gap) and board performance (performance gap) diverge. The expectation gap here spans a spectrum of expectations and a spectrum of (perceived) perceptions. It subdivides into four dimensions (from left to right; see figure 1):[14]

- The reality gap is the consequence of illegitimate expectations on the part of stakeholders and the public and is increasingly due to insufficient public knowledge of board work. It is therefore fair to say that this is a result of public failure (as they do not fully understand the role of the boards);

- the regulatory gap is a discrepancy between legitimate stakeholder expectations and current best practices (legal framework and/or professional standards). It can also be referred to as a norm gap stemming from standards failure between «legal duties» (written) and «business duties» (unwritten);

- the service/capacity gap refers to the effective performance of the board compared to the applicable legal and professional expected performance from norms and standards and is a consequence of the (low) board engagement and effectiveness/efficiency. It is thus a consequence of board failure (underperformance);

- the perception gap indicates the deviation of the effective performance (board perspective) from the perceived performance (stakeholder perspective). It addresses the performance bias resulting from media failure (wrong communications).

12 Cornforth, C. (2012). Nonprofit governance research: Limitations of the focus on boards and suggestions for new directions. Nonprofit and Voluntary Sector Quarterly, 41(6), pp. 1116-1135.

13 Among other points, the public often assumes that an audit report without objections also means that there is no immediate danger of bankruptcy for the company.

14 Figure 1 follows the «audit expectation gap»; see: Bleiker, U. & Kleibold, T. (2017). Die Erwartungslücke in der eingeschränkten Revision. ExpertFocus, 6-7, S. 391-397.

Areas with respect to board work where expectation gap thematic typically arises are, among others: the role and responsibility of board members in corporate bankruptcy or fraud cases, the level of engagement (full- vs. part-time), the time and efforts spent (pre-/post-board-meeting-preparation), the idea that each board member should be individually competent in all fields of business, the level of strict separation of supervising (control) and coaching/sparring (strategy), the extent of assurance in overseeing and monitoring activities, and, last but not least, that certain industries misinterpret and misapply the existing statutory framework.

In general, it is difficult to determine the origin of the expectation gap because it cannot be attributed to a single event. Rather, it is the sum of numerous individual factors that have contributed to its creation. The most prominent factors include globalization and technological revolution (higher complexity, lower tangibility), market opening and democratization (new wave of shareholders), media coverage on corporate scandals (pressure on management/board) and the volume of investments that directly/indirectly affected public life (focus on expectation/satisfaction).[15] The genesis of the expectation gap is thus the stronger exposure for stakeholders to corporate activity that has resulted from higher education, growing affluence, increased social influence and court disputes to corporate-level power asymmetry.[16] This is certainly also a consequence of the expectations placed on the senior leadership team of companies to deal more closely with sociopolitical concerns (i.e. responsible business initiative, say-on-pay initiative).

3. Minimizing/Bridging the Gap

«Boards face a tension concerning how much attention they should pay to these contrasting roles and how to balance the different demands on them».[17]

With this quote in mind, what do stakeholders expect from board members? This is a key question to which board members must find an answer – both for themselves and for the public. However, finding an appropriate response to this specific question is not an easy task. Initially, it was believed that reforming corporate governance and corporate organizational structuring would be sufficient to close this gap.[18] However, there was little effort to influence the destiny of these corporations. This is because the answer involves an inherent complexity based on a) the evolution of corporate dynamics, b) the sheer complexity of listed corporations, c) the majority of passive (non-active) shareholder groups with purely financial interests and d) the engagement with the multi-stakeholder community. The latter is a modern concept of corporate governance that goes beyond Alfred Rappaport's traditional approach to maximizing shareholder value.[19]

In mitigating the expectation gap by explaining board activities, there are two main strategies: the defensive and the constructive approach.[20] On the one hand, the defensive approach focuses on «public relations work» by educating and reassuring what the board recognizes as duty, responsibility and accountability.

15 Saulgrain, J. (1997). Minimizing the Expectation Gap Through an Independent Board of Directors. Thesis, McGill University (Canada).

16 Green, W., & Li, Q. (2011). Evidence of an expectation gap for greenhouse gas emissions assurance. Accounting, Auditing & Accountability Journal, 25(1), pp. 146-173; Litjens, R., van Buuren, J., & Vergoossen, R. (2015). Addressing Information Needs to Reduce the Audit Expectation Gap: Evidence from Dutch Bankers, Audited Companies and Auditors, International Journal of Auditing, 19(3), pp. 267-281.

17 Cornforth, C. (2003). Summary and conclusions: Contextualising and managing the paradoxes of governance. In C. Cornforth (Ed.), The governance of public and nonprofit organizations: What do boards do? Routledge.

18 Turnbull, S. (2008). The science of governance: A blind spot of risk managers and corporate governance reform?, Journal of Risk Management in Financial Institutions, 1(4), pp. 360-369.

19 Rappaport, A. (1999). Creating Shareholder Value: The New Standard for Business Performance. Free Press.

20 Humphrey C., Moizer, P. & Turley S. (1992). The Audit Expectations Gap – Plus ca Change, Plus C'est la Meme Chose. Critical Perspectives on Accounting, 3(2), pp. 137–161.

In this approach, the media is a key protagonist. It can create a public corporate judgement, to the advantage or disadvantage of the company and its top (non-) executives. «[...] A media bias can shape public opinion that corporations are evil [...] (and thus) have an opportunity to exploit this ignorance by sensationalizing the coverage» of board activities.[21]

The association of the «greedy banker» is one such example. Board activities by the media should thus be managed in simple (not complex), comprehensive (not limited), and contextual (not situational/subjective) terms for non-professionals. In doing so, to overcome black-box matters, the newspaper articles should there intend to reflect realities and include insider knowledge.

On the other hand, the constructive approach advocates changes in board activities to meet shareholder and stakeholder demands, i.e. strategies to enhance board engagement. To meet these challenges, board members should be well-apprised to understand them in depth and in short- and long-term. This requires (pro)active communication with the primary stakeholder(s).[22] In that sense, board engagement activity should go beyond pure influencing strategies. Such a public management standpoint is outward-oriented and, in the essence, a strategic micro-perspective of governance by defining the primary stakeholders and the extent of interaction.[23]

However, the strategy through that adapted is a consequence of the design of the internal role definition and the lived corporate system. This may change within organizations, as explained above.
After knowing the two approaches, in dealing with stakeholder priority «[...] boards face a tension concerning how much attention they should pay to these contrasting roles and how to balance the different demands on them».[24]

To bridge that tension-gap, we believe the constructive approach to be the more adequate method for the simple reason that active prioritization versus indirect influencing creates more value and connects more parties in the long-term. In terms of responsibility, level of commitment and opinion formation, we have created a «Board Activity Compass» framework consisting of the scope of task/engagement and internal/external perspective (see figure 2). Thereby, we identified the four subdimensions of (a) board connection, (b) strategy formation, (c) field commitment and (d) management cultivation that we believe are important in setting board priority from a company perspective:

- Board connection relates to internal board tasks and involves internal governance guidelines. The board as «body of equals» must succeed in generating a stable structure, self-organization and composition. To be challenged and monitored internally and to act as a representative externally, the body must be self-contained and have predefined key cross points and responsibilities (and emergency plans in extreme/ crisis situations). If this is to be achieved, formalities (committees), processes (succession, assessment) and culture (dynamics) must be professionalized and constantly adjusted to best practices – and also lived accordingly in dealing with each other.

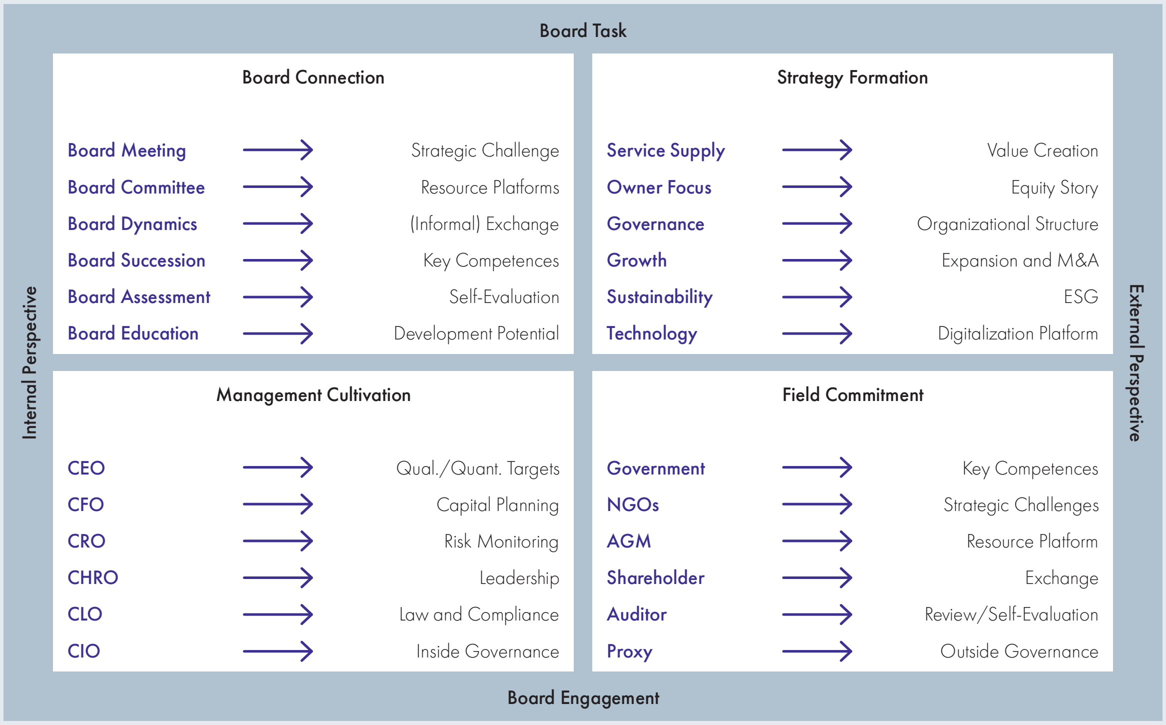
21 Cohen, J., Ding, Y., Lesage, C. & Stolowy, H. (2017). Media Bias and the Persistence of the Expectation Gap: An Analysis of Press Articles on Corporate Fraud. Journal of Business Ethics, 14(3), pp. 637-659.

22 öglund, L., Mårtensson, M. & Safari, A. (2018). Expectations and the performance of governance functions between a board, management and other stakeholders: the case of Robotdalen. Journal of Management and Governance, 22(4). pp. 805-827.

23 Cepiku, D. (2013). Unraveling the concept of public governance: A literature review of different traditions. In L. Gnan, A. Hinna & F. Monteduro (Eds.), Conceptualizing and researching governance in public and non-profit organizations. Studies in public and non-profit governance. Emerald Books.

24 Cornforth, C. (2003). Summary and conclusions: Contextualising and managing the paradoxes of governance. In C. Cornforth (Ed.), The governance of public and nonprofit organizations: What do boards do? Routledge.

Figure 2: Board Activity Compass



- Strategy formation embraces the board's external organization-related stewardship role. Having an integrated corporate strategy in place is crucial. The overall strategy should be well-founded and adapted according to the company's context and the economic situation. If it can be simultaneously addressed at the corporate (governance, owner) and business level (value creation, growth, sustainability), processes can be tackled multidimensional and opportunities addressed successfully.

- Field commitment is an externally driven engagement strategy to create success. It involves the entire board to prioritize the most important stakeholders (by law and by business opportunities), defines responsibilities (who addresses which stakeholder) and predicts the respective consequences that come along with the decision taken (what is the outcome). In this way, discrepancies in the external communication of opinion formation can be avoided and consistency promoted. In doing so, the key is to balance interests and proactively address concerns, after analyzing all pros and cons, without losing focus to make decisions in the best interest of the company.

- Management cultivation follows the intent expressed by Michael Dell when he said that success is not defined «by looking at the competitors but at how [...] engaged are our internal stakeholders»[25]. Therefore, in order to maintain a strong internal stakeholder engagement and relationship with respect to the group executive committee, it is important to determine the way and means of sparring and the thematic priorities bilaterally.

- The intensity of providing leadership and steering thereby depends on the person to whom the responsibilities are assigned (at board and group executive committee level), but activities should be institutionalized and also include informal/private information related exchanges.

25 Michael Dell (2016), founder, CEO and managing partner of Dell Technologies.

4. Concluding Remarks

The expectation gap would narrow if the frameworks were applied appropriately and stakeholder awareness was raised. «Reality has changed. So must the expectations that society and the law have of directors» says David Gonski, former Chair of the Australia and New Zealand Banking Group, persuasively.[26] Other practitioners argue that expectations need to be fundamentally adjusted before entrenched structures are changed.[27]

It is important to close the gap that results from a misunderstanding of the responsibilities and roles of boards of directors compared to internal and external stakeholders. However, it will probably never be possible to close the expectation gap completely, as the different expectations of stakeholders will never match those of the organization in question. In addition, certain issues are subject to increased stress. Ultimately, then, the board must be proactive if a solution is to be found at the corporate level. The same compulsion to find a solution applies to legislators, leading ultimately to reforms in corporate law.

One example is the Swiss company law reform of January 2023, which takes into account new competence dimensions that go beyond traditional perspectives (e.g. gender quota, non-financial reporting). In this sense, considerations that in turn impact the expectation gap.

26 Quote in: Cole, S. (2012). Mind the Expectation Gap. The Role of a Company Director. Australian Institute of Company Directors. Derived from http://www.colecorporate.com.au/uploads/2/2/3/9/22398254/mind_the_expectation_gap_-_white_paper.pdf.

27 Betschart, A. (2023, 10. Februar). Wenn Verwaltungsräte ihre Funktion nicht richtig wahrnehmen. Neue Zürcher Zeitung. Abgerufen von https://www.nzz.ch/meinung/wenn-verwaltungsraete-ihre-funktion-nicht-richtig-wahrnehmen-ld.1723667.