Rebalancing the board's agenda

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Since 2002, the activities of corporate boards have been dominated by the governance agenda. In Europe – to an even greater degree than the United States – governance codes have proliferated. This paper examines the resulting imbalance, where compliance with codes of conduct threatens to overwhelm the board's primary responsibility, i.e. the creation of wealth. We consider a model of board processes that starts with four key roles: setting direction, marshalling resources, controlling and reporting, and evaluating and enhancing for the next cycle.

> *"We must urgently bring back some pragmatism to corporate governance . . . And if we want governance schemes that actually work in a real business environment, they must be based on principles, not detailed rules that try to pre-empt all the eventualities a lawyer can think of."* Peter Brabeck-Letmathe, CEO, Nestlé SA.

The governance agenda has rightly drawn attention to the work of board committees and the question of the independence of mind directors need to show. But it may have diverted focus from three questions that ought to figure more prominently in the board's work:

- How should the board apportion its work between compliance, risk assessment and setting strategic direction?
- How do directors become determine when to focus on risk-mitigation and when to encourage strategic risk-taking?
- In face of greater personal accountability for governance compliance, where do they draw the line between their role overseeing management and interfering with management's responsibilities?

How we got here

In reaction to corporate scandals – first in the US, then in Europe – boards have been pre-occupied with external demands for greater accountability and transparency. Coupled with the bursting of the internet bubble, the collapse of Enron, WorldCom and accounting scandals at Ahold, Parmalat and others understandably created a climate in which the actions of corporate leaders came under much closer scrutiny from investors, regulators and legislators around the world. Hundreds of billions of dollars in valuation were lost, exposing a looming pension crisis that had lain hidden in part by the implausibly high assets values of the valuation bubble. These circumstances conspired to create a climate in which trust between consumers and companies, between investors and directors,

reached perhaps the lowest ebb since the 1930s. 'Restoring Trust' became the watchword.[1]

'Eurosclerosis' revisited?

In Europe, corporate directors faced a series of loosely related challenges to the ways boards work, ranging from assaults on restrictive voting practices to the growth of hedge funds and the internationalisation of ownership that left boards preoccupied with compliance-related tasks.[2] It was an uncomfortable reminder of what we knew as 'Eurosclerosis' in the 1980s – a collective lack of will to create wealth through corporate growth and innovation. Peter Brabeck-Letmathe, chairman and chief executive of Nestlé, the Swiss-based global food group, put it this way:

> *"Europe is losing ground compared to other economies around the world. . . . New regulations proliferate, not only on European level, but also on national level, and with a huge number of self-appointed regulators developing so-called 'voluntary' codes of conduct for business. Europe needs to focus on competitiveness and growth if it is to achieve its ambitions for sustainable development"* (Brabeck-Letmathe, 2005).

His lament put voice to a sentiment that has been growing in corporate boardrooms but had only rarely surfaced in public discussion, after still-fresh memories of the excesses that led to the market crisis in 2000 and the accounting scandals that followed. And there was a lot of work to be done to create stronger foundations in board practice and performance. But with codes of corporate governance in Europe now outnumbering the countries whose investors they serve, it may well be time to put growth and strategy back on the board's agenda.

The roles of the board

The wide variety of legal structures for corporations in Europe makes generalisations hazardous. Unitary boards may contain a stronger or weaker element of executive participation even in the same country. The dual boards of Germany, with their workforce representation at the *Aufsichtsrat*, or

[1] The theme of 'restoring trust' was the underlying context of the Sarbanes-Oxley Act in the US and gave the title to numerous newspaper and magazine articles and several books. It was also the title of an investigation into the functioning of the UK capital market by the Centre for Tomorrow's Company, a London-based corporate think-tank whose members include many of the top business people in a country whose governance practices were used as a model for many of the attempts worldwide at reform.

[2] Companies in Europe with US listings must comply with Sarbanes-Oxley provisions as well as local governance codes and growing pan-European securities regulation. Companies outside Britain are increasingly asked by investors how nearly they comply with the UK Combined Code as well. Pressure from external environmental lobbies and the still small but vociferous group of socially responsible investors is also much more apparent in Europe than in the US, in part due to government and trade union pressure and in some countries legislation demanding greater accountability, particularly of pension fund investments.

"supervisory" level, have a more narrowly defined range of responsibilities compared with those in Switzerland, where the supervisory *Verwaltungsrat* is the real seat of power. But in all jurisdictions boards at one level or another must perform a range of roles. Boards set the direction; they provide the resources; they monitor performance, communicating results to shareholders and financial markets; and they evaluate the outcome with the aim of enhanced performance in the next cycle. It's an iterative process performed better or worse by individual boards (see Figure 1).

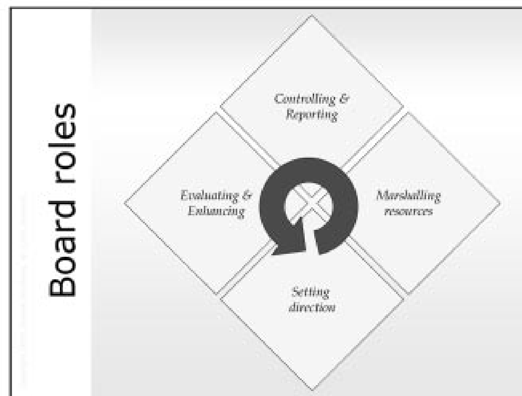

Figure 1: Board roles

In companies with dual boards, these roles tend to gravitate towards one or the other body. German *Aufsichtsräte,* or supervisory boards, tend to be responsible for budgets, appointments to both boards and controlling; *Vorstände,* or management boards, set strategy and determine how internal processes can be enhanced. One of the often-cited advantages of the dual-board structure is its clear division of responsibilities between management and oversight. Behind those four principal roles lie tasks ranging from personnel management to financial control, ethics to public relations, risk mitigation to risk-taking, and more (See Figure 2). The complexity of the tasks is such that some boards simply abdicate responsibilities to management, becoming, in effect, rubber stamps for management decisions.

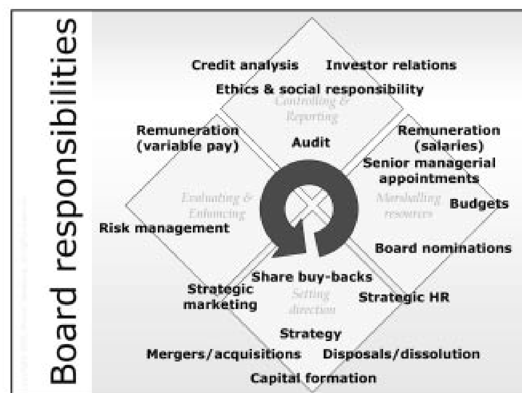

Figure 2: Board responsibilities

The governance agenda, in its broadest aspirations, has been to eliminate that rubber-stamp approach, making directors themselves more keenly aware of their responsibility to owners. Under the Sarbanes-Oxley Act of 2002, US companies and those abroad with US listings faced legislative requirements and new demands from listing requirements from the exchanges to change board structure. Greater independence was required of directors. Those independent directors now bear a greater share of the workload, too. Audit, nominations and remuneration committees must be comprised solely of independent directors.[3] Chief executive and chief financial officers must certify financial results under penalty of possible prison sentences.[4]

Outside the United States, new codes of corporate governance have relied far more on a voluntary approach combined with transparency requirements. Boards must "comply or explain" – indeed, they must explain their compliance as well. The recommendations follow – to a greater or lesser extent – provisions of the Combined Code in the UK, a document that has undergone periodic revision since its publication in 1992 after a string of scandals no less egregious than Enron and WorldCom shook confidence in financial markets.[5] Effort has been made to vary the codes country-by-country to meet local circumstances, but deviations from its broad norms are few and far between. In Belgium, for example, the draft governance code tried to accommodate the common practice, even in some of the largest companies, of giving the board representatives of controlling shareholders a central role in board processes.

The feedback from institutional investors during the consultation was firmly opposed, and the final code reinforces the central role of independent directors. The European Union's first draft principles of corporate governance explicitly urged that chief executives play a central role in board nominations to exploit their special knowledge of the needs of the company. That, too, was hammered out of the text in the next revision.

In a paper for the European Corporate Governance Institute, Gerard Hertig at the University of Zurich argues that what has resulted isn't so much a minimum standard of governance as a "one-size-fits-all" approach that has burdened companies with additional costs. This isn't just an issue for large capitalization companies, either. While the codes sometimes explicitly exempt small companies from their provisions, many face pressure from institutional investors to comply (Hertig, 2005). The emphasis by institutional investors on governance codes has prompted an undercurrent of thought that the approach may be simply an attempt to reduce the institutions' cost of

[3] In setting the final rules the US Securities and Exchange Commission made exceptions for jurisdictions like Germany, where, by local law, boards could not have a majority of independent directors or audit as the exclusive province of independent directors. In a curious wrinkle, though, Germans who listened to officials of the New York Stock Exchange in 2003 explain roles of independent directors under the new NYSE listing rules thought it sounded like the division of labour between *Vorstand* and *Aufsichtsrat*. See *The BoardAgenda* report of the conference: http://www.edgevantage.co.uk/categories/article.asp?i=1270

[4] Here, too, the SEC made some exceptions for foreign issuers where local law requires collective responsibility of the board. Indeed, in some places the notion of the "chief executive" is – at least in law – a difficult concept.

[5] Among them, the affairs of Polly Peck plc and the Bank of Commerce and Credit International in the late 1980s and early 1990s still reverberate in the press.

monitoring governance, shifting the burden, in effect, from the investor to the company. Asset managers who take a strong line on governance contend – rightly – that they listen closely to explanations from companies that choose not to comply. But many more have small or non-existent governance departments, choosing instead to buy in their governance ratings and voting recommendations.

Corporate reporting

Traditional corporate reporting has focused on only a small amount of financial information, typically showing investors only to see the tip of the iceberg of the activities of the company and the board (see Figure 3):

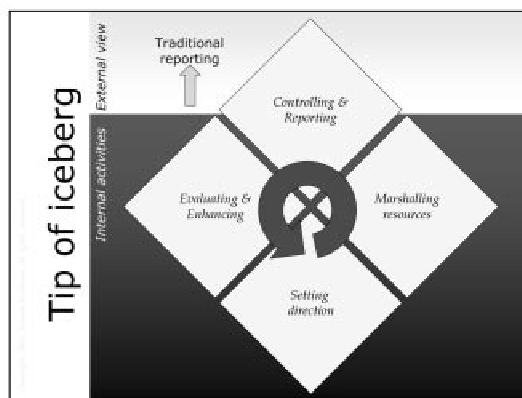

Figure 3: Traditional corporate reporting

The transparency under either Sarbanes-Oxley or a comply-or-explain regime in effect demands that more of the processes of the board, more of the reasons for its decisions, be brought to the light of public disclosure. Disclosure of details of individual executives' pay, a hot-button issue for governance advocates and many institutional investors, is one way of shedding light on the activities of directors. While now commonplace in the US and UK, it's still the subject of great controversy in continental Europe, and especially in Germany. Corporations in Germany have introduced measures to comply with many on the provisions of the code,[6] but the one seeking reports on pay for individual supervisory and management board members has been widely resisted, so strongly that the Justice Ministry threatened legislation in March 2005 to force the disclosure.[7]

It's not just details of pay that face the light of disclosure. In the UK, the

[6] Among the large-cap DAX-30 companies, the Berlin Center of Corporate Governance found that average compliance with the 72 recommendations of the German governance code was 69.3 at the end of 2004. With the governance changes planned for 2005, the average is set to rise to 70 – or a 97.2% compliance rate. The recommendation with the lowest acceptance rate was – no surprise – disclosure of individual director pay. See *The BoardAgenda* account: http://www.edgevantage.co.uk/categories/article.asp?i=2397

[7] See *The BoardAgenda* account: http://www.edgevantage.co.uk/categories/article.asp?i=2343

government adopted legislation in January 2005 requiring large- and mid-capitalisation companies to publish as part of their annual accounts an Operating and Financial Review, detailing whatever non-financial information the board deems necessary for an investor to understand the future prospects of the company. The OFR was subsequently withdrawn by the government and replaced with a less prescriptive 'business review' to meet the requirements of the European Union's Accounts Modernization Directive. While somewhat less detailed, it still urges discussion of relationships material to the long-term success of the business. This might include a discussion of strategy and key customer relationships, but the government explicitly mentioned environmental issues and indicators of investment in employees and other social factors affecting the business. In effect, these enhanced reporting requirements push far more board processes and decision-making into public view (see Figure 4).

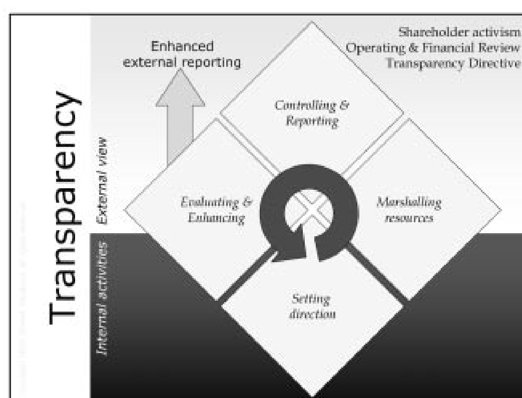

Figure 4: Enhanced corporate reporting

Board evaluation

Some boards undertake independent appraisals of their own performance, but they are still pretty rare. But board evaluation has certainly moved up the governance agenda. In response to governance code provisions,[8] the search for ways of measuring the effectiveness of the board as a whole, its committees and individual members has generated a large and growing body of literature from academics and methodologies from consulting organisations to assist in the process. A consensus may well appear, but even more than performance appraisals of employees, the evaluation of the board – with its complex roles and often conflicting responsibilities – is a challenging task. In time, there will no doubt be pressure from institutional investors to reveal highlights of these

[8] For example, the 2003 revisions to the UK Combined Code ask boards to undertake an annual, external evaluation of board performance. It is parallel to efforts in the US and has analogies to the broad principles of the EU guidelines on governance, other national codes, and the code of the Organisation for Economic Co-operation and Development. There's no requirement that the outcome of these evaluations be made public – indeed, compliance itself is voluntary, on a comply-or-explain basis.

evaluations. The effort, though, has become another double-edged sword for boards. While holding the potential to improve the quality of advice outside board members give and the quality of decisions boards collectively make, it also focuses even more attention on the *processes* of the board, rather than the *outcomes* of its decisions.

Imbalance on the agenda

The work of the board is in danger of becoming skewed towards process and away from substance – the desire to create value through strategy, innovation, stronger customer relationships and better *management processes* (see Figure 5).

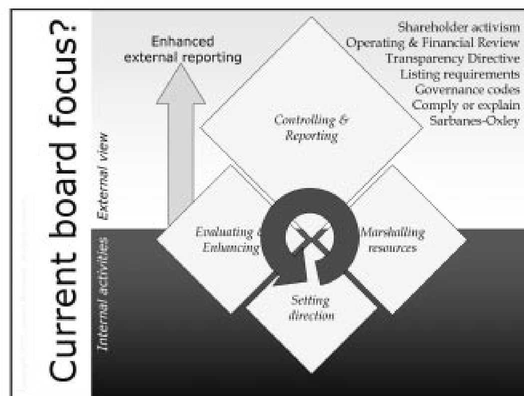

Figure 5: The unbalanced board agenda

Controlling through committees

The governance focus has been on the make-up and responsibilities of committees – so much so that has at times made it seem as though that's all a board is there to do.

Audit: After the wave of governance codes and the burgeoning number of ratings agencies focused on governance, most large quoted companies now have audit committees with either all or substantially all independent directors. They may not *appoint* the auditors – that's usually the job of shareholders at the annual meeting – nor even formally recommend them – often in law a duty of the full board. But few boards now would defy their advice. These committees generally also look after the work of *internal audit* and other issues of internal control. But they are not the right place to look beyond how risk is controlled.

Nominations: Many companies have created committees staffed wholly or in the main by independent directors to look after board nominations. The role *shareholders* should play in nominations is in dispute on both sides of the Atlantic, but at least within the board there's a consensus that directors will nominate new *directors* with much less involvement by the chief executive or

the finance director than has previously been the case. That adds resources, but only at the very top level.

Remuneration: Executive pay is now more firmly in the hands of independent directors, though the role of consultancies and executive search firms remains controversial. The external emphasis on chief executive pay risks obscures the role that the board can play in ensuring the right sorts of incentives are in place across the company.

The danger is that the board's work will become – perhaps has already become – imbalanced in favour of compliance and away from value-creation. This is the issue that lies at the heart of Peter Brabeck's complaint. "No need to repeat the story of events earlier in the decade, the bankruptcies and subsequent regulatory frenzies," he said. "In the US it was politicians, going very fast, very far. In Europe a mixture of politicians, lawyers, professors and the usual group of not necessarily business-friendly advocacy groups seized the opportunity to air their pet issues. This produces many trends and restrictions, but no clear direction."

Some of those professors, at least, are sympathetic. Take Hertig's complaint about "one-size-fits-all" governance. Board reformers, he worries, "have enacted minimum standards that embody detailed rules rather than broad principles. Such regulatory micro-management may have the advantage of reducing legal uncertainty and constraining judicial activism. However, these possible benefits pale in comparison to the costs resulting from the failure to properly take into account trade-offs faced by larger firms and one-size-fits-all effects for smaller firms." His comments echoed those of Roberta Romano of Yale Law School, who complained about the "Quack Governance" embodied in Sarbanes-Oxley and urged European countries to "avoid Congress's policy blunder" as they revise their individual company laws (Romano, 2005).

Rebalancing the board's agenda

The easy part is the diagnosis. The hard part is the cure. It lies in capturing the value that better governance can bring, while retaining a focus on creation of new value. Is it time to put more emphasis on the board's other roles – setting direction, allocating resources, and enhancing performance at the other end of the cycle? Good corporate governance doesn't create value. At best it prevents value-erosion. The oft-cited McKinsey survey showed that institutional investors were willing to pay a premium for good governance (McKinsey 2002). That was, however, a statement of intent rather than a measure of behavior. Some other studies show a significant, positive relationship between good governance and corporate performance. For example, Rob Bauer and colleagues in the Netherlands looked at European stock performance using governance data from Déminor Rating, the Brussels-based consultancy since acquired by Institutional Shareholder Services and concluded: "Well-governed companies have higher equity returns, are valued higher and their accounting statements show a better operating performance. These findings should encourage investors in US companies to consider corporate governance in their investment decisions" (Bauer *et al.*, 2004).

Other studies are less decisive, however, and raise questions about the direction of any causal link between governance and performance. Some suggest that well *managed* companies may just be those where a good chief executive invites good *governance*, too. If the re-formed board – with its active, knowledgeable and independently minded directors – is to contribute to value-creation that must come through the types of board processes the details of which companies – for legitimate commercial reasons – are reluctant to make public (see Figure 6).

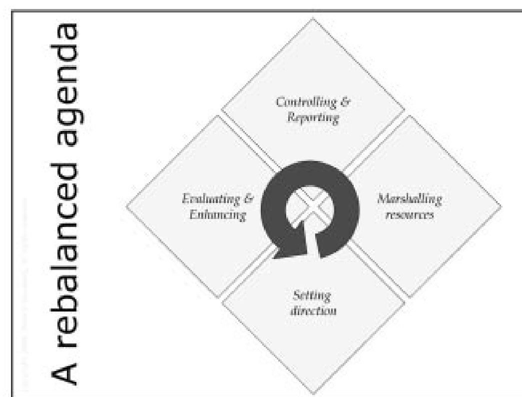

Figure 6: Rebalancing the board's agenda

Creating value

The processes that create value are those in the lower portion of our diagram of board roles. They are the parts that remain hidden from public view precisely because of their commercial sensitivity:

- Strategy formation: how many boards actively challenge the strategies presented by management? How many have strategy committees? Do independent directors review strategy independently of management as they increasingly do now for more compliance-oriented roles?
- Strategic marketing: how often do boards review key customer relationships and the approaches the management is taking to them? Do boards know the rate of customer acquisition? The churn rate? How quickly customers progress from first exposure to the company's product to being dedicated users, even advocates of the business? The lifetime value of a customer?
- Strategic human resources: how many boards are engaged in recruitment of senior managers? In evaluation of succession plans for key individuals? In evaluation of performance appraisal systems throughout the company?
- Strategic risk analysis: risk management may hit the audit committee in its review of internal controls. But how many boards engage actively in turning risk management from a cost-control exercise into one that is creating opportunities?

These approaches bring with them the temptation that the board will begin to function as a second management, second-guessing management. Strictly

speaking, that is precisely what a board does in discharging its duty to look after shareholders' interests. If the governance agenda of the past few years has had one key goal it is this: to make sure that boards function as more than rubber stamps for management decisions. The Australian scholars Kevin Hendry and Geoffrey Kiel (2004) point out that if boards take tight control of strategy as well as finances, they become *de facto* a second management. In a paper also delivered to the conference of the Centre for Board Effectiveness at Henley Management College in England, they describe a model in which boards exercise two levers of power: strategic control and financial control, which echoes of the strategic management approach of Goold and Campbell (1987). Those that abdicate both roles become, in effect, rubber stamps for management decisions. Those that exert a high degree of both usurp the role of management. In effect the balancing act the board should take is one that combines elements of each, oscillating between the role of a strategic adviser to management and its financial controller, depending on circumstances of the company and the nature of management.

By limiting their dimensions of control to strategy and finance, they underplay to some extent the complexity of both the responsibilities of the board and the levers at its disposal to monitor and control management. The board may well control more resources than just the finances at management's command. In its role in overseeing management processes and determining the risk appetite it takes on roles that go beyond those of a strategic adviser. Monitoring finances – especially through audit – only gives control over the company's past. Its future value is created from its *future* cash flows, which arises from that heady mix of strategy, customer relationships, key personnel, skills and knowledge, as well as the right processes to ensure flexibility and responsiveness when markets – as they always do – change.

Issues for discussion

These forces bring three groups of issues to the table for discussion:

- Beyond compliance: if the board is responsible for value-creation, what processes does it have in place to look beyond compliance with law and codes of conduct? Some boards have strategy committees to review the plans of management before they go to the full board. Others rely on outside advisers, but their close cooperation with management raises questions over their independence similar to those of consultancy by auditors. What processes give boards – and especially the part-time non-executives – the best insight into corporate strategy, customer relationships and strategic investments? Are they dependent on the make-up of the board, or are they general lessons we can draw?
- Beyond risk-mitigation: strengthening of the board's role in overseeing internal control should prevent value-erosion, but on its own it doesn't create new value. Should boards try to find ways of turning risk mitigation into strategic risk-taking, understanding the relationship of individual risks and determining the appropriate appetite for risk in the enterprise? Is

this best done in a committee or at the full board? Where does current best practice teach us?

- Beyond oversight? Here, there's a question mark from the outset. There is a danger that a more activist board could encroach on the role of management. This was the role of boards in history and still is for many companies backed by venture capital. Dual-board systems overcome the dilemma by dividing functions between the two bodies. Supervisory boards tend to look after provision of resources and control over outcomes, while the management board decides how to enhance those outcomes to set a strengthened direction. Is that the best mix? Where does the board draw the line in its roles? How far do individual directors go in bringing their executive experience to bear in a company where their participation is decidedly non-executive? Under what circumstances is it appropriate to overrule management? How far should directors go? What guidelines should they follow?

Addressing these issues will help us correct the imbalance that has arisen under the governance agenda and make boards ready to contribute to what Peter Brabeck called the three drivers of competitiveness: productivity, research and entrepreneurship.

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