Corporate Governance-The Paradigm Shift

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"Corporate governance is about maintaining an appropriate balance of accountability between three key players; the corporation's owners, the directors whom they elect, and the managers whom the directors select. Accountability requires not only good transparency, but also an effective means to take action for poor performance or bad decisions'"

-**Mary L Schapiro**, *Chairperson, Securit-ies and Exchange Commission, USA. Address to Translantic Corporate Governance Dialogue-September 17, 2009*

Corporate governance is the cornerstone of corporate existence.

Corporate governance is about commitment to values and ethical business conduct. It encompasses laws, regulations, processes and practices affecting the way a company is directed, administered, controlled and managed. It reflects on the company's corporate structure, culture, policies and relationships with its stakeholders.

The recent traumatic events in the financial markets and the demise of several corporations have led to an increased emphasis on corporate governance. Corporate governance is seen as a core pre-requisite for effective risk management in a corporation. The increasing complexity of global businesses has led to increased risks, making it imperative for boards to understand and manage risks at a strategic level.

The global financial crisis has revealed certain gaps in the functioning of many boards, and exposed their inability to understand the enhanced complexity of the new-age business environment. In most cases, a serious mis-alignment of interests between managements and boards was the root cause behind the decline of business. Managers took risks based on self-created models. Boards were carried away by the lure of enhanced earnings. This ultimately proved too costly for several corporate entities. Can corporate governance address these issues effectively and make up for human failures?

Corporate governance today is one of the most important parameters for evaluating the worth of a company. A company that has a culture of good corporate governance embedded into its value system is considered worthier than its peers. It abides by these tenets diligently not for fear of the law, but as a matter of principle. It has become mandatory for businesses to follow ethical practices as part of its corporate governance to gain the trust of not only its investors, but also of the larger stakeholders. A well-governed company thus has a robust corporate governance model, earns greater equity in the market, and attracts investors who quantify these at a higher level.

At the heart of corporate governance is timely and accurate disclosures regarding the company's economic efficiency, financial performance, ownership, and governance. Corporate governance practices are being increasingly recognized and their importance today is greater than ever before. Investors today are demanding greater transparency into the affairs of the company. They no longer depend on regulators for protection as they have the power to reward or penalize the company based on its governance practices.

The role of the Company's Board in formulating and sustaining its corporate governance framework is immense. The Board is responsible not only for putting the framework together, but also for overseeing how the management serves and protects the long-term interests of all the stakeholders. A proactive, well-informed and independent Board is necessary to ensure the highest standards of corporate governance.

Board's changing role and expectations

Traditionally boards use to play a pivotal role in governance, control & monitoring, and strategic direction. However, today more and more companies understand that good governance follows from the involvement and commitment of the Board. This is leading to companies implementing governance practices from within rather than waiting for regulatory bodies to impose legislations. Today, boards that follow mature governance practices are intensely involved in formulating and evaluating the following:

- Performance and health of the company that affects its market, financial and operational health.
- Risk assessment and evaluation of long-term strategy
- Performance of management
- Transparent accounting principles and legal compliance

- Review of internal controls
- Leadership development
- Talent and skill development
- Succession planning
- Sustainability practices

Also, the global economic crisis over the last year has forced most companies to rethink the role and performance of their Boards. Boards today seem to dedicate time discussing matters such as CEO succession planning, Directors' recruitment, risk management, corporate strategy and executive compensation.

Board Professionalism

The recent trend has seen the boards of several companies streamlining their function and structure and opting for more dynamic governance practices. Several companies are now choosing to have majority independent directors with fewer executive directors. The following are some of the best practices followed by companies in bringing greater professionalism to the Board:

- The trend seems to move towards having the CEO as the sole insider director. Research indicates that more than half of the S&P boards now follow this practice.
- More emphasis is laid on candidates' qualification, and appropriate business and industry experience.
- Division of the roles between Chairman and CEO is being implemented. More than one third of the S&P boards now split the Chairman and CEO roles. The Chairman is responsible for running the board and the CEO for running the business.
- Emergence of Lead Independent Directors.
- Increased independence in the nomination process of Directors.
- Efforts are made to ensure the independence of Board's committees
- Implementation of robust performance evaluation parameters for independent directors. The parameters include the ability to contribute and monitor governance practices, introducing international best practices in the governance area and commitment to fulfilling obligations and fiduciary responsibilities

Board functioning & effectiveness

Good corporate governance is critically dependant on the functioning and effectiveness of the Board. Boards today seem to expand their agendas and stretch their human capital capabilities to better reflect skills that are needed to respond to the changing technological, demographic and geographic environment.

Studies have revealed that a Board that spends only a limited period of time in its meetings has a higher rate of effectiveness than Boards which hold marathon meetings behind closed doors. An effective board is one that takes upon itself the responsibility of setting the agenda given the limited time at its disposal, while keeping itself informed enough to constructively challenge the Management's policies and decisions.

Boards today are laying emphasis on the following practices to ensure effectiveness:

- Boards have started laying down charters, codes and guidelines that will guide their functions in a more formal and systematic manner.
- They are trying to ensure diversity of expertise and experience among the members
- Orientation programs and ongoing education programs are being arranged for the Directors.
- Directors are expected to commit time and efforts in discharging responsibilities and towards this are being discouraged from taking too many directorships.
- Boards are taking leadership role in setting agendas. Agendas are no longer seen merely statutory. Boards are demanding more qualitative information from management beyond statutory reports.
- Greater emphasis is attached to constituting sub-committees and their functioning and proactively initiating Board and Committee evaluations.
- Conducting off-site retreats and undertaking detailed reviews have also become part of the Board's portfolio of duties.
- Independent directors today are seen to conduct executive sessions without management presence. These sessions provide opportunities to the independent directors to review the management's performance.

Given the economic uncertainty and challenges that boards face today, the following areas have emerged as the thrust areas for companies and their boards from the governance perspective.

CEO succession plan

Research indicates that the CEO succession plan is one of the top concerns for most corporations. While every Board recognizes the importance of succession planning, only certain companies have a well-documented succession plan in place. There is little doubt that a company that intends to keep itself sustainable in the long term must spend its resources on nurturing future leaders. The Board should nurture the prospective candidates for the CEO position and formally take them through various positions, make them attend board meetings regularly and encourage them to take on outside directorships to hone their leadership skills. The nominations committee of the Board should understand the leadership talent and skills necessary for the position, and look out for potential candidates who can be brought on to the Board.

It is interesting to note that studies have indicated that more than half the S&P boards discuss CEO succession annually. The topic is on the agenda more than once a year in these companies. Also, an overwhelming majority of the boards seem to have an emergency succession plan in place. The responsibility of CEO succession rests with the entire Board.

Risk management

Given that stakeholders' expectations of their companies' boards have risen significantly in recent times, boards are expected to focus on risks associated with business and regulatory environment and on the measures taken by corporate strategy to address them. Boards are increasingly reviewing how the risks in different time horizons could impact the company's long term competitive advantage. Apart from just monitoring risks, the Board now concentrates on mitigation actions and fixing accountability for those actions. The Board is expected to provide a clear direction to the management on the risk appetite of the company. Increasingly, the focus has shifted to risk adjusted performance management. The Board must embed risk management processes in an organization and encourage processes that identify probable events and prepare contingency plans.

Surveys have found that in answer to the question, "As a director, what keeps you up at night?" 59 per cent respondents referred to "unknown risks". More and more companies want risk experts on their boards. Given the importance of risk management, it is best that an independent risk committee be constituted and entrusted with the responsibility of overseeing risk management and mitigation. The Boards must also appoint Chief Risk Officers (CRO) who works closely with the risk management committee.

Executive compensation

Executive compensation is one of the most discussed topics in the corporate world today and is likely to gain more importance in the coming years. Given that executive compensation is public knowledge and subject to scrutiny by investors and regulators, the boards must review the compensation policies of their companies with care. Board members must deliberate on the questions of whether a customized plan is better than following a peer group or what mix of cash and equity is best in determining the pay packets of the directors. In fixing the compensation package of its executives, the Board should strike the right balance between the interests of senior executives and that of the investors.

Directors' evaluation

To assess or not to assess is no longer the question. The question is how to assess? Assessment is one of the most powerful tools available for turning a good Board into a great Board. There needs to be a proper evaluation framework in place. But before that, it is important to get the Board members, all highest-ranking professionals, to accept the idea of getting their performance reviewed. The questions of who should conduct the assessment, and how to handle feedback from the assessment, must be considered. It is a matter of hope that all most all of the S&P 500 boards conduct some kind of annual performance evaluations, be it of the full Board or including committees and directors.

Corporate strategy

Given the changing business environment and strategies, companies may have to re-assess their vision and mission statements. While it is commonly understood that it is the management which should be setting the strategy, the Board should add value by testing the plan suggested by the management and ensuing that appropriate plan is implemented at the appropriate time. In doing so, the Board should consider if the management has identified all the foreseeable risks, have different alternatives or options been considered and evaluated, have the assumptions, if any, made in preparing the plan have indeed been examined.

It is to be noted that the relationship between the Board and the management is symbiotic. The Board's understanding of the company derives a great deal from the inputs provided by the management, while the management's decisions draw upon the past experience and industry knowledge of the Board members. It is only through a fulfilling interacting between the two organs that a company can really be successful.

Boards today should relentlessly strive to strengthen the company's value system. Independent directors must be provided adequate orientation and access to the company's practices in this regard. Rigorous policies have to be implemented for evaluating the performance of independent directors, both in terms of self evaluation and peer evaluation. Finally, boards should ensure that the compliance is not just "to the letter of the law" but also to the "spirit of the law".

Corporates need to focus on enhancing the ethical judgment of employees, managers, executives and executive Board members, in the same way that they focus on developing technical and skill-based competencies. The Board should recognize that people, not regulations, run companies and the measure of success in this area is the sum total of several day-to-day decisions taken by the management and employees at every level of the organization.