The Bulletin

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Staying Focused on Core Business Issues Amid Corporate Governance Compliance

As companies address the myriad new corporate governance requirements established by Congress, the exchanges and regulators, it is equally imperative to address the core business and profitability issues facing the organization, particularly in today's increasingly demanding global marketplace. How do companies and boards stay focused on strategic, operational and other critical business matters while moving forward with corporate governance reform? A reactive approach may see a company through the woods, but being proactive will obviously be more effective over the long-term – and require less time and effort.

Directors and executives understand the importance of issues surrounding corporate governance and the re-establishment of investor confidence. But they also recognize that other critical priorities exist, including: fending off strategic threats that will put the company out of business; attracting and retaining the best talent; innovating internal and external processes for sustaining competitive advantage; and satisfying customers faster, better and more cost effectively. As one CEO told us, "With all these regulations, someone needs to remember there is a business to run." So how can management and the board achieve a healthy balance between vital business requirements and the need to comply with corporate governance reforms? Following are some practical guidelines.

Corporate governance compliance: Start with the basics

"Plan-do-check-act" tactics made popular by business schools will yield results superior to ad hoc approaches in achieving the desired balance, and particularly in developing efficient corporate governance processes. Some companies are adopting a comprehensive plan for managing corporate governance reform and ensuring new requirements from the SEC and relevant stock exchanges are not only addressed and coordinated with one another, but also are effectively integrated with existing board and management activities. These companies are organizing efforts under the direction of one or two corporate officers, often the general counsel and the corporate secretary. The CFO also plays a vital role where financial and public reporting activities are concerned. Under the auspices of these officers, an implementation program is developed under which all necessary documents are prepared and distributed for review by the appropriate board and management committees.

An effective implementation program includes timelines and meeting schedules for addressing the new requirements on a timely basis. One senior officer (the "compliance officer") is authorized to direct the compliance program. Ordinarily this individual is an officer in whom both management and the board have confidence. He or she works with the CEO and the chairman so that the appropriate people, groups and committees are held accountable for making things happen.

Since the SEC and stock exchanges continue to issue final rules, the compliance officer, general counsel, CFO and others (including the disclosure committee) must update the governance requirements regularly. In some instances, new governance requirements will not have to be fulfilled until various phase-in periods elapse – these phased requirements must be built into the compliance program. The key is that all necessary functions and activities are documented, with responsibilities assigned, deadlines established and progress monitored among management, the board and its committees.

A focused effort on effective compliance with corporate governance requirements should save a great deal of time for the board and for senior executives. Strong organization will efficiently assimilate new governance requirements into board and management processes, reduce the risk of uncoordinated false starts, and enable companies to remain focused on core business issues.

Core issues: Stick to the knitting

Boards that are already functioning effectively have an established committee structure in place with defined charters, procedures and protocol. They should continue to focus on committee activities that constructively engage the CEO and the management team, and provide

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appropriate oversight to the organization's processes and activities that matter most in terms of creating and protecting enterprise value. Those activities provide the baseline for what needs to be done going forward. As these efforts were important before the corporate governance reform movement began, they are even more so today. But how are these activities integrated with governance reform?

Many companies are revising their governance guidelines and committee charters, and adopting guidelines for board committees to address not only the broad requirements as detailed in their charters, but also guidelines for procedural steps that should be followed. In addition, they are identifying who is primarily responsible for making those steps happen. Following are examples of two strategies:

- The frequency and timing must be defined for meetings between the Audit Committee, or the Audit Committee Chair, with the CFO and accounting management to review quarterly filings.
- The timing for evaluating and approving director qualifications and independence guidelines by the full board should be clearly defined so that the nominating committee will have the appropriate criteria to perform its activities.

In a number of cases, a time schedule, or "PERT chart," is assembled to detail specifically what needs to happen before each board committee meeting. This document is a sequenced checklist which should be organized according to function (to provide an overview of who does what) and, along with the overall compliance program, should be continually updated as new requirements are introduced.

Re-examine the board's line of sight

When considering the scope of its oversight, each board must distinguish its roles and responsibilities from those of management. An effective board provides oversight on management processes and activities that matter. It avoids placing itself in the position of managing day-to-day affairs of the organization, which generally is deemed to be management's job.

As the expectations of boards evolve, many questions arise:

- Is the board's oversight role focused on everything it should be?
- Does the board give adequate attention to providing oversight on such vital activities as defining and sustaining the organization's culture and values, or designing the organization's business strategy or model, including the strategic management and business planning processes?
- Is the board satisfied with management's processes for assessing and managing risk?
- What about the management of major change events, such as mergers and acquisitions, new innovative processes and systems, significant downsizing, competitor acts, new branding strategies, or regulatory developments?
- Does the board provide oversight on the execution of the business model, including how management measures and monitors what matters?
- Does it oversee CEO and management compensation and succession planning?
- Is it satisfied that management issues "plain English" and transparent communications to external parties?

While these and other activities require further granularity to be meaningful, they cover substantial ground insofar as evaluating the board's oversight focus is concerned.

The board should also examine the roles it should assume with respect to the processes and activities it chooses to oversee as it constructively engages management. There are several oversight roles a board can play:

– An **anticipatory role** looks to the future and is focused externally. Strategy development, for example, requires an understanding of the competitive landscape and the enterprise's business model. That understanding provides a context for evaluating and providing input to management's strategic choices, which is a vital role for any board to play.

– A **proactive role** also looks to the future but is focused internally. Policy setting by the board clarifies responsibilities, authorities and accountabilities. This role also evaluates the boundaries within which managers should act and make decisions. In this role, boards determine that management has the resources and capabilities to successfully align the organization's processes and systems with its business model, is authorized to make decisions within defined boundaries, and is held accountable for results.

– A **reactive role** looks to the present and past and is focused internally. In this role, the board monitors business performance, current situations and operations; deals with execution issues; and provides oversight to management's processes for monitoring business performance and compliance with established policies. As managers are held accountable for results, directors must determine that corrective action is taken for significant variations from expectations.

– An **interactive role** looks to the future and is focused externally. In this role, the board represents the

interests of external stakeholders and is concerned with the transparency of financial and public reporting.

These roles are complementary and not mutually exclusive. In fact, recent corporate indiscretions and resulting loss of investor confidence point to the need for boards to play more than reactive oversight roles. Boards should continually evaluate their oversight activities to determine if they are sufficiently anticipatory and proactive with respect to strategy and policy issues. They should also be sufficiently interactive in the oversight over public reporting.

Adopt a risk-based approach to managing the business

A number of effective boards currently work with management to conduct a quarterly risk assessment to evaluate the potential for variances from the annual financial plan and, if variances materialize, the implications to the company. Yet in a recent McKinsey survey of 200 directors sitting on an estimated 500 boards, 36 percent of respondents said boards do not understand the major risks facing their companies, particularly the nonfinancial risks.

As the global environment becomes more unpredictable, boards and management will need a more formal and comprehensive framework for effective interaction with respect to significant business risks. Such a framework assists directors and executives in identifying all major risks that may affect corporate performance and shareholder value, and enables them to ensure these risks are measured and managed. An effective framework is one that helps management and directors agree on the threshold for taking risks as well as on new risks requiring attention.

Such a framework should include:

- A common language unique to the company that enables executives to understand business risk.
- A uniform process of the essential tasks in managing business risks so that everyone understands what must be done.
- A robust, systematic risk-identification process that is applied to all business risks, not just financial ones, and at all levels of the company, including the boardroom.

Risk mapping is probably the most common process used by companies to identify and prioritize risks associated with their activities. The most effective use of risk mapping occurs when it is integrated with business planning. One company, for example, uses the risk-mapping process to generate what it refers to as a "risk footprint," which provides a framework for evaluating strategy and planning specific actions. Such tools serve to better involve directors in key initiatives and help integrate the processes for managing risk and managing the business.

Management should articulate its risk tolerance as explicitly as possible to evaluate the impact of their recommendations on the business and the organization's risk profile. The board must understand and agree with management's expressed tolerance for risk and determine whether they agree with management's analysis. Examples of relevant questions management and boards might discuss to consider different forms of risk tolerance include:

- How crucial is it for us to achieve forecasted earnings and cash flow?
- What volatility are we willing to accept in interest and currency rates?
- How exposed are we to business interruption, substantial losses of physical assets, or catastrophic health and safety issues?
- Are we exposed to irreparable damage to reputation and image resulting from systemic failure to deliver brand promises?
- Have we aligned our risk taking with what we do best?
- Do we address and rectify off-strategy behavior, or do we tolerate it?

By addressing these and other questions, boards and management are able to constructively interact in evaluating the organization's risks. A framework helps to make a risk-based approach happen.

Keep the disclosure process fresh

Most companies will do whatever is necessary and obtain the help required to meet disclosure requirements over the near term. In particular, the Sarbanes-Oxley requirements have captured everyone's attention, and for most companies the job will get done for the initial filings. The real concern should be longer-term. What processes are organizations putting in place to keep the disclosure process active and ongoing?

The risk-assessment process, as discussed above, is closely related to the disclosure process. An effective and uniform enterprisewide risk assessment process comprises three activities:

- Identify the business risks inherent in the enterprise's business model and prioritize them according to importance.
- Understand why, how and where the risks originate by sourcing them either outside the organization or unit or within its processes or activities.
- Measure the severity, likelihood and financial impact of the risks.

Effective risk assessment requires three things – skillful business managers and risk owners (i.e., the individual, group or unit authorized to make choices to manage the specified risk and take action within established bounds); a common language; and a forward-looking, continuous process. Applied consistently across the enterprise, these elements help managers and directors understand the priority risks, their root causes and their impact on business objectives, strategies and performance goals. That understanding should fuel the disclosure process when new and emerging risks surface.

One of the many key points addressed in Issue 3 of *The Bulletin* was the need for a disclosure committee. We believe a disclosure committee (or an equivalent group of executives) would greatly benefit from the "feeds" received from an enterprisewide risk-assessment process. The committee will often consist of key internal players the company may want to engage through the risk-assessment process. Audit committees will gain more assurances from management that fresh and new issues are being identified in a timely manner, so that appropriate action and disclosure will take place. Directors will have greater confidence as they take an interactive role in their oversight of management's reporting to the public.

Summary

An upfront effort at organizing governance reform compliance for board members is now a critical element of an effectively functioning board. This effort should consist of an overall compliance program as well as tailored modifications to specific board committee charters, procedures and protocol. Such efforts will increase the confidence of directors that their interests are being met with respect to minimizing exposure to personal liability. If they have that confidence, they will be more inclined to be productive on behalf of management and shareholders (and other stakeholders) in addressing key business issues.

If the governance reform efforts are well-organized and efficient, directors should have adequate time to concentrate on core business and profitability issues. The board should satisfy itself that it is addressing all areas of the business that matter and is taking a sufficiently anticipatory, proactive and interactive stance in its oversight role. A risk-based approach to managing the business that engages the board will ensure an ongoing and effective disclosure process. ■

Key Questions to Ask

Board members:

- Are your company's governance compliance efforts organized to move ahead of the reform process, or are you constantly concerned with keeping up? Is the board satisfied that it is receiving adequate advice to effectively oversee the company's compliance efforts?
- Are you satisfied with the board's governing scope? Are all critical processes of the business that warrant oversight from the board incorporated within that scope?
- Is the board sufficiently anticipatory, proactive and interactive with respect to its oversight role? For example, is the board involved in reviewing strategic options and in satisfying itself that the organization's strategy will be effective? Is sufficient time allotted during board meetings to review strategy and the supporting fact base before final decisions are made?
- Have you recently evaluated the board's performance to determine if there is a need for improvement in its structure? For example, are any changes required as a result of the Sarbanes-Oxley Act, stock exchange proposals or other corporate governance requirements? Is there a process for evaluating independence and for appointing new independent members? Is the relationship with the CEO and with management working effectively in an environment of openness and trust?

Management:

- Do you assist the board in establishing a clear and full picture of the business? Is the governance process supported with reliable and timely information on issues that concern the board?
- Is a senior executive designated to monitor the company's compliance with the various corporate governance requirements? Does the board know and have confidence in this executive?
- Does the company take a risk-based approach to managing the business? Do you work with the board to organize meeting agendas to put emphasis on the tough issues and to facilitate dialogue among board members? Are directors involved in understanding significant risks the organization is planning to take and the value proposition for taking those risks before final decisions are made?

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