

About this *Point of view*

Welcome to Ernst & Young's *Point of view* series. These documents express our view on current public policy and regulatory matters of importance to our stakeholders, our profession and the capital markets. In this edition we focus on adjusting to new public policy demands on corporate boards.

Adjusting to new public policy demands on corporate boards

Our point of view

In response to the financial crisis, policymakers around the world are actively considering corporate governance reforms to improve the effectiveness of boards of directors. Ernst & Young believes that effective boards are vital to well-governed and successful companies and strong capital markets. For this reason, boards should make the changes necessary to strengthen their governance and effectiveness, including implementing new and pending requirements.

Context

The financial crisis has highlighted the need to strengthen corporate governance, particularly but not exclusively, within the financial sector. Across much of the world, governments – both legislatures and regulators – are adopting measures designed to enhance corporate governance, including the management of risk. One area of focus has been on how management and boards of public companies could and should work better in the interests of shareholders, the capital markets and other stakeholders.

In the wake of the crisis, policymakers are questioning whether boards carried out their duties responsibly, including whether they were sufficiently aware of the risks involved in their companies' businesses and whether they responded appropriately. While the crisis has elevated long-standing policy debates specific to some countries (e.g., proxy access and say-on-pay in the United States), other proposals are more widespread (e.g., the need to focus more on remuneration and incentives relative to long-term objectives and risks).

Another key area of focus for policy reforms is on enhancing the effectiveness of the board as a mechanism for representing shareholder interests, overseeing management and mitigating risk. Policymakers are looking carefully at the role and composition of boards, and what needs to change. Proposals range from the creation of risk management committees – the focus of which would be more forward-looking and strategic compared to audit committees – to the improved flow and use of information, and the appointment of directors who are better equipped to oversee the management of a company's risks. Again, while many of the new proposals will focus on the financial services sector where policymaker concerns have been the greatest, signs suggest the focus may not remain there.

Key points

- ▶ **Policymakers are emphasizing the important role that boards play in guiding the strategic direction of businesses while overseeing the management of risks. In this way, well-run and effective boards contribute to the strength of our capital markets and long-term economic stability.**

An effective board develops the policies, processes and procedures necessary to carry out its responsibilities, including oversight of strategic planning, crisis management and shareholder communication. This sets the foundation for good corporate governance and sound risk management. Well-governed companies are better positioned to identify and manage significant risks. They are therefore more likely to operate effectively, drive long-term value

creation (rather than encourage short-termism), and promote a more stable capital market environment. While specific initiatives vary in different jurisdictions, policymakers are highlighting the following operational factors for reform:

- ▶ **Setting the company's risk tolerance in the context of strategy.** This is currently a major focus of policymakers, particularly but not exclusively, with respect to financial institutions. Boards not only need to set the company's tolerance for risk, they also have to make sure that it is reflected in the company operations (including compensation practices), and that appropriate controls and monitoring procedures are in place to manage the risk. To help achieve these objectives, many regulators are encouraging financial institutions and other companies to strengthen their risk management practices, including creating specialized risk committees if they have not already done so. However, as boards move to implement or strengthen these committees, some are struggling to determine how they should operate alongside their other committees and responsibilities.
- ▶ **Information access and flow.** Board members should be provided, on an on-going and timely basis, the necessary resources and information to carry out their responsibilities. They should receive regular reports concerning identified risks and performance issues, and have the ability to obtain information from external sources, as necessary.
- ▶ **Ability of independent non-executive directors to meet separately.** Independent non-executive directors bring an outside perspective to a board's deliberations. They should have the opportunity to meet separately from the rest of the board. This will enhance their ability to represent the interests of shareholders and ask the difficult questions. In some countries this is already required.
- ▶ **Engagement with shareholders.** In some parts of the world, policymakers are encouraging boards of public companies to engage more regularly with shareholders. While this can be challenging and difficult to operationalize effectively, it may give directors additional insight into shareholder concerns.
- ▶ **Providing information that shareholders and other stakeholders need.** A lack of transparency magnified the effects of the financial crisis. Consequently, policy-makers are asking whether shareholders and other stakeholders receive the information they need and can reasonably expect. Boards need to consider the complexity, volume and relevance of the information their companies provide. Information should be transparent, relevant and timely, and not obscured by too much detail or volume.

▶ **The composition of the board has become a matter of public policy. Policymakers are calling for boards of public companies to include a range of diverse perspectives.**

Policymakers in more than one jurisdiction have called into question the composition of boards, with a view to enhancing their diversity. A range of diverse perspectives and thinking helps to strengthen the quality of board deliberations and deliver real value for companies and shareholders, particularly for companies that operate globally.

Research supports the fact that diversity of thought drives better solutions for organizations and contributes significantly to innovation and growth.¹ In fact, a survey of CEOs of major global companies indicated that they view the need for internationally experienced staff as the cultural factor of the highest importance when conducting international business, yet almost half (45%) reported that they have very little, if any, international diversity on their own boards.² The chemistry of the board and the personal competencies of its members are also important. A board's performance will depend on the directors' ability to work collectively, to challenge decisions in a credible manner, and to avoid "group think".

¹ A summary of the leading research is published in Ernst & Young's report, *Groundbreakers: using the strength of women to rebuild the world economy*, which can be found online at <http://www.ey.com/groundbreakers>

² *Redrawing the map: globalization and the changing world of business*, which can be found online at <http://www.ey.com/globalization>

► **Policymakers also are taking a fresh look at the balance of independence and expertise on boards of directors.**

Independent non-executive board members bring an important perspective to board deliberations and are meant to enhance shareholder representation. Certain board responsibilities should be handled by independent members to provide enhanced integrity to board processes. This traditionally has been the case with audit and compensation committees, but policy-makers are now considering extending independence requirements to other board responsibilities.

While board independence is important, so is expertise. As business models evolve and risks become more complex, policymakers are emphasizing the need for directors to possess relevant expertise and to devote sufficient time to their activities. In some cases, policymakers have questioned whether the demand for independence has overshadowed the importance of expertise on the boards of certain financial institutions. This question could appropriately be asked about other types of companies as well.

► **To identify any weaknesses and make recommendations for improvement, boards should periodically evaluate their effectiveness and act on the results.**

Policymakers are looking at measures or indicators of effectiveness as part of their focus on board performance. Effectiveness evaluations can help a board assess how it and its committees carry out their responsibilities, interact with management and external stakeholders, and manage the composition and cohesion of their members. In the aftermath of the financial crisis, such an evaluation could be particularly useful in order to reflect on how effectively the board prepared for and met the tests of the crisis. Boards can use internal assessments or external consultants to help them measure their effectiveness, and alternating between the two can help provide a level of objectivity. Some countries are beginning to require boards of public companies to undergo periodic effectiveness reviews. Where not yet required, boards should consider the benefits of doing this on a voluntary basis.

Points of debate

Are policymakers blurring the line between the role of boards and the role of senior management?

Yes, some proposals run that risk. While the purpose of policy reforms is not to encourage boards to take over day-to-day management functions, finding the right level of involvement is an art and not a science, and some boards can find it difficult to determine where to draw the line. In some countries striking this balance can be particularly challenging, especially where management may still be reluctant to accept board oversight, or where public expectation is for directors to be more active. Also, in some countries the pressure on directors may be further heightened as a consequence of the litigation environment.

As a result of these and other factors, it is possible, particularly in the current heated environment, that some board members can become excessively hands-on. In these circumstances a board could become distracted, focusing on short-term tactical issues rather than the overall strategic direction of the business and its associated risks. Maintaining a meaningful dialogue with management can help directors stay informed and avoid blurring the line. Auditors can play a role in supporting directors in this interaction with management, including by helping boards ask the right questions.

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Why do many companies struggle with enterprise risk management?

The concept of "enterprise risk" is, by its very nature, broad and should capture every aspect of a business. This should range from operating risk, strategy and finance, to human resources, insurance, foreign political risk, legal and compliance issues, and much more. Depending on the size and complexity of a company, assessing and monitoring enterprise-wide risk can be very difficult to implement and maintain. Among other things, companies struggle to determine the right level of enterprise risk to assess and monitor – for example, at the business unit level or the corporate level, or both. In addition, boards wrestle with whether the company's enterprise risk management should be overseen by the entire board, by the audit committee or by another board committee. While these challenges are not new, expectations that board members have a consolidated, enterprise-wide view are greater than ever. Therefore, directors need to be sure that their companies' risk management frameworks enable the board to understand each line of business, its volatility, and the environment in which it operates.

Would investors benefit from a single, global model for corporate governance?

Yes. Corporate governance frameworks are built on similar global principles. The corporate governance principles of the **Organisation for Economic Cooperation and Development** have become the foundation for a uniform approach to corporate governance around the world. However, specific governance frameworks vary appropriately from one country to the next and can present challenges to multinational companies. This is largely because they are embedded locally within the legal/regulatory regime and cultural environment and give varying levels of rights to shareholders, boards, and management. At the same time, we believe there is value to investors – who increasingly invest in multiple jurisdictions – in understanding these differences. This can be achieved in part through disclosures that explain the reasoning for a company's corporate governance structure.

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