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The Board Agenda

Good Practices for Meeting Market Expectations

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PricewaterhouseCoopers (www.pwcglobal.com), the world's largest professional services organisation, helps its clients build value, manage risk and improve their performance.

Drawing on the talents of more than 150,000 people in 150 countries, PricewaterhouseCoopers provides a full range of business advisory services to leading global, national and local companies and to public institutions.

These services include audit, accounting and tax advice; management, information technology and human resource consulting; financial advisory services including mergers & acquisitions, business recovery, project finance and litigation support; business process outsourcing services; and legal services through a global network of affiliated law firms.

PricewaterhouseCoopers refers to the member firms of the worldwide PricewaterhouseCoopers organisation.

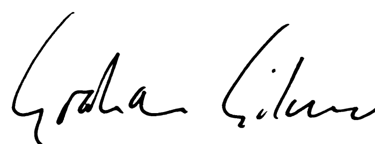
Preface

Management 'gurus' should stop here. This is not a booklet proposing new management theories, or novel ways of organising and running a business. You can find plenty of those in any airport bookstore – enough, in fact, to fill a 747. Nor is it intended to be a comprehensive guide to board responsibilities in any particular country or business sector.

Rather, we prepared this booklet in response to requests for practical guidance. International investors are increasingly taking into account board governance when evaluating companies. Board members, particularly in the world's newer capital markets, are looking for some clear direction on the sort of features which commentators are looking for in a well-run company.

The Board Agenda is the third volume we have prepared in the Meeting Market Expectations series. The two companion titles, *Audit Committees* and *Reporting Progress*, deal in more detail with the board's financial and corporate reporting responsibilities. This guide looks at the board's wider role, and the practical aspects of running a board.

In preparing this guide, we looked at the corporate governance disclosures in the annual reports of 80 of the world's largest companies. It is clear that companies are increasingly recognising that good practices and greater transparency are rewarded by the market.



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Survey of leading companies' governance disclosures

As part of the research for this booklet, we looked at the corporate governance disclosures in the annual reports of 80 leading companies around the world. The reports, mostly in respect of the year-ended December 1999, were taken from the companies' own websites. The companies selected were the top companies by market capitalisation in each region, using statistics published in the Financial Times *FT Global 500 Survey* in April 2000.

Asia Pacific	–	10
Canada	–	10
Continental Europe	–	20
Japan	–	10
Latin America	–	10
United Kingdom	–	10
United States	–	10

The sample examined provides interesting illustrations of some aspects of governance behaviour at the beginning of the 21st century.

The Board – Whose Business is it?

If a company is generating profit for its investors, does anyone care how the board is organised, or if the board is packed with friends of the CEO? Still less, does anyone care if meetings are held irregularly, or if few independent directors, if any, attend?

The evidence is that, increasingly, the world does care. New media technology and a global investor community mean that the corporate governance arrangements of companies are coming under greater scrutiny. A recent issue of The Economist included two articles highlighting governance practices in major markets, in Japan and Russia. These articles were not criticising the business cultures of those countries, but they did draw attention to the fact that companies may not always be run in the interests of all shareholders.

"...boards made up only of insiders conspire to protect company bosses from the consequences of their all-too-frequent follies"

The Economist, 18 November 2000

Market expectations

It is not just the media which notices. As more companies seek foreign equity finance, they encounter the expectations of a group of international investors. This group is increasingly influenced by "norms" of governance behaviour, captured in codes of practice issued by international bodies (such as the Organisation for Economic Co-operation and Development), national committees (the UK's pioneering Cadbury committee is the best known), and individual investment institutions.

At the same time, a whole industry has grown up to advise institutional and other investors on whether to continue to hold shares, and how to vote on matters such as director re-election. Proxy voting agencies such as the US-based Institutional Investor Services (ISS) and IRRC analyse the annual reports and general meeting resolutions of thousands of companies around the world. In a new development, rating agencies such as Standard & Poor's are looking at ways of reflecting corporate governance issues in their indexes.

The corporate governance codes on which all this activity centres are criticised by some commentators for having too much of an Anglo-American flavour. But the fact that the US markets are the most liquid has an inevitable impact – money talks. What is encouraging, though, is that we are beginning to see a dialogue emerging between international investors and local market participants. It is only by talking to board members "on the ground", that investors will understand the local business environment.

Good practices

At PricewaterhouseCoopers, we are committed to championing good governance. Because we operate in 150 countries, we understand the importance of local concerns and traditions. We would not dream of suggesting there is a "one size fits all" template which can be applied to all markets. Each board must formulate company strategy and control the business according to its own circumstances. But we do believe that there are some good practices which all listed companies should at least consider, regardless of the country and sector they are operating in.

We have organised the guidance in this booklet into two main sections: Running the Board; and Running the Business. Each area contains recommendations and practical advice.

For readers wishing to explore these areas further, particularly from a US market perspective, they are covered in more depth in the publication *Corporate Governance and the Board – What Works Best*, prepared by PricewaterhouseCoopers and sponsored by the Institute of Internal Auditors Research Foundation. That publication lists eight key areas of responsibilities for board members:

- Board dynamics – ensuring the board works effectively
- Management evaluation, compensation and succession planning
- Strategy and planning
- Transformational transactions – managing mergers and acquisitions
- Risk management
- Measuring and monitoring performance – financial and non-financial reporting
- External communications – disclosure to the market
- Tone at the top – demonstrating good business behaviour

Those areas are all dealt with in this shorter summary booklet. Where appropriate, we have illustrated board practices by reference to our survey of the governance disclosures contained in the annual reports of the world's leading companies.

Whose business?

Finally, although we believe that boards should consider the shareholders' perspective to be paramount, other constituencies are important. The board needs to tell investors how it has taken into consideration the interests of consumers, regulators, employees and other important groups which are affected by the company's activities.

"Sustainability" has become a fashionable term, but the concept is not new. The more far-sighted boards have long recognised that transparency and dealing fairly with all groups is consistent with building long-term value for shareholders. Today's board members are appointed not just to look after today's business, but to ensure there is a business to manage tomorrow.

"In my view, convergence of governance principle and diversity of governance practice are not inconsistent"

Ira Millstein,
Weil Gotshal & Manges,
writing in the OECD Observer,
June 2000

Running the Board

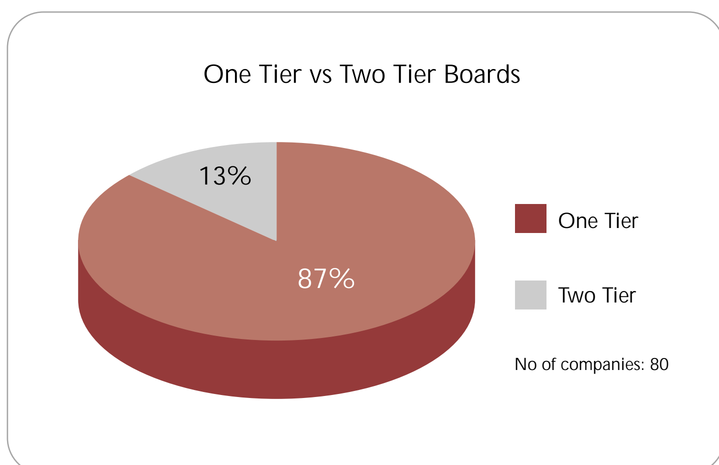
Board Structure

The structures adopted by companies' boards of directors vary widely under different jurisdictions and commercial cultures across the world. Generally, these may be summarised into two main categories:

- *Two-tier:* The supervisory and management functions are separated. The 'supervisory' or upper-tier board is typically concerned with overseeing management of the company and consists wholly of non-executive members. The lower-tier 'management' board is made up of executive directors. The model is found in continental European countries such as Germany and the Netherlands. In Germany, representatives of suppliers of finance, such as banks, and employee representatives have seats on the supervisory board.
- *One-tier / Unitary:* Executive and non-executive directors are brought together in a single structure, which assumes all directors are equal and share collective responsibility for decisions. With a strong presence of non-executive directors, this type of board can ensure broad accountability. This model is found in the UK and in other 'Anglo-Saxon' influenced countries.

There are many variations on these two basic models. In the US, there is a unitary board, but it tends to include more non-executives than might be found in the UK, and the Chief Executive Officer (CEO) tends to exert a greater role in the direction of the company. In some Asian countries, notably Japan, boards are larger in size and include many members of executive management.

Of the 80 leading companies we looked at, the great majority displayed characteristics of the unitary board model.



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Regardless of which structure is adopted, the board should operate within a corporate governance framework which ensures that:

- the board remains accountable to the company and its shareholders
- the company's management is monitored effectively by the board
- board members are committed to achieving the agreed strategic aims.

There are two keys to success:

- to appoint board members and senior executives with the necessary personal competencies and ability to work together. A successful governance framework must involve a partnership between the board and senior management – with the board providing oversight and guidance, while management is responsible for day-to-day operations; and
- to avoid sectional interests which might make the board divided and dysfunctional.

An independent element on the board

Well-run boards are all about working together and reaching at least a degree of consensus – they are not about the dominance of one individual or special interest group and the stifling of healthy debate.

Regardless of the board's formal structure, there should be adequate representation of 'independent' directors, who are able to bring an objective view to board deliberations.

Some clarification of terminology is needed here. Corporate governance literature mentions 'outside', 'non-executive' and 'independent' directors. These terms are sometimes used interchangeably, but there are differences.

Non-executive directors are just that – individuals who are not company executives and hence not involved in day-to-day operations. But non-executives may still have business or other ties with the company which prevent them from being objective or independent. To be independent, directors should, according to the UK's Cadbury Committee, '… be independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement.'

Independent directors should not be regarded as regulators or policemen whose prior approval is required for every decision by the executive. They can usefully act as guardians of the interests of all shareholders, especially in areas of potential conflict, such as remuneration and changes of corporate control. They can also 'add value' to the decision-making process, by bringing a valuable outside perspective to bear. To contribute effectively, independent directors must have sufficient access to financial and other business information, and must be consulted on all important decisions. They should also be concerned with the interest of non-shareholder stakeholders.

In every region surveyed, except Japan, at least 50% of the board sample is comprised of non-executive members, reaching over 70% in Canada, the US and Latin America. Unfortunately, the annual reports we looked at did not in many cases differentiate between those non-executives considered independent and those not.

Good Practices for an Effective Board

- ✓ A working partnership between the board and executive management
- ✓ A strong independent element on the board
- ✓ Board size small enough for effective decision-making
- ✓ International experience (for boards of global companies)

"A director's greatest virtue is the independence which allows him or her to challenge management decisions and evaluate corporate performance from a completely free and objective perspective"

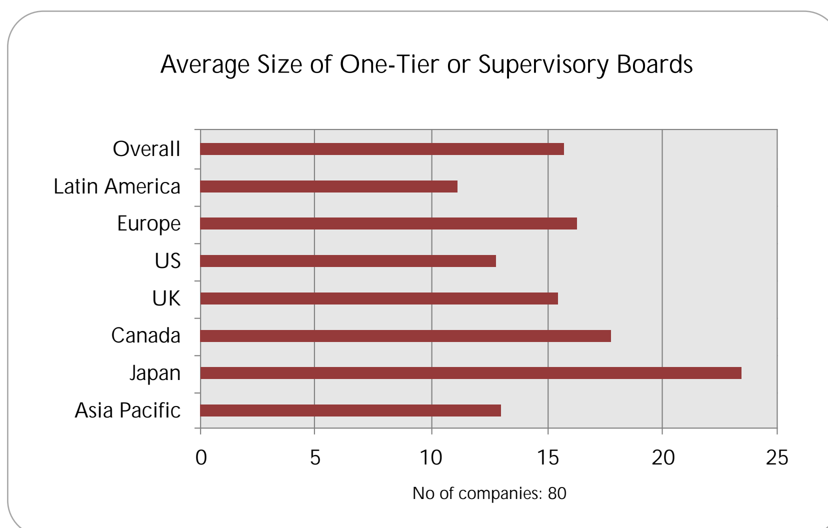
Chairman of the National Association of Corporate Directors in the USA

Board size – quality, not quantity

It is of course more important to have the right quality and experience of independent directors on the board than sheer numbers of individuals. The involvement of high-quality independent directors in the decision-making process will help attract capital, as major investors will feel more secure in the fact that their interests are being defended.

On page 16 we highlight the personal competencies which both senior executives and independent directors will need to perform their roles.

In relation to numbers of directors, it is significant that the trend in countries such as the US, and now even in Japan, appears to be towards smaller boards. Average board size in the largest companies ranges from 11 members in Latin America to over 23 members in Japan, as shown in the table below.



To provide more focused debate on important and sensitive issues such as financial reporting, executive compensation and board appointments, an increasing number of boards are setting up smaller sub-committees. These areas often require specialist outside input, and detailed consideration of reports for which there would be insufficient time in main board meetings. Also, to ensure objectivity on sensitive issues such as board pay, these committees typically include a relatively high proportion of independent directors, or may be entirely comprised of them.

The responsibilities of compensation committees and audit committees are considered in more detail on pages 18 and 30 respectively.

Internationalism

Companies are increasingly trading cross-border – through subsidiaries, through joint venture partnerships, or, in today's web-enabled world, reaching out directly to consumers in other countries. One would therefore expect that such companies' international ambitions would be replicated in the make-up of the boards.

Our examination of 80 leading companies' annual reports showed that, in some countries, it is not common practice to identify the nationality of directors. However, where nationalities were disclosed, the majority of companies had boards wholly or almost wholly composed of individuals from the country of domicile. European companies seemed more likely to have international experience on the board than Asian or North American companies.

We believe that the presence of international experience on boards is beneficial. That experience should go beyond mere proficiency in foreign languages – having people on the board who have lived and worked in different parts of the world is invaluable. It enables companies to better understand the business and social cultures of the countries they operate in. And it helps when raising capital on world markets to be able to demonstrate that the company is led by individuals who understand the "world view".

Conduct of Board Meetings

There are no firm rules for how, when and where board meetings need to be conducted, beyond the requirements of company law. However, there are a number of characteristics which we believe are likely to contribute to successful board meetings.

The most important factor is to maintain an open and inclusive atmosphere, in which members feel free to speak their minds. It is also important that people understand their specific roles and responsibilities within the overall structure.

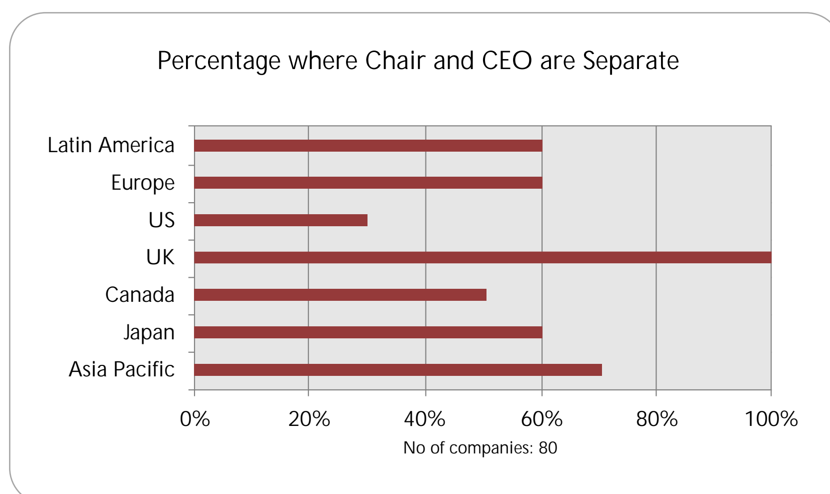
The chairman's role is crucial

Much of the responsibility for this falls on the chairman. He or she should direct the meeting in a way which stimulates open debate on each of the issues, ensuring that meetings neither get distracted by convoluted arguments, nor leap to hasty conclusions without due consideration. The chairman should be firm but fair, controlling the meeting without dominating the debate itself. It also falls to the chairman to allocate the requisite amount of time to each item, and to ensure that any variations from the order of the agenda are explained at the start.

"There are two key tasks at the top of every public company – the running of the board and the executive responsibility for the running of the company's business. There should be a clear division of responsibility…such that no one individual has unfettered powers of decision"

UK Hampel Committee on Corporate Governance, Combined Code, June 1998

Commentators have raised the issue of whether the roles of chairman of the board and CEO should be separate. The practice in some countries is towards separation, particularly in the UK (as shown by the table below.) Where the roles are concentrated in one individual, the UK's Hampel Combined Code suggests that there should be a strong and independent element on the board, with a recognised senior member other than the chairman to whom concerns can be conveyed.



Irrespective of whether the chairman and CEO roles are combined, all directors need to bear in mind their collective responsibility and that they cannot expect their own views to prevail on every occasion. They need to be receptive to other viewpoints. The chairman should maintain discussion until the point where broad consensus has been achieved, and he or she is able to sum it up in a conclusion with which most members agree.

Frequency of meetings

A board that fails to hold regular meetings runs the risk of being unable to fulfil its responsibilities to the shareholders and the company. Moreover, directors who do not meet on a regular basis could be leaving themselves open to legal or other action from shareholders for failing to discharge their duties.

The frequency of meetings will depend on the company's specific situation, and on internal and external events and circumstances. Daily meetings may need to be held in exceptional circumstances – for example, a take-over bid by (or for) the company. But even during 'quieter' periods there will be issues requiring urgent board attention. As a general rule, full board meetings should be held no less than quarterly, and quite possibly monthly. Board committees tend to meet less frequently, perhaps three or four times a year, but again this will vary with circumstances.

At the end of each board meeting the chairman or secretary should confirm the date, time and location of the next meeting.

Length and logistics

It is essential that board members are given sufficient notice of each meeting, both to ensure they will be able to attend and to give them adequate time to prepare. They may need to research and understand the issues on the agenda so they can play a full part in the debate, and a short notice period can prevent them from doing this.

The meeting itself can last anything from a few minutes to a full day, depending on the volume of business in hand. For a larger company, four to five hours is usual. The chairman should set time limits on any presentations being made at the meeting, and any director who has to leave at a particular time should say so at the start. The head office is the usual location for the meeting, but if the company has several sites, it can help give directors a wider perspective on the group's activities if board meetings are held in different locations.

Good Practices for an Effective Board

- ✓ The chairman ensures full discussion of agenda items at meetings
- ✓ Decisions are made on a consensus basis
- ✓ Meetings are held regularly
- ✓ Adequate time and information to prepare for meetings

The papers prepared for each meeting will vary depending on the company and the circumstances of the meeting itself. But there are certain basic papers which are seen as necessary to enabling directors to play a full part. These include:

- the agenda, which is generally prepared or approved by the chairman
- minutes of the previous meeting, usually provided by the company secretary
- the CEO's operational report, giving an overview of major events affecting the business since the previous meeting
- the financial report, presenting up-to-date statements of operating profit or loss, cash flow, and availability of finance.

There are also likely to be a number of further written reports, prepared for the board by members of senior management, supporting the relevant items on the agenda.

The respective responsibilities of the chairman, other board members and the secretary for participation in board meetings are summarised in the following table.

Conduct of Meetings

Responsibilities of Chairman

- ensure the agenda is prepared prior to the meeting
- maintain control of proceedings without dominating discussions
- stimulate debate by drawing out the contributions of all members
- guide discussions, while making sure genuine disagreements are aired and resolved
- ensure decisions reached are properly understood and recorded
- manage board and ensure policies are adhered to
- establish standards for preparation of board papers and reports

Responsibilities of Board Members

- prepare adequately for meetings by reading agenda and supporting meeting papers
- be objective (especially non-executives)
- be open-minded, willing to engage in debate and receptive to others' perspectives
- provide expertise and knowledge to make decisions
- commit to collective decisions, once agreed
- keep up-to-date on issues relating to the company between meetings

Responsibilities of Corporate Secretary

- work with chairman on preparing agenda
- circulate agenda and other meeting papers to board members
- arrange venue and additional secretarial support for meeting
- advise on legal and regulatory matters during meetings
- write and circulate the minutes of board meetings
- maintain statutory books in accordance with legal requirements
- send board members information relating to the company as needed
- keep abreast of and inform directors of current governance thinking and practice

Recruitment, Remuneration and Evaluation

The ability to identify, recruit, evaluate and motivate good directors and senior management is crucial to the success of any company. Strategic objectives will not be realised if the people charged with pursuing them lack the capabilities needed to execute the strategy, or do not have the 'spark' needed to drive the business forward.

Values and competencies

The task of attracting, retaining and developing the right people involves a wide range of factors. The board needs to ensure that executives with the appropriate skill sets are recruited. At the same time, recognising that people with energy and ability tend to be attracted to companies whose employees share a sense of vitality and commitment to success, the board needs to set the right tone for the company as a whole.

Many of the values which recruits find attractive in a potential employer – including openness, mutual respect, and the acceptance of a wider vision of the company's role – are embodied in good governance. Also, since an alignment between a company's people and its corporate objectives are a key determinant of success, it is of benefit for potential recruits to gain a clear sense of the strategic direction of the business before they join.

It is not possible to provide a standard 'template' of the personal characteristics which directors and senior executives will need. Different positions will require different skills. The table below outlines some of the more commonly sought after competencies which might be applied to the CEO and to other senior executives and directors.

Competencies of Executives and Board Members

General Competencies

- Ability to make informed business decisions
- Entrepreneurial
- Can see wider picture and perspective
- Integrity in personal and business dealings
- International experience

Strategic Competencies

- Can see strengths and weaknesses of company, and how decisions will impact them
- Ability to recognise opportunities and threats in specific industry
- Ability to recognise wider business and societal changes, particularly in the context of global markets

- Ensures strategies, budgets and business plans are compatible with vision and strategy
- Aware of change and the need for change
- Understands the difference between governance and management issues

Analytical Competencies

- Can read and interpret financial reports
- Ability to think critically and challenge proposals
- Understand issues from different perspectives
- Asks for and uses information to make informed judgements / assessments

Character Competencies

- Acts on morals and values
- Is willing to act on and remain accountable for board decisions
- Courage to pursue personal convictions
- Can be objective at all times about what is best for the company

Communication Competencies

- Can articulate thoughts, opinions, rationales, and points in a clear, concise and logical manner
- Is flexible and willing to change stances when necessary or appropriate
- Has the ability to listen, process and understand key points
- Can interact with other board members in a group setting, both contributing to, and valuing the contributions of all members
- Ability to coach members of staff
- Ability to deal with the media – comfortable on public platforms
- Recognises the motivations of investors, analysts, customers, competitors, employees, regulators and other groups, and communicates with them accordingly

Knowledge Competencies

- Understands responsibilities as a director or senior executive
- Aware of latest business and management practices
- Understands the roles, processes and relationships of the board and its members
- Knows the key performance indicators of the company and its senior management
- Understands legal, accounting, and regulatory requirements affecting the company

These same values and competencies should be reinforced during the period of employment. To realise their full potential, directors and employees must be given open and honest feedback on their performance. A clear and objective system of personnel evaluation, focused on the main competencies, gives the company a solid basis for decisions on remuneration, promotion within the organisation, and the allocation of people to particular tasks.

Compensation committees

In some countries, the issue of executive remuneration has risen to the top of the corporate agenda. The salary, bonuses and share options granted to senior executives in major companies have become a focus for criticism and even action from organisations ranging from institutional investors to governments. The fact that compensation and remuneration packages are under such rigorous external scrutiny makes the task of setting them all the more difficult.

We recommend that boards of listed companies should tackle this issue by forming a compensation or remuneration committee to discuss and decide on executive compensation.

Good Practices for an Effective Board

- ✓ Directors are appointed only if they display certain required competencies
- ✓ Senior executives do not set their own pay levels
- ✓ Performance is evaluated using agreed criteria, aligned with corporate objectives
- ✓ Having a succession plan for the next generation of executives

The key is that senior executives should not be allowed to determine their own levels of pay. By creating a committee of independent board members, the discussion can be "ring-fenced" from executive management. The committee then gives its recommendations to the full board.

Increasingly, compensation committees do not restrict themselves to looking at internal performance targets, but also consider external norms and benchmarks. Common methods for motivating senior executives include granting long-term performance-related bonuses and share options. To the extent that the board has set a wider range of performance targets for the business (covering financial and non-financial measures, such as market share or customer satisfaction) these should be reflected in the criteria for individual remuneration.

The board may also delegate to the compensation committee responsibility for the periodic evaluation of the performance of the CEO, other senior executives and the board itself.

Evaluating senior management

Effective evaluation reinforces the alignment of corporate and personal objectives, helps the individuals to identify and address any weaknesses, and provides a clear basis for decisions on remuneration and incentives. It also provides investors with a clear sign that the board is actively monitoring the performance of key management.

The basis for evaluating the CEO is likely to be his or her personal development plan, which incorporates short-term and long-term objectives together with performance targets linked to the company's strategy. The objective should be linked, as far as possible, to the competencies noted above. Non-financial measures such as retention of key staff and product innovation should be reflected in the assessment.

The compensation committee should review the CEO's performance in relation to this plan, and set objectives for the future. This will usually be structured as a formal annual review, together with less formal interim assessments, which will enable timely action to be taken over any issues which could develop into problems. Typically the feedback will be provided by the chairman, or – where the chairman and chief executive roles are held by the same person – by another designated independent director.

For other members of senior management, the board should consider how well the CEO is evaluating the senior executives who report to him or her. The board should look broadly at executives' performance against expectations, on the basis of specific agreed criteria covering financial, non-financial and strategic objectives.

The next generation

One challenge facing boards is how to provide for the succession of the next generation of senior management. This especially affects the many middle market companies which have, traditionally, been family concerns. Even where they have opened themselves up to external equity finance, family members have continued to hold key operating positions.

Younger family members are sometimes less keen to stay within the company, or boards may decide for other reasons that they need to bring in professional managers from outside. Many companies are turning to recruitment and selection specialists to help find suitable candidates.

All boards need to have in place a succession plan for senior management. This may involve identifying talented candidates within the business, and providing training and career planning advice to enable those individuals to progress to more senior positions.

Running the Business

Corporate Strategy and Planning

According to the Principles of Corporate Governance published by the Organisation for Economic Co-operation and Development (OECD), a company's corporate governance framework should ensure 'the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and its shareholders.'

There should be a clear division of responsibilities, with the board providing strategic oversight and tactical guidance, and management being engaged with operational planning, decisions and implementation.

How the board and management actually discharge these complementary roles will vary from company to company, reflecting the type of working relationship which is most suitable. But whatever process is adopted, the board should have enough information to support its analysis of strategy – any shortcomings in the quality of this information must be addressed.

Getting the process right

The formation of strategy should be an iterative process. The board needs to be involved in reviewing and challenging the company's strategic options, ensuring that alternatives are considered, examining the processes by which objectives will be achieved, and monitoring the implementation. It is important that the board and management feel comfortable with this process, "buying in" to the resulting strategy.

A failure to think sufficiently widely and anticipate all the 'environmental' factors affecting the business may undermine the best efforts of the board and management in framing the strategy. Hence, the company's risk management processes must identify all potential business risks. This is discussed further in the next section.

Efficient and effective implementation of strategy can often be the most difficult and challenging aspect of the entire process. Board members' role in challenging and reviewing the strategy and planning process does not end when the strategy is agreed. Instead, it continues throughout the implementation process.

The governance framework should not be a "straight jacket" – it should allow for the company to be responsive to the increasingly fast-changing commercial environment. The aim is to create a long-term strategy which will result in the creation of greater value for shareholders, alongside associated benefits for employees, customers, and other stakeholders.

Good Practices for an Effective Board

- ✓ Reviewing and challenging management's strategic options
- ✓ Thinking sufficiently widely when reviewing strategy proposals
- ✓ Taking steps to reduce risks in planning mergers or acquisitions

Thinking sufficiently widely

In understanding the type of factors that boards should take account of when reviewing management's strategy proposals, it is helpful to anticipate the questions which shareholders might commonly ask about strategy. Some examples are given below.

These are the sort of questions which board members should ask of management. If the board itself does not ask, and obtain answers for, these questions, it will be ill-equipped to provide convincing responses at shareholder meetings.

Questions Shareholders Ask about Strategy

General business strategy

- What major business challenges and risks will the company need to address in the short-term? In the long-term? How does management plan to respond?
- Analysts and financial commentators are saying the business has lost customer focus and strategic direction. What do you propose to do about this?
- What opportunities or challenges does: globalisation; trade liberalisation; reduction in tariff barriers; de-regulation; e-business; changing demographic profile; ageing / younger population; hold for the company?
- Are there plans to diversify into new markets, new products, or other businesses?
- Is there any major new legislation in the countries of operation that may affect the business? How do you plan to deal with it?
- What non-financial performance measures does the company use to evaluate operations (eg market share, customer satisfaction)? Are they aligned with strategic plans? Are the measures communicated to the market?

Innovation

- How much was spent on research and development? What new products or product improvements are in the pipeline?
- Do these new products require patents, licences, or other forms of regulatory approval, and if so what are the prospects for approval? (Especially relevant for pharmaceutical, biotechnology, new technology companies)

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- What are the prospects for exploration of new mineral/energy reserves – and obtaining rights to extract/transport those reserves? (Especially relevant for oil & gas and mineral extractive industries, and energy distribution companies)
- What level of R&D expenditures is budgeted for this year? Will cash flow from operations support current R&D / investment spending rates? Are R&D expenditures sufficient to maintain long-term competitiveness?

Mergers and acquisitions

- Is the industry consolidating? How will recent mergers and acquisitions in the industry affect the company? How does the company plan to compete against larger companies that can benefit from economies of scale?
- Are acquisitions or new ventures planned? How will they be financed? What criteria are used to identify potential acquisitions? Will they dilute present shareholders' interests?
- Is the company perceived to be an acquisition target? Has the company received offers to be acquired and, if so, how has the company responded?

Restructuring

- The business has undergone [number] major restructurings in [number] years. Is this a sign that management has no coherent strategy?
- Which businesses do management consider to be "core" activities? How soon will non-core businesses be disposed of?
- Has the company closed any plants this year? Are these shutdowns temporary or permanent? Will a loss result from plant closures?

Geographical factors

- How was the company affected by the economic and financial crisis in [country]?
- Which regions of the world / national markets does the company consider offer the greatest growth prospects?
- What potential effects could different world events have on the company (eg introduction of single currency and single market in Europe; transatlantic trade agreements; trading blocks in Asia, Latin America)?
- Has the company become involved in emerging markets? Does it plan to? How does it monitor risks related to those markets (eg credit risk; foreign currency risk; political risk)?

Mergers and acquisitions

Many companies seek growth by acquisition. Unfortunately, studies reveal that many acquisitions fail to meet acquirers' objectives and expectations. The effects of limited access to information on the target business, short timeframes for bid negotiations and due diligence, and, sometimes, the headstrong behaviour of senior executives, may conspire to result in deals diluting shareholder value. Acquisition strategies merit careful board attention.

The risks of deals turning sour seem highest where companies make acquisitions which are either outside their core businesses and areas of expertise, or where the acquirees are located in new countries. Having broader business experience, and more international experience, on boards may help reduce the risk of companies straying into unknown territory.

Steps the board can take to reduce the risks at the bid planning stage include:

- obtaining good market and competitor research
- critical assessment of the underlying strategic and market assumptions
- assessment of the capacity to "manage" the bid, and post-bid integration
- detailed risk analysis and simulation
- monitoring of the company's corporate development group, responsible for identifying M&A opportunities and for organising due diligence.

If non-executive or independent board members are to help to ensure the right decisions are taken, they need to be properly informed about the scope and summary findings of due diligence work.

Once a bid is successfully mounted, there is more work to do to ensure that the post-deal integration stage is properly managed. The board should focus priorities on:

- allocating resources first to those activities which will create shareholder value in a short timeframe – securing "quick wins"
- controlling the communications process with investors, analysts and other stakeholders
- taking decisions on organisational structure and management positions on a business, rather than political, basis.

Mergers may be particularly sensitive. Careful consideration needs to be given to the governance and public relations aspects of such transactions.

Internal Control, Compliance and Risk Management

The topic of 'risk,' and how to manage it, is one that now dominates the debate about internal control and strategy development in major companies. Until recently, 'risk' was seen as something bad which could be insured or hedged against – for example a catastrophe, earthquake or financial crash.

The concept is now much broader, and risk is no longer limited to the possibility of something bad happening, but covers a 'continuum' of future outcomes ranging from the very negative to the very positive. So it also represents opportunity – and managing risk proactively is an important element in the success of any well-governed company.

Establishing an internal control system

No company can expect to manage risk effectively without first creating a basic system of internal controls, designed to safeguard shareholders' investment and the company's assets. The controls need to take into account the risk of non-compliance with regulations affecting the particular industry.

Well-publicised compliance failures in sectors ranging from food to financial services illustrate not only the danger of punitive action from regulators, but also the likelihood of a negative impact on corporate reputation and investor confidence.

The internal control system should:

- enable the business to respond appropriately to significant business, operational, financial and compliance risks
- safeguard assets from inappropriate use and loss from fraud or error
- help ensure the quality of internal and external reporting, through the proper maintenance of records and information flows
- facilitate compliance with applicable laws and regulations and internal policies.

"Management should identify and evaluate the risks faced by the company for consideration by the board and design, operate and monitor a suitable system of internal control which implements the policies adopted by the board"

Turnbull Committee guidance for directors on internal control, UK, September 1999

Managing risk systematically

The board should ensure that the organisation has a continuous process in place to identify risk, assess its potential impact, and take the required action to manage it. Historically, boards may have taken a passive role, which involves being informed of the major risks 'after the event' and checking that the right corrective action is being taken. This approach leaves the company exposed to new risks as they emerge, with potentially damaging results – either in the form of commercial loss or missed opportunities.

What is needed is a systematic approach to identifying and managing risk. Management should examine the risks involved in achieving key objectives – including the potential barriers to success, and the factors critical to that success. This should encompass areas such as economic, competitive, political, environmental and technological risk. Based on this analysis, management can decide what actions are needed to manage these risks, and then identify and implement the additional controls needed to ensure these actions are carried out.

Review of effectiveness

Once the internal control and risk management systems are in place, the board should ensure that a regular review of their effectiveness is conducted. We believe that such a review should be done on at least an annual basis with a report back to the board or an audit or compliance committee of the board on the results. To be meaningful, the review should cover all controls, including financial, operational and compliance controls. To assist them in their review, the board or audit committee may engage the assistance of staff specifically designated for the purpose, the internal audit function, the external auditors, or a combination of all three.

Good Practices for an Effective Board

- ✓ Ensuring the establishment of a system of internal control
- ✓ Putting in place a system for the systematic management of risk
- ✓ Assessing, at least annually, the effectiveness of the control and risk management systems

In conducting its review, the board will consider how significant risks were identified, evaluated and managed. If any major control weaknesses were identified during the period, the board will want to consider how those were dealt with and whether any further remedial action is needed.

The UK's Turnbull Committee published influential guidance for directors on internal control in 1999. As part of its guidance, the Committee developed a series of questions which boards may wish to discuss with management when reviewing reports on internal control and carrying out its periodic assessment of financial, operating and compliance controls. The questions are reproduced in the table below.

Questions Board Members should ask about Internal Control

The questions are not intended to be exhaustive and will need to be tailored to the particular circumstances of the company.

1. Risk assessment

   Does the company have clear objectives and have they been communicated so as to provide effective direction to employees on risk assessment and control issues? For example, do objectives and related plans include measurable performance targets and indicators?

   Are the significant internal and external operational, financial, compliance and other risks identified and assessed on an ongoing basis? (Significant risks may, for example, include those related to market, credit, liquidity, technological, legal, health, safety and environmental, reputation, and business probity issues.)

   Is there a clear understanding by management and others within the company of what risks are acceptable to the board?

2. Control environment and control activities

   Does the board have clear strategies for dealing with the significant risks that have been identified? Is there a policy on how to manage these risks?

   Do the company's culture, code of conduct, human resource policies and performance reward systems support the business objectives and risk management and internal control system?

   Does senior management demonstrate, through its actions as well as its policies, the necessary commitment to competence, integrity and fostering a climate of trust within the company?

   Are authority, responsibility and accountability defined clearly such that decisions are made and actions taken by the appropriate people? Are the decisions and actions of different parts of the company appropriately co-ordinated?

Does the company communicate to its employees what is expected of them and the scope of their freedom to act? This may apply to areas such as customer relations; service levels for both internal and outsourced activities; health, safety and environmental protection; security of tangible and intangible assets; business continuity issues; expenditure matters; accounting; and financial and other reporting.

Do people in the company (and in its providers of outsourced services) have the knowledge, skills and tools to support the achievement of the company's objectives and to manage effectively risks to their achievement?

How are processes/controls adjusted to reflect new or changing risks, or operational deficiencies?

3. Information and communication

Do management and the board receive timely, relevant and reliable reports on progress against business objectives and the related risks that provide them with the information, from inside and outside the company, needed for decision-making and management review purposes? This could include performance reports and indicators of change, together with qualitative information such as on customer satisfaction, employee attitudes etc.

Are information needs and related information systems reassessed as objectives and related risks change or as reporting deficiencies are identified?

Are periodic reporting procedures, including half-yearly and annual reporting, effective in communicating a balanced and understandable account of the company's position and prospects?

Are there established channels of communication for individuals to report suspected breaches of laws or regulations or other improprieties?

4. Monitoring

Are there ongoing processes embedded within the company's overall business operations, and addressed by senior management, which monitor the effective application of the policies, processes and activities related to internal control and risk management? (Such processes may include control self-assessment, confirmation by personnel of compliance with policies and codes of conduct, internal audit reviews or other management reviews).

Do these processes monitor the company's ability to re-evaluate risks and adjust controls effectively in response to changes in its objectives, its business, and its external environment?

Are there effective follow-up procedures to ensure that appropriate change or action occurs in response to changes in risk and control assessments?

Is there appropriate communication to the board (or board committees) on the effectiveness of the ongoing monitoring processes on risk and control matters? This should include reporting any significant failings or weaknesses on a timely basis.

Are there specific arrangements for management monitoring and reporting to the board on risk and control matters of particular importance? These could include, for example, actual or suspected fraud and other illegal or irregular acts, or matters that could adversely affect the company's reputation or financial position?

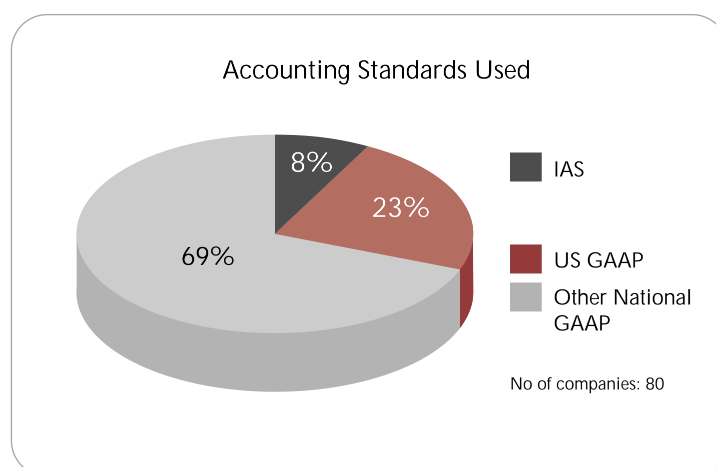
Financial Reporting

The provision of high quality financial reporting is one of the board's principal responsibilities. Good financial reporting helps investors to make informed decisions on the company's prospects, and is likely to be instrumental in building market confidence in the company and its management. Reporting also needs to reflect changing demands for information – the market is increasingly looking for more forward-looking and non-financial measures.

However, the board's task of delivering the right level of financial reporting is made more difficult by the fragmentation of accounting requirements. Business processes are increasingly global, but accounting rules are still rooted in national regulation. International competition for capital has intensified the desire for common standards as investors will only buy a company's securities on the basis of figures they understand and trust. If the capital markets are to operate efficiently, then investors must be able to compare like with like.

Working with different GAAPs

The current diversity of reporting is illustrated by the company annual reports we looked at. The overwhelming majority of 'global' companies still produce accounts in accordance with their national GAAP, as shown in the table below. A small number, all from Europe, now use International Accounting Standards (IAS). This number should increase with the positive news that IOSCO, the club for the world's securities regulators, has approved 30 IASs for cross-border listing purposes. And in Europe, all the companies in our sample should be using IAS by 2005, if the European Commission's recent proposals are implemented.



"Converting to IAS is not yet on the boardroom agenda, even though there is clear evidence that the majority of Europe's CFOs recognise its importance and know that a change is coming"

'International Accounting Standards in Europe, 2005 or now?' PricewaterhouseCoopers, November 2000

A more extensive PricewaterhouseCoopers European survey published in November 2000 showed that IAS is increasingly on the "radar screen" of companies. However, although 79% of European CFOs were then aware of the EC's plan to introduce IAS by 2005, awareness among other board members was lower. The survey also showed that a majority of respondents, for reasons of comparability of information, rated IAS as preferable to their national GAAP. Strategic business considerations, rather than accounting issues, were seen as the most compelling reasons for making the change to IAS.

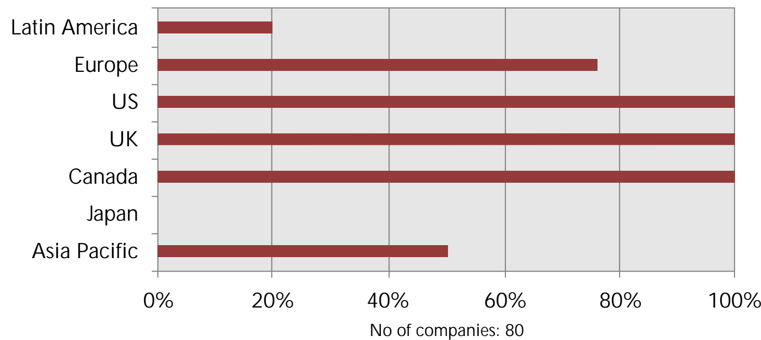
Until we move closer to harmonisation of accounting standards, company boards and finance staff must of course respect the regulatory requirements of the countries they operate in and the countries they raise capital in. At the same time the board should be aware of the benefits of going beyond national regulation to use international "best practice". Directors should challenge company management to aim for transparent financial reporting.

Audit Committees

The importance of financial reporting to a company's relationship with the investment community is reflected in the way the issue is handled at board level. In a few countries, listed companies are now required to establish an 'audit committee' to oversee financial reporting; in others, the practice is entirely voluntary. But there is a growing recognition of the valuable role such committees can play in the areas of external financial reporting and internal controls. In particular, the audit committee provides a forum for candid discussions with management and the auditors regarding the quality of financial reporting.

Good Practices for an Effective Board

- ✓ Aware of changes in accounting standards frameworks affecting the company
- ✓ Appoints an audit committee to take board level responsibility for financial reporting
- ✓ Takes responsibility for all published financial information



As can be seen in the table above, all companies we looked at in Canada, the UK and US have audit committees, according to their published annual reports. They were much less commonly found in the structures of Asian and Latin American companies.

The financial reporting responsibilities of the board or audit committee are extensive – indeed they are the subject of a separate publication in this series *Audit Committees – Good Practices for Meeting Market Expectations.* A summary of the key responsibilities is given in the table below.

Board or Audit Committee's Financial Reporting Responsibilities

Financial Reporting – general

- Gain an understanding of the current areas of greatest financial risk and how management is managing these effectively
- Have the audit committee work with the internal and external auditors to consider any fraud, illegal acts, deficiencies in internal control or other similar issues
- Review significant accounting and reporting issues, including recent professional and regulatory pronouncements, and understand their impact on the financial statements
- Review any legal matters which could significantly impact the financial statements
- Gain an understanding of the process undertaken by management to assess whether it is appropriate to prepare accounts on the going concern basis

Annual Financial Statements

- Review the annual financial statements and determine whether they are complete and consistent with the information known to board members; assess whether the financial statements reflect appropriate accounting principles
- Pay particular attention to complex and/or unusual transactions such as restructuring charges and derivative disclosures
- Focus on judgmental areas, for example those involving valuation of assets and liabilities; warranty, product or environmental liability; litigation reserves; and other commitments and contingencies
- Meet with management and the external auditors to review the financial statements and the results of the audit
- Review the other sections of the annual report before its release and consider whether the information is understandable and consistent with members' knowledge about the company and its operations

Preliminary Announcements, Interim Financial Statements and Analysts' Briefings

- Be briefed on how management develops preliminary announcements, interim financial information and analysts' briefings; the extent of internal audit involvement; and the extent to which the external auditors review such information
- Assess the fairness of the preliminary and interim statements and disclosures, and obtain explanations from management and internal and external auditors on whether:
  - Actual financial results for the interim period varied significantly from budgeted or projected results
  - Changes in financial ratios and relationships in the interim financial statements are consistent with changes in the company's operations and financing practices
  - Generally accepted accounting principles have been consistently applied
  - There are any actual or proposed changes in accounting or financial reporting practices
  - There are any significant or unusual events or transactions
  - The company's financial and operating controls are functioning effectively
  - The preliminary announcements and interim financial statements contain adequate and appropriate disclosures

Influencing the Environment

Disclosure and Transparency

A company can no longer simply publish the minimum accounting and other information required by company law, leaving investors to figure the rest out for themselves. International investors expect the board to ensure certain norms of transparency are maintained.

In particular, investors want more analytical information to accompany the basic legal disclosures. Boards should explain their activities and disclose as much as is possible without damaging the company's commercial interests. A reputation for openness will not only encourage investment but is also likely to make investors more loyal if and when things go wrong.

What to disclose

The Principles of Corporate Governance published by OECD recommend a number of areas in which companies should make timely disclosure to all shareholders. The Principles note that this should not place unreasonable administrative or cost burdens on companies – most of the areas listed below could be dealt with in the annual report.

Disclosure should include material information on:

- The financial and operating results of the company
- Company objectives
- Major share ownership and voting rights
- Identities of board members and key executives, and their remuneration
- Material foreseeable risk factors
- Material issues regarding employees and other stakeholders
- Governance structures and policies

"The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the company, including the financial situation, performance, ownership, and governance of the company"

OECD Principles of Corporate Governance, May 1999

The board's responsibilities for strategy, governance, executive remuneration, risk management and financial reporting were examined in earlier sections. Examples of what leading companies say about these areas in their annual reports are included in our companion publication, *Reporting Progress – Good Practices for Meeting Market Expectations.*

Good Practices for an Effective Board

- ✓ Understanding the information demands of shareholders and others
- ✓ Publishing a balanced commentary on the operating and financial results
- ✓ Considering the need for wider accountability

Operating and financial review

Most countries now require some form of basic narrative reporting to accompany the figures in the accounts. But there is also overwhelming demand from shareholders, potential investors and analysts for more comprehensive discussion of the company's performance. Investors are looking in particular for information that might shed light on the future performance of the enterprise.

Companies have become accustomed to including an extensive explanation of their business prospects, and the risk factors affecting them, in the prospectus for an issue to raise new equity capital. IOSCO, the organisation representing stock market regulators worldwide, is encouraging the 'internationalisation' of such information. Recommended disclosure standards, including an operating and financial review, have been issued. A key aim of these non-financial disclosures is to achieve greater comparability of information between prospectuses issued under different regulatory regimes, and enhance investor protection.

The same type of information should continue to be included in annual reports sent to investors once the shares have been taken up. Boards should regard revealing this information as an opportunity to communicate the company's long-term business strategy to the market, and to demonstrate how senior management is dealing with the operational and financial risks facing it. Potential shareholders, if provided with information on the company's financial risk strategy in areas such as interest rates and derivatives, will be better able to assess the risks they face by investing.

"Transparency is important to build trust and credibility... We are committed to working with others to challenge traditional thinking and make progress in this area"

People, Planet & Profits, The Shell Report 2000

A wider information set – ValueReporting™

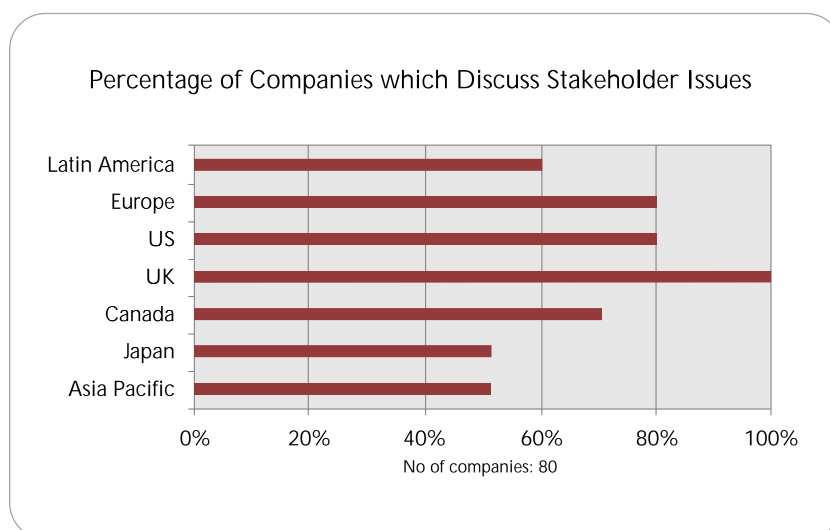
Investors are interested in the elements of a business which create value – answers to questions such as: Is the purchasing and manufacturing process more efficient than competitors? Or is the company simply better at customer service? Does the company's investment in its people generate greater returns? The current corporate reporting model satisfies only some of these demands for greater information.

Research has shown that most business managers today use a 'balanced scorecard' of measures to monitor and control the development of strategy and business activity, but that relatively little of this valuable information is formally used in the communication process with the capital markets.

We believe that, in the future, companies need to be prepared to provide this wider 'information set', if they want their shares to be fully valued. Based on extensive research into the information needs of analysts and investors, we have developed a new reporting framework called ValueReporting™. Under this framework, companies are encouraged to report on a comprehensive set of company-specific financial and non-financial performance measures and indicators of activity that underpin shareholder value creation. More details are given in our separate publication *ValueReporting™ Forecast*.

Wider accountability

In addition to reporting on a wider information set, there is evidence that boards are taking seriously the need to tell investors how they have taken into consideration the interests of a wider constituency – consumers, regulators, employees, and other important groups affected by the company's activities. In our sample of annual reports, a combined 83% of companies in Europe, the UK, the US and Canada had some discussion of other stakeholder issues (taken to include reports on employee, environmental and other 'corporate citizenship' areas.) The content and length of such reports varies enormously however.



These results indicate that, despite the absence of regulatory requirements to report on these wider areas of accountability, the boards of many leading companies believe the market wants this type of disclosure.

Reporting models which capture the social, ethical, and environmental activities of companies are discussed in the following section.

Reputation – a Sustainable Business

The task of managing, protecting and enhancing reputation has become one of the most complex challenges facing today's board. Companies now find themselves the focus of attention – and sometimes rigorous monitoring – from a growing range of interest groups. These include environmental lobbyists, non-governmental organisations, consumer groups and ethical investment consultants. The views of these groups – and the consequent media pressure put on companies who are not perceived as living up to society's standards – affect a company's share price, and so matter to investors.

'Corporate social responsibility' (CSR) or 'corporate citizenship' – increasingly captured in the fashionable term 'sustainability' – has moved up the public agenda. (Sustainability means ensuring that the actions of the business today do not limit the range of economic, social and environmental options available in the future. It is argued that, by working towards sustainability, companies can create long-term value and a competitive advantage.)
The result is that the subject is now on the board agenda for major companies.

"The sustainability agenda calls upon companies to adopt longer time scales, to take on board the views of key stakeholders, to integrate triple bottom line thinking into every aspect of the business, and to consider reconfiguring key aspects of the company's operations. These emerging challenges make it essential, and inevitable, that the agenda will increasingly come to roost with the board"

John Elkington, 'Cannibals with Forks', 1999

Boards are becoming increasingly involved in:

- debating ethical, social and environmental policies
- developing ethical or corporate codes of conduct
- conducting assessments of the social and environmental impact of potential acquisitions, or decisions to invest in new territories
- conducting and reporting the results of employee surveys
- conducting and reporting the results of consumer surveys
- assessing the reputation risk attached to major decisions.

Creating an ethical code

One sign of the increased importance attached to business ethics is the adoption by many companies of formal codes of conduct, which set out the board's guidelines for acceptable business practices.

For a code to be successful, it must not consist merely of 'mission statements' or general text about corporate citizenship. The code needs to cover practical processes and performance measures that allow the company's staff to understand what the overall objectives mean to them. There will also need to be a programme by which the board can monitor compliance with the code and enforce instances of non-compliance.

Good Practices for an Effective Board

- ✓ Debating the need for ethical, social and environmental policies
- ✓ Promoting a code of ethics or good business practice
- ✓ Communicating with interest groups affected by the company's activities

Set out below is a practical guide to help create a corporate code of conduct.

Outline of a Corporate Code of Conduct

The overall content of a corporate code of conduct could be broken down into five categories:

- The company's commitment to its employees, shareholders, and communities
- Ethical standards in dealing with customers, vendors and other relevant parties
- Company expectations of management and employees
- The privacy of:
  - Information about outsiders that the company maintains
  - Company information
  - Employee information
- Compliance with laws and regulations

Within these areas the following specific subjects could be included:

- Fiduciary responsibility
- Integrity of advertising
- Acceptable standards for company products and services
- Possible conflicts of interest matters, such as using confidential information to make personal investments, receiving money or gifts from outsiders, borrowing from suppliers, holding outside employment, using company facilities for personal matters, outside interests or relationships or family and business relationships
- Political contributions and activities
- Improper transactions and payments
- Fairness in employee relations
- Employee safety
- Security of company assets and records
- The company's role and that of its employees in community activities

Specific examples should be used to illustrate acceptable and unacceptable behaviour, to ensure that there is a clear understanding of what is meant.

Administrative matters relating to the code might include:

- Channels for communicating information on potential fraud to management (confidentiality and other factors that would encourage uninhibited communications should be considered)
- Mechanisms to follow up on reports of suspected non-compliance with the code to determine exactly what occurred and who was responsible, as well as a means of letting employees know the results of such investigations
- Mechanisms for review and approval of relationships that may appear to be, but are not, conflicts of interest
- An ongoing programme of communicating to employees their responsibilities under the code
- Provisions for continuous monitoring of compliance with the code

Social responsibility – Who cares?

A number of well-known multinationals have been criticised in recent years for a variety of social responsibility issues. Those range from consumer and product safety issues to claims of environmental damage and employment of child labour. Regardless of the facts of each case, the mere fact that companies' names are mentioned in connection with such claims can be damaging to corporate reputations. What can company boards do to protect their companies, and shareholders' interests, from such reputation risk?

There are a number of steps which boards can take:

- set down policies for how the company should act with respect to ethical, environmental and social issues
- design and implement appropriate controls to ensure that the policies are followed – and a monitoring system to ensure the control system is working
- when problems arise, tackle them in an honest manner. Experience shows that ignoring a problem seldom improves the company's situation
- develop a dialogue with groups affected by the company's activities, and consider public reporting on ethical, environmental and social issues.

In order to tackle these issues, some companies have set up committees charged specifically with addressing environmental or social issues, while others have broadened the scope of existing committees. Some have gone even further, and introduced comprehensive frameworks for assessing, monitoring and addressing sustainability across the organisation.

Leading companies now routinely publish information, or even separate reports, on business ethics, corporate behaviour, employee policies and environmental protection measures. Company websites invite interested parties to dialogue with the company about its policies. And some companies are experimenting with new concepts such as 'Triple bottom line' accountability – reporting on *all* the impacts of the company's activities: financial, environmental and social.

Critics have dismissed much of this activity as a public relations "smokescreen", but there is no doubt that companies are reaching out further than they have in the past. They are inviting employees, customers, suppliers and local communities to see – and to question – the social and environmental standards by which the company operates and judges itself.

The Other Key Players

Throughout this publication the assumption has been that the board's primary responsibility is to the body of shareholders as a whole. Even in the "new governance" areas such as sustainability, we believe the key objective is to explain to shareholders how the company has addressed the concerns of other groups.

Aside from the board and the company itself, there are three constituencies in particular which play a fundamental part in the governance framework: institutional investors; external auditors; and regulators. In this final section, it is useful to contrast the responsibilities of the board with those of these other groups.

"If investors are not confident with the level of disclosure, capital will flow elsewhere"

Arthur Levitt, Chairman, US Securities and Exchange Commission, December 2000

Institutional investors

The growing concentration of equity holdings in the hands of institutional investors and fund managers means that these investors have an increasingly powerful influence over company behaviour. The board has a responsibility to ensure that the company deals fairly with all investors and does not give undue prominence to any interest group. This means not favouring institutional investors to the extent that individual investors are disadvantaged. It also means, in some countries, that foreign institutional investors should not be unfairly treated in comparison with local investors.

In the interests of good governance, the board should:

- ensure all investors – particularly foreign equity investors – have equal access to basic information about the company
- ensure all investors are able to exercise their rights, for example to vote their shares and attend the annual meeting
- avoid introducing voting mechanisms, or clauses in the company's constitution, which prevent investors from legitimately acquiring shares or from mounting takeover bids.

Boards must also be proactive in getting their message across to the institutions if their shares are to be appropriately valued by the market. Leading analysts and institutional investors now demand regular access to the highest levels of management – with the result that CEOs and chief financial officers now spend a substantial (and growing) proportion of their time meeting these key decision-makers, and explaining company strategy.

Techniques and practices which boards need to consider include:

- ensuring the CEO and other members of senior management and the board have the appropriate personal communications skills to appear in the media and on public platforms
- employing investor relations experts to manage the company's relationship with the external marketplace
- using all available channels, including investor roadshows, media contacts, published reports and the internet as part of the company's investor relations efforts.

We also believe that institutional investors (and all shareholders) have a responsibility to take an active interest in the governance arrangements of the companies they invest in. Where, for example, there is no strong independent element on the board, or where the company does not publish a commentary on the operations and financial position, investors should be asking critical questions of management.

External auditors

The ultimate responsibility for preparing the financial statements rests with the board itself, and cannot be 'delegated' to the auditors. Whilst the auditors can, and should, advise management on matters of financial statement preparation and presentation, key decisions regarding the selection of accounting policies must remain with management.

The objective of an external audit is to enable the auditor to express an opinion on whether the financial statements are prepared, in all material respects, to give a true and fair view in accordance with the identified financial reporting framework. However, this definition – taken from the International Standards on Auditing – underplays the important role the auditor plays in the governance process.

Historically, leading companies engaged the services of a professional external auditor long before it was a legal requirement, because the capital markets place greater faith in accounts that have been subject to independent examination. While the preservation of investor confidence has always remained at the heart of the statutory audit, the audit process has adapted to the growing complexity of business. The sophisticated modern-day audit requires a multi-disciplinary team of experts in IT, taxation, pensions and many other subjects.

In an age of an increasingly transient workforce, when company management tends to change at frequent intervals, the presence of an external auditor with a wider and deeper understanding of the company's operations can be of enormous help to the board. Often, the external auditor is the main source of independent information and advice to the board. Also, financial reporting rules increasingly require a longer-term view to be taken of financial statement items such as tangible assets, goodwill and employee benefits. The ability of the auditor to track these items over a number of years contributes significantly to the quality of financial reporting.

The increasing use of audit committees has encouraged greater dialogue between the board, executive management and the auditors. The auditor certainly no longer limits his contacts with the company to personnel in the accounts department. Professional pronouncements, such as the new International Standard on Auditing *'Communications of Audit Matters with Those Charged with Governance'*, encourage the auditor to identify and communicate with those responsible for board level oversight of the business.

By making regular presentations to the board or audit committee on developments in financial reporting and corporate governance, as well as trends in internal control, risk management and other areas, the external auditors can help raise board awareness and contribute to raising the quality of the company's communications to the market.

"Although auditors have a responsibility to report to stakeholders, their objective views can also be of value to the directors who are elected to govern the entity on behalf of those stakeholders"

'Audit Committees: Best Practice Guide',
Australian Accounting Research Foundation, 1997

Regulators

Historically, the key regulators for most listed companies have been the government, in the guise of company law, and the stock exchange. As guardians of the smooth running of the markets, ministries and exchanges have played a key role in encouraging developments such as requirements for information disclosure, equal treatment of shareholders, and the outlawing and prosecution of market manipulation and abuse.

An appropriate balance needs to be struck in the level of regulation. Investors are clearly looking for good standards of corporate governance and disclosure in the companies they invest in. But if governments and exchanges make their minimum standards too demanding, or too bureaucratic, companies may regard them as onerous and overly expensive, and decide to invest or to list their shares elsewhere. Also, regulators need to carry the support of business leaders with them – boards are more likely to "buy in" to new requirements if the business community had an opportunity to comment on and contribute to the formulation of the rules.

Regulation has expanded rapidly beyond the traditional areas of company law and listing rules. Clearly, industries such as telecoms and financial services face their own particular regulatory requirements. But increasingly for all businesses, their responsibilities and activities in areas such as environmental protection, competition, data privacy, employment policies and health and safety are the subject of rigorous regulation.

Complying with all the relevant regulations can be a headache for multinational companies, as regulatory regimes vary widely between different countries. National regulators need to co-operate and share experience, in the interests of harmonising regulations for business. The European Commission is taking steps to create a single market for Financial Services in the EU. A recent committee of enquiry highlighted the need for, for example, a common standard for prospectuses and issues of securities.

"On the subject of mergers and alliances…'the devil is in the detail'. That is definitively true because of Europe's complexity from the regulatory perspective. The regulatory issues are by far the most challenging for many cross-border ventures"

Paul Arlman, Federation of European Stock Exchanges, November 2000

For the board, regulators have become an important group whose interests must be taken into account both at a strategic and operational level. The business community needs to make its voice heard and lobby for changes to regulation which would be in the interests of free trade and economic growth. At the same time, business must observe the law – complying with the complex web of national regulation remains for now a cost of doing business in different markets.

Companies are integrating regulatory compliance into their business processes – backed up by the company's code of corporate conduct and behaviour. Boards of global companies need to consider whether to standardise their internal processes at the highest level worldwide, even when laws in a particular country may not actually require it.

As regulatory structures continue to evolve, it is important for boards to keep abreast of developments – a change in regulatory policy may turn a viable strategy or business model into an unworkable one virtually overnight. A good corporate governance framework should provide for a regular flow of information to the board on regulatory issues.

All together now…

Each of the groups mentioned in this publication has an interest in ensuring that company boards are able to operate in a governance model which encourages, rather than stifles, enterprise. Economic benefits can only be realised for society as a whole if businesses are able to create shareholder value for the long term. We believe there needs to be more dialogue between the parties – business, investors, regulators and society – on how that objective may be achieved. That process of dialogue is starting to happen.

In the meantime, we believe that all listed companies should consider the good practices for effective boards outlined in this booklet. These are reiterated in the board self-assessment guide on the following pages.

Board Self-Assessment Guide

The form on the following pages can be used by board members, periodically, to determine how effectively they are meeting their responsibilities. It reiterates the good practice features discussed in this publication, and indicates who should be involved in each step.

To use the form, indicate whether the practices in each of the areas are currently being followed (yes or no). Also list suggested follow-up steps, if any.

Good Practices for an Effective Board	Who else is involved?	Is practice being followed? (Yes/No/NA)	Comments/Follow-up actions
Running the Board			
Board Structure			
There is a working partnership between the board and senior management – the board provides strategic oversight; management is responsible for operations	Senior management		
There is a strong independent element on the board	-		
'Independent' directors are free of business or other relationships which could compromise their objective judgement, or lead to factionalism	-		
Board size is small enough to provide for effective debate and decision-making	-		
Where detailed objective consideration is needed of sensitive issues such as executive appointments, compensation and financial reporting, board sub-committees are created	Board sub-committees		
There is an adequate level of international experience for the board of a global company	-		
Conduct of Board Meetings			
The chairman leads the meetings and ensures full discussion of agenda items	Chairman		
Consideration is given to separating the roles of chairman and CEO, where these are combined	Chairman & CEO		
Decisions are made on a consensus basis after due deliberation	-		

Good Practices for an Effective Board	Who else is involved?	Is practice being followed? (Yes/No/NA)	Comments/Follow-up actions
Board meetings are held regularly (at least quarterly, preferably monthly)	Chairman		
Adequate notice is given of meetings, and papers are circulated sufficiently well in advance of the meeting to enable members to prepare	Secretary		
The chairman, other board members and the secretary are clear about their respective roles and responsibilities	Chairman, secretary		
Recruitment, Remuneration and Evaluation			
In making senior level appointments, the board considers whether the candidates possess the competencies needed by a director (recognising not all positions need the full set of skills)	Nomination committee		
Senior executives do not set their own pay levels without appropriate oversight	Compensation committee		
The board appoints a compensation committee to consider matters of senior executive remuneration and evaluation	Compensation committee		
Performance is evaluated using agreed criteria, aligned as far as possible with corporate objectives. The criteria include short and long-term measures, and cover financial and non-financial performance indicators	Compensation committee		
The CEO has an annual performance review when performance against his or her personal plan is reviewed, and future objectives set	Compensation committee, chairman		

Good Practices for an Effective Board	Who else is involved?	Is practice being followed? (Yes/No/NA)	Comments/Follow-up actions
There is a succession plan in place for identifying the next generation of executives to lead the company	-		
Running the Business			
Corporate Strategy and Planning			
The board reviews and challenges management's strategic options and proposals	Management		
All 'environmental' factors affecting the business are taken into account in the formulation and review of strategy	Management		
The processes by which the agreed strategy will be implemented and monitored are reviewed	Management		
The board anticipates the sort of questions which shareholders will ask about strategy – and has answers for them	-		
Steps are taken to reduce the risks of making ill-considered acquisitions or mergers	Management		
The board ensures management focuses attention on the main post-deal priorities following a successful acquisition bid or merger	Management		
Internal Control, Compliance and Risk Management			
The board ensures management has established a system of internal control designed to safeguard shareholders' investment	Management		

Good Practices for an Effective Board	Who else is involved?	Is practice being followed? (Yes/No/NA)	Comments/Follow-up actions
The board ensures management has a continuous process in place to identify, assess and manage risk	Management		
The effectiveness of the internal control and risk management systems is reviewed, at least on an annual basis	Internal audit External audit		
Significant weaknesses in internal control identified during the period are followed up by the board asking what remedial action is required	Management		
Financial Reporting			
Overall responsibility for the publication of high quality financial reporting rests with the board	-		
Directors with financial reporting responsibilities keep abreast of changes in the accounting standards frameworks used in the group's reporting	Finance staff, audit committee, external auditors		
An audit committee is appointed to take senior level responsibility for reviewing financial information published by the company	Audit committee		
In addition to the annual report, the board or audit committee reviews interim reports, preliminary results announcements, and analysts' briefings	Audit committee		
Influencing the Environment			
Disclosure and Transparency			
The board understands the information demands of shareholders and other groups, including analysts, the media, employees, consumers, regulators and other interested groups	Audit committee, external advisers		

Good Practices for an Effective Board	Who else is involved?	Is practice being followed? (Yes/No/NA)	Comments/Follow-up actions
A balanced commentary on the operating results of the business is published, to accompany the financial statements	Management Audit committee		
To ensure its shares are properly valued by the market, the board considers publishing a wider range of non-financial performance measures	Audit committee		
Reputation – a Sustainable Business			
The board debates the need for wider accountability, and for developing corporate ethical, social and environmental policies	External advisers		
A code of ethics or good business practice is developed and championed	-		
The board ensures there are processes for monitoring compliance and dealing with any instances of non-compliance with the code of ethics	Management		
The board supervises communication with the various interest groups affected by the company's activities	External advisers		
The Other Key Players			
The board supports and ensures equitable treatment of all investors – including access to information and ability to exercise shareholder rights	Investors		
The board is proactive in its communications with investors, particularly institutions, if the company's shares are to be appropriately valued	Investors, external advisers		

Good Practices for an Effective Board	Who else is involved?	Is practice being followed? (Yes/No/NA)	Comments/Follow-up actions
Ultimate responsibility for preparing financial statements and for the selection of suitable accounting policies is with the board. Advice may be sought from the external auditors, but these responsibilities cannot be 'delegated' to the auditors	External auditors		
The board plays its part in debates with regulators on matters which concern the corporate community	Regulators		
Directors keep abreast of developments in regulation which may affect the business (including legal, fiscal, financial, employment, environmental, consumer and other industry-specific regulation)	Regulators		

Other Publications

The following companion volumes on corporate governance are available from your nearest PricewaterhouseCoopers office:

Audit Committees – Good Practices for Meeting Market Expectations

Reporting Progress – Good Practices for Meeting Market Expectations

World Watch – Periodic newsletter on Governance and Corporate Reporting

In addition, the following series of publications on International Accounting Standards has been published by PricewaterhouseCoopers:

IAS – A Pocket Guide

IAS – Similarities and Differences – IAS, US GAAP and UK GAAP

IAS – Illustrative Corporate Financial Statements

IAS – Illustrative Bank Financial Statements

IAS – Disclosure Checklist

IAS – Applying IAS 12 (Income Taxes) in Practice

IAS – Financial Reporting in Hyperinflationary Economies – Understanding IAS 29

IAS – Applying IAS 34 (Interim Financial Reporting) in Practice

IAS – Financial Instruments – Understanding IAS 39

Understanding IAS – Analysis and Interpretation of International Accounting Standards

Making the Change to International Accounting Standards

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