Proxy power

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Elizabeth Saunders, Americas Chairman of the Strategic Communications Practice, FTI Consulting

Improving board effectiveness

‘At its most fundamental, the board should see their role as defining the purpose of the business, and then ensuring that purpose is fulfilled.’

Belden Menkus, Director, MenKus & Associates

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Executive remuneration continues to be a hot topic. The shareholder vote against Sir Martin Sorrell was just the latest example that shareholders are taking an increasingly stance on what they consider to be excessive remuneration.

In this issue, Harry Chetwynd-Talbot argues that the so-called Shareholder Spring is not just about remuneration but is symptomatic of two deeper and more serious issues around boards’ communication with their shareholders and the actual composition of boards.

Boards which do engage with their shareholders and take the time and trouble to explain the reasoning behind the remuneration packages (and indeed any other major strategic decisions) and listen to and address any concerns the shareholders may have will usually be rewarded with the shareholders’ support. An open article in the Financial Times a week before the Annual General Meeting does not constitute serious engagement.

Moving onto board composition, the report covered on page 4, from the Equality and Human Rights Commission and Cranfield School of Management, looks at the current practices of the executive search firms and suggests ways they could help to make boards more gender diverse as well as making the whole board appointment process more transparent and inclusive.

One of the arguments against having more women on boards is that there simply aren’t enough women in the pipeline.

At a high-level meeting on 19 June between the chairs of Europe’s industrial and employee associations, the Deans of Europe’s leading business schools and senior executive women, European Commission Vice-President Viviane Reding launched a list of more than 7,000 women throughout Europe, the US and India who have been selected as being suitable for board level posts on the basis of a publicly available list of criteria.¹

With an increasing call, in Europe at least, for diversity quotas, if companies want to avoid having quotas imposed upon them the ball is now well and truly in their court (not to mention the executive search firms who serve them).

Executive remuneration proposals

Remuneration continues to be a controversial topic as shareholders become increasingly hostile to big rewards for directors in companies whose shares are flagging. Hermes Equity Ownership Services has published a discussion paper, Proposed Reforms to UK Executive Remuneration, which proposes reforms aimed primarily at larger publicly-listed companies.

Longer-term alignment to owners

Alignment can be best achieved by long-term share ownership and incentives. With this type of model, remuneration committees award an annual cash bonus together with shares that must be owned for the long-term dependent on the achievement of personal and company objectives. Measures could include:

- All pay rises and a minimum of 50 per cent of bonuses after tax should be deferred into shares.
- All fixed pay of executive committee members and executive directors above the average paid to the executive committee members should be paid in shares.
- Twelve months following resignation as a ‘good leaver’, consultant or director the individual would be able to sell one third of their stake in each successive 12-month period, the first sale permissible on the first anniversary of leaving.
- For a ‘bad leaver’, shares that are not clawed back should be transferable no more frequently than in ten equal annual instalments commencing on the first anniversary of departure.
- During both employment and the periods after employment described, disclosure obligations over any lending secured by the shares would remain together with a comprehensive ban on using derivatives to hedge their ownership position.
- Dividends to be retained by the individual.

Quantum

Fixed pay for directors and senior management should rise by no more than the average awarded to the rest of the organisation. Remuneration committees should consider paying senior executives in shares to increase alignment with the owners.

Often too much account is taken of ‘market forces’ in awarding pay, particularly in large companies. Remuneration committees need to question whether executives who demand greater rewards are the right people and whether they are more concerned about shorter term pay than the long-term success of the company.

Transparency and disclosure

Hermes EOS believes that executive pay has become too complex and the proposal is to make a significant change to current practice based on a simple premise: owners invest their capital for the long-term in companies and that capital should earn a return. Companies should consult on remuneration more widely and they should engage with their most important shareholders at an earlier stage. Companies should actively explain to the company’s employees how and why the executive remuneration is aligned to the strategy and culture of the company.

Pay ratios

Pay principles should be cascaded through the organisation, leading from the top. Companies should use pay ratios to justify and explain remuneration strategies: the company’s intention can be better understood by the publication of the ratio between the executive directors’ fixed pay (including all benefits, including pension) and that of the average employee together with the intended multiple for the future (maybe three, five and seven years ahead).

Binding votes and disclosure

Any binding vote should encourage engagement, though shareholders may be less likely to use a power if it is a mandatory power. Most remuneration committees currently take account of substantial expressions of disapproval falling short of majority opposition to their remuneration reports. With a binding vote, this may switch to concern only for majority support.

Significant reform on pay can be achieved by long-term share owners engaging with remuneration committees to ensure that pay policy and practice is aligned properly to their long-term interests. The proposals encourage remuneration committees to use the remuneration report and any shareholder communications to explain the remuneration practice and policy of the company and how it is aligned to achieving the strategy and to the interests of the company’s owners.

Role of nomination and remuneration committees

Nomination and remuneration committees must be tougher on enforcing the discipline encouraged by the proposals. They should ensure that succession plans are high on the agenda and consider how best to recruit, motivate and retain the executive directors and top management, using other tools as well as pay: pay for performance is not always the best motivator.

The ultimate success of companies will be influenced by boards and their remuneration committees addressing executive remuneration. This will help to reconnect these companies with their employees, customers and other stakeholders to provide the basis on which long-term success can be promoted for the benefit of their owners. Hopefully similar discussions on pay will take place in smaller quoted companies.

To see the full discussion paper go to www.icsaglobal.com/assets/files/Hermes-Pay%20discussion%20document%202012.pdf
The board appointment process remains opaque and subjective, being driven by male-dominated corporate elites who tend to favour those with similar characteristics to themselves, according to a report produced by Cranfield School of Management, International Centre for Women Leaders for the Equality and Human Rights Commission.

The report, Gender Diversity on Boards: The Appointment Process and the Role of Executive Search Firms, examines the role played by executive search firms (ESFs) and on what is being done to make boards more gender balanced in the light of the 2011 Davies Review. The report also contains recommendations on how ESFs and other stakeholders could make the board appointment process more inclusive.

Key findings

- Non-executive director (NED) appointments are still informed by how much candidates ‘fit’ with the values, norms and behaviours of existing board members.
- ESFs assess candidates not only on their suitability for the role because of their skills, but also on the subjective judgements of how they fit in with the current board. With male-dominated corporate boards female candidates are likely to be disadvantaged by this.
- There is a greater awareness of the importance of gender diversity on boards within companies and among their clients and good practices are emerging. However, there are still shortcomings in practices employed by ESFs and other stakeholders in the appointment process.
- Good practices among the ESFs interviewed were grouped around six key aspects:
  1. Proactively putting diversity on the agenda in the appointment process.
  2. Challenging chairmen and nomination committees when defining the brief, so that more importance is given to underlying competencies as opposed to prior experience.
  3. Finding creative ways to expand the talent pool and reach out to female candidates.
  4. Ensuring female representation on both the long lists and short lists.
  5. Supporting female candidates throughout the appointment process by taking on developmental and advocacy roles.
  6. Supporting chairmen in handling resistance to female candidates from other board members.

Recommendations

The report puts forward a number of recommendations.

- More transparency and documenting of best practice and initiatives around gender diversity by ESFs are needed, both internally by formalising and documenting best practice and externally through discussing diversity initiatives with the media, or through coverage on the company website.
- There needs to be a clearer definition of the term ‘intrinsics’, used in the Voluntary Search Code. There is a lack of consensus among search consultants when assessing candidates as to what exactly is sought beyond experience: Chairmen and nomination committees need to shift the emphasis from prior experience to underlying competencies.
- ESFs, chairmen and nomination committees need to pay close attention to interviewing practices: more transparency, rigour and professionalism is needed. Some appointment processes are focused on subjective aspects such as fit and personal chemistry.
- ESFs need to invest more time into engaging with women throughout the pipeline and developing relationships which are deeper and focus on the longer-term potential of placing women in NED roles.
- ESFs and chairmen need to be more willing to take on developmental roles during the appointment process and beyond, providing more guidance and mentoring to female candidates and, once appointed, more attention needs to be given to induction.
- Although it is early days for the Voluntary Search Code, there are on-going gendered behaviours, judgements and language amongst ESFs. This reinforces the importance of carrying out regular reviews of the Code and its impact, whether driving change or highlighting the need for stronger measures.
- Investors need to play a bigger role by putting pressure on companies to have gender-balanced boards.
- Board openings need to be publicly advertised in order to increase the transparency of the appointment process.
- There needs to be more emphasis on having women in executive roles. Several ESFs argued that companies should support women’s careers in order to ensure that sufficient women come through at the top of their executive ranks.
- ESFs need to carry out regular reviews of the effectiveness of the voluntary code of conduct.

Whilst the Voluntary Search Code is a good first step towards addressing the issue of gender diversity in the executive search sector, the Code is open to improvement and diversity practices across the search sector need to be more visible. There are certainly opportunities for ESFs, chairmen and corporate stakeholders in the appointment process to take on a more active role in making the board appointment process more gender-inclusive.

To see the full report go to: www.equalityhumanrights.com/uploaded_files/research/r85_final.pdf
Proxy power

‘Shareholders increasingly want to hold management teams and boards of directors accountable for corporate performance and plan to use their proxy votes as a referendum on leadership, business performance, corporate governance, and shareholder engagement,’ according to the second annual Corporate Governance Investor Survey from FTI Consulting, Shareholder Voice Growing Louder in the Boardroom. The survey was carried out amongst 143 portfolio managers and analysts from 134 different companies in the US and Canada in January 2012.

Commenting on the survey report, Elizabeth Saunders, Americas Chairman of the Strategic Communications Practice at FTI Consulting said: ‘Historically, shareholder involvement into boardroom affairs has been reserved for activist investors. But increasingly, we are seeing that the investment community at large wants to have the levers to hold executive leadership accountable for performance and corporate practices’.

Key findings

- Executive compensation is still a critical topic for investors, even more so than in 2011.
- Director independence and separation of chairman and CEO role are vital; investors are also focused on director qualifications and access to the chairman.
- The trend toward greater shareholder involvement in corporate affairs continues.
- Other emerging issues in corporate governance have reasonably strong support:
  - ability to call a special meeting
  - political contributions
  - act by written consent.
- Decision-making on proxy matters is mostly independent and fairly balanced between Portfolio Managers and Legal/Compliance.
- Respondents are more likely to engage a company over company concerns in private (64 per cent) rather than in public (18 per cent).

Say-on-pay

Executive pay continues to be at the forefront, with 81 per cent of respondents indicating that executive compensation is very important to them, compared with 54 per cent last year. Additionally, 55 per cent of respondents said they plan to scrutinise executive compensation more rigorously this year compared to last year and that executive compensation may present problems for companies this year.

Over half the survey respondents indicated that opposition of greater than 20 per cent to a company’s say-on-pay vote mandates a corporate response and management and board members should start evaluating pay practices and preparing a response to shareholder concerns well before the 30 per cent opposition hurdle that some proxy advisors are advocating.

Eighty-five per cent of respondents said they would withhold votes for, or vote against, directors of a company that did not adequately respond to shareholder dissatisfaction expressed in a prior year’s say-on-pay vote. Seventy-two per cent of investors indicated they would consider submitting or supporting shareholder proposals that push for meaningful change to compensation structures should a company fail to redress dissatisfaction with pay practices.

Director independence

Ninety-four per cent of respondents indicated director independence was at least very important to corporate governance and 85 per cent thought having a policy regarding director re-elections was at least very important. Companies must show that their directors are competent, informed, engaged, contribute value to the business and are willing to protect the company. Eighty-six per cent think that it is very important to have director re-election policies in place.

The separation of the chair and CEO roles remains an important topic in corporate governance circles and a high priority. Sixty-one per cent of investors think it is essential to separate the roles of chair and CEO. Additionally, investors want, and expect, access to the chair, with 94 per cent of respondents agreeing that the chair should be accessible to shareholders in some way.

Emerging governance issues

Those investors surveyed indicated strong interest in influencing the affairs of the organisation, including using mechanisms that enable them to implement change at their portfolio companies when they are dissatisfied with performance, executive compensation or stewardship. The survey suggests that the following emerging issues will be of interest to institutional investors and proxy advisory firms in 2012:

- ability to call a special shareholder meeting;
- act by written consent: a critical mass (80 per cent) thinks 5–15 per cent is enough ownership to act by written consent or to call a special meeting;
- corporate political contributions (71 per cent consider this important);
- corporate social responsibility – though, whilst growing in importance, this does not seem to be a critical issue yet for mainstream investors.

As executive compensation and corporate practices continue to make headlines, investors are increasingly looking at the upcoming annual general meeting season as an opportunity to express their approval or disapproval of executive leadership. They are also demanding more influence over the corporate affairs of their portfolio holdings and using more of the tools at their disposal to ensure their views are heard.

FTI is a global business advisory firm. For more information about the survey, including the methodology and access to the complete findings and white paper, go to: www.fticorporategovernance.com
Global News

Governance of State-Owned Enterprises in the Baltic States

There is considerable public dissatisfaction with State-Owned Enterprises (SOE) governance and SOE performance in the Baltic region. Many SOEs are still far removed from good practice, much less best practice. The Baltic Institute of Corporate Governance has recently launched the latest in a series intended to build a deeper understanding of how governance works in the Baltic States and to develop suggestions for how to implement world class governance standards in the Baltic region.

The report, Governance of State-Owned Enterprises in the Baltic States, ranks the governance practices of SOEs and compares SOEs internationally. It comprises four interlinked aspects of SOE governance:

1. public perceptions – the public’s perceptions of the State’s performance in governing SOEs and the public’s perceptions of SOEs themselves;
2. individual SOE rankings – identifying those SOEs in the Baltic region that have the best and worst governance practices, and highlighting both strengths and areas that require attention and improvement;
3. an examination of board structures – shows the individuals who govern SOEs on the State’s behalf and reveals inter-locking boards, potential conflicts of interest and board capacity problems;
4. an analysis of the legal and institutional framework – the legal framework in the individual Baltic States, identifies where there are gaps with best practice and gaps in implementing the legal framework.

The Appendices include valuable additional data: in particular, they include public perceptions of the governance of individual SOEs, information on the backgrounds of board members, and a detailed analysis of the legal framework for SOE governance in each of the Baltic countries.

Together they represent one of the most far-reaching and thorough attempts to describe and analyse SOE governance in the Baltic region. It is hoped that this report will provide food for thought, fuel for debate and keep the issue of SOE governance in the spotlight.

To see the full report go to: www.corporategovernance.lt/uploads/docs/Governance%20of%20State-owned%20Enterprises%20in%20the%20Baltic%20States.pdf

Boardroom conversations

Tomorrow’s Company, the agenda-setting ‘think and do’ tank, has brought out a Boardroom Guide, Tomorrow’s Corporate Governance: improving the quality of boardroom conversations. Drawing on the experience of the Good Governance Forum and the findings of a survey of FTSE 350 board members facilitated by Korn/Ferry and KPMG, the Guide focuses on the importance of boardroom conversation in underpinning board effectiveness and considers ways in which boards strive to get the very best from the skills and abilities around the board table.

Of those surveyed, only 54 per cent of respondents felt that the boards on which they serve really leverage their experience and knowledge to maximum advantage and only 60 per cent felt their contribution was valued by the chair. Only 39 per cent of respondents said that boards often discuss ways to improve the quality of interaction and debate and the majority felt the board had a single, consistent style of interaction and debate.

The following drivers of ineffective conversations were identified:

- dominant personalities/groups of people among the board members (79 per cent);
- inappropriate allocation of time at board meetings to matters requiring discussion or debate (52 per cent);
- lack of preparation by board members and other attendees in advance of board meetings (50 per cent);
- unhelpful manner of presenting information to the board (46 per cent).

The most effective boards take the time to reflect on, learn from and continually improve the quality of their conversations. They acknowledge that there is always room for improvement and a need to challenge themselves. Not only does the board need a full set of relevant industry and business knowledge experts, it also needs a full set of psychological types, ranging from those who are not afraid to point out when things are going wrong to consensus builders.

Getting the maximum value from each member of the board depends on improving the quality of board interaction and team dynamic, both of which rely on the quality of the boardroom conversations.

Good boards need to:

- Trust each other and the team as a whole.
- Have clearly defined roles and responsibilities.
- Understand and appreciate each other’s perspectives, diversity of experience and background.
- Communicate openly and clearly.
- Promote and manage healthy conflict.
- Have complementary skill sets and interchangeable skills.
- Have an overall team culture that is open, transparent, positive, future-focused and able to deliver success.
- Have a participative leadership style that involves and engages team members.

To download the Guide and the toolkit that supports the guide go to: www.forceforgood.com/Articles/Improving-the-quality-of-boardroom-conversations-618/1.aspx
Shareholder Spring

This year’s AGM season has been tumultuous, with shareholders up in arms against what they see as excessive corporate pay, which has cost a number of FTSE CEOs their positions and seen some high-profile remuneration committee (RemCo) chairmen severely criticised. Yet amid the hue and cry of this ‘Shareholder Spring’, it is probably time to take stock and reflect whether there are wider factors at work.

While the developments have been dramatic, the rebellions, we believe, are more likely to be a symptom of two deeper and more serious issues: a lack of attention/co-ordination in boards’ relationships with their shareholders and flawed board composition.

Let’s take shareholder communication first. Certainly shareholders do have reason to be dissatisfied. According to research by shareholder adviser Manifest, last year the salaries of 60 per cent of FTSE 100 companies rose 11 per cent while the value of the index as a whole fell 6.6 per cent. Between 1999 and 2010 the median pay package of a FTSE 100 chief rose annually by an average 13.6 per cent, against a market average of 1.7 per cent.

However, those institutions that take the trouble to treat their shareholders seriously and engage properly will benefit. HSBC, for example, garnered 89.8 per cent support for its pay report and last year 81.3 per cent backed the report. This reflected the fact that in 2011 the remuneration strategy was patiently worked out in meetings and discussions with shareholders. That led to HSBC’s chief executive Stuart Gulliver taking just 57.5 per cent of his total bonus for the year.

In such an approach lies the way forward. The key for companies must be to put together credible boards, which communicate effectively with shareholders and have strong, non-partisan RemCos.

Boards need to recognise that we are in a new era of transparency and that there is an inexorable shift toward greater shareholder involvement in governance matters, partly driven by the low-growth economy and partly by the greater scrutiny prompted by the huge corporate/financial failures of the past five years. Boards need to ensure they have the new skills required to communicate constructively with shareholders and view activist shareholders as partners to be engaged rather than investors to avoid.

Boards should take the same approach with executive pay as they do when they decide to invest in growth rather than say pay dividends or engage in stock buybacks: they explain the reasoning behind their approach.

It is always difficult for boards to examine themselves and identify gaps in their approach or skills, so it would be useful if say board evaluations included as key metric, assessments on how well boards were communicating with shareholders.

Board and RemCo composition is the second key issue. Again there is cause for complaint. The High Pay Centre, a think tank on remuneration, pointed in April to a lack of diversity on company pay committees. In a study entitled ‘The New Closed Shop: Who’s Deciding on Pay?’, the research group found that, of the 366 members of FTSE 100 RemCos, 90 per cent were executives themselves or financial advisers. Nearly half of the committee members were current or former chief executives, and nine per cent were currently FTSE 100 chiefs. Add to this that 26 FTSE 100 non-executives are on the RemCos of more than one FTSE 100 company – and two of them are on three and the need for change is clear.

Taking non hyphen executive directors from a broader range of sources could assist in this process of board and RemCo renewal. The broader initiative to see more women on boards/RemCos, which perhaps so far has only been window dressing, could help.

Though several of the RemCo members criticised this spring have been women, research indicates that women are more restrained in their pay demands and outlook on remuneration. Currently, just 16 per cent of FTSE 100 RemCo members are women.

Other sources should also be considered, such as academia, public bodies, law firms, think tanks, to help enrich and enliven the process of setting board level executive pay and hopefully come up with more palatable proposals.

Boards would do well to act. Suggestions by the Coalition Government that there should be binding votes on remuneration packages are not likely to be carried, but the message is clear if the private sector does not take a close hard look at itself, Government will. A far better outcome from this ‘Shareholder Spring’, would be for boards to acknowledge that their investors do have a point and reform themselves rather than let others drive the agenda.

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Feature

Improving board effectiveness

Belden Menkus says that, to become more effective, boards need to move beyond ‘comply or explain’ to re-think their role and to change the way they work.

There’s a general pattern to how boards work – and that pattern isn’t working. Here are a few worrying statistics:

- In a recent McKinsey survey¹, only 21 per cent of board members claimed to have a complete understanding of their company’s current strategy, and 22 per cent admitted having limited or no understanding. In the same survey, 44 per cent of board members said their role in strategy was to ‘review and approve’ the strategy management proposed – rather than develop it with management or develop it, and then have management implement it. If strategy sets the direction, it seems many directors aren’t directing.

- In a similar McKinsey survey from 2008², 53 per cent of respondents said they wanted to spend more time on strategy (24 per cent of board meeting time) and 53 per cent also said they wanted to spend more time on talent management (11 per cent of time). Results in the most recent survey: 23 per cent of time spent on strategy, ten per cent on talent management. No change.

- In PWC’s Annual Corporate Director Survey³, for every year from 2004 to 2011, between 56 per cent and 68 per cent of respondents said they would like their board to spend more time on Strategic Planning. Again, no real change.

These problems have been recognised and suggestions for improvement made (increase diversity, spend more time on strategy). Many of these have been on the table for some time, yet haven’t made much difference. Why is that? Given the calibre of most board members, this lack of progress isn’t due to a lack of talent, hard work or desire to improve. But, are there opportunities that have been overlooked? I think there are four areas worth exploring.

The first area: the role of the board in defining, strengthening, and renewing the purpose of the business they are directing. Boards too often ignore the question of purpose, or adopt a simplistic and inadequate ‘we’re here to earn a return for our shareholders’ point of view. At one level that is a truthful statement, but at a deeper level it is about as true as the statement that the purpose of a human being is to breathe in and out. One has to breathe. It has to be done; but surely life is about more than that. Similarly for businesses.

Today, it’s critical to have a clear, compelling organisational purpose. In the face of increasing complexity, uncertainty, and pace it’s ever more important that a large proportion of the employees of a business see what they are doing as more than ‘just a job, a way to make money’. Even more so for line managers and senior leadership.

Call it engagement, call it commitment, call it mindfulness. Call it whatever you like – the degree of attention, effort, and courage needed to be successful in today’s world will come from employees who see a connection between what they do day to day and a bigger purpose they find compelling. Put differently, the only people who get out of bed in the morning for ‘shareholder value’ are those with rich stock option plans.

As a result, the question of the purpose of the business is one that should be explicitly considered by the whole board, as the key underpinning for the strategy. At its most fundamental, the board should see their role as defining the purpose of the business, and then ensuring that purpose is fulfilled.

The second area: the stance of the board towards how the strategy gets set. The widespread adoption of ICSAs generally very good guidelines about ‘Matters Reserved for the Board’ includes ‘approve the strategy’. While meant to ensure that management doesn’t just head off on its own, in practice it often means that there is insufficient engagement by the board with key strategic issues.

Instead of participating in a meaningful exploration of the strategic situation a business is in – and the options it faces – boards are too often presented with a finished strategy and then have three choices: approve, challenge, or reject. Faced with the somewhat extreme option of outright rejecting a proposed strategy, boards are too often willing to ‘approve’ what has been served up – with a bit of ‘challenge’ before doing so. This can lead to ‘they asked a few questions, but they’ll approve it next time’. The bottom line: what was intended to be a minimum standard has too often become a limitation.

Non-executives should insist on being substantially involved in strategy development. In today’s highly unpredictable and rapidly changing world, it’s somewhere between difficult and impossible to make reliable predictions. It’s therefore equally
difficult to determine the ‘best’ strategy purely by an analytical approach. Instead, what is needed is a combination of logic, experience, intuition, creativity, and judgement. One would hope that the management team has that in abundance.

But, surely the directors bring a large portion too. They can limit themselves to ‘approval’ or they can demand a strategy development process that gives them adequate and appropriate scope to make a meaningful contribution well before the strategy is complete.

The third area: the rhythm and content of board meetings. Many boards have a roughly monthly rhythm of meetings, with perhaps an annual strategy away day. It’s not surprising that so much board time gets devoted to execution and performance management issues, and so little to strategy and longer-term talent development. Every month there’s lots of new information to discuss about operational topics, but perhaps not that much about strategic issues.

Yet, in today’s world, looking at things like strategy and talent only once a year can be a bit too infrequent. Paradoxically, even though there might not be all that much new information of strategic importance each month, it is often subtle and ambiguous, where the external perspective (and potentially more objective view) of NEDs can be invaluable.

Perhaps what’s needed is one board meeting every quarter (maybe over two or even three days), to consider important developments and fine-tune strategic priorities, with an extended meeting annually to allow for a complete refresh of the strategy. In between each board session, management would have about 13 weeks to get things done – and could provide the board with information weekly on key financial results or other topics that need to be monitored by the board more often than quarterly.

The fourth, and perhaps most important, area: the nature of the interaction between NEDs and the executive (board and non-board). It tends to have a (politely) adversarial feel. Executives could look to their board members as a source of support and guidance, as well as way to test their thinking and plans: reducing risk and improving decision-making. While many executives might like to have this sort of relationship, they generally don’t.

Executives too often view NEDs as at best a minor annoyance, at worst an obstacle. ‘We have to get their approval, but make sure they don’t delay or derail things.’ In order to achieve this, executives often engage with non-executives in a formal, ‘bullet-proofed’, almost ritualised way: they carefully present facts, analysis, options and plans so as to make it hard for non-executives to challenge. As a result, NEDs too often struggle to fully contribute their depth of experience and their disinterested and alternative points of view. That can mean important issues don’t get discussed until they have become unavoidable – in other words, too late.

NED behaviour does have an impact on this – and many effective non-executives take the time to ensure they have contact with the business and with executives outside the boardroom. However, a different place to look for improvement is to change the nature of board meetings: to make them less formal, to replace the ‘board table’, to move away from an item by item cycle of ‘presentation, Q&A, discussion, decision’, and to use different meeting facilitation techniques that foster more open dialogue and real debate.

For each of these four areas, many boards are making or have made improvements. There might even be some patterns across various firms that could be called out as ‘best practice’. But, what’s mostly needed isn’t yet more guidelines and more codes. What’s needed is for boards, and particularly non-executives, to insist on a higher standard of meaningful engagement – and then to find specific ways to make that work for them.

While some of the suggested changes may seem a bit uncomfortable at first, they are worth trying as a way to prepare a board for the increasing challenges ahead. The combination of alignment around a clear and compelling purpose for the business, a much more engaged NED role in strategy creation, more time to consider subtle strategic topics, and a new context for board conversations should allow a board to be much more effective in guiding and directing their business towards success.

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Indian corporate boards

Mariam Ahmed and Pratibha Kurnool discuss the current state of corporate governance in India and argue that culture and composition are hindering the effectiveness of Indian corporate boards.

Corporate governance in India has evolved significantly since the country liberalised its economy in 1991. The need to attract foreign capital necessitated adherence to globally accepted corporate governance standards, even among the many erstwhile family-run Indian business houses. Subsequently, increasing complexities in business performance recording and reporting, coupled with the expanding global footprint of Indian companies prompted the need for building a regulatory framework for corporate governance. The establishment of the Securities and Exchange Board of India (SEBI) enabled setting down some ground-rules for corporate governance. For example, Clause 49 of the Listing Agreement of SEBI lays down mandatory codes regarding the board structure and composition.

Overall, Indian corporate boards are diligent in complying with statutory norms and codes prescribed by the SEBI. But do these boards go beyond statutory compliances to protect shareholders’ interests? This article explores the current practices and highlights what influences board effectiveness in India. References are made to the India Board Report (IBR) 2011 to provide on-the-ground insights.

Recent events signal the need for stronger governance practices

Corporate India has been tormented by bankruptcies and frauds time and again. Recent events relating to accounting anomalies and inadequate risk management have raised questions about the effectiveness of corporate governance practices, and the effectiveness of boards in raising timely warning signals. For example, inefficient cash flow management and an over-leveraged balance sheet resulted in the recent bankruptcy of a leading airline carrier. Another incident involved the embezzlement of funds of a leading global sportswear brand by its top executives, shaking shareholders’ trust in the corporate governance mechanism. The IBR survey reveals some disconcerting truths about the state of corporate governance in India. Independent directors themselves are sceptical about the effectiveness of their boards. And despite awareness, the practice of evaluating effectiveness of boards is not common.

Interactions with independent directors and company secretaries from the boards of India’s top companies lead us to believe that the problem lies in the composition and work culture of Indian boards.

Board composition

Separation of CEO and chairperson positions not common in India

The Ministry of Corporate Affairs (MCA) in 2009 laid down the guidelines for separating the position of CEO and chairman/chairperson. However, the guidelines being voluntary, have not been adopted across all organisations. According to the IBR’s survey findings, nearly 45 per cent of Indian companies still have the same person occupying the CEO’s and the chairman’s post. In comparison, in the UK 79 per cent of companies have a separate person chairing these two positions [Millstein Center for Corporate Governance and Performance (Yale School of Management), 2009].

Friends on board – easy for compliance but detrimental to effectiveness

Composition of boards has been under the scanner on account of anomalies in the selection process of independent directors. The IBR survey highlights that despite having a formal process for selection, independent directors are chosen only from a set of known people (ie personal networks of chairpersons/CEOs/other board members). A friendly board is highly unlikely to appraise management decisions objectively. Interestingly, the IBR shows that while 38 per cent of boards have advocated increasing diversity, implementation issues persist. For instance, only nine per cent of corporate boards use formal channels such as executive search firms for identifying the right candidate. In comparison, more than 50 per cent of firms in the US and UK use this channel for selection of corporate boards. Broadening search horizons can contribute significantly to increasing diversity, in terms of skills and capabilities, as well as gender and nationality, and consequently make a board more effective.
Board culture

**Majority of corporate boards rely on management views**

Boards often, or rather always, rely on management reports for discussions with the management about the company’s performance or future direction. IBR 2011 findings reveal that 77 per cent of boards rely on management reports for reviewing business performance. Such reports have a high probability of being biased towards the top management’s views and may shield discrepancies or questionable actions from the board. In such a scenario, unbiased third-party reports including commentaries by industry experts, and reports issued by investment and broking houses can prove ideal. However, only 23 per cent of boards consider such reports for monitoring business performance.

A rising number of board memberships is also a cause of concern. On an average, board chairpersons and non-executive directors are members of around ten and seven external boards respectively. This number has increased significantly since 2006–07, particularly for chairpersons. The increase in the number of board memberships leaves directors with very little time to review documents of each company.

**Boards are less inclined to evaluate their own performance**

Given the growing qualms about the role of corporate governance in an organisation, it is imperative for boards to evaluate their own effectiveness. However, according to the findings of the survey, over 60 per cent of boards rarely or never assess their performance. In the rare event when performance is assessed, it is mostly an informal self-evaluation. Sixty-eight per cent of boards perform an informal self-evaluation, while only 11 per cent hire an external consultant or advisor.

A Confederation of Indian Industry (CII) task force on corporate governance in 2009 recommended the establishment of a nomination committee, which would be responsible for the selection and evaluation of board members. Surprisingly, only 18 per cent of companies surveyed had established a nomination committee, and only five per cent evaluated their board’s performance with the help of a nomination committee. This is despite the fact that 60 per cent of the independent directors surveyed believed that regular evaluations would improve board effectiveness. This is in stark contrast to practices in the US or UK, where it is mandatory for boards of listed organisations to undergo an annual evaluation. Assessment is not restricted to the entire board, but also involves an evaluation of individual independent directors as well.

**Effective evaluation and more proactivity are essential for Indian boards**

Assessments facilitated by an external consultant/adviser are extremely suitable for providing unbiased evaluations. Nomination committees are also capable of playing a crucial role in improving board effectiveness. They can be instrumental in changing the composition and increasing the diversity of boards by introducing a more formal structure of selection of directors.

Critics of corporate governance are not the only ones who harbour these opinions. Majority of directors are beginning to believe that board members are effective in terms of statutory compliance and performance monitoring. But in the case of guiding compensation structure, setting objectives for the CEO/MD and reviewing their performance, or guiding shareholder information, board members perceive themselves to be ineffective. However, as the IBR 2011 survey reveals, there is a general consensus and willingness to bring about transformation.

Empirical research has found strong positive links between governance and board effectiveness. With stakeholder pressure on companies mounting globally on sound and transparent governance practices, it is but logical that Indian
companies will be forced to follow suit. However, what is really required is an adherence to substance over form, ensuring that spirit is maintained and practices are not looked at in an isolated way.

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