Global Board Practices Show Evidence of Evolution

Dan Konigsburg, Deloitte Global Center for Corporate Governance, Deloitte Touche Tohmatsu Ltd.

Boards of directors in many places around the world are undergoing substantial change. Given challenges in the global business environment, in many places the aftermath of the financial crisis has permanently changed the role of directors, and in some cases has changes their perception of where they can be most effective. With change, however, often come challenges and questions: how directors grapple with these is the subject of a large study conducted by the Deloitte Global Center for Corporate Governance in late 2012 and early 2013. The survey involved interviews with 288 directors across 19 countries, including the US, France, Mexico, South Africa, Australia and New Zealand. Among the questions the survey raised were:

- In an increasingly global marketplace, how closely should a board's composition reflect that of its stakeholders? And, how should diversity be addressed on the board? Most of the directors surveyed (47 percent) agree in principle that greater diversity enhances the board's ability to consider issues from a range of perspectives and to develop more balanced business strategies. Despite this, 34 percent of directors surveyed are reluctant to recruit directors from outside their home country (an exception is where there are fewer local director candidates).

- A more connected world influences how directors carry out their responsibilities. Fifty-three percent of directors report they make use of technology to drive boardroom efficiency. Examples include accessing documents anywhere, at any time, or quickly connecting with colleagues around the world without leaving their desks. Nearly 20 percent of all directors — from India to Australia, from Mexico to Sweden, now use iPads.

- While boards seem to use technology to better scrutinize business performance and to pay closer attention to their impact in local and global markets, some directors that expressed concern that technology might increase scrutiny by shareholders and others. The survey indicates that 76 percent of directors surveyed see the level of shareholder scrutiny increasing in the next few years. However, increased attention need not always mean negative attention. Reports of business successes hit the news faster than ever before, helping organizations to attract potential investors quicker and with less effort.

- The uncertain global economic climate continues to weigh heavily on boardroom agendas. Risk oversight remains a top priority for nearly every board and as a result, directors are focusing their oversight on organizational strategies and business operations. Risk oversight considerations remain at the forefront of business decisions with 67 percent of respondents indicating that they don't expect time devoted to risk oversight to decrease over the next couple of years. Indeed, there is concern from the other direction: that new regulations, adopted or planned, to protect investors' interests may distract boards from their agenda.

Despite the diversity among survey respondents representing 19 countries from India to Hong Kong to Europe to the Americas, it is perhaps surprising to see a broad consensus among directors across the globe. For most topics, directors agree with each other irrespective of geography. This is most likely the result of an increasingly global business environment in which regulations and stakeholders' interests tend to be more closely aligned than ever before. Where there are differing opinions, these are not necessarily reflective of different geographies, but instead they may arise from differences in the complexity of organizations' activities and structure.

This chapter will provide snapshot views of directors' opinions on a variety of specific boardroom challenges, and their perceptions on how the roles of directors will continue to evolve. This chapter presents four main themes: Board Effectiveness; Regulation and Enhanced Scrutiny; Risk Oversight and Strategy & Growth. These categories are not inviolate; there is an interplay between and among them. But they provide a useful framework for thinking about such a large and diverse group of directors.

1. BOARD EFFECTIVENESS

The bulk of questions in the survey relate to board effectiveness in one form or another. This reflects the increasing recognition that it is not the formal and externally visible structures that drive corporate governance strengths and weaknesses, but often it is the more qualitative and subjective characteristics that distinguish a strong and active board from a weak board. Some of these qualities will relate to who serves on the board and how they contribute; others will relate to the processes and technology boards use for succession planning, assessment and new director orientation. Still others will relate to the delicate and difficult-to-measure quality of the relationship between the CEO and the board chairman. Survey results show that directors in different countries have diverse approaches to many of these questions.

1.1 **Internationalization of board members**

As business becomes more global, bringing directors onto the board from outside your one's home country has become a leading practice in many places. This is another form of board diversity of course, yet it can be surprising how few companies with significant global operations or global revenues consider foreign directors.

Some of this discrepancy may be explained by the idea that international experience can be hired, or consultants can be brought in when needed, rather than adding a new director to the board. But some of this may be a desire for comfort with like-minded directors, or with a common language. When asked, only 32 percent of directors from the 19 countries surveyed agreed that this was a focus of the board. Directors in Australia, Germany, Belgium and Israeli disagreed, showing a strong preference for local directors. In contrast, smaller countries like Chile, Ireland and Finland, showed much more openness to foreign directors. When asked what challenges boards face as a result of globalization, over 19 percent of all directors responded — in the most common response to this question — by pointing to the necessity, and at times difficulty, of finding strong directors from other places to serve on the board. On the other hand, when asked what measures the board or company was taking to address the question of diversity, only one percent of respondents mentioned adding international directors.

1.2 Diversity policies, guidelines, and/or goals for board composition.

With the introduction of quotas and targets for gender diversity in many countries over the last two years, it is no surprise that this topic has reached the top of the agenda in more boardrooms. Four of the 19 countries or regions surveyed have either introduced an outright quota or have promoted targets to increase the number of women directors. Indeed, among those countries whose directors were more likely to say that their boards have introduced diversity policies or goals were France, Belgium, and Australia, each of which has either introduced a quota or target.

However, the question of boardroom diversity extends beyond gender and speaks to the question of how boards can ensure that the roster of directors is sufficiently varied that discussions can be informed and challenged by different approaches and ways of thinking. Indeed, 16 percent of all directors indicated that they are more likely to focus on the diversity of skills directors bring to the table, rather than whether directors have a particular background. A further 28 percent of directors say that they take no initiatives or few initiatives in this area.

Among specific countries, Mexico and South Africa both report over 65 percent of directors who say their boards have diversity policies, the highest among all countries surveyed. However, elsewhere the picture is less sanguine: only 47 percent of global directors agreed or agreed strongly with the question about whether the board has introduced such policies. On the other hand, majorities of directors who disagree are rare — this is found only in Chile and India. Interestingly, last year's survey asked a similar question that in retrospect may provide a window into this year's results: when asked whether increasing diversity was a focus of the board, 60 percent of global directors agreed.

1.3 Processes to evaluate board performance

Board evaluations are increasingly common around the world, yet their prevalence reflects their mainly Anglo-American origins. Countries like the U.S., South Africa, Australia, Ireland and the Philippines all report large majorities of directors who say their board evaluation process is strong. On the other hand, directors from continental Europe, the Middle East and Latin America are more likely to reserve judgment or disagree. These include Belgium, France, Israel, and Chile, where strong minorities of directors report weaknesses in their board evaluations, or say that they do not conduct these evaluations at all.

For many boards, whether they are externally facilitated or completed in-house, evaluations are an important way to ensure high levels of board effectiveness. They are often used to identify weaknesses in the mix of skills on the board — an important piece of input that the nomination committee might use as it thinks about new director nominations — or they may be used to drive changes in committee membership, chairmanship, or the way the board and the committees work together. At the end of the day, board evaluations are one of the few formal mechanisms boards use to take stock of how they are doing; over time, it is expected that more countries may adopt processes to evaluate performance, particularly those outside of the Anglo-American tradition.

1.4 Board performance assessments as a method to affect future change

Where board evaluations are in place, there is a certain ambivalence about using the results to promote change — whether this means changes in board composition, changes in the way the board engages with management, or changes in how directors provide oversight of risk or strategy. Directors recognize that using board evaluations to drive change can promote tension between the board and management if handled in the wrong way, or if management is not consulted on sensitive topics.

Across all countries, the percentage of directors that agreed or agreed strongly with this question falls just below 50 percent. This could reflect the answer from the previous question, where many directors expressed doubt about the robustness of the evaluation itself; if the process is flawed, boards will hardly be likely to put stock in the evaluation's result. On the other hand, directors from the U.S., Australia, France, New Zealand and Finland express higher degrees of confidence in using evaluation results.

1.5 Connection between the remuneration of board members and their responsibilities, efforts, and time commitment

Remuneration of board members remains very different across jurisdictions, often driven by history and cultural preferences. In many smaller countries, directors are paid a flat fee; in other countries, this fee may be supplemented by shares or stock options designed to align the interests of the director with those of the company. Shares and stock options can be controversial: some directors indicate that such practices can muddy the waters of oversight and, in the worst cases, transform directors from outsiders providing oversight to cheerleaders for management. Where these practices are common, directors often dismissed these concerns, indicating that concern over one's personal reputation will always trump the financial rewards options might bring. However they are paid, directors who spend considerable time on the board providing oversight of company operations must consider whether their own pay is appropriate, or in-line with what other companies pay their directors.

When asked, 52 percent of global directors agreed or strongly agreed that their pay was appropriate. However, a substantial minority of nearly 26 percent disagreed, perhaps indicating that director fees have not kept pace with the increased time and effort occasioned by the financial crisis. For example, a similar question asked last year (‘Remuneration of board members is appropriate’) resulted in a higher level of agreement, with over 65 percent of global directors agreeing or strongly agreeing with the proposition.

2. REGULATION AND OUTSIDE SCRUTINY

A second trend relates to the increasing amount of attention paid to company governance from investors and regulators alike. As some economies emerge from the financial crisis, investors are returning to markets and asking more questions than ever about governance structures, policies, executive pay and oversight of risk-taking. Likewise, regulators are introducing more governance rules and the OECD has announced it will update its Principles of Corporate Governance over the next year or more. Taken together, this set of circumstances presents a challenge to boards who may not be used to scrutiny and who may be overwhelmed by the spotlight. This is the second year Deloitte’s survey has highlighted such scrutiny as a pattern among responses, and there may be signs that this trend will continue.

2.1 Changes in the regulatory environment and the impact on boards

Given the introduction of significant governance regulation in the U.S. and the EU over the last two years — the Dodd Frank Act and the European Commission Green Paper on Corporate Governance are just two examples — it is no surprise that directors in almost all jurisdictions agree that their boards will be impacted by regulation. Regulators in more countries are responding to calls for increased attention to be paid to governance: from a focus on the pay practices of large banks to the introduction of board level risk committees, to changes in required disclosure to shareholders, new regulations are increasing in both scope and number in many places.

This trend is reflected in the interview results: globally, fifty-two percent of all directors surveyed agreed that the regulatory environment will affect the board, while 33 percent agreed strongly, among the highest level of strong agreement in the survey. The question of course is how boards’ focus might change, whether this will be linked with changes in strategy and risk, and whether boards will spend sufficient time considering the impact of changing regulation on their business. When asked specifically what modifications they expect in board agendas as a result of changes in the regulatory environment, directors as a whole indicated there would be minimal impact (27 percent, the most common answer), however a substantial minority of 20 percent suggested their board might be distracted from its business goals.

2.2 Increase in the level of interaction between shareholders and the board

Shareholder engagement with boards of directors has emerged as an important trend in corporate governance over the last several years. Starting in the UK, where the Financial Reporting Council introduced a Stewardship Code in 2010 to increase the quality of engagement between institutional investors and companies where they invest, more investors in the US, Canada, Australia and elsewhere have increased budgets and time for speaking with companies. For their part, boards are challenged to respond to these trends; some chairmen, in particular those based in Europe, have taken on the role of interlocutor between the board and large shareholders.

The survey found that 64 percent of global directors agreed or agreed strongly with the increased level of interaction over the next few years. Moreover, when asked whether shareholder scrutiny impacts how they interact with shareholders, a resounding 80 percent agreed, pointing to considerable interaction or impact. The results are somewhat surprising in that they show consistent agreement across jurisdictions. Shareholder engagement seems no longer to be a US and UK phenomenon; it is beginning to impact firms in Latin America, Asia and Continental Europe as well.

2.3 Increase in the level of shareholder scrutiny on corporate governance practices

Along with increased interaction, directors indicate that the level of scrutiny from shareholders is also likely to increase over the short term. When asked, nearly 76 percent of global directors agreed or agreed strongly with this prediction, while 16 percent indicate they don’t know. This may reflect anxiety over increasing levels of shareholder activism as countries emerge from the financial crisis, or it may reflect responses to increased engagement from investors that boards are already seeing. For many directors, increased scrutiny is a fact of life, indicating this is simply part of the new reality of serving on the board of a listed company. Some directors Deloitte interviewed expressed a reluctance to be imputed with a public role, and wished to serve and contribute outside of the public eye. If trends of outside scrutiny continue, less visible board service of this kind may not be possible for much longer in some places.

Directors in South Africa, Australia, Mexico, Chile, France and the Philippines report unusually high levels of agreement, while on the other hand, significant minorities of directors do not foresee increased investor scrutiny in Colombia and the Czech Republic.

2.4 High levels of potential liability imposed on directors

In some ways, the threat of director liability can be the most direct consequence of outside scrutiny. For shareholders, director liability can be seen as a useful incentive to ensure board members continue to pay attention and provide oversight of management risk-taking. On the other hand, if the threat of liability is too high, this may impact the willingness of talented people to serve on boards. This may prove particularly true in smaller markets where director networks are more tightly linked. In the Deloitte survey, a minority of directors indicated that the liability imposed on them was excessive, with only 44 percent agreeing or strongly agreeing that potential liability is too high. However, in a number of jurisdictions, individual directors have recently been found liable for breaches of fiduciary duty; director and officer liability insurance premiums are also rising in a number of geographies.

There is a noticeable split in responses — countries like Australia, Belgium, Chile, India, Israel, Mexico and South Africa all show significant majorities of surveyed directors who agreed or agreed strongly that potential liability is too high. On the other hand, a majority of directors in countries like France and Sweden disagreed. Like last year, when directors were posed a similar question, some directors indicated that heightened liability may not only make it harder to recruit talented directors, but may cast a chill over boardroom discussions.

3. OVERSIGHT OF RISK-TAKING

If there is any theme that stands out from our survey more than others as a topic that has captured the attention of directors around the world, it is how multiple factors have conspired to shine a spotlight on how directors provide oversight of risk-taking. These factors may differ from country to county, but they include regulation or the threat of regulation, outside scrutiny, internal factors like pressure from management and a desire among directors themselves to improve. Some boards have been left to themselves to figure out how to provide better oversight of risk; others have spent so much time on the topic that they feel overwhelmed. Still others have crossed the line between oversight and micro-management in their zeal for more insight and involvement. The areas discussed below represent a reasonable cross-section of some of the concerns directors continue to express in this area.

3.1 The board's role in setting the organization's risk policy.

The high level of uncertainty about the global economic environment — and the lack of visibility into how these conditions may impact companies — has elevated the role that boards play in setting risk policy. Boards are perhaps more actively involved than they once were, with 73 percent of directors stating that they are involved with risk policy-setting. And while investment in other organizational functions are, in many places, being cut back or are on hold during the downturn, many boards have continued to invest in risk management. Many companies now employ specialist risk managers, including chief risk officers, and have expanded their internal audit activities. Still, the question for many boards remains how they should be involved in risk policy setting and what being 'active' means in practice. Some directors that were interviewed pointed to their involvement in setting the company's risk appetite; others played a less direct role and simply endorsed management's proposals for risk appetite levels. When asked how they divide responsibilities with respect to risk management with management, 27 percent of respondents highlighted their approach where management reports on risk while the board oversees it.

However it is defined, 'active' involvement seems to be a universal and aspirational goal for boards. Audit committees are paying close attention to their risk management frameworks to ensure they are robust. Boards across countries were unanimous in the view that they played an active role — with Australia, Hong Kong, New Zealand, Ireland, Sweden, and the U.S. reporting particularly high levels of agreement.

3.2 The board's role in establishing the proper tone at the top of the organization.

Directors around the world continue to believe that it is their role to set the ethical tone of the firm. For many directors, serving on the board means being a 'steward' of the firm and its ethical policies. Moreover, there is often a belief that staff and others look to the board to set an example. When looked at from the perspective of risk appetite, ensuring that an organization has the right tone at the top is a cornerstone of many risk programs. Directors are in a good position to do this, as they set expectations for management about the integrity of financial reporting and create and maintain tolerances for executive action across the business. Compared to last year's results, directors are even more convinced of their role in establishing the proper tone at the top, with 90 percent in agreement or in strong agreement, compared to 80 percent last year.

Outliers to this question included directors in Colombia and Israel, where more than 10 percent of directors disagreed.

3.3 CEO succession planning by the board.

For many companies, CEO succession may represent one of the largest non-financial risks the board is responsible for overseeing. Indeed, responsible and active CEO succession planning is vital to any organization's future growth. Succession planning is often more than just finding a leader to promote continued success; leaders need to be identified, developed over time and made ready to bring the organization to the next level when the current CEO leaves or steps down.

Results from interviews with directors are unusual in that they show a noticeable split between those who agreed or strongly agreed (approximately 44 percent) and those who disagreed or strongly disagreed (approximately 33 percent) that CEO succession planning is effectively addressed by the board. This result is line with the previous year's survey, which found a similar divide (In 2011, 46 percent agreed or strongly agreed that their organization had an effective CEO and senior management success plan; 31 percent disagreed or disagreed strongly). On the other hand, some countries appear to lean more in one direction. For example, in Australia, 80 percent of directors either agreed or strongly agreed, while 70 percent and 67 percent of directors in both the United States and India, respectively, are in agreement noting that the board is effectively involved with the succession process. On the other hand, significant minorities of directors in Latin America indicate disagreement. These countries — Mexico, Chile and Colombia — have many companies where families play a large role in corporate leadership, complicating succession.

4. STRATEGY AND GROWTH

The fourth and final theme of this chapter highlights is the question of board involvement in both strategy and growth. This is a broad topic, and encompasses themes as diverse as executive compensation, the environment and sustainability, trade-offs between growth and investment, and the responsibility of the board to provide input into strategy.

Yet it is also a theme where there is more than one point of view. On strategy, the 1992 Cadbury Code in the UK argued that the board chairman should be the 'architect of corporate strategy'. However, in the US and elsewhere there remains much debate on how deeply a board should wade into the waters of strategy development. In some organizations, the CEO is so closely associated with the strategy that board questioning of the current direction is tantamount to questioning the authority of the CEO him-or herself. It is these differences that are so instructive when reviewing approaches to growth and strategy in boardrooms around the world.

4.1 Board oversight of strategic plan implementation.

As discussed above, different boards have different ideas about whether it should be actively involved in developing the strategic plan. Some managements and boards prefer the board to assume the role of endorser of corporate strategy, while other managements may frankly feel that a board that is not involved in this way has abandoned its responsibilities. Whether or not a board is actively involved in developing strategy, most boards surveyed appear to assume, as one of their key responsibilities, to check back with management on the implementation of strategic initiatives. These may relate to merger and acquisition activity, entry into new markets, new product development, or a host of other topics, but in all cases they tie back to management's proposed strategic plans.

A very high 85 percent of global directors agreed or agreed strongly that they do review these initiatives, while a few countries, including Mexico, France, Hong Kong, Israel and Belgium had a minority of directors that disagreed. When asked a deeper question -- What are the most important factors for a company in successfully executing its strategy? — responses centered on three key requirements: the need for good communication, quality of management, and periodic reporting and tracking of performance.

4.2 Board discussion with management about the organization's strategic plan and strategic objectives.

Picking up this theme of the importance of communication between the board and management in strategy discussions, many directors surveyed spoke about the need to actively discuss strategic objectives with executives. While there are differences in how deeply the board is involved — as indicated above, some boards are architects of strategy alongside management and others limit their involvement to endorsing management's strategies — most boards surveyed report active involvement and discussion.

Globally, over 88 percent of all directors agreed or strongly agreed that they engage in active discussion on strategic plans and objectives; this represents one of the highest levels of agreement in the survey. Directors in the Philippines and Mexico are more equivocal, where large minorities of directors may prefer to leave strategic discussion to management. In this sense, board involvement in strategy reveals a fascinating fault line across countries.tracking of performance.

4.3 Increasing complexity of executive compensation arrangements.

For many boards, strategy and growth are tightly connected to the incentives embedded in executive compensation programs. And in many countries, the drive to link pay with performance, and to do so in a way that considers the long and short-term, and financial and non-financial performance carries with it the danger that remuneration plans and policies become difficult to understand. Features of today's compensation plans may include short-term incentives, long-term incentives, stock options, restricted stock, stock appreciation rights, just to name a few examples. Moreover, each may have its own vesting and performance criteria. Directors have considered this and, when surveyed, 49 percent agreed or strongly agreed that arrangements are indeed too complex.

Some countries, in particular the U.S. and Continental European countries like France, Germany and Belgium, where shareholders have begun to vote on compensation policy (the so-called ‘say-on-pay’ vote), feel the strongest that plans have become complicated. Other countries, like Chile, Israel and the Czech Republic, disagree, reflecting the fact that executive pay in these countries remains, for the most part, a straightforward salary and bonus. Also of note is that far more directors agree with the complexity of compensation arrangements than last year, when asked a similar question: when asked whether ‘remuneration arrangements have become overly complex for directors and board members to thoroughly understand,’ only 26 percent of surveyed directors agreed.

4.4 Board consideration of long-term performance measures in the executive remuneration policy.

If the global financial crisis has led to any change in conventional wisdom, it is that there can be dangers when executives are incentivized to think excessively about short-term performance. According to this view, bonuses paid out based on quarterly or annual performance, particularly where these are based on a small handful of top-line measures, might contribute to volatility, or at the very least may be considered unsustainable.

The group of global directors surveyed agreed with this view; nearly 70 percent agreed or agreed strongly that they take long-term performance measures into account in compensation policy. This result seems consistent with the responses discussed above about how directors take non-financial indicators into account when assessing company performance. The sentiment is not universal, however: significant minorities of directors from places as diverse as Colombia, Ireland and the Philippines all expressed doubt about emphasis on long-term performance. Of course, it can be difficult to separate these questions from the long or short-term preferences of shareholders, many of whom are now voting on compensation policy.

4.5 Board involvement with sustainability and corporate social responsibility.

While a majority of surveyed directors (68 percent) report that sustainability questions are becoming more important to the board, many directors are more equivocal. For example, 50 percent of U.S. directors say they neither agree nor disagree that these issues are growing in importance. Moreover, last year's Director 360 survey revealed only one percent of global directors listed sustainability as one of the top three key issues on their agenda for the next 12-24 months, while this year, the number indicating sustainability as a key issue increased, but only to two percent.

Certainly, this was not the case everywhere: this year's survey shows 100 percent or nearly 100 percent of directors in the Philippines, India, France and Finland indicate this may be a defining issue for the board. And with growing pressure on sustainability from investors and stakeholders like the Global Reporting Initiative and the UN Principles for Responsible Investment, many more boards may find themselves spending more time considering the wider impact of their business.

5. ISSUES ON THE BOARDROOM AGENDA

Looking at specific issues boards are grappling with, the survey asked directors to name the three key issues on their agenda in the last 12 months and also what they saw as the three key issues on their agenda for the next 12-24 months.

For the last year, global directors point to the global financial crisis, strategy and regulation/governance/compliance as the top three issues, reflecting perhaps the lingering effects of the financial crisis on balance sheets as well as the sharp increase in regulation and outside scrutiny, one of the defining themes of this report. More surprising perhaps are the relatively low numbers of directors who selected shareholder value or investors as a key issue (4 percent); globalization (1percent); competition (2 percent) and two topics no director mentioned: innovation and diversity (both zero percent).

Looking ahead, the same three issues appear when directors are asked to identify concerns in the 1-2 years in the future. Differences appear further down the list, where the issue of growth (at 20 percent) is more than twice as popular looking forward as compared to looking backward. The same is true of topics like talent management (13 percent for the upcoming 1-2 years compared to only 7 percent over the last 12 months), and also for the topic of political uncertainty (9 percent compared to 5 percent). For innovation and diversity, these topics appear 5 percent and 2 percent, respectively, when directors are asked about the future.