Framing the future of corporate governance
Deloitte Governance Framework

For those interested in the topic of corporate governance, these are dynamic times. The events of the past decade have led to the publication of a mountain of articles and research reports focusing on different aspects of governance, such as the role of the board, executive compensation, strategic oversight, and so on. But the literature rarely considers the issues holistically, looking at the entirety of governance structures.

As a result, many boards of directors still struggle with several fundamental questions, including:

- What is the role of the board in the company's corporate governance program, and how does that differ from the role of management?
- Where should we be spending the majority of our time?
- Compliance with laws and regulations is an important starting point, but how do we position the board as a strategic partner with management?
- Exactly what should we be doing in the critical areas of oversight such as strategy and risk?
- How does the work of the committees relate to and differ from the work of the full board?

Surveys and studies of directors continue to hint at the underlying frustration felt among boards. This frustration is also shared by many executives. Most appreciate that their board is under more intense scrutiny than ever before, but they struggle with providing the board with the information it needs to execute its fiduciary responsibilities while continuing to move the organization forward. More than one CEO has asked us for help in finding the right balance, worried that their board may be suffering from "analysis paralysis."

Introducing the Deloitte Governance Framework

Designed to help ease this frustration, the Deloitte Governance Framework offers an end-to-end view of corporate governance. This Framework forms the basis for the tools that help boards and executives quickly identify potential opportunities to improve both effectiveness and efficiency.

Before we examine the potential of the Framework, it may be helpful to understand what the Framework is not.

- **It is not meant to be prescriptive**. The concepts presented here should be tailored to fit the specific circumstances of the organization. Regulatory and legal requirements will vary based on the industry, and demands may differ depending on the ownership structure and stakeholder expectations for each entity. Simply stated, there is no "one size fits all" approach for a system as complex and interconnected as corporate governance.

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- **It is not a replacement for existing models for internal governance**. Rather than replacing models such as those related to enterprise risk, compliance, and internal controls over financial reporting, the Framework seeks to connect these various models to present an integrated picture of the activities that comprise a company's governance system. Furthermore, the Framework provides a useful construct for defining the roles and responsibilities — including those related to the board — within the various models.
- **It is not a tool for assessing legal or regulatory compliance**. Within each element of governance, there are specific requirements for both management and boards. In that way, legal compliance is an element of the Framework. However, the concepts presented go beyond compliance with laws and regulations to encompass attributes of an effective governance program.

Elements of corporate governance

Underlying all the elements of the Framework is the *corporate governance infrastructure* (as depicted in the Deloitte Governance Framework, shown in Figure 1). Governance infrastructure is the aggregation of governance operating models — the people, processes, and technologies — that executive management has put in place to govern the day-to-day activities of the company, as well as the processes used to accumulate information and report it to the board and external stakeholders. This is represented by the blue band that encircles the entire Framework.

How was the Framework developed?

The Framework is the result of a three-year process that involved the input of many subject-matter specialists within Deloitte. In addition to our audit practice, professionals in a range of disciplines, such as strategic planning, executive compensation, corporate compliance, enterprise risk management, and regulatory affairs, contributed to the development of the Framework. Furthermore, our senior partners across the organization interface with boards and board committees every day — often in the most trying of circumstances. The process of developing the Framework offered the opportunity to gather the collective knowledge of these professionals and organize it in a way that provides companies and boards with a more complete picture.

With the initial versions of the Framework in hand, the Deloitte Center for Corporate Governance reached out to the governance community. We sought feedback from board members, corporate executives, lawyers, academics, and governance experts. We asked questions: What feels right about the Framework? What is missing? How can it be improved? And more fundamentally, is this something boards need?

The Framework has lived through numerous revisions, and our work is not finished. Our goal is to have this Framework continue to evolve as expectations shift and the view of organizational governance evolves.

With respect to the board's role in the operating models that comprise the *corporate governance infrastructure*, it can vary from that of an overseer to an active participant in the processes themselves. The board's responsibility for the oversight of the various elements is depicted in the Framework as a flexible overlay, with the level of the board's participation in the related operating model decreasing as you move from top to bottom. In keeping with Deloitte's Risk Intelligent Enterprise™ concepts, risk and culture are at the core of the Framework, influencing and impacting the effectiveness of all elements of governance.

Figure 1: The Deloitte Governance Framework

For some elements (depicted in the bottom half of the Framework), the board's role could be thought of as one of active monitor, with the board understanding the operating models that are in place, determining such models are adequately developed and resourced, monitoring the output and any issues identified in the process, and so forth. We consider four elements of the governance system to fall into this category for most companies — programs that provide controls over the entity's *planning, operations, reporting* (both internal and external), *compliance and risk management*[2].

The board's oversight objectives and activities within each of these elements are generally quite similar to one another, and may consist of understanding the company's operating models, considering their adequacy in the circumstances, and monitoring output. These same objectives and activities apply to the board's activities for the underlying infrastructure for each of the elements at the top of the Framework.

The top half of the Framework highlights areas of the governance system where the responsibility of the board is typically heightened. It is not generally considered sufficient for the board to merely understand and monitor the company's operating models in these areas. Either because of specific legal or regulatory requirements, or because of the increased expectations of stakeholders, the board is an active party in the process. There are a number of specific duties and decisions related to each of these governance elements that cannot be delegated to the management of the company. Recognizing that some organizations will choose to draw the line differently, the board governance elements that may typically fall into this category include *governance* (used here to refer to the board's structure and composition), *strategy, performance, integrity, talent,* and *risk governance*[1].

The board has a set of key objectives and activities for each of these governance elements, which we believe could be described as:

- **Governance**. The board establishes structures and processes to fulfill board responsibilities that consider the perspectives of investors, regulators, and management, among others. The board selects its members and leader(s) via an inclusive, independent, and thoughtful process, aligned with company strategy.
- **Strategy**. The board advises management in the development of strategic priorities and plans that align with the mission of the organization and the best interests of stakeholders, and that have an appropriate short-, mid-, and long-range focus. The board also actively monitors management's execution of approved strategic plans as well as the transparency and adequacy of internal and external communication of strategic plans.
- **Performance**. The board reviews and approves company strategy, annual operating plans, and financial plans. It also monitors management execution against established budgets as well as alignment with strategic objectives of the organization.
- **Integrity**. The board sets the ethical tenor for the company, and actively participates in programs designed to promote legal and regulatory compliance and appropriate standards of honesty, integrity, and ethics throughout the organization.
- **Talent**. The board selects, evaluates, and compensates the CEO and oversees the talent programs of the company, particularly those related to executive leadership and potential successors to the CEO. The board communicates executive compensation and succession decisions in a clear manner.
- **Risk governance**. The board understands and appropriately monitors the company's strategic, operational, financial, and compliance risk exposures, and it collaborates with management in setting risk appetite, tolerances, and alignment with strategic priorities.

To demonstrate how the board's activities for the elements of the Framework are interrelated, consider this example. Some directors believe that the single most important role the board plays is the selection of the CEO. In this way, the board is not simply overseeing a management process, but it is also leading the process itself. This demonstrates the distinction between the lower Framework elements and the upper ones. The board cannot delegate selection of the CEO to management. This is one activity considered in the *board governance* element called *talent*. However, the vast majority of talent-related decisions can be — and usually are — delegated to management. This is the *corporate governance infrastructure* that lies beneath the talent element. The board's role for the oversight of talent infrastructure, such as employee incentive and compensation plans selected by management, is that of an active monitor. The board must understand the governance operating models, their impacts, and their outputs.

[1] See "At the Core: Risk and Culture" for a further discussion of the "Risk" component of the Framework.

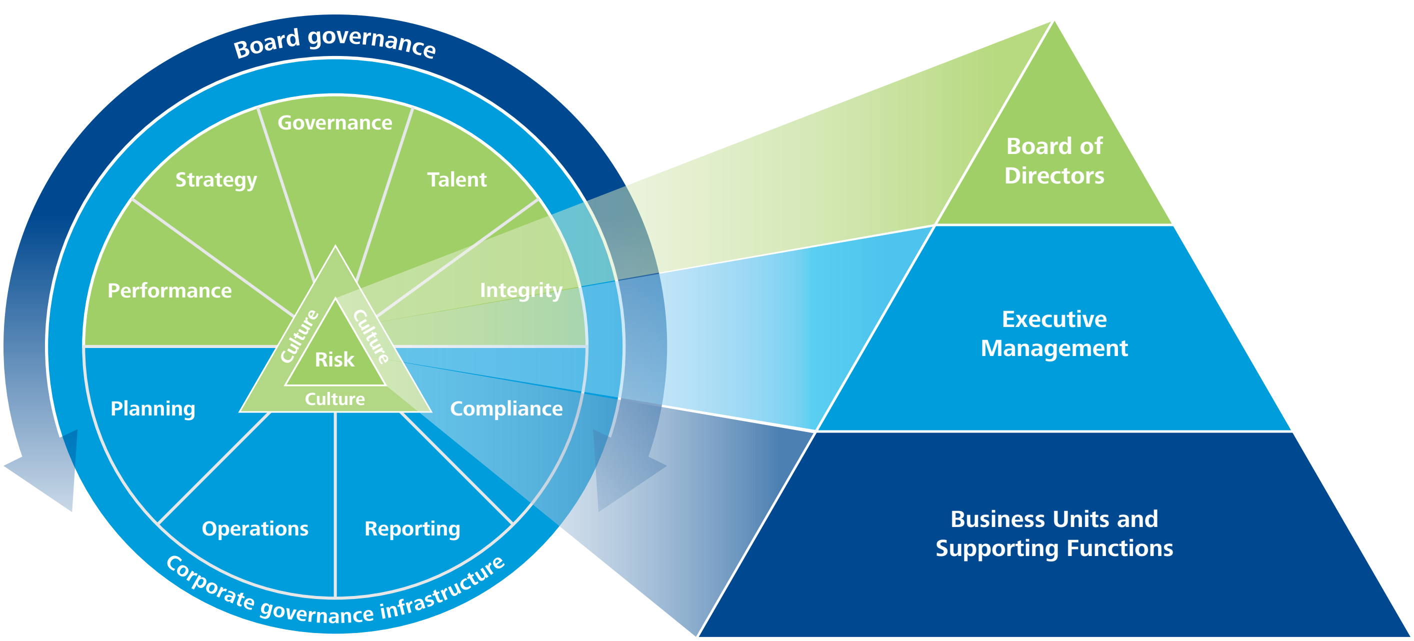
At the core: Risk and culture

The global financial crisis has sparked an active dialogue about the involvement of the board with respect to risky strategic and operational decisions made by executive management. Similarly, observers have wondered about the culture of organizations that took on significant, "bet the company" risks. In keeping with the tenets of the Deloitte Risk Intelligence methodologies, the oversight of risk and culture form the core of the Deloitte Governance Framework. When done properly, the oversight of risk and the underlying corporate culture are not processes unto themselves. Risk Intelligence is at the center of an effective framework for corporate governance — and it lays the foundation for everything the board and management do to properly govern the organization. (To learn more about the Risk Intelligent Enterprise and the Risk Intelligence prism shown in Figure 2, see www.deloitte.com/us/riskprism.)

An organization's success is, in large part, driven by how wisely it takes risks, and how effectively it manages the risks it faces, all of which takes place in the context of the enterprise's pervasive culture. With boards taking a more active role in providing risk oversight, it's increasingly important for board members to have command of the issues that affect strategic decision making and long-term success.

We believe that the way forward starts at the top of the governance/management "pyramid," with directors and senior executives establishing the organization's risk appetite and tolerances and putting in place the philosophy, framework, tools, and methods that drive the risk management approach through every level and role in the organization. Everyone becomes to some degree a "risk analyst," being alert to signals about shifts in reputation or reputational

Figure 2: Linking the Governance Framework to the Risk Intelligent Enterprise



drivers. The better everyone understands where the company is going and how it plans to get there, the better everyone will be at recognizing potential strategy killers. This applies to the board as well. The first priority of the board in the execution of its responsibilities in each *board governance* element is to understand inherent risks and the ways management is monitoring, assessing, and mitigating those risks.

Most observers agree that the board has a clear responsibility to understand the enterprise risk management activities of executive management. This includes a detailed review of the resources devoted by the organization, the quality and positioning of key risk personnel such as the chief risk officer, and the output of such processes. In this way, board oversight of risk management is not significantly different from oversight of other governance infrastructures and operating models, such as controls over financial performance or ethics and compliance programs. The board can more effectively perform this role by understanding how the company's risk programs — including its own risk governance activities — align with Deloitte's nine principles of a Risk Intelligent Enterprise. (See page 8, "Putting risk in the comfort zone: Nine principles for building the Risk Intelligent Enterprise," www.deloitte.com/us/9principlesofrisks.)

However, the board's role in risk oversight does not stop there. The expectations of the board have never been higher and, in some cases, they are resulting in new or expanded regulatory requirements. Examples of these expanded requirements include the board's role in setting risk appetite and risk tolerances, understanding and monitoring critical risks (regardless of where they come from), and providing robust disclosures about those risks to stakeholders. For instance, when considered in the context of the governance elements, boards have a critical role to play in examining strategic risks, including both risks to the strategy (which could cause it to fail) and risks of the strategy (which may result from successful implementation of strategic plans).

Therefore, a board often frames its activities for the oversight of *risk* (depicted at the center of the Framework in Figure 1) into these two areas: oversight of enterprise risk programs (risk management), and oversight of critical risks and risk decisions (risk governance). The skills, information, and operating models for each may be different, but these areas are certainly intertwined.

Boards should always be mindful of *risk culture*. Risk management is inexorably linked to the organization's culture, characterized by the values of the entity, the motivations of personnel, and the ways in which decisions are made. For example, the board influences incentive and reward systems, performance systems, and management accountabilities. The board also sets the tone regarding risk management through risk governance and reporting protocols, behavioral and ethical expectations, and approval of resources for strengthening risk management capabilities.

Certainly, the concept of "tone at the top" is not new. But attaining an appropriate tone that provides enough structure for ethical decision-making without stifling innovation and intelligent risk taking remains an elusive goal for many organizations, especially in a challenging economic environment. Still, without a strong culture of accountability, a governance program may face a greater chance of collapse. (For more about risk culture, see "Cultivating a Risk Intelligent Culture: Understand, measure, strengthen, and report," www.deloitte.com/us/riskintelligentculture.)

Principles for Risk Intelligence

Deloitte's Risk Intelligent Enterprise model is founded on nine principles. We believe that the board's role in providing oversight to the company's risk programs should, at a minimum, include understanding how management has implemented programs that align with these principles. The board should also consider how policies and activities are inclusive of the principles that incorporate governing bodies, which are identified below with an asterisk.

1. A common definition of risk, which addresses both value preservation and value creation, is used consistently throughout the organization.*
2. A common risk framework supported by appropriate standards is used throughout the organization to manage risks.
3. Key roles, responsibilities, and authority relating to risk management are clearly defined and delineated within the organization.*
4. A common risk management infrastructure is used to support the business units and functions in the performance of their risk-related responsibilities.
5. Governing bodies (e.g., boards, audit committees, risk committees, etc.) have appropriate transparency and visibility into the organization's risk management practices to discharge their responsibilities.*
6. Executive management is charged with primary responsibility for designing, implementing, and maintaining an effective risk program.
7. Business units are responsible for the performance of their business and for the management of risks they take within the risk framework established by executive management.
8. Certain functions, such as HR, finance, IT, tax, and legal, have a pervasive impact on the business and provide support to the business units as it relates to the organization's risk program.
9. Certain functions, such as internal audit, risk management, and compliance, provide objective assurance as well as monitor and report on the effectiveness of an organization's risk program to governing bodies and executive management.*

Role of board committees

As board committees become increasingly critical to the operations of the board, the Deloitte Governance Framework may help to mitigate the risk that critical board responsibilities are not addressed. The board can start by inventorying the critical responsibilities of each governance element (see "Assessing effectiveness," below) and then identifying those that are appropriate for a board committee and those best addressed by the full board. As long as the oversight of both the *infrastructure* and the *board governance* elements are contemplated by either a committee or the full board, directors can gain comfort that important responsibilities are covered. Of course, it is critically important that board committees communicate fully and transparently with the entire board.

The board's oversight of risk offers a unique example of how the committees and the board can work together. It is common practice to allocate responsibility of the process for enterprise risk management oversight to a committee — either the audit or risk committee. In addition to being sure that the full board is adequately briefed on the oversight programs and deliberations at the committee level, it is advisable for the board to be involved in the oversight of the key risks — those that typically fall under the strategic risk category — devoting time to this discussion at every meeting. In addition, other key risk governance activities, such as advising on and working with management to set the risk appetite of the organization, may be too fundamental to be deliberated only at the committee level. The entire board will likely have a much broader perspective and range of experiences to bring to the discussion of key risks and risk appetite.

Assessing effectiveness

The Deloitte Governance Framework was created with the intention of providing companies with a means of pinpointing the areas of its governance program that may need attention. To accomplish this, we have created a model for each *board governance* area. The models are not meant to be prescriptive; each board will have its own approach to the activities and attributes within the Framework. Rather, the models are intended to provide a picture of effective governance to spark a board's thinking about the maturity of its program.

To understand the models, it may help to think about each element of the Framework as a box. Inside the box are the things a board and management team would need to have in place to create an effective oversight program. There may be a set of required activities that have been set by law or statute. Beyond that, there are common or leading practices that can help make the program effective. The model seeks to articulate both requirements and leading practices within four distinct areas, referred to as "attributes," which are necessary for effective board oversight of each of the *board governance* elements.

- Skills and knowledge
- Process
- Information
- Behavior

To illustrate, the model for the talent element has been provided in Figure 3.

Figure 3: Talent oversight model

Objective: An effective board selects, evaluates, and compensates the CEO and oversees the talent programs of the company, particularly those related to executive leadership and potential successors to the CEO. The board communicates executive compensation and succession decisions in a clear and compliant manner.

Attributes	A highly functioning board exhibits the following:
Skills and knowledge	The board understands the attributes of successful leaders and how to apply them to the organization and its strategic plans; has experience developing leadership pipelines in organizations of similar size and scale; understands the mechanics of the company's compensations plans and the risks inherent in the plans.
Process	• Appoints the CEO and oversees the CEO's development, goal-setting, and compensation • Approves and monitors compensation performance metrics for the CEO • Oversees CEO compensation and transparent disclosure of executive compensation to stakeholders • Ensures development of executive succession plans that contemplate various scenarios • Collaborates with management to develop and adopt a compensation philosophy for the organization • Meets periodically with executive leadership, including risk and HR, to understand organizational compensation plans, talent pipeline, and underlying risks • Monitors external stakeholder considerations related to executive management and compensation
Information	Obtains independent views and peer company benchmarks of compensation plans proposed by management; has access to and receives periodic reports related to compensation plans, including internal audit and other reports; monitors marketplace developments.
Behavior	Board leadership takes responsibility for the development of the CEO; appropriately supports and mentors the CEO; develops and maintains relationships with other key executives, especially those with potential to succeed the CEO.

The model first seeks to define the objectives of the board governance program for the area in a broad opening statement:

"An effective board selects, evaluates, and compensates the CEO and oversees the talent programs of the company, particularly those related to executive leadership and potential successors to the CEO. The board communicates executive compensation and succession decisions in a clear and compliant manner."

The example provided articulates examples of how effective boards might accomplish this goal. Within skills and knowledge, for instance, it is acknowledged that the board — on a composite basis — has enough experience in behavioral and organizational methodologies to effectively exercise its responsibilities in this area. Knowledge of leadership principles, the strategic plans of the organization, and compensation plans and trends, for example, would be necessary in order to effectively execute the board's responsibilities in talent oversight.

The high-level assessment, which can be done quite informally by the board and executive team, would involve discussing the board's skills and knowledge as compared to the model. It would also identify the current state as high (the board could be viewed as a role model in this area), low (the board may have some knowledge gaps in this area), or medium (acceptable level of knowledge

but worth keeping an eye on for future development).

This "quick hit" assessment is not the end of the board's attention on continuous improvement. In fact, it is just the beginning. Based on the high-level assessment using the model, the board and executive management will be able to pinpoint the specific areas of their current board governance programs that need further attention. In this way, boards can avoid assessments that attempt to address everything at once, which can be an overwhelming and often unnecessary exercise.

Getting started

Given heightened regulatory expectations and increasing board scrutiny, organizations are seeking a common and holistic framework that boards can look to to create and assess critical processes and activities. The Framework outlined in this document articulates areas of board governance, how the board's oversight role aligns with management's operating models, and provides a clear context for building a common understanding of the role of the board.

We invite you to take the Deloitte Governance Framework and its underlying assumptions and tailor them in a way that feels right for your organization. Our hope is that the Framework provides a useful starting point for the development of a common view among the board and management, as well as an opportunity to enhance the board's efforts to continuously improve.

Bringing the Framework to life: A practical application

The versatility of the Framework allows companies to apply their principles in a variety of situations, ranging from key board member transitions to preparing for an IPO, or even as a guide in conducting annual board evaluations. Examples of how Deloitte has helped boards to apply the Framework include:

- **Board chairman transition**. The Framework gave structure to the Deloitte Chairman Transition Lab, which was designed to help newly appointed chairmen make an effective and efficient transition. The key objective of the lab is to help an incoming chairman consider the board's key oversight activities and develop a plan to address challenges. The Framework organizes and creates a methodical yet dynamic context for the lab by structuring the discussion around the organization's "maturity" in each of the *board governance elements*.
- **IPO readiness**. Enhanced corporate governance has become an important component in a company's preparation for going public. Governance-related rules for public companies affect board activities and structure. In assisting companies with their IPO readiness, we utilize the Framework to build a desired "future state," recommending the key areas of board governance that should be addressed in the months leading up to the IPO. The Framework helps to ensure that the structural and other changes made today position the company's board for the long-term, not just the initial offering.
- **Board performance assessment**. When performed effectively, board assessments are a strategic activity for the company, bearing long-term benefits for both the board and senior executives. The Framework provides the construct for the design of an assessment that allows the board to isolate *board governance* elements that deserve the most attention, and the attributes (skills and knowledge, process, information, and behavior) within each that provide the most opportunity for improvement.

Contact us

For more information on the Deloitte Governance Framework, please contact the practitioners below or visit us at www.deloitte.com/us/governanceframework.

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About the Center for Corporate Governance

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