



A NEW FOCUS  
ON GOVERNANCE

Managing Stakeholder  
Expectations to Sustain  
Business Value

ASSURANCE AND ADVISORY SERVICES

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## INTRODUCTION

Although corporate governance is defined and regulated differently throughout the world, organizations of every size, industry, and country agree on its ultimate goals: to help leaders maintain sustainable organizations that are accountable to shareholders, capable of returning value to them, and worthy of marketplace trust.

How an organization seeks to achieve these critical goals has never been subject to greater scrutiny. Business and regulatory failures have prompted new analysis of governance practices worldwide. Indeed, from the Americas and Europe to Australia and Asia, the general perception that corporate governance practices need overhauling has rallied regulators, investors, business leaders, politicians, and other stakeholders — all of whom have different perspectives and varying remedies. Challenges as diverse as compliance, remuneration, independence, and maintaining market confidence are among the areas being examined by government and business entities around the globe.



### Boards Face Critical Challenges

One result of this increased scrutiny has been a new awareness of the wide array of risks inherent in the governance process. “Governance” is a multi-faceted endeavor encompassing a wide range of activities over which a board has oversight, including the formulation and execution of strategy, the audit and assurance process, and shareholder and stakeholder communications. It includes significant organizational activities, from legal and regulatory compliance to the management of

risk. Its influence is evident in organizational ethics, brand loyalty, and employee retention. It can change how much an organization pays to borrow money; determine the quality of an organization’s vendors, partners, and employees; affect what premium investors will pay for an organization’s shares; and influence an organization’s reputation in the marketplace. Organizations exist to create value (financial and otherwise) for shareholders and other stakeholders. Ultimately, the values embodied in governance practices affect organizational value.

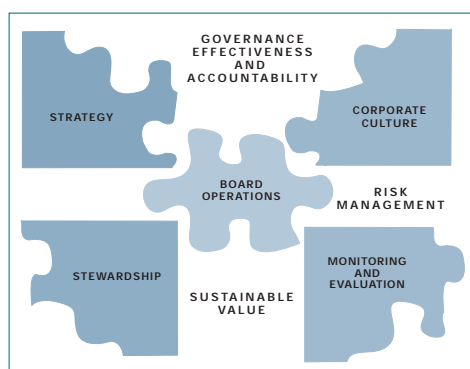
Whatever its mission, culture, industry, or country, an organization must manage a host of governance-related activities and expectations that affect its ability to create and sustain value. These risks and expectations will vary, depending on the organization and the environments in which it operates. Leaders know they need to ensure that a strong governance structure is in place, understand the expectations of shareholders and other stakeholders, and respond to changing risks. This white paper will discuss the current governance environment. It will describe the expectations boards face today and then suggest an approach boards can take to manage stakeholder expectations so as to drive organizational value.

## THE CURRENT ENVIRONMENT

Its importance affirmed as early as the 14th century in the Swiss cantons,<sup>1</sup> the quality of corporate governance has been critical to business value among organizations worldwide for as long as owners and managers have been separate.

Organizations seeking to access global capital markets are finding that capital is often available only to those that meet internationally accepted standards of governance and disclosure.<sup>2</sup> At the same time, those operating in multiple countries are increasingly subject to a wide variety of regulations as well as differing views about how best to facilitate strong governance. Indeed, because of variations in regulations across borders and jurisdictions, organizations may find themselves accountable to multiple masters as well as subject to highly diverse approaches. Organizations must account for these constraints in developing governance practices so that their values can influence value appropriately (see *Figure 1*).

**Figure 1: Piecing Together the Big Picture**



Source: KPMG, 2002

Boards must monitor a number of interconnected efforts — all of which vary in emphasis by country, industry, market, and regulatory environment — to succeed in their responsibilities to stakeholders, ensure that risks are managed, and ultimately drive sustainable value for the organization overall.

### ALL GOVERNANCE IS NOT ALIKE

A variety of economic and cultural differences have given rise to existing governance models.<sup>3</sup> Historically, two broad approaches have been at play—one characterized by large liquid capital markets, power concentrated among institutional investors, and an active takeover market; and the second characterized by less liquid markets and comparatively greater power concentrated among banks, families, employees, and governments.<sup>4</sup> For example:

- Banks play an important role in Germany.
- The government is an important stakeholder in France.
- Employees have an important role in the Netherlands and Germany.
- Shareholders have a key role in Australia, Canada, the United Kingdom, and the United States.
- Families have a central role in many Asian countries.

### Governance Reform Under Way Worldwide

Under pressure from regulators and other stakeholders, many countries in Europe, Africa, Asia, and North and South America are charging different groups with reviewing the corporate governance process. Almost every country has begun or recently completed some activity to set standards for governance policies and practices.

Some countries are focusing their attention and reform efforts on rules-based approaches, others on reinforcing the “independence” of outside directors, others on executive remuneration, and still others on protecting particular interests, such as those of shareholders. Whatever a country’s focus or approach, governance depends on board accountability and effectiveness the world over (see *Appendix I: Governance Developments and Practices*).

### The Board and the Value of Oversight

Organizations worldwide generally confer the responsibility for governance to a board of directors. In some countries, organizations use a two-tier system to divide governance responsibilities between a “supervisory board” composed of non-executive board members and a “management board” composed entirely of executives.<sup>5</sup> Whatever the structure in which they operate, directors are accountable to shareholders and other stakeholders for monitoring the organization’s man-

agement and providing oversight of strategic planning and risk management processes.

The importance of the board’s responsibility for such activities is becoming increasingly apparent (and valuable) as pension funds and other large investors continue to focus their attention on the corporate governance practices of the companies in which they invest. A July 2002 McKinsey study, for example, indicates that pension fund investment managers are willing to pay a premium of up to 38 percent for the shares of organizations that demonstrate good corporate governance practices<sup>6</sup> (see *Figure 2*). Demonstrating high standards for corporate governance can help attract investors and reduce the cost of capital. Researchers at Yale University’s new International Institute of Corporate Governance<sup>7</sup> have shown that “companies in countries that protect shareholders and creditors [are able to] borrow and raise capital more easily and at much better terms than in countries with poor laws and weak enforcement.”<sup>8</sup>

**Figure 2: The Governance Effect**



Source: Compiled from survey by McKinsey & Co., 2002.

Research shows that investors value organizations that emphasize values: A July 2002 McKinsey & Co. study indicated that more than 75 percent of institutions surveyed were prepared to pay a premium of between 11 and 38 percent for the shares of organizations they perceive as well governed.

## The Board and the Critics

Organizational value is increasingly dependent on organizational *values*, and board members play a key role in defining those values and embedding them throughout the organization. Although “tone at the top” is a phrase with which senior leaders have long been familiar, bringing appropriate meaning to these words is an increasingly critical board responsibility especially in an environment in which mounting evidence demonstrates the damage to shareholder value that can ensue when governance practices (and values) are shown or perceived to be lacking.

Board members are facing new scrutiny and critical challenges as they seek to fulfill their roles in twenty-first century organizations. Shareholder activism (and litigation) are increasing in the wake of business failures and concern over transparency of corporate transactions and communication between board and management. “Even at companies untouched by scandal, directors are under attack for approving exorbitant CEO pay packages and seeming to protect the interests of management rather than investors.”<sup>9</sup> Many shareholders want to see more independent directors on boards, but evidence indicates that fewer executives want to take on the responsibility or commit the time required to be effective in the role.<sup>10</sup> “Even before Enron, one in four board candidates declined seats,” says Dennis Carey, a vice chairman of the recruiting firm Spencer Stuart and a co-founder of the Directors’ Institute at the University of Pennsylvania’s Wharton School. “The biggest reason people don’t want to serve is time demands,” he says.”<sup>11</sup>

Potential directors are especially wary of serving as members of audit committees. This reluctance had developed before Enron’s collapse, according to a 2000 survey KPMG’s Audit Committee Institute conducted in the United States. Among the audit committee members surveyed, a significant number

felt that their exposure to liability had increased in some way as a result of the introduction of new SEC regulations governing the membership, processes, and disclosures of audit committees serving U.S. public companies. Although 37 percent felt that their liability increased moderately, and 13 percent felt the increase in liability was significant,<sup>12</sup> just 4 percent expected to have directors step down as a result of increased liability.<sup>13</sup>

Thus, as governance becomes increasingly complicated, so do stakeholder expectations. The next section will describe some of those expectations, as a preface to a discussion of how directors can go about managing them.

### GUIDELINES FOR DIRECTORS PROLIFERATE

The Business Roundtable, a U.S.-based association of 150 CEOs of leading corporations, is among the industry groups offering new guidelines and other proposals for enhancing corporate governance.<sup>14</sup> Among its recommendations are the following:

- Enable employees to alert management and the board to potential misconduct without fear of retribution
- Require boards to ensure prompt disclosure of significant developments
- Publish corporate governance principles
- Increase the ratio of non-executive to executive directors
- Allow only non-executive directors to sit on the audit, corporate governance, and compensation committees
- Charge the board with ensuring that the management remuneration structure directly links the interests of management to stockholders’ long-term interests

## THE OPPORTUNITY: UNDERSTANDING STAKEHOLDER EXPECTATIONS

Boards of both for-profit and not-for-profit organizations face ongoing scrutiny and increasingly high expectations from investors, lenders, analysts, employees, customers, and many other stakeholders.

### TRIGGERING EVENTS THAT CAN AFFECT GOVERNANCE

As leaders assess their governance structures, policies, and procedures, they should consider a number of a “triggering events” that may pose new challenges for governance:

- Adverse publicity or criticism related to accounting practices, remuneration arrangements (particularly incentive arrangements), or other areas of board accountability
- Criticism of controls, processes, risk management, or reporting
- Impending legislation or market pressures that are likely to force changes in reporting requirements
- Expansion into geographical or business markets that could make the organization subject to new regulations or stakeholder attention
- Questions as to whether existing performance measures are appropriate and sufficiently rigorous
- Technology changes that affect how business operations are carried out
- Development of new or unanticipated business, industry, or market risks

As part of their responsibility for governance oversight, board members need to take steps to identify and understand stakeholder expectations; how they may vary across industries, capital markets, and geographic borders; and how they are continually changing.

The table on page 6 outlines some of the significant questions boards face today in the five general areas of oversight for which they are accountable. Addressing these questions can help members begin to understand their stakeholders’ expectations so they can be sure they are properly anticipating and managing them as part of their overall responsibilities for oversight. Organizations in every industry, country, and market will likely face variations on these questions (among others).

Once board members determine what their stakeholders expect of them, they can determine how well they are meeting and managing those expectations as well as how they might improve. The section beginning on page 7 will present a potential approach to understanding and managing stakeholder expectations.

## AREAS OF BOARD RESPONSIBILITY

### **Board Operations**

The board's ability to manage its own activities

### **Strategy**

The board's role in the strategy process

### **Corporate Culture**

The board's role in setting and communicating standards for ethical organizational behavior

### **Monitoring and Evaluation**

The board's role in monitoring management and evaluating its performance against defined goals

### **Stewardship**

The board's responsibility toward stakeholders and accountability for their interests

## TO WHAT EXTENT DO STAKEHOLDERS EXPECT THE BOARD TO...

- include a balance of executive and non-executive (or outside) directors (including independent non-executives) who offer a mix of financial, business, and personal skills appropriate to the needs of the organization and who have the time and energy necessary to meet their growing responsibilities?
- have the independent directors meet informally (at least annually) without the CEO or other non-independent directors?
- have access to appropriate training and independent professional advice on issues members deem necessary?
- participate actively in strategy development?
- review — and challenge — the strategy?
- create a strategically adaptable organization that is able to respond quickly to changing market opportunities?
- foster openness with management on issues for which the board will ultimately be accountable?
- support management's organizational code of conduct?
- promote the use of appropriate incentives that make such codes meaningful?
- ensure that the organization complies with all relevant laws and regulations as well as with accounting, human resource, and other internal policies?
- understand organizational risks and be informed routinely about how they are managed?
- apply a rigorous process for evaluating the performance of the CEO?
- uphold rigorous standards for individual members' preparedness, participation, and candor?
- protect the organization and its stakeholders from the potential damage of conflicts of interest?
- safeguard stakeholder interests, in part by ensuring that communication with various stakeholders is thorough, timely, and transparent?

## MANAGING STAKEHOLDER EXPECTATIONS

Once board members understand potential stakeholder expectations, they can take steps to be sure they are meeting them – within the context of the organization’s current governance structure, the various business environments in which it operates, and its evolving business risks (see *Figure 3*).

**Figure 3: A Governance Model**



Source: KPMG, 2002

The board concentrates its efforts in five key areas to drive value as it is perceived by a wide variety of stakeholders, within the context of its industry, capital markets, culture, and regulatory environments. Board members concentrate their efforts in varying degrees on these focus areas in accordance with the type and level of stakeholder expectations (fundamental, developed, or strategic) they face.

What follows is an approach to meeting and managing stakeholder expectations in the context of a defined yet flexible framework for developing and implementing appropriate governance practices. Such practices, and their overall framework, will be influenced by the type and level of expectations (characterized here as *fundamental*, *developed*, or *strategic*) that stakeholders have of the organization.

These categories are not mutually exclusive. One builds on the next in an evolutionary manner, and they will change and evolve depending on the organization’s business environment, strategy, and culture. Moreover, divisions or business entities within an organization may face different stakeholder expectations at different times. These categories may be described as follows:

- **Fundamental:** The board seeks to ensure that directors and management comply with laws and regulations and high standards for ethical conduct.
- **Developed:** The board establishes/monitors feedback mechanisms for ensuring appropriate organizational behavior and strategic decision-making.
- **Strategic:** The board uses governance principles to guide organizational strategy and drive added value for stakeholders.

### Improve Board Operations

Effective board operations are critical to the development of a strong governance structure. Board members’ skills and experience must remain sufficient to the organization’s needs, whatever the standards, culture, and markets to which it is subject. A board should take steps to ensure that it continues to have the appropriate mix of skills and levels of experience as conditions change. Periodic self-evaluation will help it meet this important goal. A board’s focus will vary according to the level of its stakeholders’ expectations, as shown below.

BOARD OPERATIONS	
Stakeholder Expectations	Board Focus
<i>Fundamental</i>	Ensure that members have basic experience and knowledge and are appropriately independent of management
<i>Developed</i>	Evaluate overall and individual performance against strategic goals
<i>Strategic</i>	Use an independent review process that enables the board to reflect on its performance and consider ways to improve

### Participate in Strategy Development

The board should seek to ensure that the organization is sufficiently agile to be able to respond to competitor movements and take advantage of relevant market opportunities even as it continues to pursue and achieve planned goals and objectives. Aligning board and management efforts is an important first step — one that will help enable both groups to work cooperatively to realize organizational strategy and ultimately add value for stakeholders. A board’s focus will vary according to the level of its stakeholders’ expectations, as shown below.

STRATEGY	
Stakeholder Expectations	Board Focus
<i>Fundamental</i>	Ensure alignment of goals, strategies, initiatives, and performance measurement systems throughout the organization
<i>Developed</i>	Evaluate risks to strategy, and conduct scenario planning
<i>Strategic</i>	Ensure the organization can deliver against its strategy even as it adapts to evolving circumstances

## Embed Governance Principles in Corporate Culture

Efforts to ensure ethical behavior and to protect the organization's reputation are part of the fabric of governance. A culture that condones negligent or even mediocre behavior puts the organization's reputation at risk. Moreover, when an organization lacks integrity, its employees' statements and behavior and the information it produces are equally unreliable. The board must help ensure an appropriate tone at the top. A board's focus will vary according to the level of its stakeholders' expectations, as shown below.

CORPORATE CULTURE	
Stakeholder Expectations	Board Focus
<i>Fundamental</i>	Establish a system of values supported by a code of conduct that stipulates both acceptable and unacceptable employee behavior
<i>Developed</i>	Establish procedures to help ensure understanding and ownership of organizational values and the code of conduct
<i>Strategic</i>	Use organizational values to drive business value and competitive advantage

## Monitor and Evaluate

No matter what their level of focus, boards should recognize that what gets measured is what gets attention. Therefore, they need to ensure they understand what management should be doing and assess whether those activities are being managed and measured. The reports the board receives should reflect this broad measurement perspective. How well management has met the organization's financial goals should be just one aspect of the board's evaluation. The board should also ensure that the combined scope of internal and external audit is such that it is able to provide greater assurance that management has adequate governance systems and processes in place to protect shareholder value. A board's focus will vary according to the level of its stakeholders' expectations, as shown below.

MONITORING AND EVALUATION	
Stakeholder Expectations	Board Focus
<i>Fundamental</i>	Ensure that information is concise and timely and that it encompasses appropriate performance measures in keeping with strategic objectives
<i>Developed</i>	Track the business operating environment through information from management and external sources
<i>Strategic</i>	Monitor the organization's ability to adjust strategy in response to changes in its environment

**Ensure Appropriate Stewardship**

Board members face a variety of risks in their efforts to be appropriately accountable to stakeholders. Concern about reaching financial targets, for example, could induce directors to promote unreasonable expectations for organizational performance. In addition, boards must remain informed about the increasing range of non-financial opportunities and risks their organizations face — and the wide range of stakeholder demands — that are driving the need for enhanced transparency, corporate accountability, and stakeholder engagement. A board’s focus will vary according to the level of its stakeholders’ expectations, as shown in the table below.

STEWARDSHIP	
Stakeholder Expectations	Board Focus
<i>Fundamental</i>	Ensure that a spirit of honesty and transparency pervades the overall reporting process
<i>Developed</i>	Consider how to integrate financial and non-financial indicators in efforts to measure and report on organizational performance
<i>Strategic</i>	Promote stakeholder engagement to gain a better understanding of the marketplace, improve strategic positioning, and gain competitive advantage

Understanding these expectations and seeking to anticipate and respond to them as part of an overall governance framework are important steps. Taking these steps will guide the board in improving its own operations. It will also help it ensure that it has aligned its processes appropriately so it can add value in overseeing organizational systems and processes — from strategic planning to reporting to shareholders (stewardship). Thus the board can evolve from a focus of simply ensuring conformance to one of helping enable the organization to create value from strong governance (see *Figure 4*).

**Figure 4: Understanding the Big Picture**



Source: KPMG, 2002

Once boards fully understand their stakeholders’ expectations within the various interconnected efforts for which they are responsible, they will be better able to ensure governance effectiveness and accountability and thus add value to the organization overall.

## IMPLICATIONS AND OPPORTUNITIES

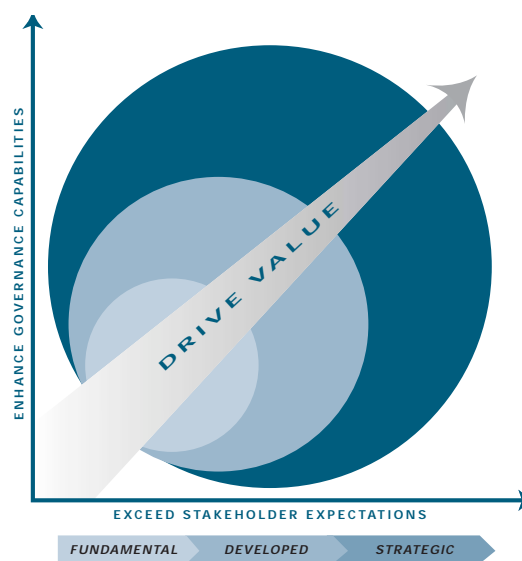
Once board members have taken steps to identify and fully understand stakeholder expectations, they need to consider whether simply meeting those expectations is a sufficient and appropriate approach to governance. Indeed, they should begin to reflect on whether to go about *exceeding* expectations — in ways designed to enhance the organization's values, its value, and the board's own performance (see *Figure 5*).

Heightened scrutiny of governance issues and calls for new regulation provide board members with an opportunity to help management define new standards for organizational governance. Such an effort should extend throughout all five of the board's major focus areas — board operations, strategy, corporate culture, monitoring and evaluation, and stewardship — and ultimately become the foundation of enhanced or new organizational values. Transparent efforts to communicate its values to stakeholders will help board members improve internal and external understanding of the organization and ultimately help provide a strong foundation for assessment of the organization's value.

With value increasingly embodied in intangibles such as reputation, the values an organization espouses in its operations and embeds in its governance processes will increasingly affect its ability to leverage new opportunities and sustain long-term financial value.

By seeking ways to exceed stakeholder expectations based on enhanced values, board members will be acting in the highest interest of both the organization and its stakeholders. In so doing, board members will lead by example and remain at the forefront of efforts to safeguard and enhance both *values* and *value*.

**Figure 5: Exceeding Expectations Drives Value**



Source: KPMG, 2002

## CONCLUSION

Strong corporate governance is essential to preserving reputation, investor confidence, access to capital, employee satisfaction, customer loyalty, and other key indicators of organizational performance and sustainability.

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Poor or inadequate governance, by contrast, diminishes these and other measures of value, both tangible and intangible. Because governance influences both value and values, a focus on performance, rather than conformance, has become the board's greatest priority as well as its highest calling.

Meeting stakeholder expectations is essential, but ultimately boards should seek to add value by exceeding expectations. To do so they will have to overcome the predominant perception that the focus of corporate governance is compliance — either with legal and ethical standards or with the popular view of “best practice,” in areas such as independence, directors' remuneration, or the ratio of executive to non-executive directors. These issues are certainly fundamental, and stakeholders expect boards to attend to them. However, if these basics remain a board's sole focus, directors will likely miss opportunities to add value to their organizations. Indeed, they could end up reacting to short-term problems in isolation rather than anticipating new opportunities and risks or providing oversight in a comprehensive and thoughtful manner.



For a performance focus to become a realistic goal, rather than a theoretical ideal, directors need to ensure that good governance prevails in their own operations. Then, from the strength of that position, they can consider how well they are overseeing systems and processes associated with their key focus areas of strategy, corporate culture, monitoring and evaluation, and stewardship. Once they determine how well they are meeting stakeholder expectations in these areas — and seek independent guidance in their assessment of their own performance — boards can begin to evaluate how they may be able to exceed expectations, specifically by using governance values to drive new value for the organization and its stakeholders.

## APPENDIX I: GOVERNANCE DEVELOPMENTS AND PRACTICES

Governance standards and proposals for reform continue to evolve worldwide. Countries are evaluating both regulated and unregulated codes of conduct as well as established statutes. What follows is not a comprehensive summary but is rather a review of efforts under way in selected countries that have existing codes or commissions established to study corporate governance.

### ASIA

#### Hong Kong

Since the Asian financial crisis in 1997, corporate governance has gained increasing attention in Hong Kong. Despite the publication of several reports and guidelines (mainly by the Hong Kong Society of Accountants), the Hong Kong corporate governance regulatory framework has not changed significantly. It may do so following the issuance of two consultation papers on corporate governance by the Standing Committee on Company Law Reform (SCCLR) in July 2001 and the Hong Kong Exchange and Clearing Company Limited (HKEx) in January 2002. However, while the consultation period for both these papers has ended, no decision has yet been reached on when new requirements may be adopted.<sup>15</sup>

#### Japan

Corporate governance is legislated by the Japanese Commercial Code. A reform proposal, which passed the Diet in May 2002, introduced the option of a unitary board structure (for some companies); a two-tier structure is compulsory under the current Code. Under the unitary board system, a corporation is to establish: 1) audit, nomination, and compensation committees within the board, each with a majority of outside directors, and 2) executive officers appointed and monitored by the board. Under the two-tier system, the board of directors is responsible for managing the corporation and monitoring representative (executive) director(s), while the board of corporate auditors is responsible for overseeing the board of directors.

Japanese judiciary authorities also opine on governance structures. In April 2002, the Kobe District Court said that directors of a corporation are legally responsible for establishing internal control systems. In addition, the 231-member Japan Corporate Governance Forum (established in October 1994) issued the Revised Corporate Governance Principle in November 2001, encompassing principles emphasizing the supervisory role of the board of directors as well as the appropriate roles of the board committees, CEOs, shareholders' derivative actions, internal controls and disclosure, and the relationships between companies and shareholders/investors.<sup>16</sup>

#### Malaysia

The Kuala Lumpur Stock Exchange Listing Requirements (Listing Requirements) has given practical efficacy to the Malaysian Code of Corporate Governance (Code) by requiring mandatory disclosures in the annual reports of public listed companies (PLCs) of the extent to which the Code's prescriptions have been adopted.

Specifically, disclosures are required of how the principles of corporate governance have been applied within the PLC,<sup>17</sup> best practices that have not been adopted within the PLC, and an explanation of the reason for its non-adoption and alternatives, if any,<sup>18</sup> as well as disclosure of the state of internal controls via a formal "Statement of Internal Control."<sup>19</sup>

Non-compliance with the listing requirements in the form of non-disclosure or making false or misleading disclosures would carry stringent penalties. Such penalties include a fine not exceeding RM3 million and a term of imprisonment not exceeding 10 years, which may be directed at companies or directors or both,<sup>20</sup> public/private reprimand, suspension of trading, penalties, and delisting.<sup>21</sup>

## People's Republic of China (PRC)

Recognizing the importance of corporate governance in the continuous development of the Chinese capital market, the China Securities Regulatory Commission (CSRC) recently issued two corporate governance requirements: the “Guiding Opinion for Listed Companies on the Establishment of Independent Directors System,” in August 2001 and the “Guideline on the Management of Listed Companies” in January 2002.

These guidelines represent a significant step forward for the proper governance of PRC-listed companies. Adopting most of the international best practices, the PRC corporate governance framework represents one of the most comprehensive and demanding frameworks in the world. The effectiveness of these requirements in ensuring a good corporate governance framework will, however, ultimately depend on effective practical implementation.<sup>22</sup>

## Singapore

The Singapore Corporate Governance Committee recently unveiled a code calling on boards to introduce a one-third cadre of independent directors who are set to dominate board committees. From 2003, companies listed on the Singapore Exchange will be required to disclose how they comply with the new code, which also seeks to improve transparency and remuneration.<sup>23</sup>

## AUSTRALIA

The Australian Stock Exchange (ASX) Listing Rules provide that a company's annual report is to contain a statement of its main corporate governance practices, including the procedures for nominating external auditors and for reviewing the adequacy of existing external audit arrangements. Where these procedures involve an audit committee, directors are required to set out or summarize the committee's main responsibilities and the names of committee members. The ASX listing rules also require a company to state in its annual report whether the entity has established an audit committee at the date of the directors' report and, if it did not, it must explain why. Although establishing such a committee is not mandatory, in practice most large public companies have long-established audit committees.

Recent high-profile corporate collapses and reports of poor governance practices have prompted the Australian government to commission Professor Ian Ramsay to conduct a review of the independence of Australian company auditors. The government is still considering the Ramsay report, whose recommendations include amending the ASX Listing Rules to make the establishment of an audit committee compulsory for all listed companies.<sup>24</sup> The Listing Rules and Guidance Notes would be amended to require that the audit committee be independent, qualified, and composed of at least three members. It would also require the board of directors to adopt a written charter to govern the audit committee.

The recommendations also include:

- Prescriptive requirements for meetings and systems of reporting to the board,
- Disclosure of both the membership of the audit committee and the provision of non-audit services by the external auditor in the annual report, and
- A detailed list of the duties and responsibilities of a qualified audit committee.<sup>25</sup>

If adopted, the recommendations are expected to help to strengthen audit committees and provide a more effective forum for communication between management and the external auditors.

## EUROPEAN UNION (EU)

Corporate governance has been on the European political agenda for some time. However, the current disputes over executive remuneration, restated financial statements, and high-profile corporate failures have reinforced Brussels' drive to ensure that European companies have good corporate governance.

In addition to a comparative study of the 43 Codes currently used in the European Union, the European Commission has set up a “High Level Group of Company Law Experts” to drive consultations on possible reforms to company law in Europe. Issues under consideration include efforts to improve corporate governance for efficient business in the EU and for an integrated European securities market. Such issues encompass better information for share-

holders and creditors, increased disclosure on corporate governance structures and practices of companies in Europe, extent of compliance with a corporate governance code, and role of shareholders in fixing directors' remuneration.

Other proposals on corporate governance include strengthening shareholders' rights, minority protection, and the right to vote by "special investigation" procedures as well as holding directors accountable for letting the company continue to do business when it can no longer pay its debts.<sup>26</sup>

## LATIN AMERICA

### Mexico

A group of leading Mexican business organizations presented a new Corporate Governance Code for Mexico in June 1999. The first of its kind in Latin America, the Mexican Code encourages more transparent management practices to enhance investor confidence and reflects the interests of various economic sectors that Mexican companies attain international standards and improve their competitiveness. Its recommendations complement many applicable legal provisions and can be applied to any Mexican company. Compliance is voluntary, but publicly traded firms that do not follow the Code must establish an alternative mechanism.

The document was a joint effort of the Mexican Stock Exchange, the Mexican Bankers' Association, the Mexican Institute of Finance Executives, and the Mexican Institute of Public Accountants, as well as representatives from the industrial, retail, and service sectors. They examined the experiences of England, Spain, France, Holland, Canada, and South Africa, among others, but remained attentive to the need to formulate recommendations that are consistent with the country's economic and social reality. For example, in various developed countries, corporate capital is fragmented and held by major institutional investors, whereas in publicly traded Mexican companies, control shareholders hold most of the capital, which gives them a preponderant role in the company's management.

The Corporate Governance Code for Mexico consists of five sections:

- Board of Directors (recommendations on the functions, makeup, structure, operation, and duties of the board)
- Evaluating and Compensating Directors (suggestions to allow company management to function more efficiently)
- Auditing (selection of auditors or examiners, verification of financial information, internal controls, and compliance with applicable legal provisions)
- Finances and Planning (suggestions and operating aspects)
- Stockholder Information (discussion of agenda of stockholders' meetings, quality and promptness of information, and communication between the board and investors)<sup>27</sup>

## NORTH AMERICA

### Canada

Canada's Joint Committee on Corporate Governance (JCCG) released its final report on November 22, 2001. Entitled *Beyond Compliance: Building a Governance Culture*, the report outlines 15 recommendations focused on specific areas where action can be taken aimed at improving the effectiveness of governance in Canadian public corporations. Among the recommendations: as a condition of listing on a Canadian stock exchange, all boards should have an independent board leader chosen by the full board who is accountable for activities including succession planning and responsible for leading regular meetings that include outside directors and exclude management. The Canadian Institute of Chartered Accountants (CICA), the Canadian Venture Exchange (CDNX), and the Toronto Stock Exchange (TSE) established the JCCG to review the state of corporate governance in Canada and recommend changes "to ensure Canadian governance practices are among the best in the world."<sup>28</sup>

### United States

Various congressional committees, the Justice Department, and the SEC are conducting investigations in the wake of the collapse of Enron in December 2001. Significant changes in regulations and

practices are expected to affect organizations and their boards, external auditors, and others involved in preparing and disseminating financial information to investors. These events appear to have increased some shareholders' expectations concerning the diligence displayed by directors, audit committee members, senior management, and auditors, and have already begun to affect companies' governance processes. Key issues include the audit committees' interaction with management and the auditors, changes in shareholders' expectations related to both financial and non-financial disclosures, and the challenge of maintaining a competitive advantage in an increasingly complex business environment.

Two major U.S. stock exchanges proposed new standards and changes in corporate governance rules in June 2002.<sup>29</sup> The New York Stock Exchange (NYSE) Corporate Accountability and Listing Standards are sweeping changes that the NYSE board is scheduled to bring to a vote at its August 1, 2002, meeting. In addition, the Nasdaq Stock Market has submitted a first round of proposals to the SEC and announced additional governance proposals to be released later in the year.

These proposals would increase the authority and responsibilities of audit committees. The NYSE proposals, among other things:

- Designate the audit committee as the "sole authority" to retain and terminate the external auditor
- Require the audit committee to approve all independent auditor fees and terms, including significant non-audit engagements
- State that NYSE-listed companies are expected to have an internal audit function
- Limit audit committee member compensation to board-service fees only
- Require an annual performance evaluation of the audit committee

## SOUTH AFRICA

Regulators released King II in early 2002, updating 1994's King I report (named after former judge Mervyn King) to include "more stringent corporate governance rules."<sup>30</sup> King II recommends the appointment of independent non-executive directors, who are

expected to play key roles in board committees and in board operations. The new report also recommends publishing a register of delinquent directors, new laws to allow attorneys to file class action lawsuits on behalf of shareholders, and statutory backing for GAAP. "Its recommendations are voluntary, but companies who do not follow its tenets face serious penalties, such as suspension from the Johannesburg exchange."<sup>31</sup>

## UNITED KINGDOM

In light of the current round of restated financial statements and high-profile corporate failures, the U.K. government is conducting a number of reviews. The first is aimed at ensuring the effectiveness of financial reporting and audit regulation, and will address:

- The quality of audit, particularly ideas aimed at strengthening the independence of auditors,
- Financial reporting and auditing requirements, and
- Corporate governance, in particular the role of the audit committee.

The second key review investigates the role and effectiveness of non-executive directors and is led by Derek Higgs, respected for his experience as a non-executive director and institutional investor. The review will assess:

- The population of non-executive directors in the United Kingdom — who they are, how they are appointed, and how they can be drawn from a wider pool of talent,
- The independence and effectiveness of non-executives,
- The actual and potential relationship between non-executive directors and institutional investors, and
- How the quality, independence and effectiveness of U.K. non-executive directors could be strengthened.<sup>32</sup>

"For U.K. productivity performance, the progressive strengthening of the quality and role of non-executive directors is strongly desirable. The review will consider how more independent and more active non-executive directors drawn from a wider pool of talent can play their part in raising productivity."<sup>33</sup>

## APPENDIX II: AN INTERVIEW WITH JONATHAN CHARKHAM

Jonathan Charkham is the former Advisor to the Governors of the Bank of England. A member of the Committee of the Joint Disciplinary Scheme of the Accounting Profession, he was also the first director of PRO NED, an organization promoting the benefits of independent directors. Mr. Charkham has served, and is serving, on the boards of several leading companies, and he is the author of numerous publications on corporate governance. He discusses here board members' responsibilities in the evolving governance debate.<sup>34</sup>

### **In what fundamental way does corporate governance help create competitive advantage?**

Good governance is essential to the long-term health of an enterprise. A company can do well for a time with virtually no corporate governance, led by an entrepreneur with flair and intelligence. So why isn't that pattern ideal? Because nobody's clever enough for long enough. The histories of companies led by dominating people with weak boards confirm this perspective. The CEOs were often the media's darlings, and that's the kiss of death, because it atrophies judgment.

A board will never have the flair of an individual entrepreneur. But if you want entrepreneurial flair to succeed in the long run, you're best to put it inside a framework that maintains the standards of decision-making and the judgment of the people making decisions.

### **What critical roles does a board play in the running of an organization and what factors contribute to a strong relationship between it and management?**

Effective directors believe their company is doing something worthwhile and wish it to succeed. They also know, however, that management occasionally will get carried away, and their job is to ensure management has understood all the risks it faces.

A board's most important job is assessing management and ensuring it's got a grip of the business. If not, then you have to act. You need a board where each person is more than just knowledgeable and experienced. Directors must be willing and able to talk with their co-directors about perceived problems. Assessing management takes careful consultation among members. After such con-

sultations, you may together conclude that management is in error. And when you reach that conclusion, you become quite powerful.

The non-executive directors that make up the audit committee are helpful here because they've had a chance to get to know each other in the context of the detailed running of the business. If they form a unanimous view of an issue, it's a brave CEO who will easily resist them.

Teamwork is critical, and creating it rests with the chairman. In selecting members, you must assess a person's capacity to act jointly in the interests of the company. Skillful chairmanship is a matter of understanding the contributions directors can make and then ensuring they make them. And being a good director requires a certain character as well as skills. I wouldn't put someone on a board, for example, just because he'd been a good executive.

There's a very fine line between a board's understanding an enterprise and double-guessing management. We shouldn't double-guess management on minutiae. Conversely, if you want to make a board fail, give it too many minor decisions.

Peter Drucker put this very well about 50 years ago, when he described the bicycle-shed syndrome. At the top of the agenda of an important board meeting, management puts the issue of repainting bicycle sheds outside headquarters. Every director knows sheds and painting and has something to say about them. The ensuing discussion occupies two hours, after which a \$50 million dubious proposition for a new plant goes through on the nod. I've watched this happen endlessly. I now sometimes read my board papers back to front to ensure that any issues stuffed at the bottom of the agenda don't go unexamined.

### **In what ways can boards ensure they are getting good information?**

There are three primary ways. First, make sure you have reasonable confidence in management and their reporting system. Second, ensure that management's information systems are sufficient, which brings in the role of internal auditors. The audit committees I've sat on take a keen interest in the internal auditors and their audit process to ensure that areas deemed high risk are properly monitored. An audit committee should be concerned with the systems covering all kinds of loss other than business risks. Business risk is a job for the board, and it's they who should be doing a SWOT analysis [Strengths, Weaknesses, Opportunities, Threats]. Internal audit is there to see whether the other systems for controlling risk actually work and to report on these systems.

Finally, you have external auditors. From these professionals you want assurance about the numbers and about internal audit as well as their observations of management. I always start our meetings with no one present but the audit committee, who are by definition non-executives, and the external auditors. I ask the auditors if they have any observations that they wouldn't want to produce before management. Later, I'll occasionally ask the external auditors to retire and question management about the auditors. This kind of process, if done sensibly, will give you good governance without a lot of fuss. It's basically doing a lot of simple things, but doing them very systematically.

### **Corporate governance is the subject of heated debate today. What perspectives are of concern to you and what would you like to see emerge from this debate?**

I disagree with the current American tendency to combine the roles of the CEO and chairman of the board. It creates too great a concentration of power. And it means an outside director has no one to consult if he or she perceives a problem in management.

Another concern is that if our boards take on more of a supervisory role, we risk creating a two-tier structure, broadly along German lines, with a management board and a supervisory board. To some

extent that situation already exists in some U.S. companies with a formal board and an executive committee. The executive committee runs the business and only brings in the board every quarter or so on serious policy issues.

The principle of separating the monitoring function from other directorial functions is an interesting one. Critics of the German system say that the supervisory board tends to be less well informed because it doesn't see the other directors. I wouldn't recommend it, but I don't think that it's necessarily the wrong kind of structure.

Finally, in the wake of recent scandals, I believe one question ought to dominate any director's service: Do the accounts give a reasonable picture of the company's position and its progress? That rules out accounting treatments that keep important items off the balance sheet. You must ensure that profit recognition, critical in most industries, is sensible, robust, and conservative. The pressures on people today to recognize profit prematurely leads to endless troubles. I wouldn't permit it. It's a resignation issue for me. You must feel comfortable with what you're putting your name to.

I frequently ask myself what I would say if I were a director of a company where fraud was discovered. A director in a company of any size simply cannot be held accountable for all the details. If you've been cheated, if management has given you false figures, you must be able to say, "There's no way I could have found this out. I believed these people were reasonable managers, I've examined their track records, I consulted with both internal and external auditors, and attempted to obtain all information I felt was important." You must address the whole question of the information systems and make sure they work. Quite difficult, but that's what you have to do.

## APPENDIX III: AN INTERVIEW WITH GUYLAINE SAUCIER

Guylaine Saucier has seen the relationship between board and management from a variety of perspectives — as former CEO of a forest products company, as non-executive chair of a broadcasting corporation, as a director for a variety of organizations, and as chair of Canada’s Joint Committee on Corporate Governance, which produced the report *Beyond Compliance: Building a Governance Culture* in 2001. She talks here about evolving governance issues and how board and management can work together more effectively.<sup>35</sup>

**Corporate governance is the subject of much discussion today among business leaders, regulators, investors, and other stakeholders. What developments would you like to see come out of this debate?**

The Toronto Stock Exchange guidelines provide a good base for how boards should be structured and operated. What has to improve now is boardroom behavior, which we addressed in our Joint Committee’s report. Quite simply, board members have to take steps to act more independently of management.

A lot has been written about how a board’s most important job is to appoint and evaluate the CEO. But how much time do we take for that? The HR committee will probably spend a few hours, the board, perhaps 15 minutes; I’m overstating the case to make the point that the board’s responsibility in this regard should be much more extensive. The board needs to discuss with the CEO his or her values and objectives, and then put in place benchmarks to evaluate his or her performance. I’ve had arguments with people who say, “boards don’t add value.” I disagree. If we appoint, evaluate, and compensate the CEO properly, and work at setting the strategy with him or her, the board will add value.

Similarly, we also say that a board must guide organizational strategy — rather than simply listening to management, asking a few questions, and essentially rubberstamping strategy. For its part, management needs to engage the board in more active discussions, so directors can contribute. If the board discusses the assumptions at the beginning, engages in debate, proposes alternatives to be analyzed, then it will add value, assuming we have the right people around the table.

**What factors contribute to a strong relationship between a board and management? What practices can boards employ to help facilitate a good relationship?**

If the board and management are to have a good relationship, the two groups must buy in to a good governance culture. Governance cannot be imposed by the board. Management has to believe that, in the end, good governance will mean good performance.

Also, each group must understand its own responsibilities as well as the other’s, or they risk stepping on each other’s toes. The role of the board is to oversee management, but the border between the two groups is never defined permanently. In a crisis, the board may need to take on some management responsibilities. If a CEO is committing fraud, for example, the board will need to step in to fulfill the leadership role until the situation is resolved.

In all circumstances, the board and management must be continually communicating, to ensure mutual understanding. The problem is that the CEO cannot engage in constant dialogue with the board; he or she simply lacks the time. This is why it is quite important to have a non-executive chair fill that gap and facilitate communication between the board and the CEO.

**What ways have you found effective to ensure that a board is getting good information from management and about organizational risks?**

The CEO is responsible for ensuring that the board has the right information to make decisions. But governance is changing, and since the Enron case, boards are becoming more demanding; they want more and better information. They must define their own

needs, however, so they can help the CEO adapt to this new environment. Again, a non-executive chair's role is crucial in facilitating that effort.

Being a board member right now is a real job. If we want to challenge what management is presenting to us in a constructive, efficient way, we have to develop other sources of information. We have to read analysts' reports and industry magazines. We have to do our homework.

#### **Is it harder to recruit board members now?**

Yes. Some headhunters told me recently that they are having increasing difficulty in persuading people to sit on boards and particularly on audit committees. The time commitment required of board members is a big factor. In fact, when I am asked about the characteristics of a good board member, I say independence of mind, good business judgment, a specific competency — and sufficient time. Boards now meet much more often than quarterly; they may get together as often as monthly, and in between they have conference calls. That's one reason it's more difficult to find active CEOs to sit on boards. Every business is now so demanding that CEOs have no extra time for board memberships.

#### **What challenges do most boards grapple with?**

Fulfilling one's responsibilities as a board member is a continuous improvement process — especially in today's challenging environment. Boards are more demanding now. At the same time, we have to be cautious. We don't want to cross the line from overseeing to managing.

As a result, I think that we are all reassessing how we are fulfilling our roles, some more formally than others. Environments are becoming so complex that we have to create and use tools to ensure that we're adding value, and then measure the results. We have to set our own objectives. We have to pause from time to time and say, are we sure we are seizing all the opportunities? This is why we should have not only board evaluation but also constructive evaluations of individual directors.

#### **Is there one roadblock that, if overcome, would enable boards to improve their performance and/or contribution?**

In our global environment, it is increasingly difficult to assess a strategy and to identify the risks and opportunities that are part of it. As we said in our report, risk management is the least developed governance process. It must be better defined and better implemented. When we are discussing strategy, how can we ensure that the board and management take into account all the principal risks? There are some risks that are generally well managed; for example, that of the sudden death of the CEO. People recognize that succession planning is important and complex — especially in entrepreneurial organizations — but they know how to do it.

But, how do we evaluate other aspects of a strategy or compare it to alternatives? And how do we ensure that the changing environment is always put in perspective? We may have one set of risks today, but six months from now, two of our competitors might merge and create a new set. The board has to be comfortable that risks are continually reassessed, managed, and mitigated — but we also have to let the CEO do the job. So, where is the line between the board's comfort and management's autonomy? There is no clear line. It is a difficult balance. Every corporation, every CEO, is different. A few board members change, and suddenly it's a new dynamic. Every board, today, faces a challenge in seeking to get highly competent people who understand the business enough to evaluate the risks and the opportunities involved in a strategy and really add value.

## FOOTNOTES



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- <sup>23</sup> KPMG research.
- <sup>24</sup> Independence of Australian Company Auditors: Review of Current Australian Requirements and Proposals for Reform: Report to the Minister for Financial Services and Regulation by Ian Ramsay, October 2001, p. 15.
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- <sup>33</sup> DTI Press Release, April 15, 2002.
- <sup>34</sup> Telephone interview with Jonathan Charkham, June 5, 2002.
- <sup>35</sup> Telephone interview with Guylaine Saucier, May 15, 2002.

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