



# Private Sector Opinion

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## WHERE WERE THE DIRECTORS?

### Foreword

The credit crisis has caused a cataclysm in corporate governance circles. Distinguished professors, leaders of industry, regulators, legislators and blue ribbon panels around the world are examining everything from bank regulation to how individuals relate to society. There are more “big ideas” floating around than ever. Most, of course, will come into the world with a bang, only to be forgotten equally quickly.

Into this unsettled, shifting landscape, David Beatty takes a different approach. Rather than one big idea, Beatty proposes a series of concrete, common-sense methods to improve the effectiveness of Boards of Directors. These are improvements born of the current context, but which seem timeless. Much in the same way that a magician’s trick seems obvious once you know how it is done, Beatty’s suggestions seem absolutely intuitive once read, yet few boards now practice them.

Beatty’s prescriptions divide into three parts:

- Equipping Boards with adequate expertise to deal with today’s complex issues;
- Managing the time of Directors more efficiently so as to allow true strategic planning; and
- Bridging the expertise chasm between Managers and Directors.

Those are all long-standing issues, what makes Beatty’s advice valuable are the specific steps he recommends to achieve them.

As Sarbanes Oxley codified the importance of having financial expertise on a board, so, too, does Beatty see the current situation as highlighting the need for risk management, domain knowledge and compensation expertise. Perhaps he goes too far—the need for generalists asking questions seems assured for some time, lest boards suffer from the tyranny of specialists with deep but narrow experience—but the need for a mix of domain expertise and general knowledge is a point well made. Directors, particularly those on the nominating committee, need to focus on the skill

sets needed on the board, how to acquire them and how to utilize them effectively. Only then can a board oversee a complex business; boards need adequate knowledge of what can go wrong so as to set risk parameters? Directors need to know how to align compensation so as to encourage the risk profile they seek.

Beatty both identifies the problems and the solutions for the other two thirds of the puzzle. He cites a Canadian study which highlights the frustration of many directors: Too little time is spent on strategy. But he goes further, suggesting step-by-step instructions for how to reverse the problem. Keep a running tally of how the Board spends its time. Use consent agendas to speed routine issues. Specify the action items desired in briefings sent to the Board in advance. Maintain an inventory of strategic issues and put one on each meeting agenda, in the second position, immediately after the CEO report. Certainly, each Board will want to modify the suggestions to meet its particular circumstances, but Beatty's building blocks can be reshaped to suit most situations.

Similarly, Beatty suggests everyday ways to bridge the knowledge gap between a manager who spends 3,000 hours focused on the company and a board whose members spend perhaps a tenth that time on that company, even while balancing competing demands on their time and attention.

In the end, Beatty makes a compelling case for the corporate governance equivalent of "think globally, act locally". He suggests rock-solid little ideas that will survive and add value long after the frothy big ideas dissipate.

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## WHERE WERE THE DIRECTORS?

**By David R. Beatty**

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**W**e are in the midst of a tectonic-plate movement in the financial world that now appears to be shaking the 'real' world quite dramatically. The purpose of this chapter is not to review the causes and potential consequences of our current situation but to explore the possibility that once again, in the world of publicly traded companies, boards of directors have let us down.

### A Long Look Back

**If we go back to the bursting of the South Sea bubble in London in 1720, we can record the first time shareholders belloped this refrain: 'Where were the directors?'** Following the collapse of the Great South Seas Corporation (and many other companies also publicly traded at that time), Alexander Pope wrote a sonnet that began 'At length corruption, like a general flood, /Did deluge all, and avarice creeping on,/Spread, like a low born mist and hid the sun' and ended with the sad conclusion that 'Britain was sunk in lucre's sordid charms.' The British Parliament acted swiftly, putting many directors in jail, taking over their estates, and banning joint-stock companies for one hundred years.

In *The Way We Live Now*, nineteenth-century novelist Anthony Trollope wrote about the board of the magnificently named Great South Central Pacific and Western Railway Company as follows: 'The Chairman, Augustus John Melmotte himself, would speak a few slow words ... always indicative of triumph, and then everybody would agree to everything, somebody would sign something, and the board would be over.' John Galsworthy in the Forsyth saga records Soame Forsyth asking in *The White Monkey*, 'What, besides the drawing of fees and the drinking of tea, were the duties of a director?' And finally, Irving Olds, the chair and CEO of U.S. Steel in 1940, declared that directors were 'the parsley on the fish—decorative but not useful.' Perhaps he was right.

### Modern Times

Following the market crash of 1929 and the Great Depression that ensued, a revolution in oversight and regulation of public markets occurred under President Franklin D. Roosevelt. The Securities and Exchange Commission was established and stock exchanges dramatically tightened their listing requirements.

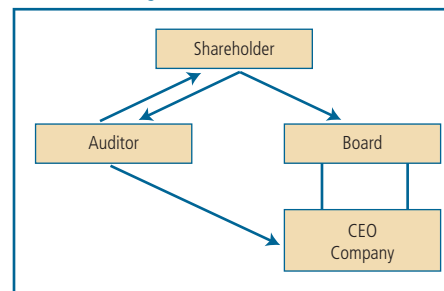
Fast forward to 2001 and the failures of Enron, Worldcom, Adelphia, and a clutch of other companies including Conrad Black's Hollinger Ltd, listed in Toronto, and its subsidiary Hollinger Inc., listed in New York, when once again the question surfaced: 'Where were the directors?' These failures resulted in the tectonic plates of regulatory reform moving again for the first time in over seventy years. **The Sarbanes-Oxley Act of 2002 (known as SOX) created dramatic changes in the way modern, publicly traded companies must govern themselves.**

Figure 1, examines the typical structure of an American board prior to Sarbanes-Oxley. In this simple model, the shareholder elects the board; the board selects the CEO, and the CEO picks his/her team. The board then delegates the management of the corporation to the CEO while looking after compensation matters and maintaining a general oversight of the company. At the same time as the directors are elected, the shareholders select an auditor who independently examines the books and reports back to the Audit Committee of the board and then to the shareholders. The report of the auditors is intended to provide the shareholders an unvarnished account of the true state of the financial affairs of the corporation.

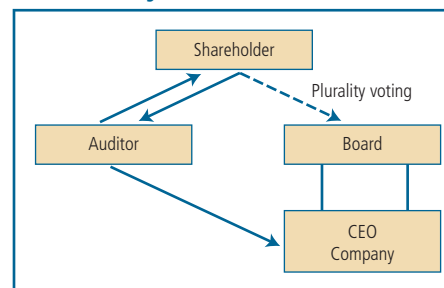
That's the theory, anyway, but prior to the scandals of 2001 things did not actually work this way. As shown in Figure 2, there was some blurring of the lines: The first anomaly in this structure is that, in both Canada and the United States, but nowhere else in the world, shareholders are given a choice of voting 'for' the director candidate or 'withholding' their vote from that candidate. This means that you need only one vote 'for' to be elected. This perverse system is called 'plurality voting' and is in stark contrast to the rest of the world, which embraces 'majority voting.' Under majority voting, you vote 'for' or 'against' a director candidate, and to get elected you need more votes 'for' than 'against.'

So, in a very real sense, in Canada and the United States, shareholders do not elect their directors. Instead, they bless the proposals put forward essentially by the board chair. It's a system more reminiscent of a Soviet tradition than a democratic tradition: 'Here's the slate—approve it!'

**Figure 1. Corporate governance: The theory**



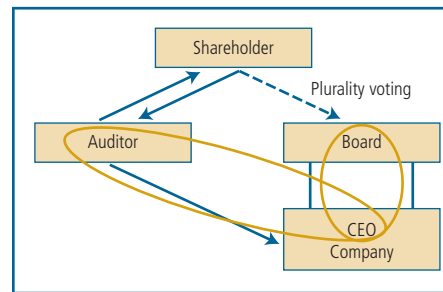
**Figure 2. Corporate governance: The reality**



There is a second anomaly. In 80 per cent of American companies, the CEO is also the chair of the board. In Canada the number is reversed, with 80 per cent of publicly traded companies having a chair of the board independent of the CEO. The rest of the world looks more like Canada than the United States. The practical consequence is that, in the United States, the chair selects his/her board to oversee him/her. 'How can the fox be put in charge of the henhouse?' is a common reaction.

Two consequences flow from these anomalies. First, with the chair selecting the director candidates and the shareholders not being able to vote against the directors, it is often (though not always) the case that an 'Imperial CEO' emerges who essentially is responsible to no one but him/herself. Neither the check nor the balance assumed by the shareholder's election of the board is in place. Second, the ability of the auditor to examine independently the finances of the corporation is seriously compromised. The possibility exists that the CEO, acting as chair, might also select the chair of the Audit Committee. Further, the auditor might, for all practical purposes, be deemed to report to the chief financial officer, who might also advise the Audit Committee on the terms under which the auditor should be hired (see Figure 3).

**Figure 3. The role of the auditor**



Prior to Sarbanes-Oxley, there was no clear distinction between 'auditor' and 'corporate executive'; a fog of conflict had descended, obscuring the separation of duties and responsibilities upon which shareholders rely. This obfuscation rendered it awkward, if indeed at all possible, to have an unbiased and independent view of the financial affairs of the corporation.

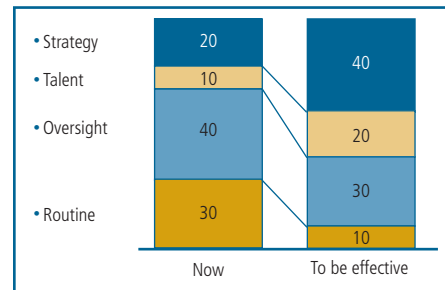
Then, almost immediately following the disclosures surrounding Enron, WorldCom, and Adelphia, the U.S. Congress acted to reform the consequences of the anomalies mentioned above. At their most basic, the SOX reforms ensured the separation of the auditor from the management of the company and clearly established that the auditor worked for and was paid by the board's Audit Committee and reported independently to shareholders through that committee. To ensure that there was a further check on the auditor/company relationship, the auditors' historic right to regulate their own profession was stripped away, and a Public Company Accounting Oversight Board (PCAOB, known colloquially as 'Peekaboo') was put in place. The PCAOB, among its many duties, must certify any audit company working for publicly traded corporations. Without that certification, the audit company is not eligible to perform work in a publicly traded firm.

A vast array of details was also included in the SOX legislation, including CEO/CFO certification of the accounts, under the threat of criminal prosecution. At its very core, SOX transformed the nature of the auditing profession's relationship to the corporation that it audited. This reform, in the American context, was sorely needed.

SOX also had three major effects on American boards that spilled over to corporate Canada as well. First, the chair of the Audit Committee had to have solid financial credentials and members of the audit committee were expected to be 'financially literate.' No more earnest amateurs allowed. Second, the work of the board in its oversight functions, particularly the review of the financial accounts, became much more detailed. The average American board began to spend significantly more time in the boardroom and in preparation for the boardroom. Estimates vary widely, but some observers suggest that the average time spent as a director of a major American company increased from 250 to 350 hours a year. Third, because of the heavy overlay of regulatory approval, the time spent by directors was shifted towards regulatory and oversight matters and away from longer-term work such as helping management develop strategy and talent.

In a survey done jointly by the Canadian Coalition for Good Governance (CCGG) and McKinsey in 2004, some 275 directors estimated their time allocation from two perspectives: as they found it to be and as they wished it to be. Figure 4 shows the results. Today, most boards continue to work approximately 350 hours a year but have effectively absorbed the SOX burdens and are gradually shifting their time back to strategy and talent development.

**Figure 4. How should directors invest their time?**



## The Impact of the Financial Crisis

Having only recently recovered from the SOX reforms, boards now not only have to navigate the troubled credit and liquidity waters of the financial tsunami but also face the prospect of yet more governance reforms. This will be especially true in the financial-services sector. I expect that there will be one new reform that boards will need to address and two 'old chestnuts' that will remain a constant challenge: 1) ensuring that the board has the requisite skills, particularly in risk management and in compensation; 2) managing directors' time more effectively; and 3) spanning the information chasm effectively.

Just as SOX imposed skill requirements upon directors serving on Audit Committees, I am confident that a call will be raised for at least one director—especially in financially regulated institutions—to have had direct line experience with risk management.

There may also be requirements for the Risk Management Committee to be composed only of 'risk literate' directors, to be independently 'audited,' and to report to shareholders separately from the auditor's report on the risk-management practices of the board.

There is a good chance that boards will have to specifically address their competence to set compensation. The need for independent and unconflicted advice to the Compensation Committee will be further emphasized. As it happens, the compensation-advisory industry is dominated by firms who provide many compensation services to company executives (for example, pension-fund calculations). There will likely be a much more pronounced push to ensure that the board gets advice from non-conflicted advisers and that those advisers work for and report only to the chair of the Compensation Committee. Such arrangements would mimic the relationships of the auditor to the Audit Committee after SOX.

In general, I would expect to see boards move to a more 'expert' model. **SOX imposed the financial expert; the current crisis will likely establish the need for a risk expert on the board and possibly a compensation expert.** But, to be an effective contributor to strategy, a board must also contain subject-matter experts. The task is certainly not to meddle with management but to increase the likelihood that boards can contribute to management's thinking about future strategic direction.

The day of the all-amateur board that flies over at 50,000 feet and Mach 2 is gone. Directors need to be able to ask more than generic questions: 'What is the competition doing?' 'How will this affect the employees?' 'Have you thought about X and Y?' **Insight into strategy in a fast-moving and globally competitive business demands directors who actually know something about the business** which they are supposedly overseeing in the interests of the shareholders.

Most boards do not track how their directors invest their time, even by the rudimentary categories shown above. The old managerial saying that 'If you can't measure it you can't manage it' holds for boards as well. If directors are going to spend their time maximizing their potential to contribute to shareholder well-being, they are going to have to wrestle the allocation of that time away from the mundane and towards the strategic end of the spectrum. There is no chance that a director will want to spend more time being a director—they are already 'maxxed out.' Changing the way directors invest their time is never easy, but there are a few tips gleaned from best practices:

1. Ask the corporate secretary to keep a simple running tally of how the board is investing its time. This tally should be considered by the chair as the agenda is designed for each subsequent meeting.
2. Push as hard as you can to get routine matters dealt with in a 'consent agenda' to free up time for strategic business issues.



3. Ensure papers coming to the board are clear, memorable, and compelling in that they:
  - bring directors into the story;
  - describe the issue you are grappling with;
  - propose the answer; and
  - defend the answer with logical reasons.
4. The better the briefing, the more effective the use of the directors' time, both prior to the meeting and during it. Do not let executives make PowerPoint presentations at the board meeting. The operative assumption must be that the directors have done their homework and have both read and thought about the materials. The job of the executive is to refer the directors to a few relevant pages of the briefing book to refresh their memory and then get straight into the Q&A dialogue.

The one problem that is common to all boards and all management teams at all times is the spanning of the information chasm between managers and directors. A manager spends perhaps 3,000 hours a year at work, usually surrounded by other executives labouring just as long. It is also frequently the case that most, if not all, of the senior management team have spent a lifetime in the company or industry where they now work.

Compare that to a director who might annually invest 300 hours in board meetings and preparation. That director will almost always have many other business matters 'on the go,' so there is not a clear and complete focus on the business at hand. What an intellectual conceit it is, then, for a director to 'wander in off the street' for a board meeting and make a contribution to corporate strategy! Or even to make intelligent and informed comment on a particular decision.

How do managements and boards come to terms with this challenge? Or should boards simply stick to their compliance and oversight roles and leave strategy and major decisions entirely to management? Experience has shown that there are techniques and processes that can help directors make more informed and considered decisions that create value for shareholders. Below, I offer a few hints from leading practitioners on how to span this chasm—all derived from the Rotman School's 'Directors Education Programme,' run for the Institute of Corporate Directors ([www.icd.ca](http://www.icd.ca)).

### *Maintain the Dialogue*

**The chair must take the lead to ensure that the dialogue among directors is initiated and maintained.** As the meeting begins, the chair should 'formally' enquire about the preparedness of the directors. Then, as the meeting progresses, the chair should note the quality of the dialogue. And, at the end of the meeting, during the 'in camera'



session, the chair should explicitly seek out views of the board members on whether or not they felt they had been brought into the picture and were given an opportunity to contribute to the discussion in an informed way.

It is also vital that the chair report back to the CEO and/or the management team following the 'in-camera' session. The wise chair will first canvas opinion from the CEO (or the entire top management team) regarding the meeting. Were the directors engaged? Did management get any new insights or points of view? Did management feel that the board should have weighed things somewhat differently? What kinds of things worked with the board? Where did the board feel uncomfortable? Only when management's points of view are ascertained should the chair give his/her feedback on the board's perspective.

From this dialogue among the directors and between the chair and management, the chair and the CEO must distil opportunities to improve the spanning of the information chasm. Perhaps the briefing books needed more background; perhaps the risks needed to be more carefully explored; possibly the directors wanted more discussion. These adjustments are vital to a longer-term understanding of what works for a board and what doesn't. Only if the chair makes these adjustments, and does so adeptly, is there any hope that the governance-management chasm will be effectively spanned to create long-term value for the shareholder.

### *Keep Strategy at the Top of the Agenda*

**Many boards have ensured that they are allocating their time to the most important issues facing their company.** Here are some of their practices:

1. Developing a strategic orientation:
  - building a one/two day off-site strategy session into the annual board-meeting calendar;
  - getting the directors into a rigorous orientation program; and
  - Continuously learning about the business, i.e., analysts reports, field visits, conferences, regular updates from CEO, etc.
2. Starting every board meeting with a CEO update, focusing on the following questions:
  - 'What's different in the environment since we last met?'
  - 'How might our strategy be adjusted in response—if at all?'
  - 'What are the things I am looking out for?'
3. Making it one of the chair's tasks to encourage a discussion that is strategic but enquiring and free ranging.
4. Maintaining an inventory of 'strategic issues' and allocating the #2 agenda item (after the CEO update) to one of these issues when possible/necessary.

*Use the 'In Camera' Meetings to Assess How Effectively You Have Spanned the Chasm*

In the end, **spanning the information chasm is the single biggest challenge for a board that is determined to add value.** Facing this universal problem requires constant attention from both sides. A simple technique is to use the 'in camera' meetings at the end of each board to assess the overall, and possibly decision-by-decision, effectiveness of management's presentations and materials in bringing the directors into the picture. Three questions that need to be asked are:

- Did the directors feel sufficiently well briefed to have been able to come to an informed decision?
- Were the pre-meeting briefing papers models of clarity and structure?
- Was the discussion during the board meeting insightful and directed?

## Conclusion

Boards have been struggling for centuries to represent their shareholders effectively. Intermittent catastrophes have shone a bright light on the way in which directors have carried out their responsibilities and have led to the now universal question 'Where were the directors?'

There is no doubt that today's multiple crises will lead to further evolution in the corporate-governance practices of boards and that future crises will again raise the bar. In the meantime, boards must work hard at evaluating themselves, their practices, and the lessons to be learned from others.

## About the Author

Mr. Beatty is an experienced businessman in Canada and abroad. He spent a decade managing one of North America's largest food companies and serves on the boards of 3 publicly listed companies. Over his career he has served on 30 different boards and been chairman of 5 public companies in Canada, America, Mexico, Australia and England.

He was created a "Fellow" of the Canadian Institute of Corporate Directors in May of 2005.

He was until recently the founding Managing Director of the Canadian Coalition for Good Governance, an organization that represents 50 institutional investors with ~C\$1.3 trillion of assets under management.

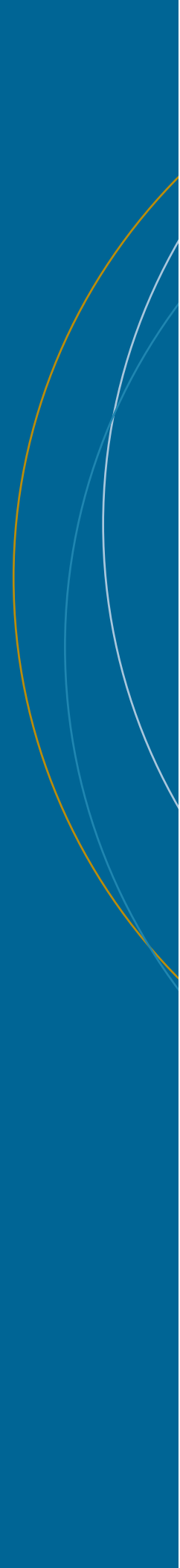
David is a Professor at the University of Toronto's Rotman School of Management where he teaches Corporate Strategy.

David served on Peter Drucker's Foundation Board in the United States for over a decade, the last few years as Vice Chairman.

David was educated at the Universities of Toronto and Cambridge, England. He was named a Nuffield Fellow and spent two years in the Planning Ministry of the Government of Tanzania before returning to Toronto to join McKinsey & Company. He later was a founding partner of The Canada Consulting Group (now part of The Boston Consulting Group.)

He worked in Papua New Guinea from 1974–78 and then spent almost a year at sea sailing from Port Moresby to the Bay of Islands in New Zealand with his wife Debby and their four young children on their 42' ketch.

Her Majesty Queen Elizabeth II inducted him as an Officer of the Most Excellent Order of the British Empire (O.B.E.) in 1994 at Buckingham Palace. He has also been awarded the Papua New Guinea Independence medal and the Papua New Guinea Independence 30th Anniversary Commemorative medal.





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The Forum sponsors regional and local initiatives that address the corporate governance weaknesses of middle- and low-income countries in the context of broader national or regional economic reform programs.

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