UNIVERSAL CORPORATE GOVERNANCE STANDARDS: RECOMMENDATIONS FOR THE COMPOSITION OF A BOARD OF DIRECTORS

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Abstract

In the study reported here, suggestions that the global financial crisis revealed shortcomings in current board of director structures were researched. It was found that the current boards of directors do not have much of a chance of playing a constructive role in the success of any company, giving in to pressure from shareholders to exceed prior results, and failing to monitor the business and to assess its risk profile. In order to enhance board of director efficiency in companies around the world, a new board of director structure called the "management council" is proposed. The structure was discussed with industry experts who agreed that the implementation of the council structure could solve the problems experienced with current board of director structures.

Keywords: Board of Directors, Corporate Governance, Corporate Governance Standards, Global Financial Crisis, Regulatory and Supervisory Activities, Shareholders, Stakeholders, External Audit, Internal Audit

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1 Introduction

The board of directors of a company can be defined as a group of persons elected by the shareholders of a company to govern and manage the affairs of the company (USLegal, 2014). The board of directors is responsible for providing direction for the company, establishing a governance system, governing the company and the relationship with the chief executive officer (COE) as well as protecting the company's assets and members' investments. In addition, the board has an additional monitoring and control function (Boland, 2013).

In the wake of the financial crisis of 2008, it is widely recognised that the current boards of directors do not have much of a chance of playing a constructive role in the success of any company or organisation (Sahlman, 2009). Amongst the reasons cited are that boards are not sufficiently trained, do not spend sufficient time on critical issues, and they have little knowledge to formulate strategies. The absence of a skilled and experienced board is impeding a company in reaching its set goals.

In addition, Holstein (2007) expresses the view that boards of directors often become dysfunctional due to a lack of appropriate skills, inadequate preparation for board meetings and a tendency of directors to try and dominate proceedings. Other authors, such as Gassée (2011), are more outspoken and states that a good board can't make a company, but a bad one will inevitably kill it.

The board of a company has certain specific responsibilities, which have evolved over time (Gevurtz, 2004). A company's board of directors is charged with the responsibility of maintaining good corporate governance, which includes important policy and performance elements. The board of directors is the guardian of fairness, transparency and accountability in all of the financial and business dealings of the company, preserving the interests of investors and other stakeholders.

Rehman (2013) identifies the following roles and responsibilities of a board of directors in a company:

- retaining, evaluating, recruiting, supervising and cooperating with the leader of the company, often referred to as the CEO;
- providing strategic direction for the company;
- controlling and monitoring the auditing process;
- governing the company through interactions with the CEO;
- protecting the investment of the shareholders and the assets of the company; and
- formulating policies for the company.

The board is typically headed by a chairperson, and comprises other directors, the number of which varies from company to company (Mcgrath, 2012). Effective boards usually include a mix of directors

with the expertise and experience to fulfil their roles. PWC (2013) however mentions that directors' responsibilities are expanding, and the number and complexity of the issues they have to oversee are ever increasing. In addition, PWC (2013) mentions that the composition of the board of directors must take into account the development phase of the company, the special requirements of the industry and the needs of the company's operations.

Other critics have also long complained that boards are not up to the task (Henderson and Bainbridge, 2013). Additional reasons cited by Henderson and Bainbridge (2013) include that directors are part-timers with weak incentives and limited information. Directors are also accused of being generalists and that they are selected based on an unknown set of factors. Shareholders also have no information about how decisions are made or how individual directors perform.

Several corporate governance experts, have proposed reforms, some of which have ended up in specific legislation. Henderson and Bainbridge (2013) were, however, of the opinion that these reforms shared several unattractive features, for example that these reforms were one-size-fits-all, notwithstanding the differences across companies and industries. In addition, the reforms relied solely on academics or other "experts" knowing more about what was good for particular companies than the managers and owners of those organisations.

Generally, the proposed reforms seemed to be focusing on board independence as well the enhanced independence of key committees and meaningful disclosure (Khan, 2002). The majority of these reforms were, however, hampered by changes that had to take place in the laws pertaining to corporate governance. These laws currently mainly revolve around the number of independent directors.

Legislation regulating the percentage of directors who must be independent often fail to account for the inherent differences in the talent challenges individual companies face and the real contrasts between industries when it came to the performance of industry outsiders as board members (Moos and Pecchio, 2012).

As a result of the statements made by Sahlman (2009), Henderson and Bainbridge (2013), this study proposes possible reforms in terms of the composition of a typical board of directors of a company. The objective of the study was to propose a new structure of board directors that could alleviate the problems experienced in this regard following the financial crisis of 2008. The proposed new structure was tested amongst high-profile financial executives from around the world with the objective to ascertain whether it could in fact be used by companies to enhance corporate governance in companies.

2 Research methodology

The currently research was firstly aimed at obtaining information from various knowledgeable sources on the traditional board of directors. Secondly, a new structure for a board of directors was developed to possibly replace the traditional board of directors. Lastly, the new structure was tested amongst high-profile financial executives to produce a final council structure by interviewing selected experts.

These experts were selected on the basis of involvement in board of directors' practices, involvement in corporate governance matters as well as applicable legal matters. To achieve this goal, semi-structured interviews were used based on relevant aspects regarding board of director responsibilities. The interviews conducted were strictly confidential and, at their explicit request, none of the experts interviewed were named.

The new structure was provided to the experts to study, express an opinion and provide suggestions to possibly enhance the structure, should it be necessary. This was followed by a discussion of the structure between the author and the relevant experts. The information obtained was then consolidated and incorporated to provide the final new structure. Specific information was obtained from the experts by way of the following research questions:

- Do you agree with the risk-based structure of the council?
- Will the new structure solve existing problem with boards of directors?
- Could legal requirements hinder the implementation of the council structure?
- Is the council structure cost-effective?
- Is the council structure adaptable enough?
- Do you think that supervisors will participate?
- Do you have any general comments or suggestions?

A total number of 27 industry experts were interviewed from a total of 30 experts who were invited to participate.

3 New council (board of directors) structure

3.1 Background

The proposed new board of director structure is a body of elected and appointed members, which jointly oversees the activities of the company. It is further proposed that the new structure be called the "board management council" (or "the council" for short). No changes to the legal requirements of current boards are proposed but this will depend on the specific jurisdiction within which the council operates.

The main differences between the current board structures and the proposed new council are the composition thereof and the fact that the new structure is a risk-based composition. Robinson (2007) states

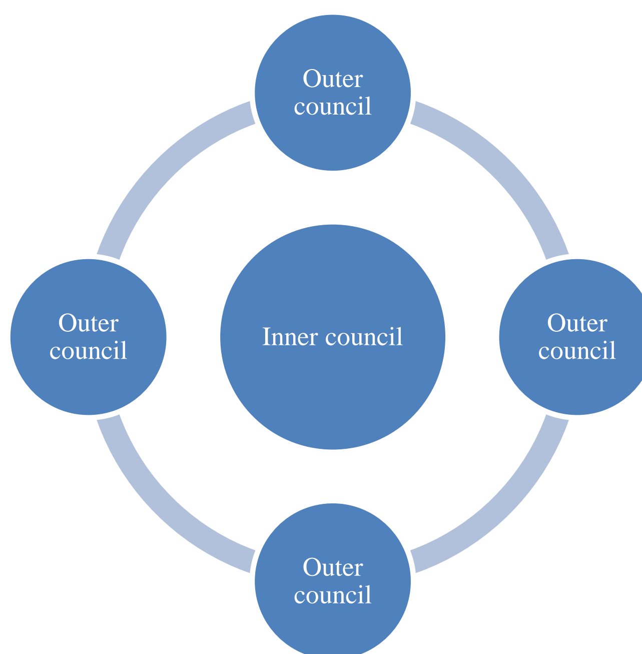
that a risk-based approach means that the company must understand the risks it is exposed to. The council should define its risk appetite, and develop criteria against which the risks can be measured. The risk-based approach is embedded in the internal control framework with more resources devoted to the higher-risk activities.

With regard to the composition, the council will consist of an inner council as well as an outer council as depicted in Figure 1 below. The responsibilities of the council includes amongst others:

- governing the company by establishing broad policies and objectives;
- selecting, appointing, supporting and reviewing the performance of the CEO;
- ensuring the availability of adequate financial resources;
- approving annual budgets;
- accounting to all the stakeholders for the company's performance; and
- setting the salaries and compensation of company management.

The council is also responsible for setting council objectives and the assessment of the council process through standardised assessments of council members.

Figure 1. The council



Source: Author's own compilation, 2014

As can be seen in Figure 1, the council consists of an inner and an outer council as indicated by the four smaller circles. The inner council consists of three independent, voting council members of which one is the elected chairperson of the council. In addition, the inner council also includes two executive staff members of the company, the CEO and the company secretary, also with voting powers. This inner council has the sole voting power but decisions will generally be based on advice obtained from the outer council.

The outer council consists of executives of the company, which represents all the risks to which the company is exposed. This will differ from company to company, as not all companies are exposed to the same type of risks. Also included are the company's external auditors, internal auditors and the representatives of the applicable regulators.

The proposed new council structure is depicted in Figure 2.

3.2 The inner council

The inner council comprises two types of members. Firstly, there is an independent inner council member who can be defined as a member who has no meaningful connections to the company other than serving on the council and being remunerated for applicable services rendered. An inner council member is therefore not allowed to have any financial connections to the company or hold any shares in the company.

The presence of independent representatives on the board, capable of challenging the decisions of management, is widely considered as a means of protecting the interests of shareholders and, where appropriate, other stakeholders (ECGI, 2004). In order to be eligible to be elected as an independent council member, the following criteria are applicable (CGG, 2014):

The independent council member should:

• not be an employee or executive director of the corporation, or an employee or director of its parent company;

• not be an executive director of the company in which the corporation holds a directorship;

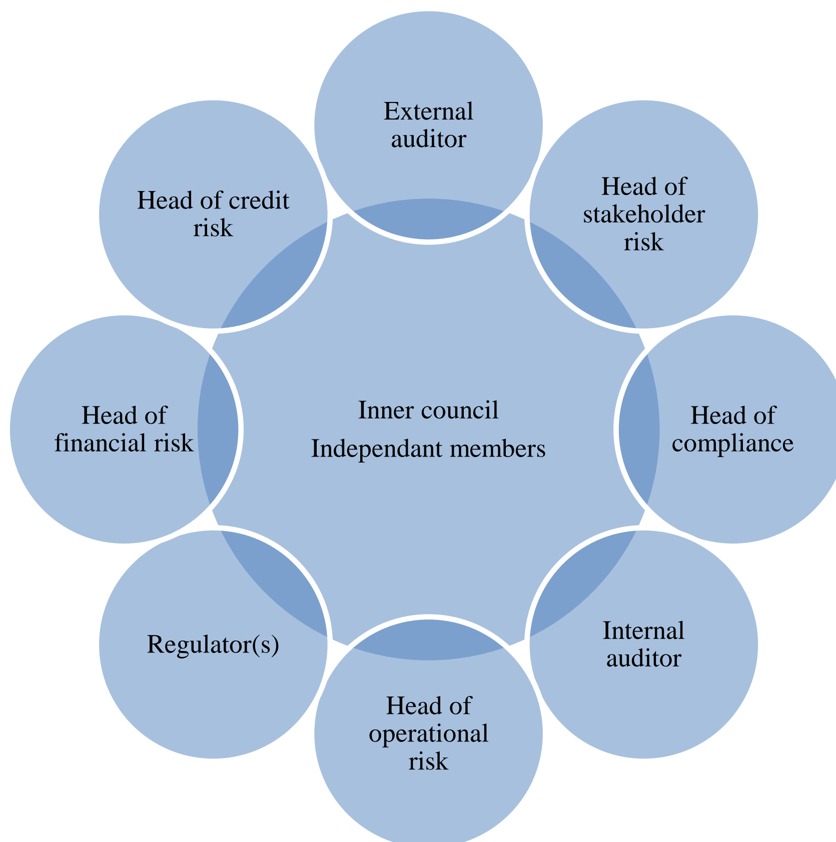
• not be a customer, supplier or banker of the company;

• not be related by close family ties to another inner or outer council member;

• not have been an auditor of the corporation within the previous five years; and

• not have been a council member of the corporation for more than ten years.

Figure 2. The council



Source: Author's own compilation, 2014

The role of the independent council member will vary from company to company but there are certain general requirements that need to be fulfilled. Independent inner council members are not expected to be engaged in the day-to-day management of the company. They are expected to be guardians of the activities of the council and the company as a whole.

The primary task of independent inner council members is to adopt an oversight role and to ensure that the corporate assets are used only for the company. This task includes becoming familiar with the fundamentals of the business in which the company are engaged and continuing to be informed about the activities of the company. Inner council members act as a check on proposed company strategy, bearing in mind the economics of any potential transaction.

Inner council members have to attend council meetings regularly to ensure the ability to monitor corporate affairs and policies generally and to participate in the appointment, assessment and remuneration of inner and outer council members. Where an error or negligence was discovered the independent inner council member cannot claim ignorance and assume that the outer council members were performing their responsibilities towards the company (adapted from Singapore Institute of Directors, 2014).

Independent inner council members' remuneration is one of the most difficult issues to ascertain. Anandarajah (2008) is of the opinion that there are no standard recommendations as to what independent inner council members should be paid for their contributions in companies. It is impossible to set remuneration standards and standards are subject to numerous differences that exist within a company as well as in the industry.

Economic conditions in a country and in the world also affect which fees are to be paid. Anandarajah (2014) further mentions that there is a consistent cry amongst countries that the independent

director (council member) is not adequately compensated.

King III (2012) however suggests that companies should adopt remuneration policies and practices for independent directors that create value for the company over the long term. Such policies and practices should be aligned with the company's strategy, should be reviewed regularly and should be linked to the executive's contribution to company performance.

Secondly, there are two executive inner council members who are employees of the company, namely the CEO and the company secretary. An executive inner council member is allowed to have financial connections to the company and or hold shares in the company. These connections should however be compliant with the any applicable laws, rules and regulations.

The CEO is responsible for leading the execution of the company's long-term strategy with a view to creating shareholder value. The CEO's role also entails being ultimately responsible for all day-to-day management decisions and for implementing the company's long- and short-term plans. The CEO also acts as a direct liaison between the council board and management of the company, and communicates with the council on behalf of management. This also includes managers of risk in the company. The CEO communicates on behalf of the company with shareholders, employees, government authorities, stakeholders and supervisors.

The company secretary is also included in the inner council of the proposed new council structure. King III (2012) suggests that the board of a company should be assisted by a qualified and experienced company secretary. In the new proposed council structure, the role of the company secretary is elevated to that of decision-maker in the inner council. The secretary is legally an officer of the company, and has a number of statutory and fiduciary duties.

The company secretary is included in the inner council as this council member has a key role to play in ensuring that council procedures are both followed and regularly reviewed. The chairperson and the council will rely on the company secretary for guidance on the rules and regulations to which they are subject. All council members have access to the advice and services of the company secretary and should recognise that the chairperson is entitled to strong support from the company secretary in ensuring the effective functioning of the council. The company secretary is therefore a valuable member of the council and indeed of the inner council.

3.3 The outer council

It is the duty of the outer council members to assist the inner council. Outer council members are non-voting members and serve mainly in an advisory capacity.

With reference to Figure 2, the outer council consists firstly of the risk experts, which include compliance, and secondly, the auditing experts including both internal and external auditors and the relevant governmental supervisors.

As the foundation of the new council structure is risk-based, each company is supposed to identify the risks to which the company is exposed, and to manage these risks, report on the risks and take corrective actions if needed. Marquette University (2014) defines risk management as the continuing process to identify, analyse, evaluate and treat loss exposures and to monitor risk control and financial resources to mitigate the adverse effects of loss.

Each identified area of risk should have a risk committee that manages that particular risk in the company. The chairperson of the risk committee is a member of the outer council. Sometimes these chairpersons are also called "heads of risk".

Typical risks include credit, financial, operational, compliance, and stakeholder risk. In this regard –

- the credit risk committee manages all the credit-related issues in the company, including debt recovery;
- the financial committee manages all financial issues in the company, including audit matters;
- the operational risk committee manages all operational issues in the company;
- the stakeholder risk committee manages all stakeholder relationships and related reporting;
- the compliance risk committee manages all compliance-related issues of the company; and
- the compliance committee also acts as liaison between the company and the company's governmental supervisors.

In addition, the company's internal audit department should have an open invitation to attend any of the above risk committees.

It is important to note that, in the new council structure, the traditional audit and risk committee structure have been disbanded and has been incorporated into a functional risk-based structure.

The chairperson of each risk committee has a particular responsibility towards the council for each particular risk, namely:

- identify the risks – risk identification allows individuals to identify risks so that the council becomes aware of potential problems;
- analyse the risks – risk analysis transforms the data about specific risks that developed during risk identification into a consistent form that can be used by the council to make decisions;
- risk planning – risk planning takes the information obtained from risk analysis and uses it to formulate strategies and plans, and to change requests and actions. Risk scheduling ensures that these plans are approved by the council and incorporated into the standard day-to-day processes and infrastructure;

• track and report – risk tracking monitors the status of specific risks and the progress in the company's respective action plans. Risk reporting ensures that the council is aware of the status of top risks and the plans to manage these risks.

• control – risk control is the process of executing risk action plans and their associated status reporting to the council; and

• advice – risk learning formalises the lessons learned and uses tools to capture, categorise, and index such knowledge in a reusable form that can be shared with others and especially council (adapted from Technet, 2014).

Historically, external auditors were appointed by the company's audit committee, and they also reported to this committee. Their objective has always been to express an opinion on the fair presentation of the company's financial statements in conformity with generally accepted accounting principles, international accounting standards and international financial reporting standards.

In the new council structure, the role of the external auditors is enhanced. The auditors are now appointed by the financial risk committee but they are also members of the outer council. Regarding the financial committee, the role of the external auditor stays the same as it was previously in the audit committee.

However, in the council, the role of external auditors changes dramatically. At council level, external auditors are represented by the lead auditor of the appointed audit firm. The new role reflects an advisory capacity. The external auditor can contribute to effective functioning of the council by providing information and advice from an accounting point of view on, amongst others, the following (Larmore, 2014):

• requirements regarding the finances and financial activities of the company;

• economic, political, social, cultural, legal and technological developments in the market;

• current and potential competitors, including strategies for increasing the company's market share, distribution channels, marketing mediums and value chain structures;

• opportunities which are feasible for the company to pursue; and

• the current composition of the target market, and revision of trends to determine needs of the target market.

Internal auditors deal with issues that are important to the survival and prosperity of the company. These auditors look beyond financial risks and statements to consider wider issues such as the company's reputation, its growth, its impact on the environment and the way it treats its employees. In terms of the financial committee, the role of the internal auditor stays the same as it was previously in the audit committee.

The internal auditor also plays an advisory role at council level where the internal auditors are represented by the head of the internal audit department. The internal auditor can contribute by providing information and advice from an internal audit point of view on, amongst other, the effectiveness of governance, risk management and control processes.

Traditionally, the government supervisor had a specific role pertaining to a company. This role varied according to the type of company that was being supervised. For example, for banks this role encompassed, amongst others:

• research regarding emerging issues in the local and international financial stability arena;

• supervision of banking groups on a consolidated basis with a view to supervise all material risks to which the banking group may be exposed appropriately;

• analysis of the financial and risk information of banks, ensuring compliance with prudential requirements, and verifying that banks adhere to regulatory capital requirements;

• assessment of the adequacy of risk management and compliance;

• analysis and assessment of banks' adherence to minimum regulatory disclosure requirements;

• provision of legal administration services; and

• ensuring that the legal framework for the regulation and supervision of banks and banking groups remains relevant and current and aligned with regulatory, supervisory and market developments at a domestic and international level (adapted from South African Reserve Bank, 2014).

The off-site supervisory role of the supervisor has not changed at all but is instead enhanced by adding an enhanced on-site supervision role. The supervisor will attend the council meetings in both a supervisory as well as an advisory role. The advantage of having a supervisor at council level is that the supervisor can advise the council on the latest developments in the market, raise supervisory concerns about the company, liaise with all role players, and provide feedback on the company's supervisory performance.

The following are the perceived advantages of instituting the new council structure:

• the company can be managed according to a risk-based approach;

• all relevant role players are present at council level;

• the council is kept up to date with the latest information;

• the inner council can make informed decisions based on the input from various experts;

• the council structure is adaptable according to the needs and activities of the company;

• fewer meetings are taking place resulting in cost savings;

- council agendas can deal with both operational as well as strategic issues;
- non-functioning board committees are eliminated;
- the council provides strategic direction instead of management; and
- the council can easily deal with external and internal requirements.

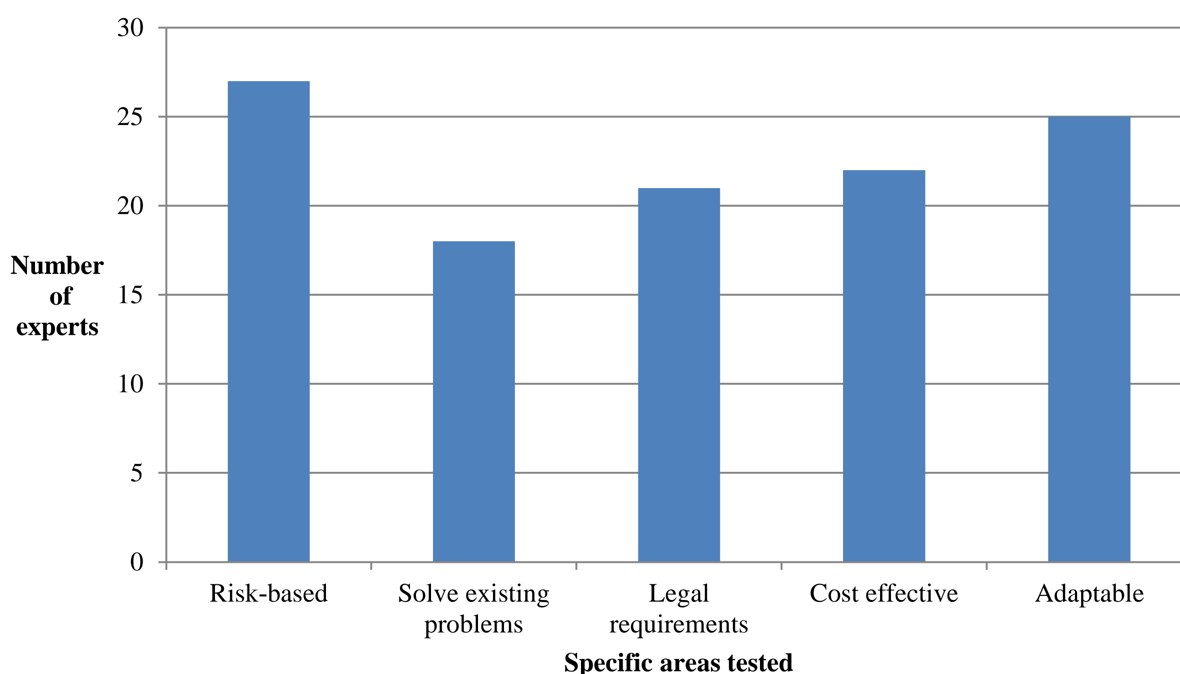
There could also be some disadvantages to implementing the council structure such as:

- resistance to change;
- supervisor's reluctance to participate;
- legal constraints in a particular country; and
- a shortage of experienced and qualified inner council members.

4 Test results

As mentioned above, the proposed new council structure was presented to a panel of experts to test its viability and to propose possible enhancements. The results are depicted in Figure 3 and are based on the questions as reported under the research methodology above.

Figure 3. Results



Source: Author's own compilation, 2014

The following specific results were obtained:

- The experts unanimously agreed with the fact that the new council's foundation should be the risk-based approach.
- The majority of the experts, 16 out of 27, agreed that the new council structure could solve existing board problems. The others agreed to the concept but were not certain that it would solve problems immediately. The main concern was that it was viable but it could take some time to implement.
- The majority of the experts, 21 out of 27, agreed that legal constraints could hinder the implementation of the council structure but thought that there are definite advantages once these constraints have been overcome.
- The majority of the experts, 22 out of 27, agreed that the council is a cost-effective alternative to current structures as it means fewer committees, fewer independent members and faster turnaround times.
- The majority of the experts, 25 out of 27, agreed that the council structure is adaptable enough to be introduced in different companies in different sectors of the economy operating in different countries.
- The following are some of the general comments on the proposed structure:
  - It is possible to implement the structure, and the structure has some definite advantages.
  - There could be some resistance from the supervisors.
  - Auditors might be reluctant to participate because of independence issues.
  - The introduction of the new council structure might be costly at its initial implementation.

The experts offered no specific enhancements to the council structure and agreed that the implementation of the council structure could solve

the problems experienced with current board of director structures.

5 Recommendation

The study on which this article is based, proposed that a new board of director structure called "management council" be introduced by different companies around the world in order to alleviate the current problems experienced with boards of directors in the wake of the financial crisis.

6 Conclusion

Suggestions that the global financial crisis revealed severe shortcomings in current board of director structures were researched. Research in this study found that boards of directors were accused of being too complacent in allowing their management and staff to engage in risky behaviour, adopting compensation programmes that encouraged risky behaviour, giving in to pressure from shareholders to exceed prior results, and failing to monitor the business and assess its risk profile.

In order to enhance board of director efficiency in companies around the world a new board of director structure called "management council" was proposed. The structure was discussed with experts around the world who agreed that the implementation of the council structure could solve the problems experienced with current board of director structures.

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