Corporate governance frameworks: Hype or an essential practice?

As more companies adopt formal frameworks, we examine who should be involved in governance strategies, the evolving nature of such structures and the main benefits.

Awareness of the importance of corporate governance was given a boost this September, when WeWork, the US-based provider of co-working spaces, shelved its planned IPO largely due to concerns among potential investors about its governance practices.

Given those developments, our survey on corporate governance frameworks—the set of policies and procedures for governance, a description of the aims and values used to judge its success, and the demarcation of precisely who is in charge of what—is all the timelier.

In September, we surveyed 25 senior executives at US and Canadian companies, including heads of governance and investor relations, general counsel, and corporate secretaries.

Every company surveyed had a formal governance framework in place. Respondents say they valued its role in improving governance processes and accountability, and to a lesser extent in improving transparency for stakeholders.

The survey shows the wide pool of knowledge that companies draw on when setting frameworks. This includes not merely senior executives from inside the business, but also outside experts. It is also interesting to see an appreciation by companies that the governance framework is not merely something that needs setting once and then forgetting about, like the foundations of a building. Instead, companies evaluate and update their frameworks frequently.

We hope that this survey proves useful to anyone committed to improving governance frameworks.

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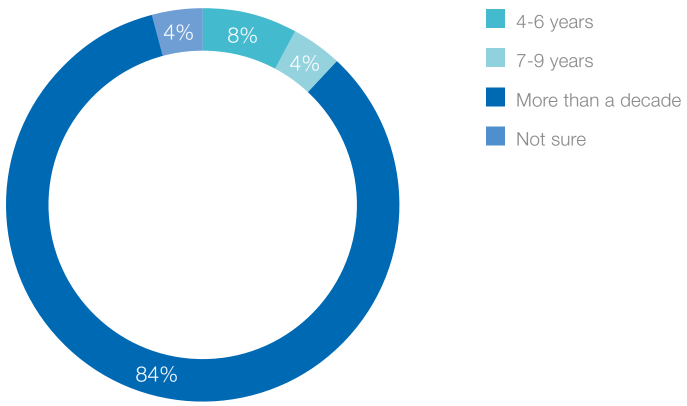
Gaining consensus

Formal corporate governance frameworks are well-entrenched among large companies: every respondent to our survey said their company had a formal corporate governance framework, and 84% said their company has had theirs for more than a decade.

To the best of your knowledge, for how long have your company's corporate governance policies been formalized? (Select one)



This widespread adoption can be credited to the increased awareness of the importance of good corporate governance after a few highly publicized fraud cases between 2000 and 2002, at Enron, WorldCom and Tyco, which revealed major corporate governance failures among companies that were hitherto looked up to as examples of well-run businesses. Moreover, the scandals led to the Sarbanes Oxley Act (known as SOX) in the US, which made governance much stricter in a wide range of areas. While SOX did not require US companies to create formal corporate governance frameworks, it did encourage their spread, by prompting senior executives to think hard about governance. Canada agreed to an equivalent law, known as C-SOX, in 2003.

Over the past decade, pressure to establish formal governance frameworks among the minority of US and Canadian companies that lacked one has increased further as investor interest in the ESG (Environmental, Social and Governance) agenda has grown.

Why a formalized framework?

Many investors are reassured about a portfolio company's governance standards if they see a formal framework, and our survey shows that this view is shared by executives. The most important benefit of formalized policies is that it establishes straightforward processes for maintaining effective governance, say 48% of respondents.

A further 36% cite improved accountability of the board and management as the most important benefit. "Having a clear set of rules helps in management and in a sound communications system," a head of investor relations notes. "It has become increasingly important that these are followed without wavering, and one can be assured of the set standards and ethics being practiced."

However, establishing a formal framework is not an easy process; keeping it up-to-date and relevant to new developments is challenging too. Four in ten respondents say the biggest challenge with maintaining and implementing a formal framework is gaining consensus on the right priorities for new policies. This may be particularly hard at times of rapid change in what business leaders, and wider society, regard as important. "Working out areas such as ethics, environmental and social responsibilities

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>
> **Head of investor relations, power company**

may be given priority at times, depending on the company and sector of operation", says a director of investor relations. "These priorities often change depending on the economic and political climate."

A further 32% say the greatest challenge is making sure all stakeholders are kept informed about the policies, including any updates. "It is essential that all the stakeholders are aware of any changes, so they can make the appropriate modifications to actions as soon as possible", a general counsel and corporate secretary warns.

Aside from the board of directors, the responsibility for updating corporate governance policies is mainly seen by respondents as falling on CEOs: 100% of respondents agreed on this. The general counsel (chosen by 96% of respondents) and the corporate secretary (88%) are seen as important participants too. Most companies also see value in using outside consultants, with 76% of businesses surveyed saying they used the services of consultants when updating governance policies and procedures.

The role of outside consultants is rarely discussed by senior management in public. However, a director of governance and corporate secretary surveyed notes: "We found it effective to base our policies on recommendations from consultancies. They are well aware of the risks and possibilities to consider while creating the policies, so it was a more practical approach." The common use of outside consultancies may explain why only 12% of organizations surveyed say they have a chief governance officer.

In a noteworthy finding in our survey, 40% of respondents say they communicate only some of their governance policies publicly. Making all governance policies public and high-profile carries a risk: if the policies lay down highly ambitious standards for behavior and policy, stakeholders may contrast lofty ideals with actual practice that does not quite measure up. Activist shareholders may then press aggressively for change if there is a clear gap between theory and practice.

A new set of priorities?

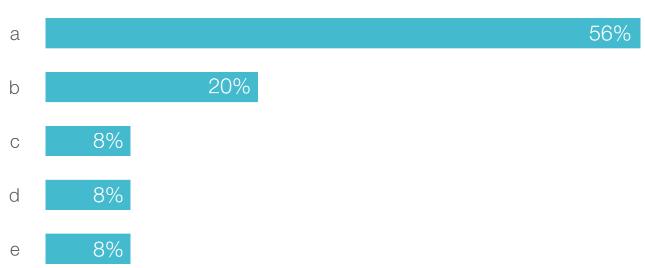
In deciding corporate governance policies, companies consider a wide variety of sources and influences. All respondents say they take account of their particular company's principles and beliefs. However, shareholder proposals, laws and regulations, and recommendations from consultancies all score 80% or higher. The lowest-scoring factor is peer company practices, though over half (64%) chose this among their answers to the question.

When asked to select the single most important factor shaping their policies, respondents saw the company's own principles and beliefs as the main influence, with 56% of those surveyed choosing this answer. A director of risk management surveyed stated: "As a company, we are expected to grow and deliver to better standards each time. As such, emphasis on the company's principles and beliefs was highly important to the governance framework." In other words, importing policies from outside the company may not, they felt, be appropriate. This reasoning is particularly understandable when companies have a very particular culture. For example, US-based clothing business Patagonia styles itself as an "activist company" for environmental causes—an unusual principle unique to that specific company.

It is worth noting that 44% of respondents did not consider their own internal principles and beliefs as the most important factor when setting governance policies. Two in ten cite federal and state laws and regulations as the most important factor. This is more likely to be the case more in more heavily regulated sectors. Moreover, 8% apiece regard shareholder proposals, recommendations from consultancies or peer company practices as the single most important factor. This shows that the policies of a sizeable minority of organizations are shaped primarily by outside forces.

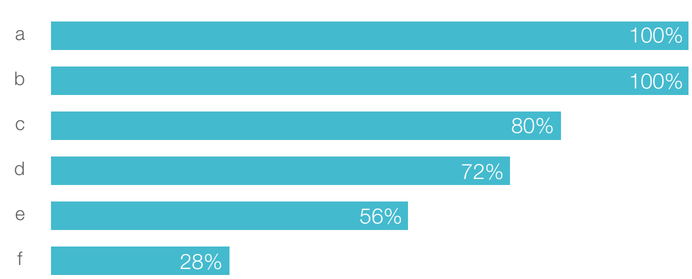
When considering their corporate governance policies, all companies surveyed recognized shareholders and employees as stakeholders—and any other result would have been surprising. Additionally, 80% of respondents identify customers as stakeholders. Strikingly, the environment was also seen by a large majority of our respondents as a stakeholder, with 72% choosing this among their answers. Society at large was seen by fewer respondents as a stakeholder, though this was still selected by more than half, at 56%. Lastly, suppliers are seen by a minority of companies surveyed as among their stakeholders (28%).

On which of the following are your corporate governance policies based? (Select the most important)



a Our company's own principles and beliefs
b Federal and state laws and regulations
c Shareholder proposals
d Recommendations from consultancies
e Peer company practices

In your corporate governance policies, which of the following groups does your company recognize as stakeholders? (Select all that apply)



a Shareholders
b Employees
c Customers
d The environment
e Society at large
f Suppliers

A director of governance and corporate secretary surveyed justifies this big tent policy by saying: "For our governance policies, we've regarded shareholders, suppliers, employees and customers as stakeholders as they have a direct relationship with returns and the standards of the company as a whole."

These findings are interesting to consider in the context of a recent announcement by Business Roundtable, an association of CEOs at leading American companies. In August, the organization released a statement on the purpose of a corporation, redefining it as "for the benefit of all stakeholders—customers, employees, suppliers, communities and shareholders".

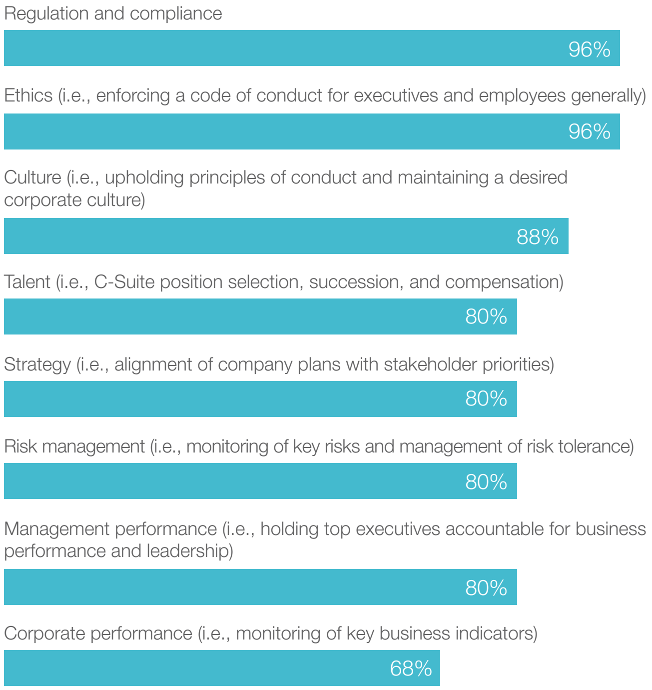
Our survey suggests that rather than setting the agenda, the Business Roundtable statement reflects pre-existing sentiment. In fact, our survey demonstrates that businesses are perhaps willing to embrace a broader definition of stakeholders than the Business Roundtable announcement demonstrated—nearly three quarters of our respondents saw the environment as a stakeholder, whereas the Business Roundtable statement subsumed a reference to the environment under its commitment to "communities."

Wide-ranging policies

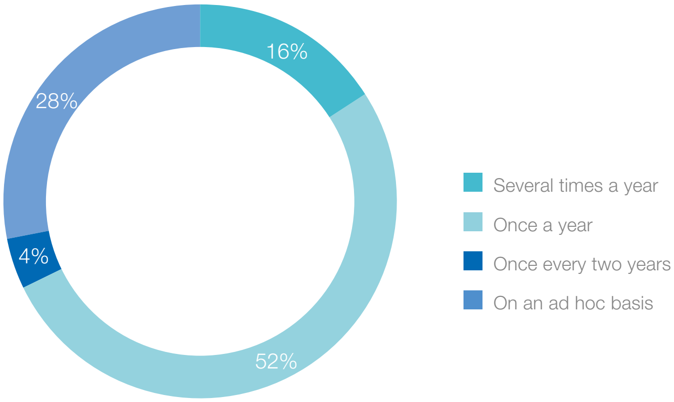
Our survey shows that governance policies tend to be extremely wide-ranging. An overwhelming majority (96%) of companies surveyed say regulation and compliance is an area covered by their corporate governance policies and procedures. The same proportion of respondents said ethics was an area covered. Furthermore, a wide range of other considerations score 80% or more: culture, talent, strategy, risk management and management performance. Only corporate performance, at 68%, was chosen by fewer than 80%—suggesting that the bottom line is not early as high on executives' mind as other matters when it comes to issue of governance.

All respondents surveyed say that their company formally evaluates its adherence to corporate governance policies. This is done at least once a year by 68%, with 4% doing so once every two years, and 28% on an ad hoc basis.

In which of the following areas does your company have a written set of corporate governance policies and procedures? (Select all that apply)



How often does your company evaluate its adherence to corporate governance policies? (Select one)



Corporate governance policies are updated at least once a year by 64%, with the remainder doing so as needed. A director of risk management whose company updates its policies once a year speaks of the process as something akin to an annual servicing that boosts corporate performance: “Outdated structures tend to affect productivity levels and may increase risks over a period of time. Timely updates would naturally reduce the costs resulting from these increased risks and lack of proactive behavior.”

One respondent explained the rationale for updating policies on an ad hoc basis thus: “Our policies are updated as required, due to internal changes and external influences as well. Personnel changes affect the management and immediate direction of the company, so updates are made to ensure they are up to date. Moreover, political, economic and influencing conditions also prompt decisions for change in policies.”

An annual—or even more frequent—review of policies could be beneficial given that recent history has shown how some issues can rise rapidly into public and investor consciousness, creating the risk that management will be seen as out of touch if they do not react quickly enough. For example, complaints about the issue of executive pay surged a few years ago and have not subsided. Concerns about sexual harassment at work rose even more abruptly when the #MeToo movement took off in October 2017. While the majority of our respondents say their governance frameworks were developed with help from outside consultancies, it is worth noting that such consultants usually build on existing frameworks, rather than throwing them out altogether. This is partly due to how widespread corporate governance frameworks already are in large US and Canadian businesses. Consultancies should therefore be mindful of the long-standing beliefs and principles of the company, which have shaped corporate governance up until that point. However, in some cases, governance policies require dramatic overhaul, especially after a governance crisis. For example, many banks moved to strengthen governance during the global financial crisis a decade ago.

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Director of risk management, travel operator

Conclusion

Our survey shows that many US and Canadian companies take corporate governance seriously, apply it to a broad range of issues, consider a wide spectrum of stakeholders, and draw on an expansive pool of expertise both inside and outside the company. They also evaluate and update policies periodically, which suggests a nimbleness in responding to future governance issues. What might these issues be?

One governance issue likely to continue to grow in importance among executives is the environment, in part because of pressure from a wide range of stakeholders. Another issue that looks set to ascend the list of governance priorities is the broad topic of gender—not only sexual harassment, but also family-friendly employment practices, and the adequate representation of women in the stratum that oversees and implements governance: the board and C-suite.

Whatever the challenges, and wherever they come from, a rigorous governance policy and frequent reviews on adherence and updates are necessary. No matter how committed executives are to governance, constant review and improvements are not only good practice, but critical in a rapidly changing environment.

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