

# Corporate governance: Business under scrutiny



A white paper from  
the Economist Intelligence Unit  
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## **Corporate governance: Business under scrutiny**

*Corporate governance: Business under scrutiny* was written by the Economist Intelligence Unit and sponsored by KPMG.

The Economist Intelligence Unit bears sole responsibility for the content of the report. The Economist Intelligence Unit's editorial team conducted the interviews and online survey and wrote the report. Craig Mellow was the main author. Additional material was supplied by Chris Leahy and Marina Williams-Wynn. Andrew Palmer was the editor of the report. The findings and views expressed in this report do not necessarily reflect the views of KPMG, which has sponsored this publication in the interests of promoting informed debate.

The research effort for this report comprised a number of key initiatives:

- The Economist Intelligence Unit conducted a special online survey to test the attitudes of senior executives worldwide to corporate governance. A total of 310 international executives participated in the survey, which was conducted in June–July 2003. Full survey results are available in the appendix to this report.
- A series of in-depth interviews was held with leading corporate, academic and regulatory figures in July and August 2003. Executives and officials at over 30 different companies and organisations were interviewed from a diverse range of countries and industries.
- The Economist Intelligence Unit also undertook substantial desk research into corporate governance and transparency practices worldwide. The research was co-ordinated by Anthony Ray.

Our deepest thanks go to all the interviewees and survey respondents for sharing their insights.



## Corporate governance Business under scrutiny

### Executive summary

It is over a year since the Sarbanes-Oxley Act was signed into law in the United States, over a year and a half since Enron, the emblem of poor corporate governance, filed for bankruptcy. The flood of corporate scandal has slowed and the financial markets look healthier. Might the governance issue be losing steam?

This white paper from the Economist Intelligence Unit, a follow-up to *Corporate governance: The new strategic imperative*, published in September 2002, argues not. Corporate governance is still a front-burner issue for senior executives. Companies remain focused on corporate governance reform—in a survey of more than 300 senior managers around the world, executives reported that top management is spending more time on governance now than it did 12 months ago, and will be devoting even more attention to the issue in the future.

What impact is all this activity actually having on business? Asked whether companies are better governed now than they were before Enron became a household name, a third of the survey respondents agreed, double the number who felt that companies are no better governed. But the largest group of respondents, 45% of the executives, said that there was no way of telling. And only one-fifth of the executives we surveyed agreed that public trust in business was returning.

Nevertheless, evidence that substantive change is afoot is compelling:

- Shareholders have become more active in their examination of companies, and to judge by the recent rows over executive compensation at Glaxo-Smithkline, Tesco and others, they are acquiring a taste for showing the CEO who really is boss. Almost three-quarters of the survey group believe that investors are more energetic in their pursuit of information than before.
- Many companies are responding by becoming more transparent. Research for this report shows that, compared with 12 months ago, information

about governance policies and processes is easier to find on company websites and in annual reports.

- A majority of survey respondents believe that senior managers have a better grasp of the business realities within their company as a result of the governance focus. And over 60% think that governance procedures have a positive impact on the ability of organisations to form alliances and partnerships.
- The board has become a more potent force within the organisation. Over half of the executives we surveyed agreed that the board wields more clout now than it did before. But as the responsibilities of the board have increased, so the hunt for top-quality directors has become more trying. Good non-executive directors are harder and more expensive to recruit, in the view of almost two-thirds of the survey group.

### The future focus

How the governance issue develops over the next 12 months is an intriguing question. Three areas of potential focus stand out:

- **The measurement problem.** There is an apparent disconnect between the time and effort companies are putting into governance and the impact of these initiatives on both general levels of public trust in business and on the share prices of individual firms. Put simply, good governance is hard to gauge. There are telltale signs of the right "tone at the top" (see box opposite), but there is a need for outside ratings agencies to develop more meaningful governance yardsticks and for firms to communicate their governance processes even more effectively.
- **Japan.** Whereas the wounds inflicted on the reputation of US business have started to heal, and Europe's governance regimes elicit relative approval from survey respondents, there's scant evidence of progress in Japan. The survey group clearly pegs Japan as the country with furthest to go in



## Ten signs of the right tone at the top

- 1** Thorough oversight of company finances by qualified independent directors free of pressure from management and with funds to hire their own expert consultants.
- 2** Absence of any conflicts of interest on the part of outside directors—relationships with their own businesses, consulting contracts, and so forth.
- 3** A well-balanced board by skill and age, selected by a nominating committee independent of the CEO.
- 4** Top executive compensation that is convincingly tied to longer-term performance on a variety of criteria. Linking incentive pay more closely to relative performance against competitors, both financially and in the market, is sensible.
- 5** Tightening up of holding requirements that limit the ability of executives and directors to unload shares at a peak.
- 6** Regular meetings of outside board members away from the CEO.
- 7** Comprehensive and regular briefing of the board on strategic questions, followed by open debate.
- 8** A board that knows how to stay out of operational questions and focuses on the big picture.
- 9** Accessible financial accounts that clearly set out the principles behind, and consequences of, significant accounting policies and decisions.
- 10** Transparent information on, and explanation of, corporate decisions on matters of both strategy and governance.

improving standards of governance; our research into corporate transparency reinforces the point, with Japanese firms making only marginal improvements in this area since last year.

● **Executive pay.** Compensation is the last area most companies have wanted to touch as they refurbish their governance platforms. Yet the appearance of greed at the top may be the easiest way to damage a corporate reputation in the current climate. CEO compensation in major stock markets rose by 10% during 2001, while their companies' values slumped by 23%, objects Peter Montagnon, head of investment affairs at the

Association of British Insurers. Pay that properly relates to performance is likely to be the next, and most volatile frontier, in shareholder activism.

The sustained focus on corporate governance is already having some long-term effects on companies. The dynamics of the relationship between boards, managers and shareholders are changing—boards are becoming more powerful, shareholders more aggressive, managers more circumspect. As the governance imperative takes even deeper hold over the coming months and years, the scale and impact of these changes will become ever more obvious.



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**Introduction**

Is the corporate governance issue losing steam? The headline-grabbing scandals of 2001-02, such as Enron, WorldCom and Tyco, are fading into history. The principal culprits have been identified and many are scheduled to have their day in court.

Lawmakers and regulators around the world have been busy drafting rules to punish miscreants and prevent further lapses. Executives now eagerly embrace the language of governance, ethics and trust. Standards of transparency at the largest companies have improved as a result—research for this report shows that information on governance practices at the largest firms is more accessible now than it was 12 months ago.

Meanwhile, the equity markets have stopped wobbling and, dare one say it, the global economy is starting to look less fragile. Many suspect that passion will start to fade from the governance debate as a result. “Will a bull market make everyone forget about all this again? I rather fear

it will”, says Alistair Ross Goobey, chairman of the International Corporate Governance Network.

Institutional investors, the group in the best position to apply sustained pressure to managers, have one excellent reason to ease up: playing watchdog is expensive and time-consuming. Asset managers, competing for ever-decreasing commissions, are still by and large staying away from it, while badgering from activist pension funds is something companies have lived with for a decade.

So might the focus on governance turn out to be a convulsion, a corporate and regulatory spasm that defined a few months in 2001 and 2002 but produced no lasting change in the corporate landscape?

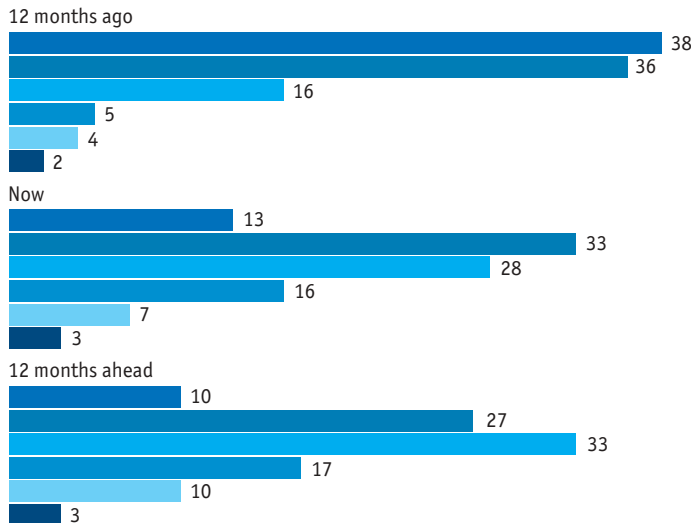
**Pressure maintained**

The short answer is no. The mess of the past few years is just too profound for corporate leaders, as

**How much time does the senior management team devote to corporate governance now compared with 12 months ago? How much time will they be devoting to the topic a year from now, in your view?**

% of respondents

■ Under 5% of time ■ 5-10% ■ 10-20% ■ 20-30% ■ 30-50% ■ Over 50% of time



Source: Economist Intelligence Unit survey, June-July 2003



**If you have implemented changes to governance processes over the past year, how have costs and revenues at your company been affected as a result?**

% of respondents

■ Large drop ■ Slight drop ■ No change ■ Slight rise ■ Large rise

**Costs**



**Revenues**



Source: Economist Intelligence Unit survey, June-July 2003

a group, to go back to business as usual. Enron and the other corporate scandals of 2001-02 set off a chain of events that no listed company can ignore. As a result, executives are devoting more time, not less, to the governance issue.

In a survey of 310 senior executives around the world, conducted for this report in July and August 2003, more than half the respondents reported that top management is spending over 10% of its time on governance. Only a quarter reckoned governance absorbed that much time 12 months ago. And the demands of governance on corporate leaders are expected to rise further. Almost two-thirds of the respondents expect their top managers to devote over a tenth of their time to governance a year from now.

It's not just time that's being spent on governance. Almost 40% of the executives surveyed have seen a rise in costs over the past year as a result of changes to governance processes, and just 13% have seen costs fall. Fully one-third of executives say that governance is among the top three priorities in their organisation, the same proportion of respondents as an equivalent Economist Intelligence Unit survey in 2002.

## The governance impact

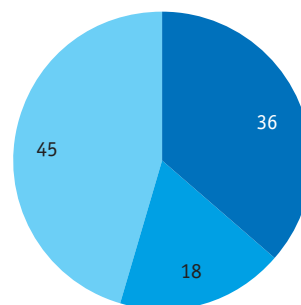
Improving corporate governance is still a front-burner issue. But what impact is all this activity actually having on business?

Asked whether companies are better governed now than they were before Enron became a household name, a third of the survey respondents agreed, double the number who felt that companies are no better governed. But the largest group of respondents, 45% of the executives, said that there was no way of telling. And only one-fifth

**Are listed companies better governed now than they were before the Enron affair broke, in your view?**

% of respondents

■ Yes ■ No ■ There's no way of knowing



Source: Economist Intelligence Unit survey, June-July 2003



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of the executives we surveyed agreed that public trust in business was returning.

Despite upward pressure on costs, revenues have not been obviously helped: almost 80% of the survey group think that governance changes have had no impact on money coming into the business.

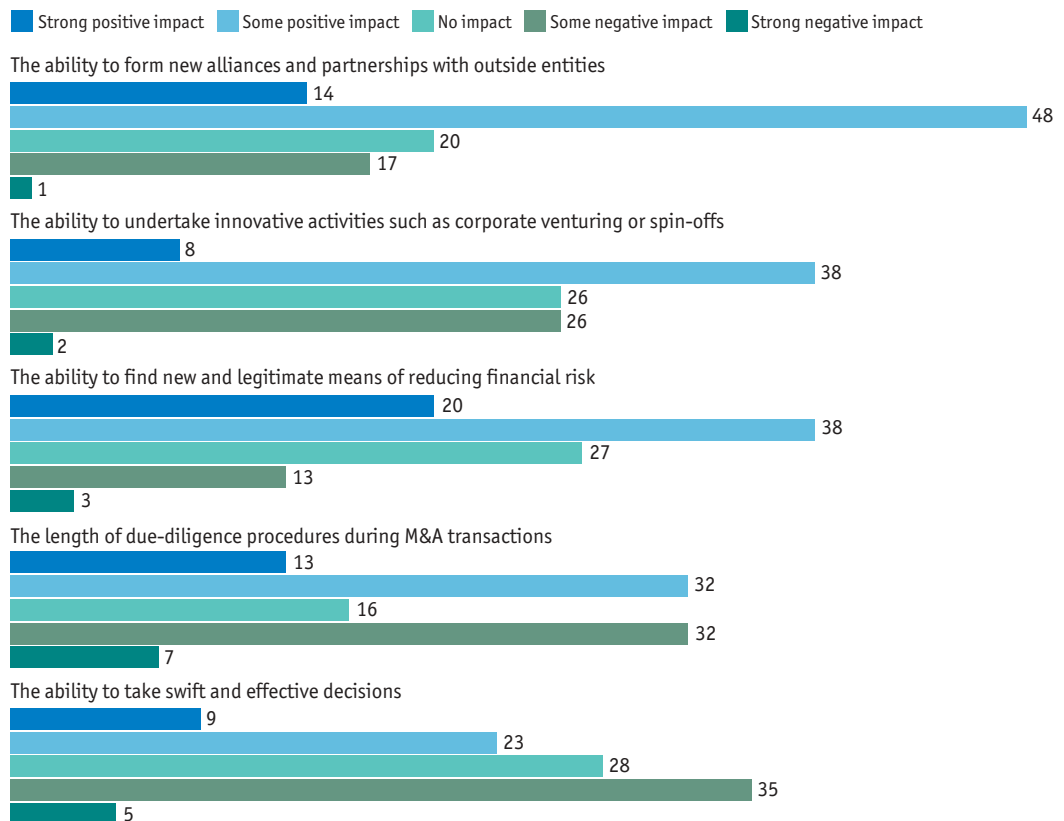
As for share prices, it's still early to reach a definitive verdict on the relationship between governance and share price. The view of the survey respondents that a perception of poor governance will hurt an organisation's share price is surely right. But the survey group's conviction that positive perceptions of corporate governance can

help a company's market value is unproven. Firms that have gone out of their way to be shareholder-friendly still wait for their market reward. "We threw out eight systems of executive compensation when we had our merger and designed a new system from scratch in close consultation with our institutional investors", recalls Ian Fraser, chief of human resources at BHP Billiton, an international mining company. "Have we been rewarded by investors for it? Not yet."

What about worries that a focus on governance is stifling risk-taking, a theme of our 2002 report on governance? More respondents believe that governance procedures militate against swift and

### What impact does the imposition of strict and formal corporate governance procedures have on the following aspects of business?

% of respondents



Source: Economist Intelligence Unit survey, June-July 2003



effective decision-making than think they encourage it. Robert Cox, vice-chairman of Chubb, a US insurer, fears that a culture of second-guessing could hamper corporate growth. "Are people less willing to take appropriate business risk? Are they putting off non-routine decisions to study them a little further?" he asks rhetorically. "From hints I hear I'd say there's a fear of being blamed if something goes wrong even for legitimate business reasons."

But Ben Heineman, general counsel at GE, is among those who disagree. "Governance changes are neutral as to risk-taking", he declares. "The idea that independent boards are curtailing executive decisions is a complete and utter misnomer." The survey group is also in two minds: more executives think governance changes enhance the ability to undertake innovative activities such as corporate venturing or spin-offs than diminish it.

There are two possible explanations for this disconnect between the time and effort companies are putting into governance and the apparently modest impact of these initiatives. The first is that changes are genuinely occurring to the way companies are doing business but they aren't always visible. The second is that companies are putting in place new governance processes but that these processes do not necessarily lead to substantive change. There is truth to both answers.

Let's look at the second hypothesis first, which might be termed the problem of form over substance. Regulators and lawmakers have issued a welter of new rules and codes since the governance storm broke, and there's more to come. In the United States, the Securities and Exchange Commission is still busy interpreting the Sarbanes-Oxley Act, and the New York Stock Exchange has yet to formalise its (well-flagged)

regulations. The European Commission has put forward a governance action plan, while the UK authorities continue to chew over the recommendations of the Higgs Report. Regulators in emerging markets have, if anything, been busier still (see box, The Asian experience, on page 8).

A strong governance framework is certainly important in shoring up market confidence. The wounds inflicted on the reputation of the US market in particular are healing as a result of the steps taken there by lawmakers. One indication is that 70% of the respondents to our survey of 310 executives ranked the US as the most-improved market for corporate governance over the past year.

But a prescriptive approach also risks encouraging firms to focus on avoiding penalties, rather than pursuing good governance. "At the end of the day, it's hard to know how much difference Sarbanes-Oxley and the rest of it will really make," says Deborah Zemke, director at corporate governance at Ford.

The form-over-substance problem is exemplified by efforts to supercharge the audit committee. The survey group picks an enhanced role for the audit committee as the best way of ensuring good governance; it's also the area where most respondents had taken action over the past year. "There's been a sea change in the relationship between boards and CEOs, and the best evidence is that audit committee meetings are three or four times longer than they used to be", enthuses Raymond Toubh, Enron's current post-bankruptcy chairman and a veteran of more than 25 US boards.

But here more than anywhere else, companies must not assume that a new "expert" audit committee head and longer meetings means a clean bill of health. Consistent, accurate accounting that resists end-of-quarter adjustments and off-balance sheet trickery is as much a cultural commitment impressed

## Form over substance



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### The Asian experience

Like the apocryphal curate's egg, Asian corporate governance is a case of good in parts and rotten in others. A recent report, produced jointly by CLSA Emerging Markets, a stockbroker, and the Asian Corporate Governance Association, a non-profit investor pressure group, highlights the point. The report reviewed governance in ten Asian markets and found that in almost all countries efforts are being made to improve the legal and regulatory systems that underpin good corporate governance.

Korea is planning to implement class action legislation and continues its purge of family-controlled conglomerates. China has introduced both quarterly reporting and requirements for independent directors. Indonesia now requires audit committees and independent directors. Malaysia has implemented a code of corporate governance, as have Taiwan, the Philippines and Thailand.

So far, so encouraging. But the report also scored individual Asian companies on seven key categories, such as discipline, transparency and accountability. The results show a vast disparity in quality, underlining just how far many Asian companies have to go before they approach generally accepted international standards.

Top of the country class, as might be expected, is Singapore, followed by Hong Kong and, somewhat surprisingly, India, where overall disclosure standards have improved dramatically, accounting differences between local and US standards have been minimised and the number of companies with a majority of independent directors has risen significantly.

A satisfactory but could-do-better report card is returned by companies in Taiwan, Korea and

Malaysia, while in need of significant improvement are firms in Thailand, China, the Philippines and the perennial laggard, Indonesia. In these countries in particular, corporate governance is more a matter of form over substance, with enforcement of legislation raising doubts as to how serious these governments really are about raising governance standards.

Two key Asian markets are missing from the report. Japan's blushes have been spared. Out of the US, the UK, France and Germany, Japan has most to do to improve governance, in the view of our survey group. It is also the worst performer in the new transparency research carried out for this report.

Australia, by contrast, deserves genuine plaudits. Corporate governance guidelines issued by the Australian Stock Exchange (ASX) in March 2003 avoid a rules-based approach. With the exception of audit committee requirements (which are compulsory for Top 500 companies) implementation of the guidelines is flexible, taking into account the particular circumstances of each company.

Especially important in this regard, and in line with the "comply or explain" approach being taken in other parts of the world, is the so-called 'if not, why not' requirement. If companies choose not to adopt all the new ASX guidelines, they must inform shareholders which principles have not been followed and why. The pressure on companies to meet the guidelines will be considerable, and the market is thought likely to punish those who cannot satisfactorily explain a divergence from recommended practices.



What, in your view, are the principal ways to ensure good corporate governance within individual companies?  
Please choose the top two prescriptions.

% of respondents



Source: Economist Intelligence Unit survey, June–July 2003

throughout the organisation as a function of board effectiveness.

First, the most conscientious director will only know what he or she is told. “You have to remember that boards don’t produce the numbers, they get the numbers from other people,” says Ira Milstein, a high-profile legal corporate governance advocate in the US.

Second, no rules or oversight can keep the numbers straight if there is a culture of bending them. Trevor Harris, a managing director at Morgan Stanley who formerly chaired the accounting department at Columbia Business School, tells a story about Qwest, another star of the 1990s that burnt out in a shower of questionable financial assumptions. The company swelled its cash-flow figures by reporting revenue guarantees from distributors as cash in hand. “The US government had 420 pages of rules applying to these kinds of transactions,” he recalls, “but that particular one wasn’t in it.”

Third, corporate executives and board members do not understand bookkeeping as well as the general (and investing) public probably assumes. Almost a quarter of EIU survey respondents listed “lack of financial understanding on the part of senior executives and the board” as a primary barrier to effective corporate governance. That

may be understating the problem, according to Roman Weil, a professor at the University of Chicago graduate school of business who runs top-up accounting seminars for US board members. “I’ve given 500 board members or candidates a test of 25 multiple choice questions that come from chapter two of a basic accounting textbook,” he relates. “The median number of correct answers is 10.”

Professor Weil also has limited faith in the new wave of “financial experts” whom Sarbanes-Oxley requires to head board audit committees. To meet this obligation, companies have sent recruiters out to hire chief financial officers, active or retired, for this slot. But, he points out, many CFOs who came on board in the 1980s and 1990s were investment bankers by background, skilled in directing corporate finance and merger activity but with no particular accounting expertise. Only CFOs who emerged from the environment of the comptroller’s office have day-to-day accounting skills, and these were in a minority during the boom era. “We’ve come through 15 years when the CFOs of the most glamorous companies didn’t know much accounting”, says Professor Weil.

His solution: hire retired auditors as audit committee heads, starting with the many ex-Arthur Andersen partners lying fallow around the



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world. But many companies remain reluctant to elevate what they see as one-dimensional specialists to board level," says Julie Daum, who heads US board services at Spencer Stuart in New York. "They're looking for businesspeople with financial backgrounds", she explains. "That might include someone who ran a business for one of the auditing firms, but not just an accountant."

What CEOs and boards can do, without going back for an accounting degree, is make war on

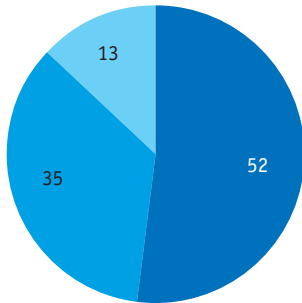
numerical obfuscation. "The criterion has to be whether the CEO and board members can read the statements and know what's going on in the company," says Mr Harris at Morgan Stanley. "Companies have to get the point that disclosure is not transparency", agrees Richard Singleton, director for corporate governance at ISIS Asset Management in London. "We don't want to see this Enron-style, 'Oh yes, we disclosed it in Note 7 on Page 203.'"

**What effects has the focus on governance had on the business environment in your industry?**  
**Please state whether you agree or disagree with each statement.**

% of respondents

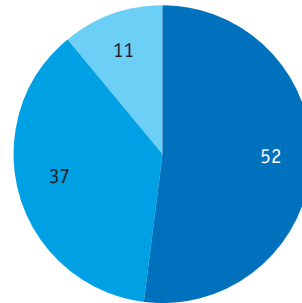
■ Agree ■ Disagree ■ Don't know

Senior managers have a better grasp of the business realities within their company



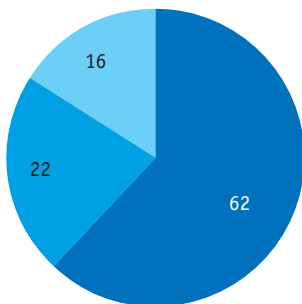
■ Agree ■ Disagree ■ Don't know

The board has become a more potent force within the organisation



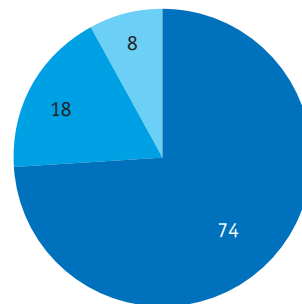
■ Agree ■ Disagree ■ Don't know

Good non-executive directors are harder and more expensive to recruit



■ Agree ■ Disagree ■ Don't know

Shareholders are more active now than they were before in pursuit of information



Source: Economist Intelligence Unit survey, June-July 2003



## Beneath the surface

Rules and regulations may help shore up confidence in the market but they will not magically produce good behaviour. In the words of David Morgan, CEO of Westpac, an Australian bank, “at the end of the day, you can’t legislate goodness”. The problem is, you cannot always see it either.

The most obvious indicators of corporate health—the share price and revenues—betray little yet about the impact of governance. And while an entire “governance industry” is emerging to satisfy the thirst for information on how well companies are controlled and managed, it is not yet mature. “I don’t think we are quite of age”, says Jan van

## A better picture for corporate transparency?

For the second year running, the Economist Intelligence Unit assessed the transparency of the top ten firms by market capitalisation in France, Germany, Japan, the UK and the US. Each company was scored for the provision and accessibility of information (notably in the investor relations section of their websites, annual reports and SEC filings) on 29 governance issues ranging from disclosure on executive pay and information on non-executive directors to retention of auditors and ease of voting at the annual general meeting.

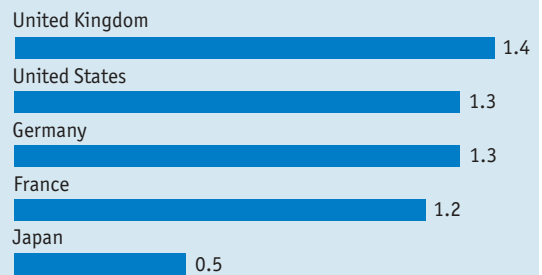
The good news: information is getting easier to find. In August 2002, 32% of the companies we looked at did not have a separate section on corporate governance either on their website or in their annual report. In August 2003 this proportion had fallen to 24% (and Japan alone accounted for three-quarters of the laggards).

With the exception of Japan, most companies now provide clear information on the various committees and supervisory boards responsible for auditing and executive compensation. Companies in all countries also provided good information on accounting policies and analysis of the different types of risk the company faces. US corporations in particular appear to have taken significant steps to become more transparent.

Despite these improvements, information remains patchy in a number of areas. It was still very difficult to find adequate guidance on voting rights for shareholders without hunting through proxy statements. Disclosure of remuneration remained opaque in French and German companies—in a number of cases, remuneration details were not broken down to the level of the individual and only a lump sum for the whole board was disclosed. Perhaps most disappointing was the lack of detail on selection and attendance of non-executive directors—only one company in the entire sample provided a record of individual attendance.

### Average corporate transparency scores in each country

Maximum possible score = 3



Ten companies in each country were marked for transparency on 29 items of governance information, according to the following scale:  
0 = information was not available or well hidden  
1 = the information was there, but hard to find  
2 = easily found, but incomplete  
3 = easily found, understandable and complete enough to answer the question

Note: Full research results are available from the Economist Intelligence Unit on request. Please contact Andrew Palmer on [andrewpalmer@eiu.com](mailto:andrewpalmer@eiu.com)  
Source: Economist Intelligence Unit



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der Poel, director of a would-be Dutch rating agency called Governance Metrics. “Investors need something that can be measured, not just a qualitative impression.”

Nevertheless, beneath the surface evidence is mounting that the past 12 months have seen a substantive change in the way companies are being run.

- Shareholders have become more active in their examination of companies, and to judge by the recent rows over executive compensation at Glaxo-Smithkline, Tesco and others, they are acquiring a taste for showing the CEO who really is boss. Almost three-quarters of the survey group believe that investors are more energetic in their pursuit of information than before.
- Many companies are responding by becoming more transparent. Research for this report shows that, compared with 12 months ago, information about governance policies and processes is easier to find on company websites and in annual reports.
- A majority of survey respondents believes that senior managers have a better grasp of the business realities within their company as a result of the governance focus. And over 60% think that governance procedures have a positive impact on the ability of organisations to form alliances and partnerships. “I don’t think we could have integrated our mergers as easily as we did without the clarity about rules of the game that our procedures give us”, says David Jackson, company secretary at BP.
- The board has become a more potent force within the organisation. Over half of the executives we surveyed agreed that the board wields more clout now than it did before. But as the responsibilities of the board have increased, so the hunt for top-quality directors has become more trying. Good non-executive directors are harder and more expensive to recruit, in the view of almost two-thirds of the survey group.

## The tone at the top

Where will the governance focus fall next? The post-Enron consensus aggressively endorses the old adage that a fish rots from the head. Respondents to our survey largely agree with the premise that good governance starts, or ends, at the top. “Vested interests of top management” was the top pick as an obstacle to governance reform, cited by 42%. Would-be governance raters comb through minutes of board meetings to divine the “tone at the top.” Insurers dissect the business activities of outside directors for potential conflicts of interest before setting directors and officers (D&O) insurance premiums.

For many, the focus is narrower still—on the “imperial CEO”, in the memorable phrase of the US Securities and Exchange Commission Chairman, William Donaldson. Titans of the corporate world are taking notice. Michael Eisner, CEO of Disney, has hired Mr Milstein as a special counsel to the board, while recruiting one of the US’s most estimable public figures, retired Senator George Mitchell, as a senior director. General Electric, ruled for two decades by the most lionised imperial CEO of them all, Jack Welch, kicks off a new briefing paper on governance with the phrase: “GE CEO Jeff Immelt is sharing more power with the board than his predecessor ... Immelt’s new power-sharing is codified in GE’s new governance principles.”

As the governance debate continues to unfurl, it is in this area—curbing the prerogatives of the imperial CEO—that the most heat and light is being generated. Two issues in particular are emerging as touchstones.

## Collegial, not cosy

The first is control of board appointments, and ultimately of CEO succession itself. The New York Stock Exchange has proposed that only independent directors sit on board-nominating committees, and Mr Donaldson’s SEC is mulling a statutory right for investors to put forward their



own candidates. (This practice, traditionally viewed by US business as too fractious, has long been standard in the UK and other jurisdictions.)

Even before any regulations are finalised, US board members are taking over many searches for new colleagues that would formerly have been handled by the CEO. The chief executive's acquiescence is not always enthusiastic, but it is coming, professional head hunters are happy to report: "It's hard for some of them, but I don't think we're going backwards", says Ms Daum at Spencer Stuart.

When it comes to the question of who actually sits on the board, the vision of management tends

to differ from that of investors and regulators. The outsiders see a rapid diversification away from the traditional fraternity of other-company CEOs to specialists of various stripes, "shareholder representatives", and managers from the public and non-profit sector. "A broader search for talent, into networks you wouldn't normally think of personally because you're not part of them, is likely to produce benefits for the firm", asserts Laura D'Andrea Tyson, the dean of London Business School and author of a recent report on finding non-conventional directors. "That's not rocket science."

More contentious is the idea of the professional

## The GE way

Jack Welch was not really the tyrant that legend made him out to be, says Ben Heineman, General Electric's long-time top attorney. Mr Welch's senior director was Walter Wriston, a retired Citicorp CEO and as far from a yes-man as could be imagined. Still, Mr Welch's successor as CEO, Jeff Immelt, responded to the Enron disaster by delegating Mr Heineman to overhaul governance practice, with an eye toward making the GE board "our most constructive critics and wisest counselors."

Step one was to tilt the board more heavily toward independent directors—11 out of 17 members—and to define that independence explicitly: no more than 1 percent of revenue in their own firms can come from business with GE.

Mr Heineman then set the outside board members a workload well above and beyond even the Sarbanes-Oxley requirements—three meetings a year without the CEO present, plus two visits annually to GE business units (again without executive meddling). The audit

committee is required to meet seven times each year. To make sure they focus, GE directors are restricted in their other commitments. Active CEOs are permitted a maximum of two other boards (as if they would want more).

GE enshrined two anti-"pump and dump" principles in its guidance for executives' share options. First, officers must hold on to options worth a fixed multiple of their base salary—six times for the CEO, four for more ordinary mortals. That limits cashing in on an upward blip in the share price. Second, they have to keep shares they decide to redeem for a year after exercising the option, then sell at the year-later price.

But perhaps most important, from Mr Heineman's point of view, is the annual strategic review Mr Immelt is required to present to the full board. "Do you discuss important decisions in your own life in depth with family and friends beforehand?" he asks rhetorically. "That's the partnering relationship with the board that the governance changes encourage."



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director. "The search for truly independent directors may well lead to the professional non-executive director, a person in his mid-40s who sits on six or so company boards and has time to do a good job", says Jaap Winter, a Dutch lawyer who headed a study that generated the core of European Commission governance recommendations.

Companies, by contrast, are bent on caution in disturbing what they see as delicate boardroom chemistry. Professional directors are a non-starter, says Charles King, head of global board services at Korn/Ferry International in New York. "Companies are looking for businesspeople who are active and operating and adding their own competence to the mix", he says. "A professional director is not something most companies are looking for."

So far management is finding candidates that meet its criteria, even if it takes a little longer, reports Mr King. But will that continue? As we have seen, the EIU survey points to simmering anxiety on this score: nearly two-thirds of respondents agreed that good non-executive directors are getting harder to find. So does simple arithmetic. The time commitment of the average US corporate board member has risen by half in the past two years, estimates Mr King. This will mean traditional CEO types serving on fewer boards, all the more so if continued hard times demand more of their attention for their own business. Wise boards will be quietly thinking about how to extend their mix in order not to run short of candidates in the future.

### Pay for performance

The second touchstone issue, and potentially the more explosive, is pay. Compensation is the last area most boards have wanted to touch as they refurbish their governance platforms. Just 12% of survey respondents have tinkered with their remuneration committees, compared to 55% who

"strengthened the internal audit function." Yet the appearance of greed at the top may be the easiest way to damage a corporate reputation in the current climate. "Executive pay is the biggest issue for the general public", comments Peter Forstmoser, chairman of insurer Swiss Re. "It's the one issue where we might still see some action from legislators."

Companies' response to this simmering area of contention can be thought of as the next chapter of the great governance debate, one whose early paragraphs are just now being written. Executive compensation is a potent symbol to investors of whether a CEO and his cohorts are working for them, or vice versa. But runaway option plans can also be a very real drain on the business and the stock price. Some companies, including blue-chip names, have blithely given away up to 25% of their market value in unaccounted-for option grants, estimates Mr Singleton at ISIS Asset Management. In the US, more than 200 companies have already voluntarily starting reporting employee stock options as a cost, in anticipation of regulatory requirements to that effect becoming law by 2005.

The good news for bosses is that no one on the inside of the governance debate has any real problem with their getting rich as long as they are adding lasting value to their companies. How to define that "lasting" is the critical question. "Best-practice companies lead with how they define success, then shape the compensation to those goals—whether it's being number one in a market, top-line growth, return on capital or whatever", says Peter Chingos, who leads executive pay consulting for Mercer in the US.

More concretely, Mr Chingos and others point to a few trends in the super-pay brackets:

- A shift to restricted stock grants instead of options. This is as much a bottom-line decision as a governance one. Once option costs appear in the balance sheet, companies will have to pay even for options that are "underwater," adding insult to



the injury of already-aggrieved shareholders.

- Tightening up of holding requirements that limit executives' and directors' ability to unload shares at a peak. The latest thinking centres on "retaining net shares," meaning an active officer can only sell when he receives a new stock grant, keeping the total shares in his possession constant.
- Curbing the practice of every company aiming to pay 60% to 75% of average compensation for whatever peer group their consultant defines, thus constantly ratcheting up pay. This is wryly known among investors as the "Lake Wobegon Effect," after Garrison Keillor's mythical US prairie town where "all the children are just above average."
- Linking incentive pay more closely to relative performance against competitors, both financially and in the stock market.

These are shifts that investors and executives can broadly agree on, even if they quibble over particulars. Tougher to finesse may be the guarantees and golden parachutes that increasingly excite shareholder accusations of "paying for failure." While CEOs accept their jobs are insecure, they may not come to work at all if they can lose all their income on each market downturn. "You're generally going to recruit a chief executive from some other attractive job, which means you've got to give him some financial guarantees", argues David Ewers, a professor at Henley Management College in the UK. "We see a lot of pissed-off CEOs saying, 'I work 14 or 16 hours a day and I don't need all this aggravation from the newspapers.'"

Others have less sympathy. "The belly of the corporate beast is an options-centric CEO appointing a board of other current or former CEOs, listening to experts he or she has hired about how everybody's compensation always has to be in the 75th percentile", roars Herbert Denton, president of Providence Capital in New York and himself a veteran of seven US boards.

Whatever their inner feelings, though, top corporate managers are showing belated signs of temperance in their pay packets, observes Mr Chingos. CEO pay in a Mercer survey of 350 US corporations rose by 14% in 2002, while profits rose by 15%. Sixty-two of the 350 corporate chieftains got no bonus at all last year, while 22 saw "significantly less" than in 2001. Compared to years past, this is a wave of corporate austerity.

## Known risks, unknown rewards

It is wrong to say that the global torrent of new laws and regulations has solved the governance problem. It is too early to say whether good governance increases revenues or bolsters the share price. It may even be the case that governance fosters caution at the expense of risk-taking (though many disagree, and others might argue that's no bad thing in a post-dotcom world).

But the governance imperative has, if anything, strengthened over the course of the past 12 months. Enron and the other corporate scandals of 2001-02 remain fresh in the minds of regulators, investors and managers. The issue is absorbing more senior management time than it did 12 months ago and it will take up still more in the future.

This sustained focus on governance is having some long-term effects. The dynamics of the relationship between boards, managers and shareholders are changing—boards are becoming more powerful, shareholders more aggressive, managers more circumspect. And information flows within companies are improving, to the extent that executives believe management has a better grasp on business realities.

These changes are helping to erode the perception that governance is an obligation. "The debate over governance is really a huge opportunity for companies, which they will pass up at their peril," says BP's Mr Jackson. The scale of that opportunity will become ever clearer over the coming months and years.



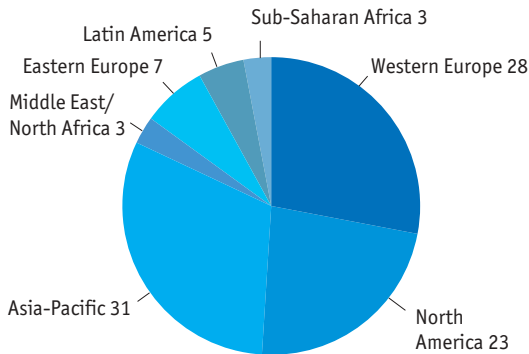
**Appendix**  
Executive survey results

## Appendix: Executive survey results

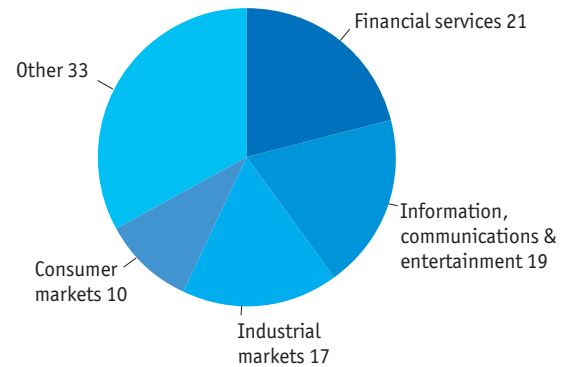
A total of 310 senior executives participated in our online survey on corporate governance. The survey was conducted in June and July 2003, and our thanks are due to all those who shared their time and insights.

**Respondent demographics**  
% of respondents

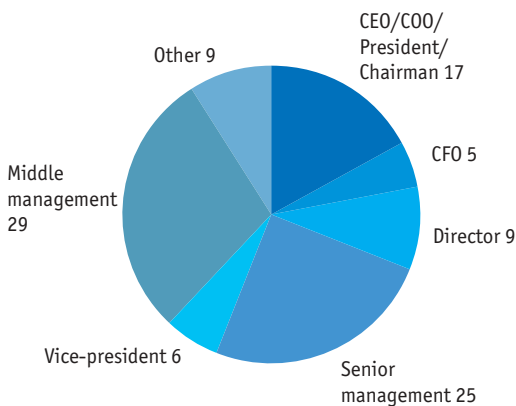
**Where are you located?**



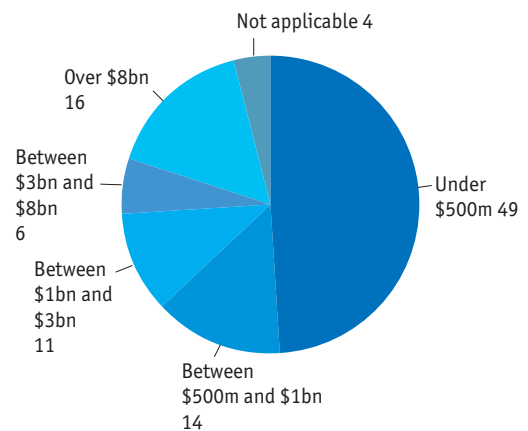
**What industry are you in?**



**What is your job title?**



**What is your company's annual turnover?**



SECTION 1

## The marketplace

### 1. Are listed companies better governed now than they were before the Enron affair broke, in your view?

% of respondents



### 2. What effects has the focus on governance had on the business environment in your industry?

% of respondents

Agree Disagree Don't agree

Senior managers have a better grasp of the business realities within their company



Public trust in business is returning



The board has become a more potent force within the organisation



Unnecessary legislation has added to the regulatory burden on business



Good non-executive directors are harder and more expensive to recruit



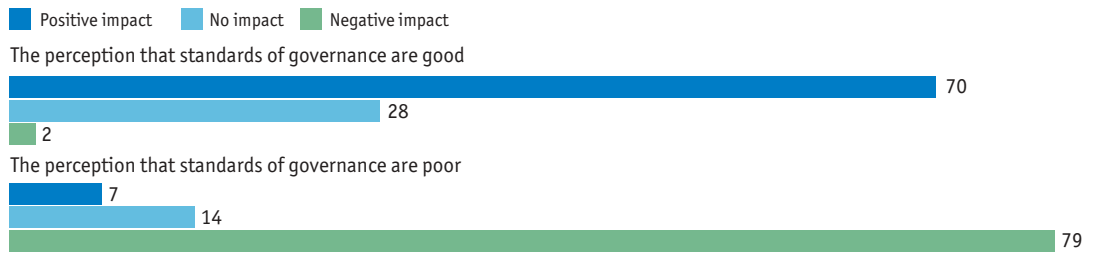
Unlisted companies are at a greater competitive advantage because of increased governance requirements on listed firms



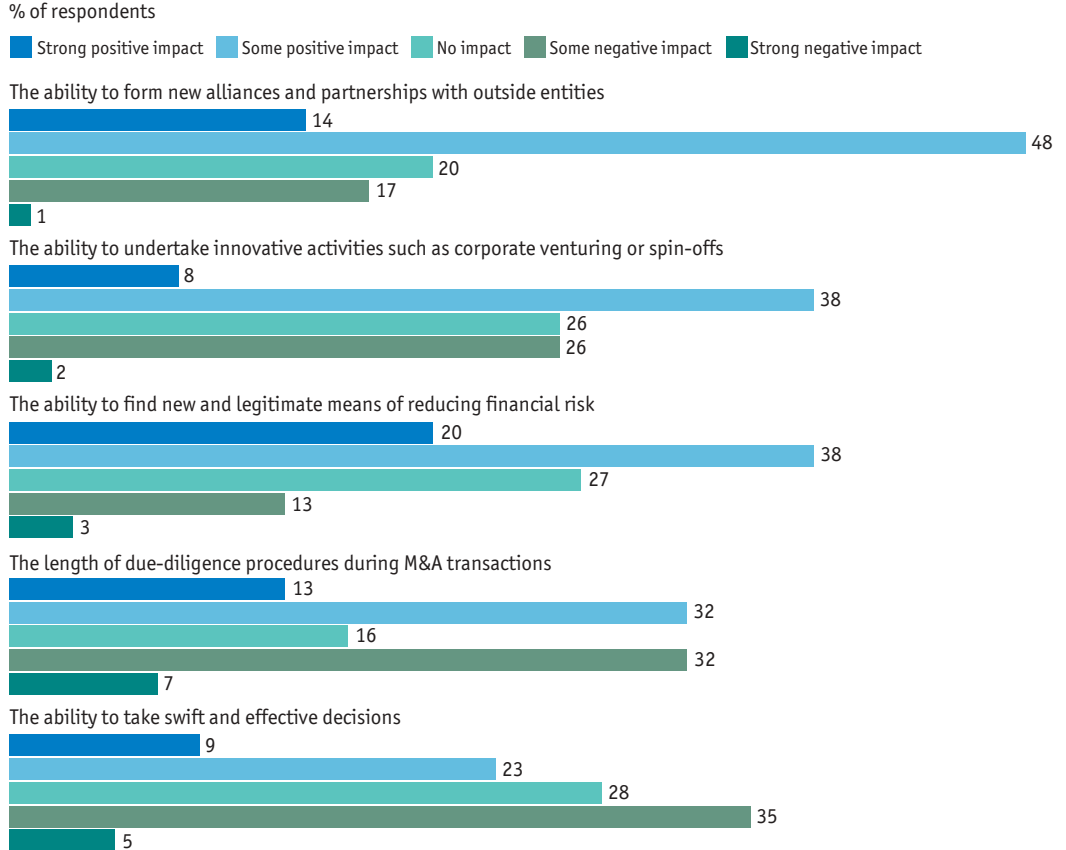
Shareholders are more active now than they were before in pursuit of information



**3. What impact do perceptions of corporate governance standards have on the share price of listed companies, in your view?**  
% of respondents



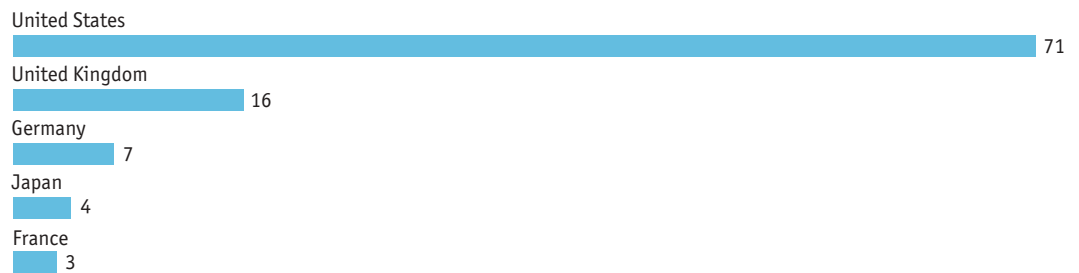
**4. What impact does the imposition of strict and formal corporate governance procedures have on the following aspects of business?**  
% of respondents



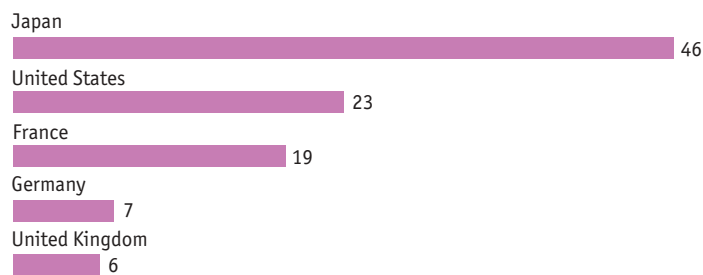
**5. In your view, is significant outperformance of peers likelier to be a sign of good management or poor governance?**  
% of respondents



**6. Which of the following countries has done most to improve standards of corporate governance over the past year?**  
% of respondents



**7. Which of the following countries has the furthest to go in improving standards of corporate governance?**  
% of respondents



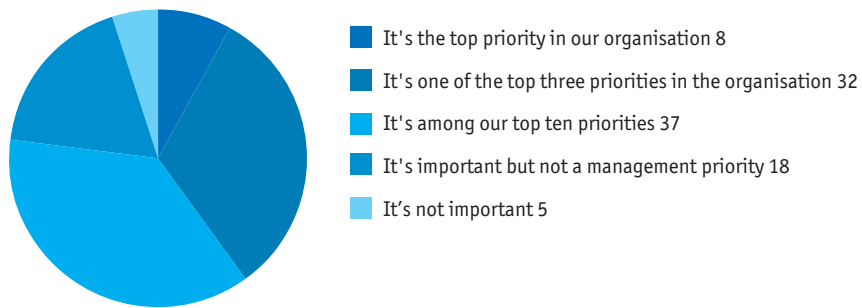
**8. Which of the following is most effective at applying pressure on managers to improve corporate governance, in your view?**  
% of respondents



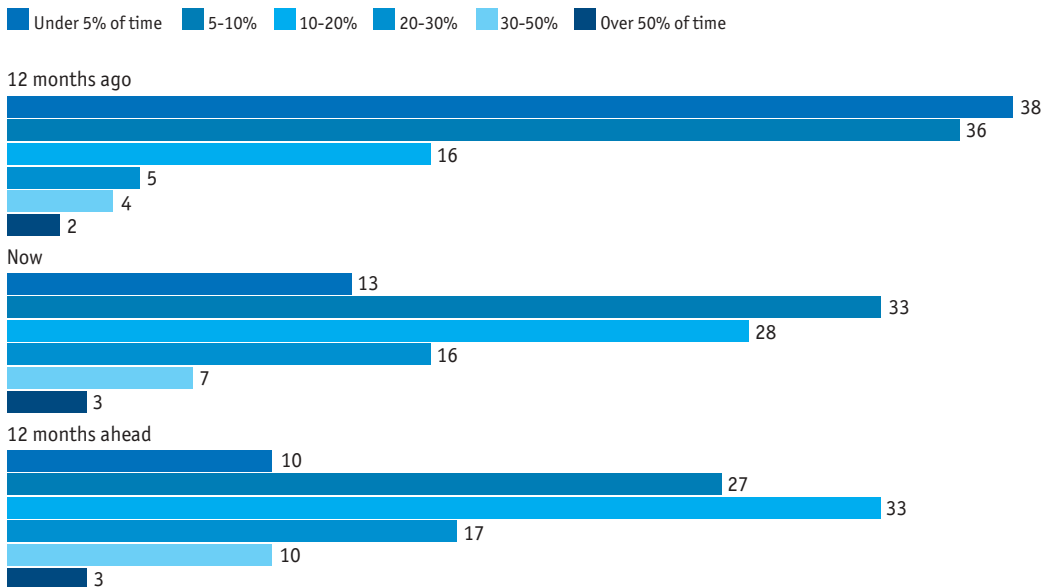
SECTION 2

# The organisation

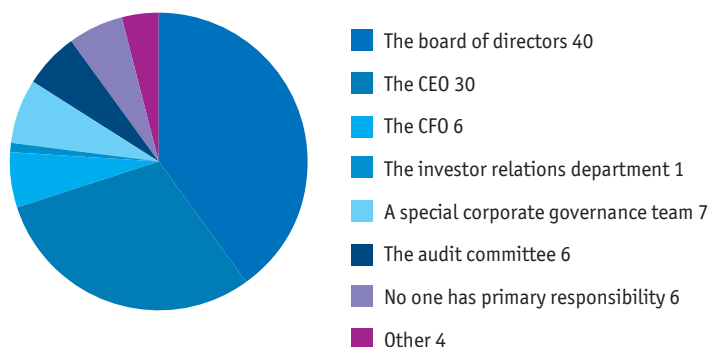
**9. Where does corporate governance rate in the list of current priorities within your organisation?**  
% of respondents



**10. How much time does the senior management team devote to corporate governance now compared with 12 months ago? How much time will they be devoting to the topic a year from now, in your view?**  
% of respondents



**11. Who has primary responsibility for corporate governance issues within your organisation?**  
% of respondents



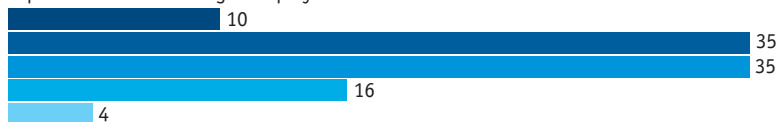
**12. How confident are you that the following types of governance failure could not happen to your firm?**  
Please rate each from 1 to 5, 1 signifying that you have complete confidence and 5 signifying that you have no confidence at all  
% of respondents

Complete confidence ■■■■ No confidence at all

Systemic governance failures and fraudulent accounting



Exposure to actions of rogue employee



Exposure to unexpected market or macroeconomic movements



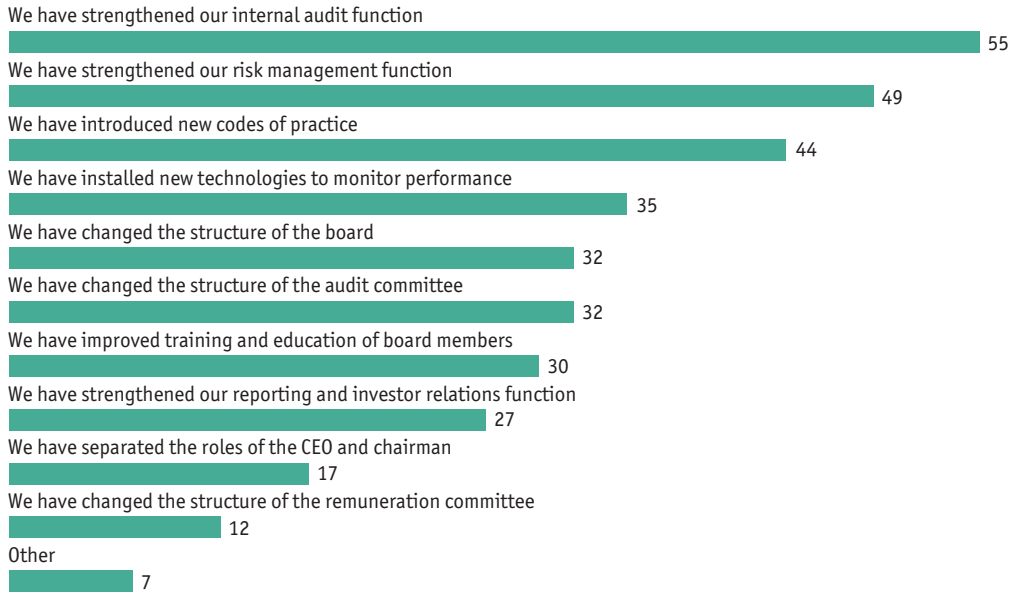
Inadequate flow of information internally to senior management



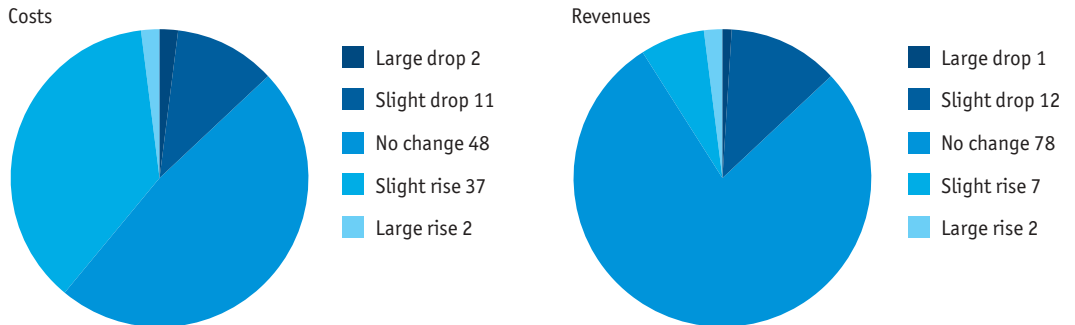
Withholding of sensitive information from independent directors



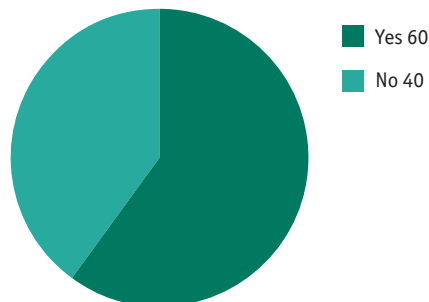
**13. What changes to governance processes and practices have you implemented over the past year?**  
% of respondents



**14. If you have implemented changes to governance processes over the past year, how have costs and revenues at your company been affected as a result?**  
% of respondents

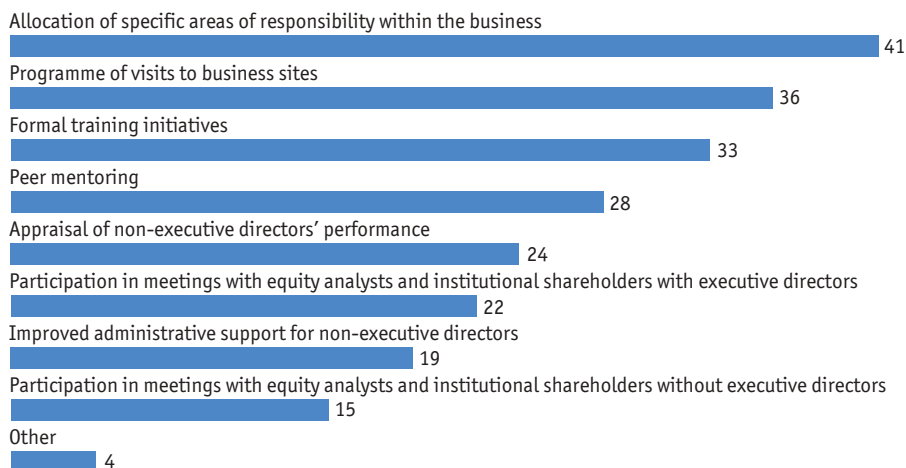


**15. In your view, do your non-executive board directors have an appropriate depth of understanding of your organisation?**  
% of respondents



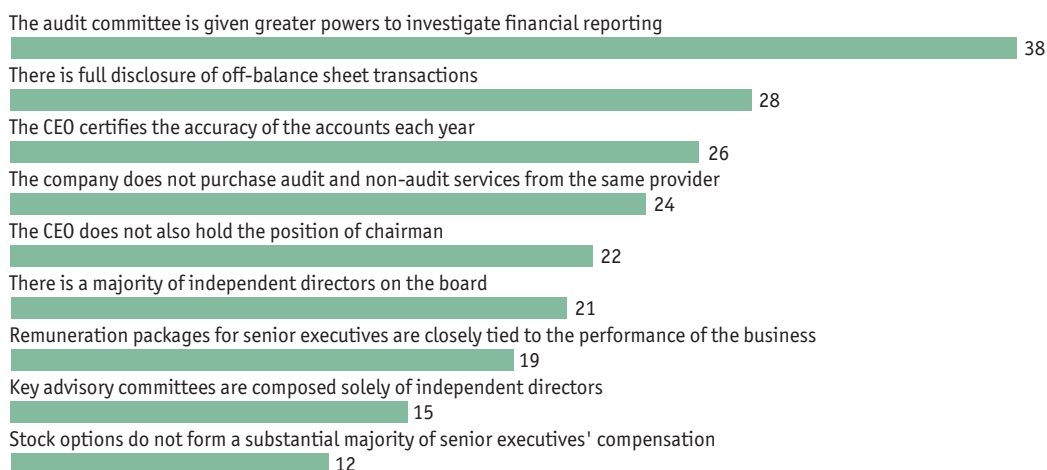
**16. What steps are most effective, in your view, in improving non-executive directors' understanding of the business?  
Please choose two answers only.**

% of respondents



**17. What, in your view, are the principal ways to ensure good corporate governance within individual companies?  
Please choose the top two prescriptions.**

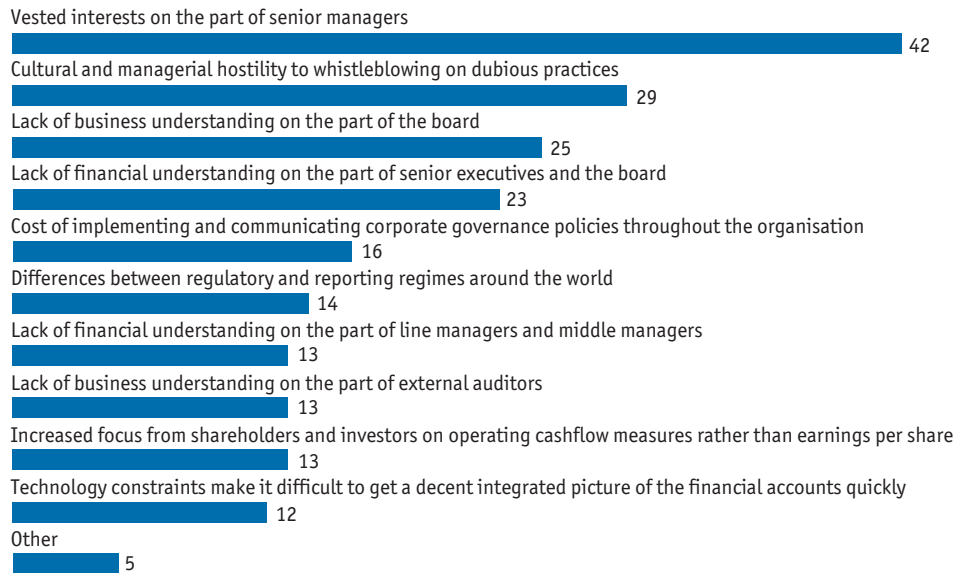
% of respondents



**Appendix**  
Executive survey results

**18. What are the principal barriers to the implementation of proper corporate governance policies within companies?  
Please choose the top two barriers.**

% of respondents



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