Global Governance: The View from the 2005 World Economic Forum in Davos

The establishment of good governance is crucial for companies as well as countries, and it must become a major priority. Recognizing this reality, CEOs and political leaders at the World Economic Forum held last month in Davos, paid considerable attention to this issue. Michael Useem, director of Wharton's Center for Leadership and Change Management, who moderated a workshop on the subject at the Forum, provides an inside view of the discussion.

"Taking Responsibility for Tough Choices" served as the organizing theme for the 2005 annual meeting of the World Economic Forum held at the end of January in Davos, Switzerland. A first step for making tough choices, according to many of the nearly 3,000 attending the forum, is the establishment of good governance.

Malaysia's deputy prime minister Najib Razak suggested that national growth required "good governance" based on "un-corruptible leaders." Pakistan's prime minister Shaukat Aziz observed that the effective distribution of development aid depended upon "good governance." Former U.S. president Bill Clinton noted that peace came to North Ireland once the conflicting parties embraced the requisites of good governance, including "shared decision making" and "shared responsibilities."

Corporate Disclosure

Good rules of the game are essential for companies too, according to many who spoke at a packed session in Davos on "Corporate Disclosure." But while the new rules imposed by the Sarbanes-Oxley Act of 2002 on U.S.-listed companies are generally viewed as useful, downsides have been felt as well.

On the affirmative side, one session participant reported that he had witnessed a "tremendous amount of behavioral change" among firms in the wake of Sarbanes-Oxley. A culture of personal responsibility, he said, has been driven far more deeply in many firms. Executives are consequently more certain of their own results, and equity investors are more confident in what executives report.

An institutional investor said he welcomed, in particular, the greater discipline that Sarbanes-Oxley has forced on financial reporting, resulting in more consistency and greater transparency in areas ranging from pension assets to acquisition accounting. Another participant reminded the audience that as investors become more confident in a company's reported earnings, they will pay higher multiples for the company's stock. In the final analysis, observed a third participant, "there can't be any substitute for honesty in auditing and governance."

Other participants cautioned, however, that the focus on regulatory compliance may have come at a significant price. Companies are devoting too much time to Sarbanes-Oxley, complained several, and too little to growth. Still others warned of a chilling effect on business innovation. An institutional investor confirmed that in the wake of Enron's and WorldCom's collapses, his investment firm has become very sensitive to reputational risk. If even a hint of scandal is in the air, he said, his firm now sells "instantly" and asks questions later.

Regulators and prosecutors are usurping the role of non-executive directors in monitoring companies, complained one participant, and she urged that directors reassert their rightful role. To that end, another participant urged that governing boards redouble their efforts to 1) master the complexity of their companies' operations, 2) smoke out creativity in reporting, 3) reduce their coziness with management, and 4) understand the tough choices that executives must make. But others felt that the power pendulum has already been swinging the other way. "Responsibility is being shifted back to the board," concluded one participant, "where it already belonged."

With the U.S. leading the way in governance reform with Sarbanes-Oxley, a non-U.S. participant observed that his country has a bad habit of adopting American regulation and then making it more draconian. Still, despite the evident downsides, many saw the cross-national transfer of corporate disclosure practices as a move in the right direction. In the end, it should help spread consistent governance practices around the world, making for greater harmonization in standards and a more global equity market.

A More Demanding Boardroom

A number of practical steps for improving company governance in any national setting emerged from a workshop on "A More Demanding Boardroom." The workshop focused on the intensifying demands on governing boards to take greater responsibility for tough decisions. "Stung by scandal," stated the session's call, "corporate boards face pressure from shareholders and governments to become more involved in the day-to-day management of companies."

A panel of 17 discussion leaders and several dozen other participants -- from countries ranging from Belgium and Germany to Kuwait and Mexico -- developed a set of guidelines for improving governance in light of investor and regulator pressure.

The discussion leaders included: Robert W. Alspaugh, International CEO, KPMG; Matthew W. Barrett, chairman, Barclays Bank Plc; Clemens Börsig, member of the board, Deutsche Bank AG; Michael D. Capellas, president and CEO, MCI, Inc.; John Evans, general secretary, Trade Union Advisory Committee to the OECD; Mark Foster, group CEO, Accenture; Orit Gadiesh, chairman, Bain & Co., Inc.; Robert R. Glauber, chairman and CEO, NASD; Oswald J. Grübel, CEO, Credit Suisse Group; Reuel J. Khoza, chairman, Eskom; Rakesh Khurana, professor, Harvard Business School; Wayne W. Murdy, chairman and CEO, Newmont Mining Corp.; John A. Quelch, senior associate dean, International Development, Harvard Business School; Paul C. Reilly, chairman and CEO, Korn/Ferry International; Thomas A. Russo, vice-chairman, Lehman Brothers; Laura D. Tyson, dean, London Business School; Lutgart Van den Berghe, director, Belgian Directors' Institute; Vlerick Leuven, Gent Management School; and Daniel Vasella, chairman and CEO, Novartis International.

The discussion leaders first identified four areas of concerted action for the board, and groups of 10 to 15 leaders and participants then identified a host of steps for good governance within each of the four: 1) setting company strategy, 2) overseeing compliance and risk, 3) structuring the board, and 4) planning executive succession.

Setting Company Strategy: Non-executive directors cannot be expected to fully appreciate their company's strategy, but they must understand the principles underlying its business model. To build their understanding, directors should ask eight questions of management:

1. How does the company make money?

2. Where does its cash flow come from, and where is it going?

3. How is the firm faring against its competitors?

4. If the firm is doing far better or far worse than its competitors, why is that?

5. Does the company have in place a CEO succession plan?

6. How is the company going to grow, what rate is expected, and can the company afford to grow that quickly?

7. Is the firm living within its means?

8. How well does bad news reach the board, and what can be done to improve its upward flow?

The discussion group concluded that if the non-executive directors did not fully comprehend management's answer to the eight questions, the questions should all be asked again. If the directors still do not understand the answers, they should then get off the board.

Overseeing Compliance and Risk: The accounting problems that brought down Enron and WorldCom, and recent settlements holding their directors personally liable for the failures, have intensified the need for directors to be particularly vigilant in the areas of compliance and risk.

For the moment, only small adjustments can be expected in the implementation of the Sarbanes-Oxley Act. Companies should learn to use the act's provisions to advantage, especially Section 404, which requires companies to assess and guarantee their internal controls over financial reporting. By driving the Sarbanes-Oxley principles deeply into all aspects of a firm's operations, more reliable results and fewer surprises should result.

The personal liability that directors face in board service is increasingly of concern, and companies should directly address this issue if they are to attract the quality directors they need. But the liability question also requires special attention once directors are on board. If directors are preoccupied with minimizing personal risk and protecting their own assets against shareholder litigation, they may come to focus too much on private concerns and too little on shareholder returns.

Four steps are required for effective director oversight of compliance and risk:

1. Directors should become more deeply engaged with company plans and executive decisions.

2. The audit committee should shoulder full responsibility for overseeing audit issues so that the remainder of the board can devote its time to other pressing issues.

3. The board should consider creating an "operating exposure committee" that would focus on what could go wrong, thereby relieving the audit committee and the full board of this essential but burdensome task.

4. The board should insist on high ethical standards throughout the company so that employees at all levels will recognize and root out malfeasance.

Structuring the Board: The proper composition and organization of the board have become more vital in an era of greater board responsibility and engagement. To that end, the board should conduct an annual evaluation of its own performance and compensation.

In selecting new directors to join the board, the nominations committee will want to ensure that the new directors are highly competent, work well with one another and the chief executive, and bring functional, gender, and international diversity to the boardroom. Non-executive directors should come with no conflicts of interest, either evident or perceived.

Critical devices for ensuring a well structured board include:

- Informational updates to the board, both during and between board meetings
- Involvement of directors in educational programs on corporate governance
- Formal evaluation of the board chair with feedback for improvement
- A written charter with explicit expectations set forward for directors and executives, and a formal delegation of authority to management.

Planning Executive Succession: The most important single decision taken by the board is the selection of the chief executive. To ensure that the right replacement is ready when the time comes, the board should:

- Initiate succession planning at the first board meeting after a new CEO is appointed
- Include an updating of succession planning at every board meeting
- Establish clear metrics of executive performance
- Evaluate executives one and two levels below the CEO.

Whether directors should be directly involved in hiring and promotion decisions for the executive layers below the top tier remained an open question.

Taking Responsibility

While these four arenas of change are creating a more demanding boardroom, they also are making it more challenging for directors to serve on boards. One of the workshop discussion leaders, Matthew Barrett, chair of the British bank Barclays, told a *Wall Street Journal* writer in Davos that he had turned away some 10 invitations to consider joining boards during the past year. And of those that he would consider, due diligence has become essential. "I will go through a degree of risk analysis," he said, "that I wouldn't have gone through in the past." Another discussion leader, MCI chief executive Michael Capellas, confirmed to the reporter that he no longer serves on the boards of any publicly-traded companies other than his own.

For those who do serve on the more demanding boards of our era, a key question is now: "How can board members and chief executives strike the proper balance between lack of involvement and micromanagement?" While the precise point of proper balance varies from company to company, it has become incumbent upon more empowered directors to know when to stop.

Much is yet to be done in refining the essence of good governance, but improvements should be a worldwide priority for both companies and countries, said many in Davos. At a "town hall" meeting during the World Economic Forum, a thousand participants named six action priorities for the coming year: poverty, climate change, education, equitable globalization, the Middle East -- and "good global governance."

Victor Yushchenko, president of Ukraine, received a standing ovation when he appeared in Davos to seek world support for his democratic reforms and entry into the European Union. And for that, he said, he wants to make public operations transparent, stabilize tax collection, separate business from politics, privatize state industry, and build a culture attractive to international investors. In other words, good governance is the essential prerequisite.

Published: March 30, 2005

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