

# Hong Kong Institute of Directors

## Directorship in the 21<sup>st</sup> century

### Asking the right questions - the role of directors

Professor Bob Tricker



# Asking the right questions

## - the role of directors

- Three challenges in 21<sup>st</sup> century
  - Board's role - conformance or performance?
  - Corporate governance by rule or principle?
  - Shareholder or stakeholder responsibility?
- Directors' role - handling enterprise risk
- New focus on board style and leadership

# Asking the right questions - the role of directors

The good old days

Today

Managing director not chairman

Third of board independent

New directors induction programme

All directors need continuous development

Required board committees

# Asking the right questions

## - the role of directors

Corporate governance codes response to  
corporate collapse, domination, corruption

Maxwell (UK)

Bond (Australia)

Nomura (Japan)

Burnham Drexall/Boesky (USA)

Carrian Investments (Hong Kong)

Codes emphasise conformance and compliance

## Asking the right questions - the role of directors

### Cadbury Report

“... not a code of corporate governance...  
but of the financial aspects...”

### Hilmer Report

– conformance *and* performance

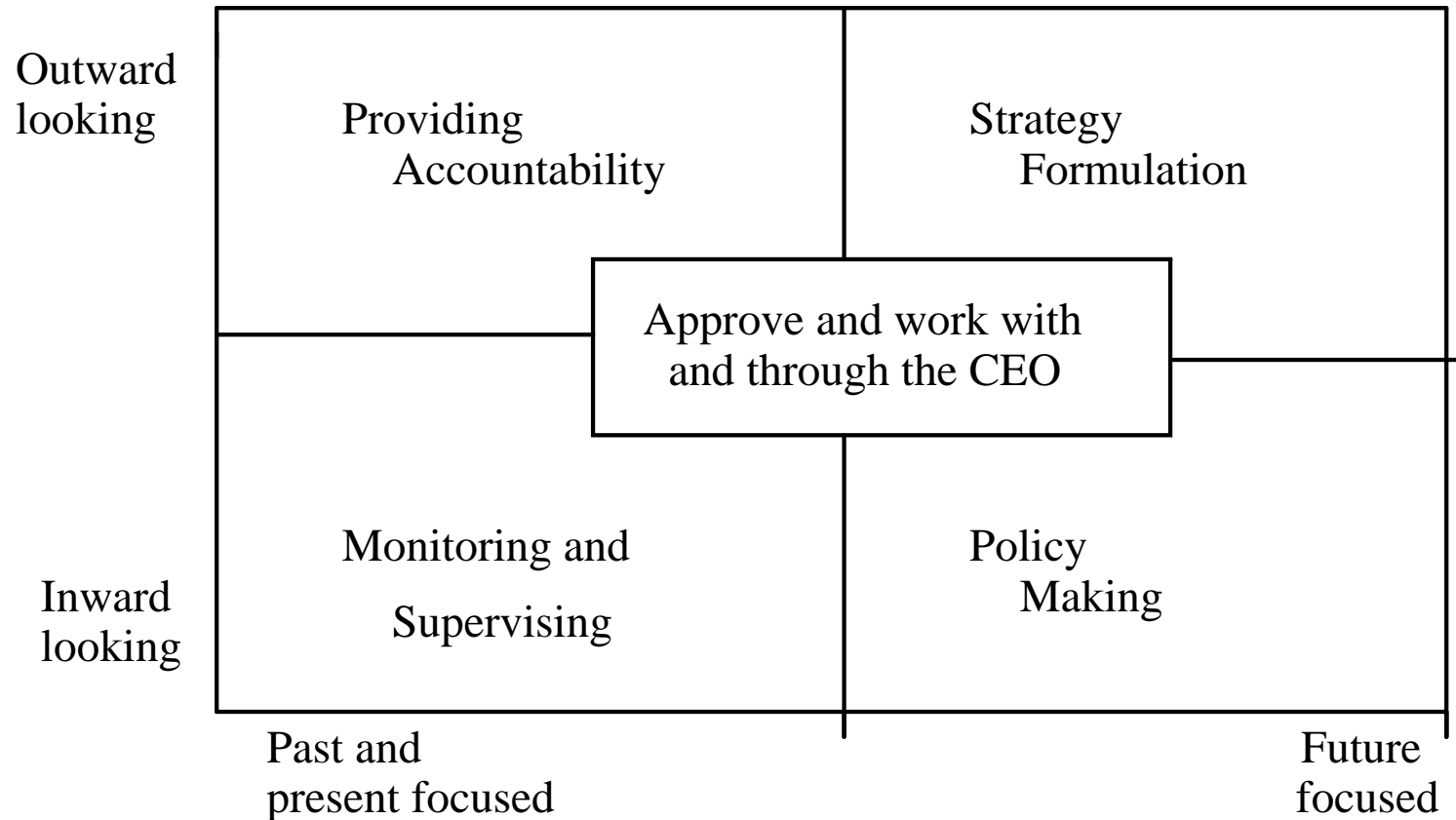
So what is a board really for?

# Asking the right questions - the role of directors

## The basic board processes

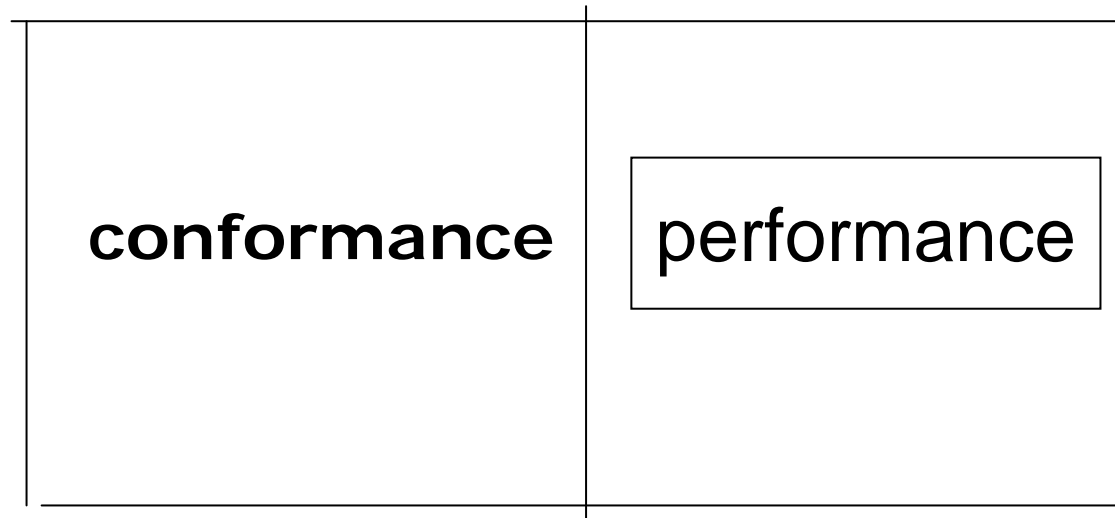
Outward looking	Accountability	Strategy formulation
Inward looking	Supervising executive activities	Policy making
	Past and present focused	Future focused

# Asking the right questions - the role of directors



# Asking the right questions - the role of directors

Conformance v performance



# Asking the right questions - the role of directors

**How should boards spend their time?**

Accountability	Strategy formulation
Supervising executive activities	Policy making

# Asking the right questions - the role of directors

## How should boards spend their time?

Accountability 15%	Strategy formulation 45%
Executive supervision 25%	Policy making 15%

# Asking the right questions - the role of directors

## How do boards spend their time?

Accountability	Strategy formulation
Executive supervision	Policy making

# Asking the right questions - the role of directors

## How do boards spend their time?

Accountability 20%	Strategy formulation 10%
Executive supervision 50%	Policy making 20%

# Asking the right questions - the role of directors

## **UK Company Act 2006 Codification of Directors' Duties**

[www.publications.parliament.uk](http://www.publications.parliament.uk)

- Duty to act within powers
- Duty to promote the success of the company
- Duty to exercise independent judgement
- Duty to exercise reasonable care, skill and diligence
- Duty to avoid conflicts of interest
- Duty not to accept benefits from third parties
- Duty to declare interest in proposed transaction or arrangement

# Asking the right questions - the role of directors



# Asking the right questions - the role of directors

## SEC require US Exchanges to reflect SOX

- Board must have majority independent outside directors
- Establish corporate governance committee (to develop CG principles and ensure board and director evaluation)
- Require compensation (remuneration) committee to ensure CEO rewards aligned with corporate objectives
- Require audit committee to produce and disclose CG guidelines and codes of business conduct and to review external auditor's reports on internal controls

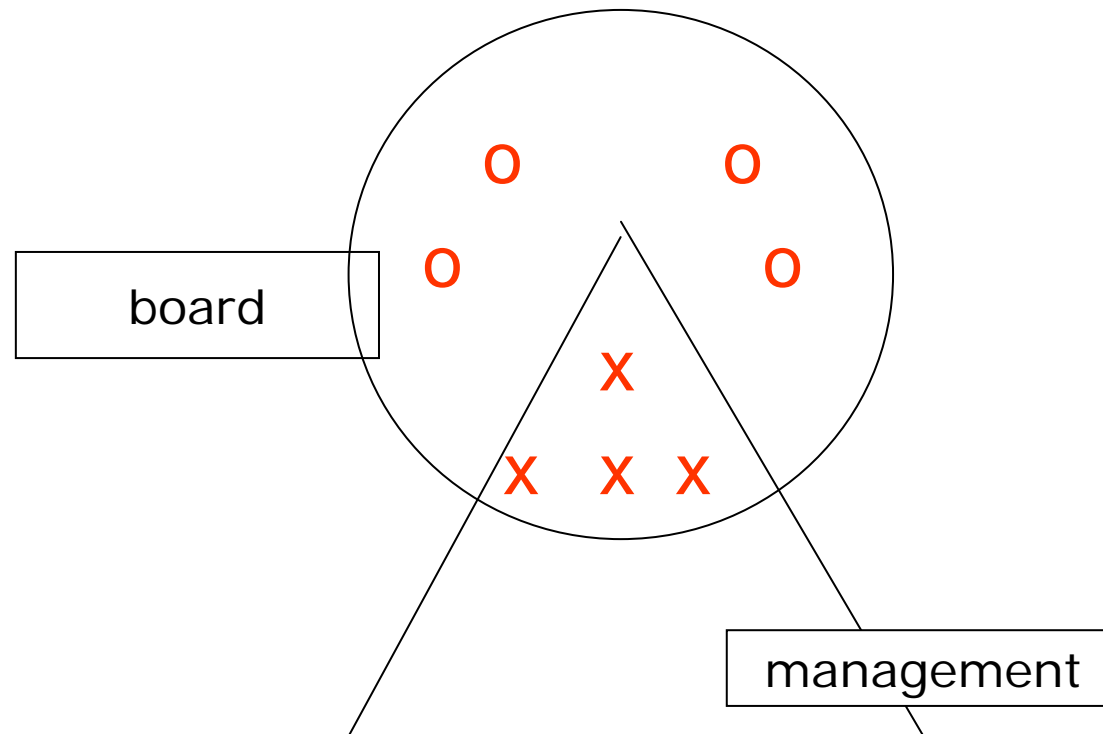
# Asking the right questions

## - the role of directors

- **Section 404 SOX**
- **Management to produce an “internal control report”**
- **Report to “contain an assessment of the effectiveness of the internal control structure and procedures of the company for financial reporting”**
- **Independent outside auditors must attest to managers' internal control assessment, pursuant to SEC rules**

# Asking the right questions - the role of directors

So what does the board do?  
Conformance or performance?



# Asking the right questions - the role of directors

Management runs the business:  
the board ensures that the business is  
running in the right direction  
and being run well

All directors equally responsible under the law

## Asking the right questions - the role of directors

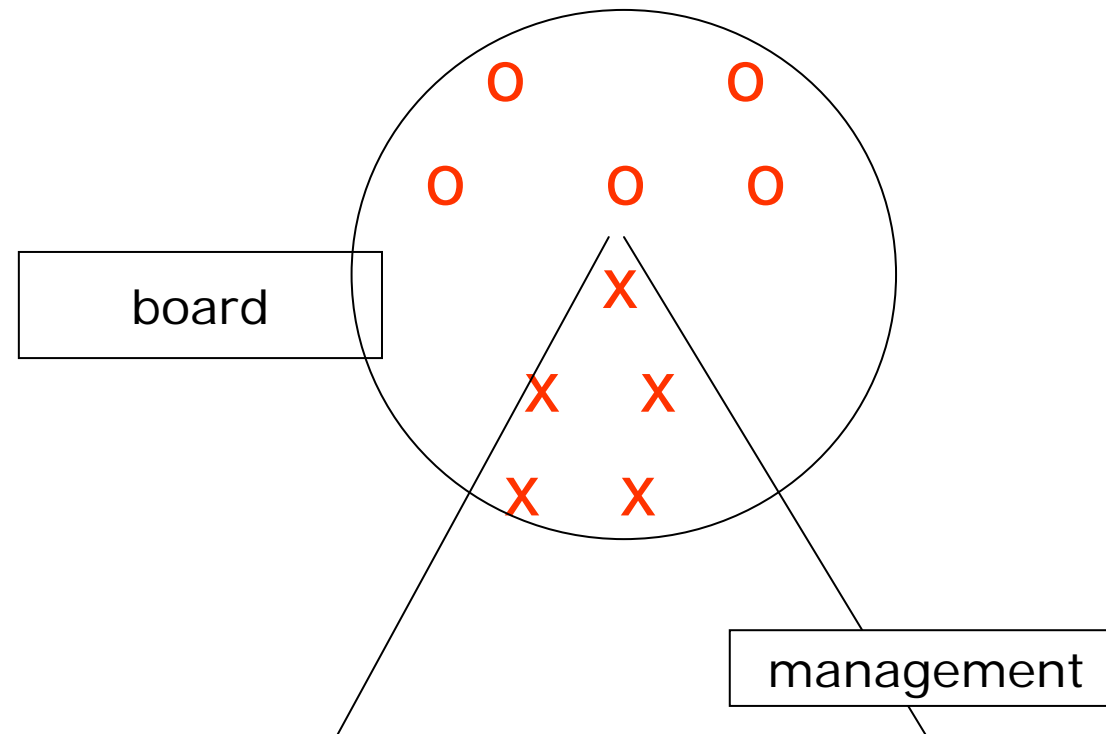
Executive directors – two hats challenge

Outside directors

- not knowing enough about the company to be useful
- knowing too much to be independent

# Asking the right questions - the role of directors

Who formulates strategy?



# Asking the right questions

## - the role of directors

Strategy formulation involves

Thinking strategically

Understanding strategic context

Helicopter vision – external and internal

SWOT plus societal expectations

Understanding the competitors' strategies

- aims, capabilities, assumptions

- strategies – markets, scale, margins

# Asking the right questions - the role of directors

## **Strategy formulation**

### **Imagining strategic possibilities**

**New entrants to market**

**Changing strategies of existing competitors**

**New products or services**

**Substitute products or services**

**Government action**

**Economic conditions**

**Strategy - A shared vision of the future**

**Director's role to ask what if...**

## Asking the right questions - the role of directors

### Directors' responsibility for corporate risk

*Economist survey (January 2007)*

*“Fewer than half of the companies we questioned conduct an ongoing risk assessment*

*... companies that fail to carry out regular monitoring of the environment can easily miss vital risk information and jeopardize their investment.”*

# Asking the right questions

## - the role of directors

### Directors' responsibility to handle corporate risk

McKinsey survey directors of major US companies (2002)

- 40% admit not knowing where value created in their business
- 40% said risk management process not effective
- 20% no process at all

## Asking the right questions - the role of directors

Corporate governance codes require systems to assess and manage corporate risk

- Turnbull Report UK governance codes 1999
- Sarbanes-Oxley Act US 2002
- Basel II agreement for the financial world 2003

# Asking the right questions

- the role of directors

Corporate risk arises at a number of levels:

Strategic level risks

- threats from outside organisation

Management level risks

- risks from the firm's activities

Operational level risks

- hazards within the enterprise

## Asking the right questions - the role of directors

For every director (executive and independent)  
the crucial question should be:  
**...what if ?**

What is our strategic exposure?

Enron

Northern Rock

# Asking the right questions

## - the role of directors

### **Strategic level risks**

#### **From competitors**

**New entrants into significant products or markets**

**Change of ownership of competitors**

**Change of competitors' distribution strategy**

**New research breakthrough**

**Expansion into new markets (country or type)**

**Competitors change manufacturing technology**

# Asking the right questions - the role of directors

## **Strategic level risks**

### **From customers**

**Adopting substitute product or service**

**Collapse or bankruptcy of major customer**

**Change of ownership of main distributor**

**Catastrophic failure of our product in use**

**Legal actions for damages**

**Alleged patent, trademark or copyright infringement**

# Asking the right questions - the role of directors

## **Strategic level risks**

### **From government actions**

**New regulation of our industry**

**Tariff barriers, protectionism, border controls**

**New environmental or hazard limitation laws**

**Monopoly, anti-trust or pricing inquiries**

**Cost-cutting by government**

**Political threats in overseas countries**

# Asking the right questions

## - the role of directors

### **Strategic level risks**

#### **In financial field**

**Predators - hostile take-over approach,  
including private equity**

**Sources of finance - recall of debt capital**

**Share price collapse following media revelations**

**Reputational loss following an adverse law case**

**Errors in trades (unintentional or deliberate)**

**Deals made by staff beyond their limits**

# Asking the right questions - the role of directors

## **Strategic level risks**

### **Information technology area**

**Failure of overall IT system**

**Hacking of our systems for fraud, spying or mischief**

**Loss of e-links with customers, suppliers**

**or shareholders**

**Effect of terrorism, criminal activity, political activity**

**Government or regulatory activity**

# Asking the right questions

## - the role of directors

The extent of any risk (R) is a function of the magnitude of the potential cost or loss (L) and the probability (p) that the uncertain future event will occur

$$\text{Specific risk } R = L \times p(L)$$

# Asking the right questions

## - the role of directors

- Both of these quantities can be difficult to assess
- A risk, with high loss but low chance of occurring, should be treated differently than one with a lower cost but greater probability
- Need to identify the risk or hazard and face up to the reality of the situation.

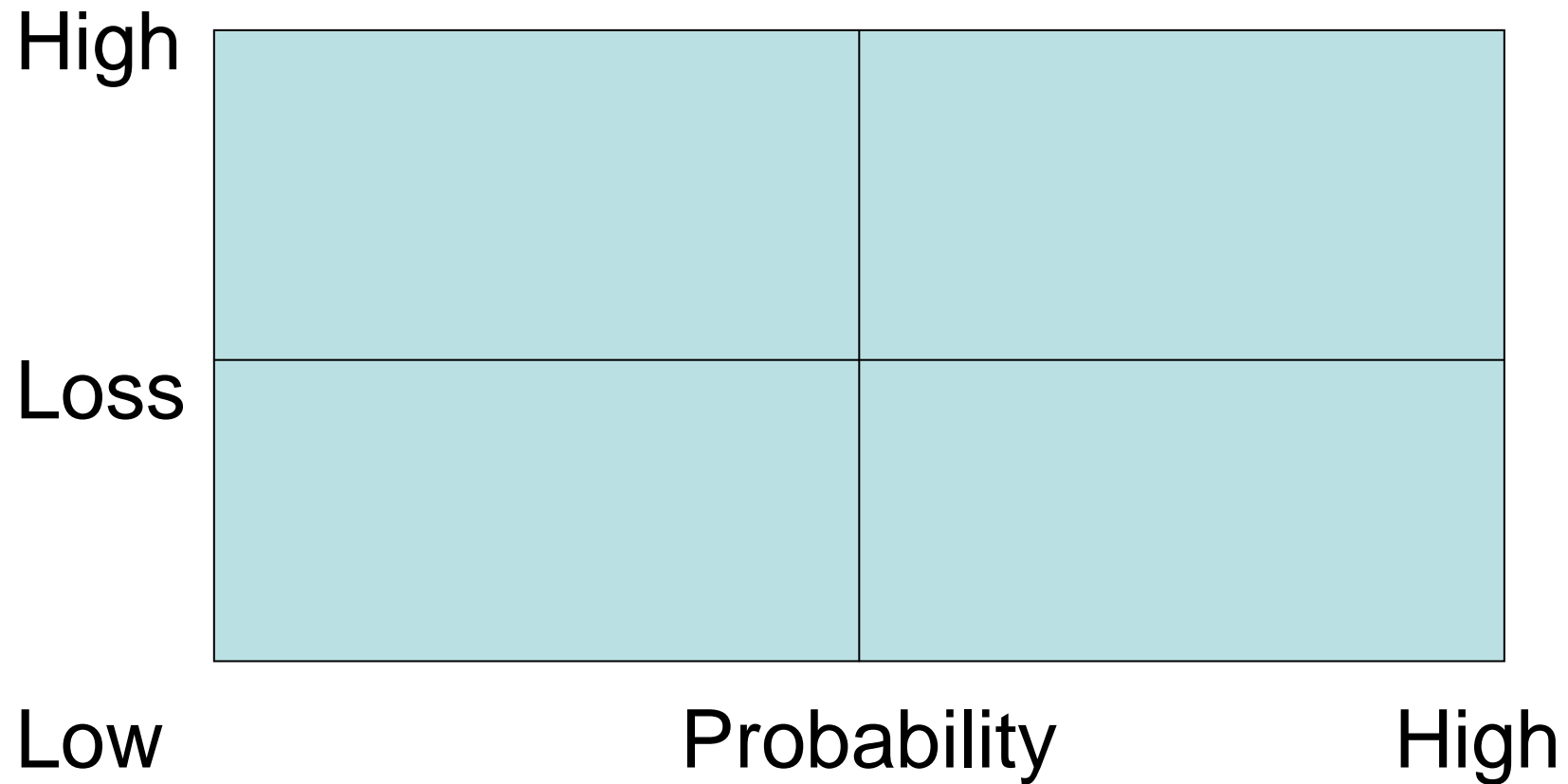
# Asking the right questions

## - the role of directors

Boards face four choices in handling risk

- Avoid risk by avoiding the activity
- Transfer risk to 3<sup>rd</sup> party
  - insurance, hedging, outsourcing
- Mitigate risk – preventive controls
- Accept the risk to generate shareholder value

# Asking the right questions - the role of directors



# Asking the right questions - the role of directors

Leading Hong Kong insurer reports that

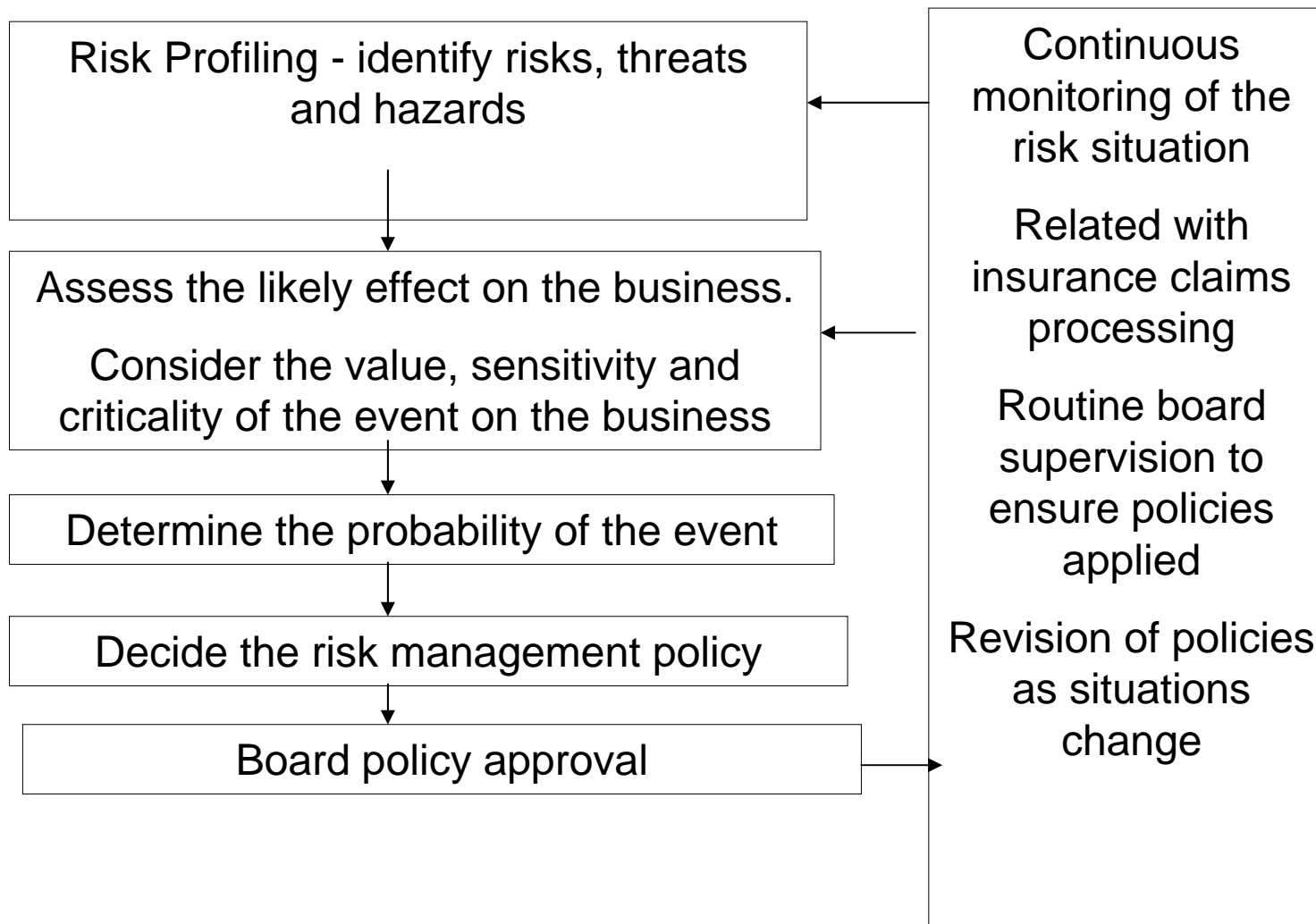
- some boards have no involvement in risk assessment
- there is often an organizational bottleneck between the board and the manager responsible for risk assessment
- Board Risk Management Committees and Chief Risk Officers are quite rare

## Asking the right questions - the role of directors

- Risks unrecognized in companies in Asia
  - business interruption risk
  - earthquake, typhoon or tsunami
  - kidnap of executives
  - merger and acquisition risks
- Failure to take broad strategic perspective
- Need for rigorous systems and due diligence

# Asking the right questions

## - the role of directors



# Asking the right questions - the role of directors

**Early focus on board structure**

**New emphasis on**

**board style**

**board culture**

**the role of the chairman**



Leadership in strategy formulation and risk assessment

Management of the board

Support and appraisal of CEO,

linking directors with management

Management of meetings

Figurehead – the public face of the company

# Asking the right questions - the role of directors

## **New ways of working for boards**

- New board styles – more transient,  
flexible, and adaptable
- New board level information systems
  - new ways to access knowledge
  - internal and external information
- New communication systems
  - between directors
  - between board and management
  - between organisation, investors  
and other stakeholders



# Asking the right questions - the role of directors



**Society's expectations are changing**

**New demands on boards**

Balance conformance with performance

Balance shareholders with stakeholders  
Corporate social responsibility (CSR)

New corporate measurement criteria

# Asking the right questions - the role of directors

## **New demands on directors**

- risk assessment
- wealth generation
- meeting market and societal needs
- socially responsible and accountable
- business a social partnership with  
government and society



## Asking the right questions - the role of directors

**19th century**  
- *entrepreneur*

**20th century**  
- *management*

**21st century**  
- *governance, directors and boards*

