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2023 US AGM season

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The purpose and effectiveness of board committees

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Hans-Kristian Bryn and Carl Sjostrom

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News

Corporate reporting review

The FRC has published its annual review of corporate reporting in the UK. The review ranks topics most frequently resulting in a substantive question (ie where the FRC requires additional information or further explanations) being raised with companies during the past year. The top three issues were impairment of assets; judgements and estimates; and cash-flow statements.

Impairment of assets

Queries raised were generally unchanged from the last review, but in light of ongoing uncertainties companies had not risen to the need for more robust and detailed disclosures. Also, most substantive queries raised related to whether climate-related risks had been appropriately incorporated into impairment testing.

Judgements and estimates

Most queries raised by the FRC related to estimation uncertainty disclosures. These disclosures did not always include detailed information or were inconsistent with other areas of the annual report, which indicated potential unidentified sources of estimation uncertainties. Missing information about significant judgements that had been made was also identified as an issue with some companies.

Cash-flow statements

A number of issues were related to less common or more complex transactions that were not clearly explained, however there continue to be common errors. The number of companies that were required to restate their cash-flow statement was down 53% on the prior year. Other financial reporting areas where issues were raised included financial instruments, income taxes, revenue, provisions and contingencies, presentation of financial statements and fair value measurement. Though these topics were not in the top three ranked issues, in aggregate, they accounted for over half of the total restatements.

Narrative reporting

Issues relating to the strategic report and other Companies Act 2006 matters ranked fourth in the top ten issues. Key points that emerged included: queries where strategic reports did not explain material balance sheet and cash-flow items, including significant movements from the prior year; and failure by companies, including large private companies, to provide a compliant CA 2006 s 172 statement. The FRC also challenged companies on the lawfulness of dividends and questioned whether amounts from certain transactions had been treated as realised or unrealised profits.

Governance reporting

The FRC identified 13 companies that fell short of the high-quality corporate governance disclosures expected. Consistent with prior years, the issues raised with companies related to potential undisclosed departures from the Code and inadequate explanations for any departures. Also raised was the lack of clarity on how the Code Principles were applied, particularly when disclosures lacked detail about actual actions and outcomes of governance arrangements. In addition, many companies still find it difficult to provide genuine and transparent explanations in the case of departures.

Climate-related reporting

The review shows very different stages of maturity of climate-related reporting among companies. A number of substantive queries were raised on the Task Force on Climate-related Financial Disclosures (TCFD)-aligned disclosures of premium listed companies. Issues mainly related to missing compliance statements on the extent to which disclosures are consistent with the TCFD framework and lack of clarity on plans for future disclosures.

Across the framework's four pillars the following issues were raised:

1. Governance – lack of clarity around board oversight and management's role.
2. Strategy – lack of clarity in descriptions of risks and opportunities relating to financial/transition plans and scenario analysis undertaken.
3. Risk management – insufficient disclosure of the process for managing climate-related risks and how these risks are integrated into the overall risk management process.
4. Metrics and targets – information on scope 1, 2 and 3 emissions were either missing or unclear, as was explanatory information on defined targets and the link between metrics and targets and identified risks and opportunities.

Expectations for 2023/24

The review also sets out expectations for the coming reporting season, particularly focusing on areas where companies have been challenged most frequently, or where requirements are complex or changing. The FRC expects companies to:

- ensure disclosures about uncertainty are sufficient to meet the relevant requirements and allow users to understand positions taken in financial statements;
- give a clear description in the strategic report of risks facing the business, their impact on strategy, business model, going concern and viability, cross-referenced to relevant detail in the reports and accounts;
- provide transparent disclosure of the nature and extent of material risks arising from financial instruments;
- provide a clear statement of consistency with TCFD which explains, unambiguously, whether management considers they have given sufficient information to comply with the framework in the current year; and
- perform sufficient critical review of the annual report and accounts. A robust pre-issuance review is also expected to consider issues commonly challenged.

For the full review go to: https://bit.ly/3QEJ4j0

International

Separation of Chair and CEO roles

Investors are pressing US boards to separate Chair and CEO roles, according to a review by Institutional Shareholder Services (ISS). In the first half of 2023 there was a significant increase in the number of shareholder proposals calling for an independent board Chair in Russell 3000 companies. One in four S&P 500 companies chaired by a non-independent director received a shareholder proposal calling for change.

Combined CEO-Chair roles

There is a general trend toward separating the CEO and Chair roles. The number of combined CEO-Chair roles has decreased across all indices since 2013 and these combined roles now make up less than half of Chair roles across all US indices. The number of independent Chair roles has increased across all indices, indicating a push for not only separate CEO-Chair roles but also truly independent oversight of the board.

Historically, companies in the S&P 500 have had more combined CEO-Chair roles than the rest of the Russell 3000. Those companies have also received the largest share of independent Chair shareholder proposals. However, combined CEO-Chair roles in the S&P 500 have decreased by 13% over the last ten years.

Independent Chairs

Independent Chairs are becoming more common, a trend supported by investors. The first half of 2023 saw a significant increase (113%) in the number of shareholder proposals that went to a vote at Russell 3000 companies calling for an independent board Chair. Despite this increase, average shareholder support levels have only slightly increased, contrasting with an overall decline in support for shareholder proposals that went to a vote. No independent Chair proposals were approved in the first half of 2023.

Over the last ten years independent Chair proposals have received significant investor support but have almost never gained a majority: only 15 proposals have been passed out of 593 that went to a vote across the Russell 3000. However, this type of proposal has continued to send a strong signal to boards, receiving a substantial minority level of support (54% of all independent Chair proposals received more than 30% support).

Looking at the proportion of independent Chair proposals compared to the total number of companies with non-independent board Chairs, one in every four S&P 500 companies chaired by a non-independent director received a shareholder proposal aiming for a change. There is also a correlation between the trends for combined Chair-CEO roles and shareholder proposals calling for independent Chairs.

Independent Chairs following a CEO-Chair role separation are more prevalent among smaller companies, even though they are far less likely to get called on to split the roles.

‘Independent Chairs are becoming more common, a trend supported by investors.’

To separate or not?

Some argue that separation of the Chair and CEO roles increases board independence and leads to better monitoring and oversight. Others supporting a combined role say that the combination creates clear lines of authority that allow management to respond more efficiently and sends a clear signal to stakeholders about who is accountable. Possible rationales for companies to separate the combined CEO-Chair roles can be internal, for example succession, crisis management, potential conflicts of interests, growing workloads; or external, for example shareholder or regulatory pressure, crisis events (pandemic, war, natural disasters) and economic conditions.

Proxy advisory firms and large institutional investors take a case-by-case approach to supporting independent Chair shareholder proposals. Many institutional investors defer to the board to select the most appropriate leadership structure for the company. However, one major influencing factor is the effectiveness of the board and whether there are governance concerns. Factors taken into consideration include:

- the scope and rationale of the proposal;
- current board leadership structure;
- governance structure and practices;
- company performance; and
- any other relevant factors.

Other factors that might attract support for independent Chair proposals are:

- a majority non-independent board and/or the presence of non-independent directors on key board committees;
- a weak or poorly-defined lead independent director role that fails to serve as an appropriate counterbalance;
- the presence of a non-independent Chair in addition to the CEO, a recent reinstatement of the combined role of CEO and Chair, and/or departure from a structure with an independent Chair;
- evidence that the board has failed to oversee and address material risks facing the company;
- a material governance failure, particularly if the board has failed to respond adequately to shareholder concerns or has materially diminished shareholder rights; or
- evidence that the board has failed to intervene when management’s interests were contrary to shareholders’ interests.

For further detail go to: https://bit.ly/3sf2hyq

Feature

Political capital on corporate boards

Gonçalo Pacheco de Almeida looks at how political ties in corporate governance influence firm performance over time.

The revolving door between the realms of politics and business is a widely recognised global phenomenon. Former government officials, once in power, frequently resurface in the public eye, making the transition from political roles to corporate boardrooms.

In many countries, the appointments of ex-politicians to company boards often make the headlines, particularly if they held high-profile positions during their political careers. Companies seek board-level appointees with a deep understanding of their industry and regulatory environment, leading them to consider former politicians and government ministers as valuable additions. However, the extent of influence these individuals can exert in changing the rules of the game to protect and prolong firms' market power and performance advantages over time deserves further scrutiny.

A collaborative study conducted by HEC Paris, the Nova School of Business and Economics, and the Leeds School of Business at the University of Colorado Boulder sought to examine whether political connections at the board level significantly contribute to sustained company performance. This research aimed to determine if such connections genuinely translate into tangible, enduring competitive advantages for a firm. The study encompassed over 6,000 firms across 14 democratic nations, including the UK, the US, Australia, Brazil, Canada, France, Germany, India, Israel, Italy, Japan, Mexico, Poland and Spain. The research aimed to unveil the extent to which political ties can lead to lasting competitive benefits.

Contrary to initial expectations, the study reveals that the impact of political capital at the board level is surprisingly short-lived. While companies with political connections do experience slightly extended periods of performance advantages, the effect is remarkably modest, with only a 2.4% increase in performance duration. This translates to just over two additional months of sustained competitiveness compared to their counterparts without political connections. Intriguingly, the results also expose a nuanced reality – the luster of political connections gradually fades after approximately seven-and-a-half years. This sheds light on the swift depreciation of the advantages conferred by political affiliations in the boardroom, hinting at the influences of political cycles, power dynamics shifts, or unforeseen adverse political events. This unexpected twist challenges the notion that political connections yield enduring and formidable influence over a company's performance trajectory.

A thought-provoking finding of the study centres on how corporate political activity influences firm performance volatility. Conventional wisdom has often argued that companies that have political capital adopt riskier strategies, driven by a sense of security stemming from their politically connected management teams. In contrast, the study showed that firms with board political connections tend to exhibit reduced levels of risk, that is, lower volatility of firm profits over time. Yet, as with the previous findings, this effect is also transitory and diminishes significantly beyond a span of seven years. While this suggests that political connections can confer advantages, it also underscores that these advantages are not long-lasting.

This research also emphasises the pivotal role played by the political environment in shaping the effects of political capital. Companies must remain acutely aware of the political context in which they operate and adapt their strategies accordingly. The ever-shifting sands of political landscapes can significantly undermine the efficacy of political connections at the board level.

One of the most striking results of the study is the short half-life of political capital compared to other strategy interventions. This raises pertinent insights about the inadequacy of relying solely on political connections for long-term success. Companies should recognise that, while political affiliations can provide some advantages, they are not a standalone panacea for sustained performance.

In the realm of corporate governance and market dynamics, these findings hold significant implications for competition and resource allocation strategies among companies. First, the study highlights the limitations of political connections in suppressing competition and 'turning the tables' of market dynamics and firm rivalry in favour of the focal firm. Therefore, anti-trust restrictions on firms' acquisition and use of board political connections should perhaps not be a top governmental priority for innovation and welfare.

Secondly, the findings also suggest that companies may want to reconsider how they allocate their resources, considering the short-term and modest benefits of political affiliations. Specifically, alternative investments may be more effective at prolonging firms' competitive advantages and superior profitability. For example, prior research has established that investments in R&D may increase performance sustainability by 16 months – an eightfold increase compared to what this study estimates as being the two-month extension in performance advantages from political capital. Arguably, R&D is the lifeblood of innovation, which allows firms to constantly adapt to today's fast-paced and rapidly evolving business landscape by launching new products, services, or technologies – contributing to companies' long-term success. In contrast, most board political connections have an 'expiration date' that is often dependent on the transitory nature of the world of politics.

continued on page 6

Feature

2023 US AGM season

Amanda Buthe and **Kilian Moote** consider the growing influence of shareholders during the season.

The 2023 Annual General Meeting (AGM) season in the US witnessed a slight increase in the number of ESG shareholder proposal submissions, reaching an all-time high of 947 compared to 941 during the previous year.

Overall support for ESG proposals, however, experienced a decline during the past year, dropping from an average support level of 34% in 2022 to 26% in 2023. A higher percentage of proposals did go to a vote in 2023, with nearly 65% (612 proposals) compared to 60% (562) in 2022.

Anti-ESG

Anti-ESG proposal submissions increased by 65% during the 2023 AGM season: over 94 proposals submitted during 2023 compared with 57 proposals submitted in 2022. Anti-ESG proposals continue to receive low levels of support, with average support down to 5% during 2023, compared to 9% in 2022.

Among anti-ESG proposals, those related to governance tended to garner higher average support, with an 11% average support rate in 2023, compared to 16% in 2022.

Notably, independent Chair proposals brought by anti-ESG proponents continue to drive higher average support (21% average support in 2023), but still less than independent Chair proposals brought by all other proponents by 10 percentage points (31% average support in 2023).

Many investors see the role of the independent Chair as practicing good governance and will likely support an independent Chair proposal, even if the proposal opposes the proponent's justification for why the Chair should be separate.

Environment

In 2023, there was a 2% increase in the number of environmental proposals submitted, but average support decreased from 38%in 2022 to 23% in 2023.

Only four environmental proposals received majority support in 2023; topics included one on climate-rated lobbying, one on methane and two on plastics or sustainable packaging.

Proponents continue to submit high levels of proposals covering GHG emissions reduction year-on- year, indicating the need for boards and management teams to ensure they understand climate disclosures and reduction strategies to respond to such requests. Additional scrutiny around climate risk was also the theme of the 2023 season, with more proposals incorporating language around risk (11 proposals) than in the 2022 season (3 proposals).

Notably, anti-ESG environmental proposals also saw a notable increase in 2023: there were six proposal submissions compared to just one in 2022. These proposals mainly called for reporting climate change activities, including the fiduciary impact of decarbonization goals or policies.

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continued from page 5

Similarly, comparable investments in skilled labour prolong firm profits by an additional 15 months, which is over seven times the benefits conferred by board political connections. Assembling a team of employees with expertise and proficiency can foster lasting competitive advantages. A skilled workforce enhances a company's ability to adapt to changing market conditions and promotes a culture of innovation. Investing in human capital ensures that a company remains agile and responsive in a rapidly evolving business environment.

In short, political capital in corporate boards seems less effective at sustaining performance advantages than what was initially expected. A possible explanation for the most effect of board political connections may be that, by vying for political influence, firms eventually compete away the persistent rents associated with political capital. This may happen when companies engage in competitive overbidding to secure access to political capital, including hiring board members with political ties, contributing to PACs, and investing in lobbying, political donations or campaign financing.

The value of having political leaders on corporate boards erodes over time – and perhaps faster than anticipated – due to political cycles, adverse political shocks, the frequent transfer of power in most democracies. Also, constraints embedded in political and government systems often curb the ability of board members with political ties to exert their influence to favour a certain firm.

In conclusion, the study's implications are significant for corporate governance. They call for a fundamental re-evaluation of how companies compete and allocate their resources. In particular, it sheds light on the limited advantages derived from political affiliations.

Gonçalo Pacheco de Almeida, is Professor of Strategy and Negotiation at HEC Paris

Feature

Social

Average support for social proposals was also down in 2023, dropping 7 percentage points between the 2022 (29%) and 2023 (22%) seasons. Topics with notably higher average support in 2023 included board diversity (19% in 2023 and 14% in 2022) and gun violence (20% in 2023 and 10% in 2022).

Five social proposals received majority support in 2023, related to diversity, equity and inclusion (DEI), freedom of association and human rights, workplace harassment, and gender and racial pay gaps. There was, however, a decrease in average support for racial equity audits and civil rights audits, and proponents shifted their focus from metrics and data such as EEO-1 requests to more substantive DEI disclosures on hiring practices and racial justice impacts.

Governance

Average support for governance proposals dropped by seven percentage points, from 37% in 2022 to 30% in 2023. However, certain areas did see notable increases in support, such as board composition (8% average support in 2022 compared to 33% in 2023) and compensation clawbacks (28% in 2022 to 42% in 2023).

During the 2023 season, 24 governance proposals received majority support in 2023 compared to proposals on environmental and social topics garnering single-digit levels. This shift indicates sustained support for strong governance practices and waning support for more prescriptive proposals on social and environmental topics.

Other key trends from the 2023 AGM season:

Focus on material ESG issues: During the 2023 AGM season, many of the largest institutional investors further emphasised that boards should focus on material issues, including relevant ESG topics that may impact company performance. Proposals supporting increased reporting to help investors understand a company's approach to managing ESG risks garnered greater support than those deemed too prescriptive.

Majority support for proposals declined: Although the volume of ESG proposals remains high, the number of proposals receiving majority support has declined year-on-year. In 2023, 33 proposals received majority support, compared to 88 in 2022.

Environmental proposals saw the largest drop in majority support. Of those that went to a vote, only 2% of environmental proposals (4) received majority support in 2023 compared to 9% (16) in 2022. Similarly, social proposal support declined from 6% of all social proposals receiving majority support (23) in 2022 to 1% (5) in 2023. Governance support also declined from 14% of governance proposals (49) receiving majority support in 2022 to 7% of governance proposals (24) in 2023.

> '… [however] average support for ESG proposals has declined, indicating that there may be some divergence among investors about exactly how they want these issues addressed.'

Exempt solicitation on the rise: Proponents have increasingly turned to exempt solicitations for shareholder proposals and director elections, with 398 filings of this type in 2023 compared to 322 in 2022. This rise in exempt solicitations reflects shareholders' efforts to voice their opposition to, or support for, dissident directors or specific shareholder concerns.

The 2023 AGM season has demonstrated a growing interest in ESG topics among shareholders, as evidenced by the record number of proposals submitted. However, average support for ESG proposals has declined, indicating that there may be some divergence among investors about exactly how they want these issues addressed.

The rise in exempt solicitations underscores the importance of effective constructive dialogue between companies and proponents to address ESG concerns. Tracking investor expectations and maintaining engagement with shareholders throughout the year will be critical for boards to successfully navigate the evolving governance landscape. As the focus on ESG matters continues to grow, companies must proactively address material ESG issues and respond to shareholder concerns to maintain investor confidence and corporate reputation.

To address these challenges, boards might consider engaging shareholders throughout the year to understand their priorities and proactively respond to arising potential questions, concerns or shareholder proposals. Companies must also prepare to address proposals with significant societal impact, such as human capital management, diversity, and climate change. By aligning their practices with investor expectations on ESG matters, companies can foster stronger relationships with shareholders and drive sustainable long-term value for all stakeholders.

Amanda Buthe is a director and Kilian Moote is a managing director at Georgeson.

Feature

The purpose and effectiveness of board committees

Hans-Kristian Bryn and **Carl Sjostrom** look at the roles of the Audit & Risk and Remuneration Committees and suggest ways in which committee performance can be enhanced.

The regulatory and governance landscape facing companies is becoming more crowded and changes in demands as well as expectations are putting more pressure on boards individually and collectively. Our 2016 article[1] raised a concern that the committees of the board often work in silos and we argued that a more collaborative approach would benefit both the Audit & Risk Committee ('ARC') and the Remuneration Committee ('RemCo'). In this article we revisit the roles of the RemCo and the ARC (from a risk and governance perspective) highlighting areas that can be challenges for their respective Chairs and where we observe distinct differences between effective and less effective committee work.

As we noted in our previous article, the reason boards appoint committees to deal with matters such as audit, risk and executive remuneration is primarily to manage the board's workload by dividing it so that the committees' attention to more detailed matters free up time to focus on critical strategic issues. In addition to achieving time efficiencies, committees are also able to hone specialist knowledge and processes, which in turn allow them to address the increasingly complex regulatory and governance matters associated with their topics. Our previous discussion on how to take advantage of overlapping committee work illustrates the key tasks of the ARC and the RemCo:

Some overlapping agenda items

- Strategy implementation support
- Performance setting and evaluation
- Legal and regulatory compliance
- Risks linked to reward
- Reward linked to risk taking
- Reward and tax
- Accounting and reporting on compensation
- Costs of reward
- Internal audit performance and reward

Audit and Risk Committee

- Assurance over financial statements
- Internal controls and risk management
- External and Internal Audit
- Corporate tax
- Risk
- Budgeting and evaluating financial performance

Remuneration Committee

- Executive reward
- Reuneration policy
- Incenitve structures
- Benefits
- Evaluating pay
- Investor relations around executive reward
- Linking reward and performance

Source: Governance, September 2016, Issue 267, Bryn, H-K and Sjostrom, C, 'Linking risk and reward'

The illustration shows that the overlap of agendas needs to be managed. For example, the risk appetite of the business should be used as an input to evaluating the executive reward and incentives to ensure that they don't encourage actions and behaviours that can lead to exposures triggering breaches of the risk appetite.

Over the past decades, the roles of ARCs and RemCos have changed significantly, not least in response to the evolutions of governance codes and regulatory reform. However, the specificity of these changes has left little room for fundamental reviews of the purpose and structures of committee work. Committees should not be over-reliant on strong leadership from the Chair and we observe that, in particular, the following remain common obstacles to effective committees for many companies:

- Lack of shared understanding of approach and organisational context;
- Information flows; and
- Complexity of solutions and processes.

Shared understanding of approach and organisational context

Most boards will be alert to the need for committees to have at least one member with 'recent and relevant experience' of the subject matter, for example appointing someone with CFO or audit experience to the ARC or HRD experience to the RemCo. However, we would argue that such experience is positive but not sufficient for an effective committee. It is equally as important for the committee to have established a shared understanding of the subject matter and the principles upon which the company should base its decisions.

Such principles may be summarised for the RemCo in a remuneration policy statement and for the ARC in a risk appetite statement, but what is critical is that the position is

Feature

first established by creating a common understanding within the committee, and by extension the board in plenary, without creating barriers to constructive challenge and fresh thinking.

For the RemCo it is important that the shared understanding includes:

- How the key remuneration vehicles work;
- How remuneration is implemented throughout the company;
- The history of remuneration at the company; and
- The principles and philosophy that underpin decision-making.

Many RemCos fail on the first hurdle of how key remuneration vehicles work. Salary, pensions, benefits and short- and long-term incentives tend to have local variations but also terminology that mean different things to different people. For example, in Europe it is customary to set annual bonus opportunities with reference to 100% being a maximum, whereas in the US it is more common to refer to 100% as pay for an expected, or target, level of performance.

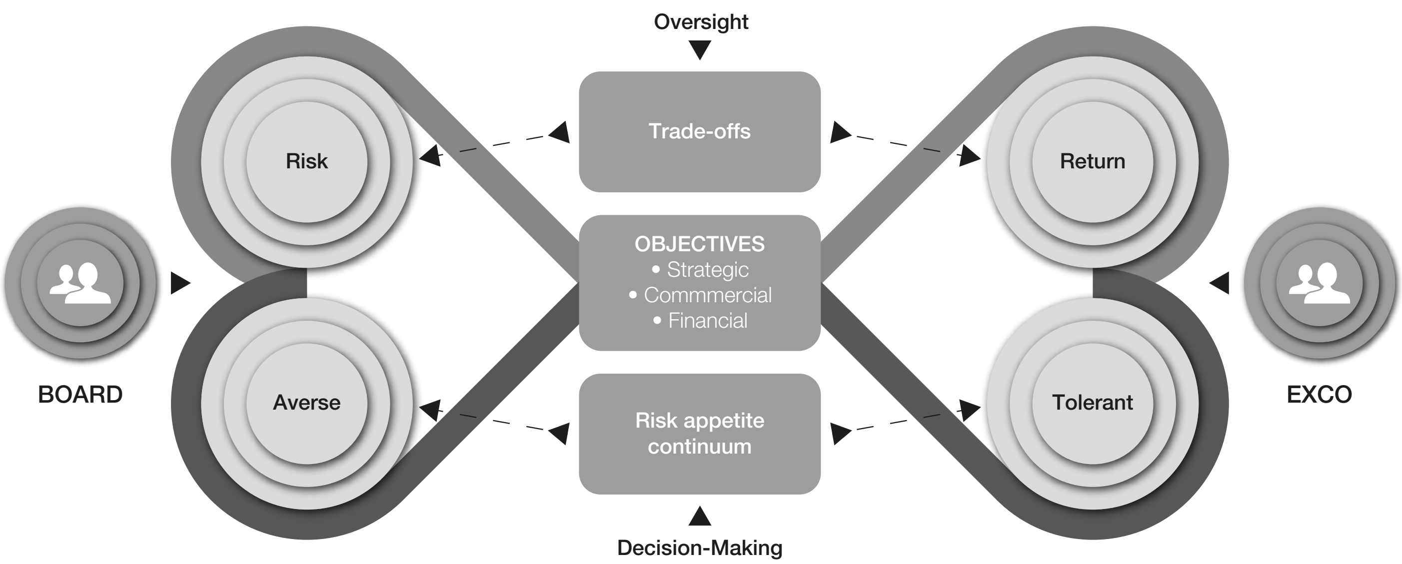
It is therefore important to understand how remuneration is implemented – both in terms of how it differs for different parts of the organisation and what the intentions are, so that committee members with diverse experience have the same reference points. For example, in some industries where cash is scarce the use of share-based pay to form part of basic employment income may be taken for granted, but elsewhere it is expected to be used with great caution. However, it is not only the circumstances but also the history that determines the company's position. Such history may include negative experience, like losses in connection with personal investment requirements, which may not be understood by new committee members. It is therefore essential that all committee members understand reward in the same way and can articulate this understanding when determining the principles and framework for decisions to be based on.

The role of many Audit Committees has migrated from its traditional financial focus to include risk management – hence the ARC label. As a committee, the ARC tends to bring together a wealth of financial, risk and business understanding from multiple organisations as well as sectors and, although primarily not a decision-making forum, it can add significantly to the understanding of the risk framework as well as the risk profile and provide challenges to management and insight to the wider board.

In this context, the ARC becomes a key mechanism for reviewing the risk and controls framework, testing the effectiveness of the risk process in individual businesses and doing deep-dives on specific principal or material risks. It can also be a vehicle for reviewing and testing the proposed risk appetite in advance of a plenary discussion at board level. However, the risk management role that the ARC fulfils varies between different companies reflecting scale, complexity, committee and board composition as well as different levels of exposure to new challenges like cyber security, technology change and ESG, making it equally important to ensure that these circumstances are translated to a common understanding. This can be achieved by the ARC encouraging the organisation to take a more formal and structured approach to risk appetite. A more formal structure helps to ensure that the risk appetite framework and statement become both a governance and oversight tool for the board (and its

continued on page 10

Risk Appetite in Oversight and Decision-Making



Source: Strategic Risk Magazine, Q2 2017, Bryn, H-K, 'Building up an appetite for risk'

Feature

continued from page 9

sub-committees) as well as an executive decision-making tool, providing better line of sight to executive execution. The risk appetite statement will then support better risk-return trade-offs and enable the business to consider the level of risk that it is willing to take in pursuit of its strategic, commercial, operational and financial objectives. See an illustration below of what the key dimensions are that could deliver a shared understanding.

‘In addition to achieving time efficiencies, committees are also able to hone specialist knowledge and processes, which in turn allow them to address the increasingly complex regulatory and governance matters associated with their topics.’

To achieve a shared understanding, committees need to spend time considering the fundamental aspects of subjects like risk and reward and their interactions, which is helpful for the development of both remuneration policy and risk appetite statements. If the work can then extend into the whole board, or at least a joint session between the ARC and the RemCo, the shared understanding will be further enhanced so that it doesn’t fail in areas of overlap. The ARC needs to be cognizant of the risk implications (both financial and reputational) of changes to the reward strategy and to factor this into its deliberations and deep dives on specific risks or indeed, the risk processes in key businesses and functions. Equally, the RemCo should take into account any changes to the risk appetite when considering changes to the reward strategy.

Shared understanding helps to bridge different points of view and enables better dialogue within the board but it is also essential to be aware of the dangers of ‘group think’ so that principles, articulated into reward philosophy and policy and risk appetite, are not written in stone, creating self-imposed barriers to needed change. In addition, the committee Chairs have a key role in surfacing both conscious and unconscious biases to ensure that the discussions and proposed approaches for the business in question are fit for purpose and reflect a ‘best possible outcome’, for the organisation.

Information flows

To help ensure that common understanding does not lead to the creation of barriers to change and new ideas there also needs to be an appropriate flow of information to the committee, to then filter and escalate to the board as appropriate. Unsurprisingly, the two main information flow concerns we observe are, first, if the committee fails to articulate what information it needs and, secondly, where the organisation fails to provide the committee with that information due to inappropriate filtering, lack of information or poor communication of available data.

The information flows to the ARC are relatively straight-forward as they pertain to defined financial information, controls information and risk reporting. Notwithstanding this, there can be considerable variation in the timeliness and quality of financial and risk information flowing to the ARC, not least within emerging areas like sustainability, which needs to be addressed to allow the committee to discharge its mandate in an effective manner.

Equally, the ARC can support in improving the information flow to the RemCo in relation to alternative performance measures and the discussions and decisions that impact the profile and exposure for Principal Risks as well as utilisation of risk appetite for reward.

For the RemCo the information flow most discussed tends to be the acquisition and analysis of market data for levels of reward. But since most executive compensation depends on links to performance it is information for incentive design that will most likely trigger challenges from different stakeholders. Many committees find it difficult to gain sufficient understanding of the probabilities attached to the consequences of actions and behaviours in order to determine the desired performance/reward relationships. The starting point of equating the level of compensation that one wants to pay for expected performance outcomes, such as the budget, may be relatively straight-forward. However, where committees often struggle is to then calibrate threshold levels of performance, below which it would be unacceptable to reward someone, and stretching levels of performance, at which either incentives are capped or not expected to be achieved.

To be able to set or assess appropriate performance/reward relationships or risk processes requires that data be provided by management. We suggest that helpful first steps to determining what the committee’s information requirements are would be to:

- Determine a standard agenda for each of the planned meetings of the annual committee cycle;
- Define the minimum amount of information required for each agenda item, eg primary information for key risks plus secondary data in the form of key accounting items and ratios;
- Clarify the purpose of the required information to help management understand its value and how it will be used; and

Feature

‘Effective board committees have become key to successful and well-functioning boards and corporate governance.’

- Define the process flow and responsibility for validating the data, including whether the committee can take outside help. For example, finance and risk functions prepare management information and performance data for their respective areas and validation is undertaken by assurance functions internally or externally.

Complexity of solutions and processes

Having a common understanding and access to the right information may still not be enough to address the complexity inherent in the subject matters of the committees. Many committees struggle to determine the level of complexity appropriate for the situation. One of the challenges typically facing the ARC is that both the business and the environment in which it is operating are becoming increasingly complex. This will have an impact on the risks, exposures, risk appetite and indeed the compliance requirements that the ARC needs to relate to and define appropriate processes for.

In tackling the complexity of a subject, it is sometimes necessary for the process to be more rigorous. ARCs would benefit from encouraging the business, and indeed the board, to embrace new approaches to risk assessment, scenario modelling and risk appetite processes to help ensure that the Principal Risks and the way they are being managed at both Group and Business Unit level reflects the nature, scale and industries in which the business is operating. Therefore, at a minimum, the following improvements should be considered:

- Increase frequency and rigour of Principal Risk discussions and reviews. A yearly review and to go through last year’s Principal Risks is not sufficient;
- Move risk assessment from looking at risks in isolation to capturing interdependencies or aggregations through more effective scenario modelling;
- Move away from using simplifying assumptions such as symmetrical risk distributions to better capture the uncertainty in the business and risk environments; and
- Embrace the emerging regulatory requirements to address financial and business model viability in multiple time horizons with clearer links between the underlying risk scenarios and the viability considerations and disclosures.

For the RemCo the complexity question usually comes up in relation to the design of incentives. Committees find it difficult to combine the complexity of the business with the complexity of the pay and performance relationship. Sometimes this is exacerbated by not differentiating between the complexity perceived by an outside stakeholder and that of an informed participant, often adding further confusion through cognitive bias. To address this the committee needs to discuss and determine what complexities:

- It is not allowed to live without (eg regulatory requirements);
- What it can’t live without (eg performance measures critical for the business or its owners);
- What it wants to retain (eg linked to a specific behaviour or action); and
- What it should seek to remove (eg obfuscating features).

In addition, complex reward matters are sometimes ignored or pushed down the agenda. For example, incentives are typically much less complex than pensions, mobility, insurance or termination arrangements, not to mention the total reward picture that encompasses all these remuneration vehicles, but the focus tends to follow items that are understandable to most. It is therefore essential that a committee challenges itself and management, to ensure that there are no risks or unnecessary costs overlooked by oversimplification of required rigour or ignoring what is both complicated and superfluous.

‘In addition, complex reward matters are sometimes ignored or pushed down the agenda.’

Conclusion

Effective board committees have become key to successful and well-functioning boards and corporate governance. That effectiveness relies first and foremost on the combination of leadership, diverse expertise and experience and purpose. However, we have made the case that the contribution of committees can be improved by putting increased emphasis on shared understanding and common reference points, providing the right information to support decision-making, challenge and review and having a considered approach for dealing with the inherent complexity of the considerations of each board committee.

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1. Governance, September 2016, Issue 267, Bryn, H-K and Sjostrom, C, ‘Linking risk and reward’.

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