Public Online Consultation on Corporate Governance and the Financial Crisis

Thank you for this opportunity and in response to your call for consultation, Anne Molyneux, Chartered Accountant, FAICD, Director, CSInternational, is pleased to provide you with her comments on The OECD Consultation on Corporate Governance and the Financial Crisis.

General Comments

- In responding to the financial crisis and recognising its impact on corporate governance globally, the OECD, through its constituents and through its broader outreach to non-OECD countries, is well placed to lead on any responses required.
- Further in responding to the global financial crisis, any measures arising will respond to the heart of the matter - to causal issues, and will seek to avoid unintended consequences and an unwarranted increase in regulatory burden.
- The consultation recognises the current status of existing regulation and voluntary mechanisms in corporate governance in a wide variety of countries and companies. Such a state also recognises that in corporate governance there is 'no one size to fit all'. Therefore in any response, the OECD should continue its path of preferring a principles' based approach.

Specific Comments

- In a climate of 'easy credit', debt became the preferred source of capital and in many cases was easier to access than equity. Inadequate assessment of the risk of debt as compared to equity was made – only the cost seems to have been taken into account. A regular review of the funding framework of an entity should occur and Balance Sheet management actively undertaken. Generally a 'restrictive' credit climate was not considered. It was not on the horizon. Debt margins were low. Better assessment of the risk of debt and longer term costs is necessary.
- There was a fundamental debt culture in that relatively high levels of debt were acceptable. Analysts would criticise boards for conservative levels of debt saying they had a 'lazy balance sheet'. Only strong Chairmen and Boards withstood these influences which, in the short term, often resulted in share price mark-downs. Greater understanding of the debt / equity trade off is required of market influencers. They also need to understand they do not have a similar and risk / reward view and it is not aligned with the risk / reward perspective of investors.
- One reason this occurred was because the risk of debt was under-priced and mostly took into account only the interest cost of debt and not the other costs of debt to the business accruing from asset restrictions and covenant details, such as the cost of re-paying or re-structuring debt if the share price fell below a certain level. What is a long-term debt may quickly become a current and callable liability in times of share market volatility. Therefore, boards and senior management should also consider 'worst case' scenarios.
- Strategic risk reviews should be regularly undertaken and robustly debated at the board. The internal reporting of risk to the board in complex organisations should be improved. If management present insufficient or inadequate explanation of assumptions and sensitivities to test the risk monitoring and controls, the board should not be accepting and compliant. The board should ensure adequate expertise, within their ranks, is available to identify, manage and monitor risk and to question the conclusions presented.

- More rigorous assessment of project specific benefits and costs is necessary. Projects may seem attractive and 'on strategy' on the surface. However the full costs of major projects should include an assessment of the costs and risks of integration, including management time and focus, compatible governance models, availability of expertise etc.
- Risk management in complex organisations is in itself complex and must be monitored, reported and reviewed in a holistic manner. For example, the recognition of risks of sub-prime mortgages in one function of some of the major financing institutions did not translate to an understanding, recognition and management of the risks of those same sub-prime mortgages to the entire company. Boards must demand such assessments and rigorously challenge management on their assessment. Board should improve the supervision of risk and ensure all risks are included, especially questioning 'off balance sheet' exposures.
- The focus on short-term goals and targets and the demand of the market for constancy of performance is counter-intuitive to the cyclical nature of many businesses. Greater awareness of the cyclicality of business and the economy is necessary.
- Generally, boards and management were accustomed to lengthy periods of growth and were inexperienced in managing major global downturns that occur in a very short time horizon. In periods of growth, adjustments for poor investment decisions are easier to digest and to hide. However when revenues are rapidly falling, some costs can be reduced but there is inevitably still less room to manoeuvre on longer term commitments. The magnitude of the losses was unexpected. Boards must learn to look for and expect the unexpected.
- Largely management was rewarded based on an improvement on earnings per share. Therefore in a low margin environment and easy credit availability a preferred course of action in increasing earnings per share ("EPS") was to reduce capital and increase debt - EPS may be manipulated relatively easily. Traditional, older financial ratio acceptable levels were ignored. Boards and management should assess debt on sounder and more realistic benchmarks. They should review the basis of remuneration of senior management to ensure greater weighting to board values and to judgment factors.
- Board competence is assumed around the world, yet it is not always evident. Many experienced board members have a 'good' director heritage. They are on the boards of respected companies with other respected individuals. However many have not kept abreast of the developments in good board practices in recent times. Regular and unabashed training of directors is needed, albeit the training must be suitable in its content and delivery for very senior members of society. Each director must assess his needs that will enable himself / herself to fully understand, assess and assure him/herself that the best decision has been taken in the current environment.
- The value of good corporate governance practices is well established. However it is recognised more in form than in substance. As recognised in the consultation document, there is an implementation gap to be addressed where in many countries and companies' formal good standards have failed. National and corporate programs to close this gap are to be encouraged. Steps to make regular board and director education in corporate governance best practices compulsory would raise the awareness of the value of good corporate governance at the entity level. It would also achieve at least recognition of the seriousness of regulators regard for improvements to corporate governance.

- Board balance between executive and non-executive directors is desirable. However to strengthen the power of independent non-executive directors, it is recommended that they meet regularly amongst themselves, separately from executive directors, to discuss and seek clarification on major issues prior to their determination.