Institute of

Corporate Directors

# ICD EXPANDED GUIDELINES
# FOR PROPER CORPORATE GOVERNANCE PRACTICES

## Background

1. In 1999, OECD issued a set of principles of corporate governance, which were formulated with a global perspective.

2. In 2001, APEC Leaders endorsed "Guidelines for Proper Corporate Governance Practices', which APEC Ministers had earlier adopted. These Guidelines were fully consistent with the OECD corporate governance principles.

3. Of late, there has been increasing importance given to strengthening the audit, risk oversight, and governance functions of the Board of Directors. There has also been greater insistence not only on box-ticking compliance but more importantly on a corporate culture of proper governance with stress given to a culture of ethics and social responsibility. It is to take into consideration these more recent concerns that these expanded guidelines are being put forward for consideration in East Asian economies. They add to the APEC Guidelines that have already been adopted and endorsed. They may be used as reference in refining and enriching the Codes of Proper Corporate Practices that banks and other non-bank corporate institutions already have formulated.

## Audit Committees

4. A key duty of the Board of Directors is to oversee the corporation's reporting, control, and audit processes, which must be designed, installed and made operative to ensure that reports about the corporation's over-all performance and financial condition are true and fair.

5. The task of ensuring quality reporting and controls is demanding of time, commitment, and expertise. Its proper discharge also demands independent, professional judgment. To focus on the discharge of this critical task, the Board of Directors sets up an Audit Committee, which is a Board committee, to oversee in the Board's behalf and with greater focus and time commitment, the corporation's financial reporting, control and audit functions. The Board of Directors---and the management it directs---must be fully committed to making its Audit Committee effective.

6. An effective Audit Committee must be duly empowered. It should develop and maintain a written charter, which clearly spells out its duties and responsibilities as well as the resources with which to carry out its functions. This charter has to be formally approved by the Board. It has to provide benchmarks against which to assess the Audit Committee's performance periodically.

7. The charter of the Audit Committee needs to secure and protect the independence and professionalism with which its chair and its members should carry out its functions.

8. The chair of the Audit Committee should be distinguished for competence, dedication, leadership skills and independent judgment. The few other members of the Audit Committee should possess all the traits expected of all the other corporate directors, but in addition they should stand out also for their independent judgment and financial literacy.

9. The Audit Committee should be provided access to timely and focused information, to experts in the event external professional expertise is necessary, to internal and external auditors, and to continuing education in the specific demands of their work in the Audit Committee as well as in the Board of Directors. Ordinarily, the Audit Committee determines and specifies the information that needs to be submitted for it to carry out its functions properly.

10. The chair and the members of the Audit Committee should be prepared to spend the time that the work of the committee demands. Generally, the time demanded of them can be significantly more than the time that other corporate directors may be required to put in. In part this is due to their having to follow a more involved and detailed annual calendar and agenda for committee meetings.

11. An annual calendar for the Audit Committee would help ensure that all the functions assigned to the committee under its charter would be fully and properly discharged. The annual calendar sets out the frequency of committee meetings and the special topics---in addition to the regular topics taken up at every committee meeting---that certain meetings may focus on.

12. The chair of the Audit Committee should consult with management in the formulation of the committee's annual calendar and the agenda of committee meetings.

13. The Audit Committee should meet as frequently as necessary to perform its role. Audit Committee meetings tend to be longer and are ordinarily subject to less of the time constraint that formal meetings of the entire Board of Directors are.

14. The chair and members of the Audit Committee should arrange for occasional meetings with the external auditors and with the internal auditors without anyone from management present. Increasingly, the Audit Committee assumes responsibility for the appointment, compensation, and oversight of the external auditor. It should also oversee the professional aspects of the work, and assesses the professional performance, of the internal auditor. Ordinarily, the internal auditor provides secretariat functions to the Audit Committee.

15. The Audit Committee should arrange to meet with other directors and with management to further mutual understanding of its work and its findings as well as recommendations.

16. The Audit Committee shall receive in behalf of the Board of Directors written representation from management as to the integrity of the corporation's control and financial reporting system and the conformity of the corporation's financial statements with mandated and globally accepted accounting principles.

17. The Audit Committee shall take an active interest in ensuring that the tone at the top of the corporation conveys the values and best practices contained in the internal culture, which stresses proper governance, ethics and social responsibility.

18. The Audit Committee needs to assess its performance at least annually. It reports the results of that assessment to the Board of Directors. It recommends changes in the Audit Committee charter, which needs to be updated, refined, and improved over time for the sake of greater Audit Committee effectiveness.

Risk Oversight Committee

19. Another key duty, and one closely related to the audit function, of the Board of Directors is to oversee the corporation's risk management, and to install a process by which the Directors understand the risks the corporation faces as well as get alerted to their probable and actual occurrence. The Board needs to ensure that management has identified the specific material risks of the corporation, and formulated a program as well as systematically pursues action plans for addressing those risks properly and mitigating their impact prudently.

20. The task of risk oversight may require special expertise, particularly in banks, and a high degree of commitment as well as professionalism. It may also demand more time than would normally be asked of the other corporate directors. Board of Directors should, when circumstances warrant, consider

setting up a board committee, a Risk Oversight Committee, to act on its behalf and ensure that the risks that a corporation faces in every aspect of its operations are properly and prudently managed.

21. The Board of Directors should determine the modalities under which it exercises its risk oversight functions. When operations are starting and volumes relatively small, the Board of Directors may choose the option of exercising those functions directly without the benefit of a separate Risk Oversight Committee. Later, when the business shall have grown and become more complex, the Audit Committee of the board may be asked to expand its scope to include risk oversight.

22. In banks and in other corporations that face significantly big risks in many aspects of corporate operations, however, it is necessary to set up a Risk Oversight Committee separate from the Audit Committee. Much of the work (although not exclusively) of the Audit Committee is focused on what has already transpired, and how truly and fairly this is recorded and reported. Much of the work of the Risk Oversight Committee is oriented towards probable events that can occur in the future and how risks embedded in corporate operations can be covered and managed. Given the complex and different demands made on both the Audit Committee and the Risk Oversight Committee, banks and other corporations are setting up these two board committees as separate and independent, although related to each other.

23. The Board of Directors should show a strong commitment to make its Risk Oversight Committee effective, with powers and resources that enable it to fulfill its functions with independent judgment, professionalism, access to information and expertise as well as continuing education in relevant fields. In this regard, the Board should approve a written charter for the Risk Oversight Committee that can help ensure its effectiveness.

24. In particular, the Risk Oversight Committee should oversee the system of limits to discretionary authority that the Board delegates to management. It should ensure that the system is effective, that the limits are observed, and that corrective actions are immediately taken, if and when limits are breached. It should pay special attention to the process of avoiding and, when the situation cannot be avoided, of resolving conflicts of interest, especially those involving controlling owners, directors, and managers.

25. In close cooperation with management, the Risk Oversight Committee should monitor the possible stresses and strains that the resources---assets and liabilities---of the corporation would be subjected to, given the myriad changes that would most probably occur in the environment (business, economic, social, political, international). The committee should determine the adequacy of capital and of other insurance and risk mitigation schemes to cover various types of risks, given their different probabilities.

26. The Risk Oversight Committee should ask management to regularly update the principal risks the company faces, indicating their likelihood of occurrence and their potential cost (versus the cost of preventing them). It should ask the internal and external auditors to look out for financial reporting red flags. It should also ask management to assess the risk factors related to economic and industry conditions as well as to management and operating characteristics.

27. The Risk Oversight Committee should ensure that management has a crisis or contingency plan, regularly updated and tested, for anticipating and preventing a major crisis or, should it occur, for continuing to manage and promote the best interest of the corporation in the midst of such a crisis.

28. The chair of the Risk Oversight Committee should be known for personal integrity, informed judgment, appropriate experience, financial literacy, and superior leadership. The chair should demonstrate deep commitment to the corporation's code of ethical and professional conduct as well as to full compliance with laws and regulations.

29. All the members of the Risk Oversight Committee should have the conviction that adherence to proper governance practices provides a firm foundation for the prudent management of risks that the corporation faces. They should be willing and able to spend the time necessary---which often is considerably more than the time demanded of other corporate directors---for the diligent discharge of the duties of the committee. They should also be in a position to provide independent judgment in assessing the adequacy and robustness of the risk management practices that management observes in actual practice.

30. The Risk Management Committee should work in close cooperation with management, and in particular with the Chief Risk Officer, with a staff function and with full commitment to ensuring that the risk management process is duly observed and all operating officers are risk-minded. The Chief Risk Officer is ordinarily asked to provide secretariat functions to the committee.

31. The Risk Oversight Committee follows an annual calendar and a regular schedule of committee meetings throughout the year. The annual calendar helps ensure that all relevant items necessary for the full discharge of the functions of the committee are taken up. Committee meetings should be scheduled at regular intervals and with the appropriate frequency.

32. The Risk Oversight Committee should evaluate its performance and transmit the results of its performance evaluation to the Board. It should periodically review its written charter so this can be refined and strengthened to promote its greater effectiveness.

Governance Committee

33. The law and the regulations that emanate from the law invest in the Board of Directors the power to govern the corporation and direct its affairs. The law originally empowers the Board of Directors to make corporate decisions and perform corporate acts. It is necessary, therefore, for the Board of Directors to make sure that it governs itself properly, and that its internal governance practices are fully aligned with corporate governance principles and guidelines.

34. The chair of the Board of Directors has the specific responsibility for ensuring the proper governance of the board. Ordinarily, the specific responsibility for managing the day-to-day operations of the corporation is delegated to the chief executive officer (CEO) and the management team assembled around the CEO. The trend has been moving towards separating the role of the chairman of the Board of Directors, to whom governance responsibilities are entrusted, and the role of the CEO and the management team, to whom management responsibilities are delegated. Increasingly, the chairman of the Board of Directors is a different person from the CEO.

35. In recent years, there has been growing insistence that the Board of Directors should operate and act in full conformity with the powers, duties, and responsibilities that the laws and regulations have mandated for it. In particular, special importance is being given to a number of critical roles the board should be playing. Among these are the nomination, continuing education, assignment into board committees, performance evaluation, remuneration, and succession planning of corporate directors. All these tasks are closely inter-related, and they have vital and serious impact upon the internal governance of the board itself. They are so critical that the chairman of the Board of Directors should not be left alone to tackle all these closely related issues, which can become very complex to handle by one person alone.

36. There has, therefore, been a proliferation of board committees or sub-committees of late. In addition to Audit and Risk Oversight committees, which in the case of banks are already mandated, there are also separate committees or sub-committees for director nomination, performance evaluation, and remuneration. There may also be yet another board committee, the Governance Committee, tasked to take on issues directly connected with the internal processes and work procedures of the board. Recognizing the close inter-connection between director nomination, continuing education, assignment to committees, performance evaluation, and remuneration with each other and with broader board governance, Boards of Directors are increasingly putting all these functions under the Governance Committee. Furthermore, since boards are shrinking in size for

greater effectiveness and working cohesion (from 15 directors down to about 9 or even less), putting all these functions under the Governance Committee could bring about a few realistic advantages. For one, corporate directors need not be assigned to many board committees.

37. Boards of Directors, therefore, increasingly are setting up a Governance Committee, tasked with ensuring that the internal governance of the board is in line with governance principles and guidelines, and with addressing issues directly connected with corporate directors themselves. Among these issues are the nomination of directors, their continuing education, assignment into board committees, performance evaluation, remuneration, and succession planning. Since the CEO is also a director, the board Governance Committee also addresses all these issues as they refer to the CEO and by extension---in close collaboration with the CEO---to senior officers.

38. The Governance Committee, in close cooperation with the chair of the Board of Directors, needs to ensure that the board fully discharges its main oversight functions. In particular, it should see to it that the board's annual calendar provides sufficient opportunity for the board to review the corporation's statement of vision and mission, to review and approve the management's strategic and business plans as well as monitoring performance against those plans, and to review and approve all material transactions not in the ordinary course of business. It should also help ensure that systems are in place and fully operative so that all corporate activities are conducted in an ethical, legal, professional, and socially responsible manner.

39. The Governance Committee, always in close cooperation with the chair of the Board of Directors, needs to ensure the board's effectiveness and due observance of corporate governance principles and guidelines. It formulates a Code of Proper Practices for corporate directors, and it should get the board to approve this code along with its written charter (i.e. for the Governance Committee).

40. The Code of Proper Practices for corporate directors should lay out the process for nominating directors, taking into account the specific needs of the corporation at any given year or period of time. It should spell out clear guidelines for proper practices of corporate directors in the boardroom. It sets out rules of director conduct covering matters such as board attendance, time commitment to board matters and committee assignments, conflicts of interest, executive sessions, access to and working relationship with senior management, director interaction with institutional investors and other stakeholders. It should specify arrangements for continuing education for directors, assignment to board committees, evaluation of their performance, and their remuneration. It should also make clear the need for a systematic process of succession planning at both the level of the board as well as of management (in particular the CEO).

41. The chair of the Governance Committee would normally be the chair of the board. In the event that the chair is heavily weighed down by other responsibilities, and especially where the chair is also the CEO, a separate chair of the Governance Committee should be chosen. The choice should be made mainly on the basis of deep commitment to corporate governance principles, outstanding leadership, proven competence, professionalism and integrity.

42. The few other members of the Governance Committee should stand out also for their capacity to exercise independent judgment, commitment to corporate governance principles and their genuine interest in observing them with smartness and appropriate flexibility in the boardroom.

43. The Governance Committee should work closely with the Corporate Secretary, who normally provides secretariat functions to it.

44. The Governance Committee should meet with the frequency and regularity that its manifold duties and responsibilities demand. Ordinarily, in view of the annual calendar it proposes for the Board of Directors, this means, in practice, that the Governance Committee should meet as often as the board itself. In addition, immediately after each regular board meeting, the Governance Committee may meet very briefly---generally without the CEO present---to have a quick evaluation of the board meeting that just ended.

45. The Governance Committee takes care of the process of board evaluation and of the performance evaluation of senior management (starting with the CEO). It must therefore set the example by rigorously making an annual evaluation of its performance against the duties and responsibilities that its charter has assigned to it. As in the case of other board committees, the results of its performance evaluation are duly reported to the board. Based on such results and other experiences during the year, particularly those that the accumulated quick and very brief evaluation sessions after each regular board meeting may highlight, the Governance Committee should propose refinements and improvements to its written charter.

<u>Corporate Culture, Ethics and Social Responsibility</u>

46. The Board of Directors sets the tone at the top. The CEO and others in management have the duty to reinforce that tone so it conditions and pervades all aspects of corporate operations and activities. The corporate culture that the Board of Directors institutes---with the Governance Committee ordinarily charged with the primary responsibility of instituting it---should capture the basic values and fundamental commitments of the corporation. Management should then see to it that it reverberates through all levels of the

corporate hierarchy and enlivens all decisions and actions within the corporation.

47. The Board of Directors, and in its behalf the Governance Committee, should therefore give the prime importance that the operative corporate culture deserves. After all, the internal culture that is actually lived and observed within the corporation determines whether or not the corporate environment is conducive to the dutiful observance of the principles of governance, ethics, and social responsibility. It is the consistency between the actual internal culture with those principles that is the ultimate test of whether or not they would be taken seriously and determinedly enough to be complied with and observed in practice.

48. The Board of Directors, using its Governance Committee, should take some time out, once a year, to assess the quality of the internal culture that actually pervades the corporation. In making that assessment, it should inquire into how faithfully the principles of governance, ethics and social responsibility are observed at all levels of the corporate hierarchy and in all aspects of corporate operations.

49. The Board of Directors should challenge and empower management to bring the principles of governance, ethics and social responsibility from their lofty perch, down to the ground where day-to-day operations are conducted. It is on this ground where those principles have to come alive. It is here where they have to make a real difference, not only for short-term viability but also for the long-term sustainability of the corporation. And it is the corporation's personnel, its human resources, under the management of the CEO and other officers, who must give life, through their decisions and actions, to those lofty principles. In the final analysis, the people within the corporation must be the ones who should actually live by them.

50. Any corporate culture, pervaded by the principles of governance, ethics and social responsibility, orients people beyond the corporation itself. It makes them think of the broader environment, of which the corporation is a part, and to whose welfare and development the corporation must be able to contribute positively. In the first instance, as a prime demand of their social responsibility, corporations need to be strong and viable in the short run as well as progressive and sustainable over the long run. In addition, they also need to contribute positively to the broader environment by the propriety of their example, the effectiveness of their outreach programs, and the strength of their advocacy for responsible citizenship.

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