Governance Matters: Board Committee Models

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Letter from the Editor

In this issue of *Governance Matters*, we continue our series on board committees with a look at the competing models of board-committee governance.

This gives us an opportunity to share some of the research results from our latest national co-operative and credit union governance practices research, conducted in 2008 and being published this spring (2009).

Five years ago, in 2004, the Canadian Co-operative Association and Brown Governance Inc. undertook the first national survey of its kind on co-operative and credit union governance practices across Canada. In 2008, a second national survey was completed by 115 Canadian-based co-ops and credit unions.

Released in March 2009, ***Counting on Canada's Co-ops*** analyses credit union and co-operative governance practices while ***Advancing with Distinction*** focuses on credit union governance practices. For more information go to **www.governance.coop**.

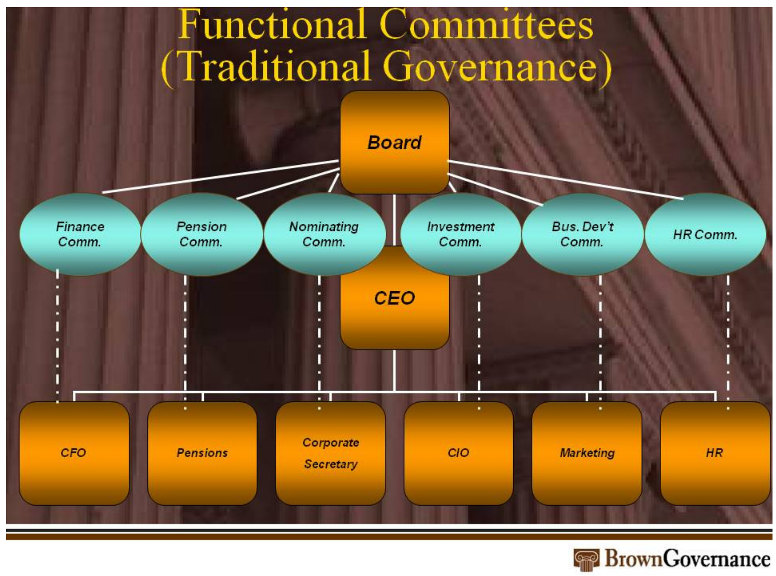
Canada' co-ops and their boards have taken some important steps in governance in the 4 years since the baseline study. An overarching theme is enhanced accountability: many of the new or improved governance practices enhance the accountability of the co-op, its board and performance to its members, community and beyond.

We like to say that "there is no single right answer to the question of governance models . . . but there are some wrong answers." It is my hope that the research we're sharing with you today will help to better inform your choices, to help you make the "right" choice for your co-operative or credit union, and to avoid "wrong" choices.

Debra L. Brown
Editor

Traditional Model: Committees follow function

One of the biggest changes in corporate – and co-operative – governance in the past few years has been the board's use of committees. Broadly speaking, this transformation has taken two forms: the choice of which committees the board should use (if any), and the authority/accountability relationship between these committees and the board.



Twenty years ago it was common practice for boards, using the traditional model of governance, to strike committees to deal with the major functional areas of the organization (see illustration.)

Each board committee works closely with the management staff responsible for its functional area. There is often not a clear line differentiating between the committee's responsibilities and management's. They work hand-in-hand to address issues, solve problems, develop policy and plans, and to monitor the performance and compliance of each function.

For example, a Human Resources or Staffing Committee of the Board typically works with the HR manager to develop HR policies, including hiring, conduct, discipline, compensation, training and performance management. The Board may be asked to approve the higher level policies, others may be approved by the committee and implemented by management.

Or, a Business Development Committee of the Board works with marketing staff to develop new products, services and markets for the organization (co-op.)

Under this model, boards would strike a committee to deal with a new issue – a strategic opportunity or challenge, for example, new facilities or a new IT system (remember "Y2K Committees" in 1999?)

Policy Model: No Committees

Policy governance, in its purest form, as promoted by John Carver among others[1], takes issue with the traditional model of governance, including its over-reliance on committees.

Policy governance argues that a board must focus its attention exclusively on setting policy, and then on ensuring that management adheres to those policies.

Its criticism of traditional governance is that the board often spends too much of its time on operational matters – staffing, pricing, supplier, product, facility, IT and marketing decisions, for example. Not only does this severely limit the decision-making scope of, and so discourage, the people who are better equipped to operate the organization (managers), it also does a disservice to the board and owners – because the board has so little time left to focus on governing the organization, protecting the organization's long-term interests, and those of its owners (shareholder or members) and other key stakeholders.

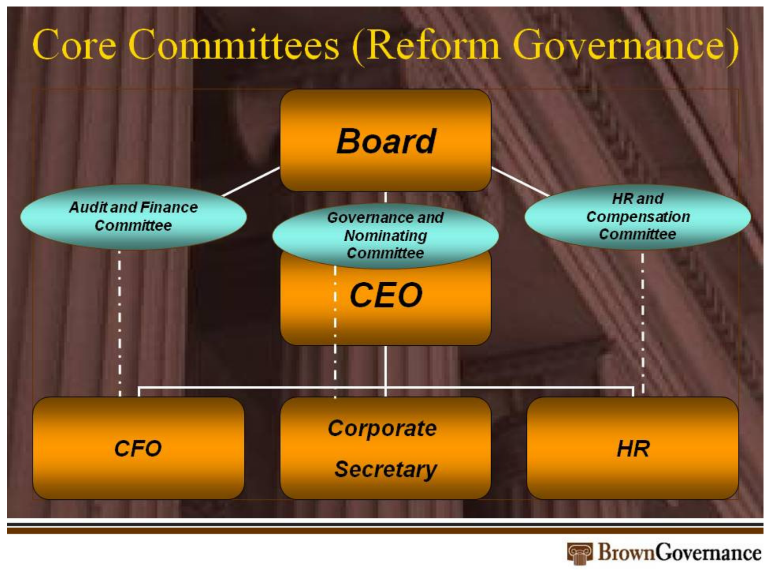
The use of committees is frowned upon, because it creates "two tiers" of board members, insiders and outsiders. A fundamental principle of policy governance is that the board as a whole must deal with the CEO alone. Whenever committees are formed, this inevitably results in a sub-set of board members dealing with managers beyond the CEO, disrupting the single clear authority and accountability line, and risking managers being directed by board members, whether intentionally or unintentionally.

While some versions of policy governance have made allowances for committees, especially an Audit Committee, in the past 10 years or so, the general principle of a board dealing as a single cohesive unit still stands.

[1] *Carver's Policy Governance* is the copyright of John and Miriam Carver, and is a proprietary product of theirs. These comments represent our experiences working with boards who have adopted this model.

Reform Model: Core Oversight Committees

The more complex, larger, and heavily regulated an organization is, the more difficult it is for its board to operate without committees. That is a major theme of reform governance, usually credited to the Cadbury Committee in the U.K. (in 1992), and here in Canada to the Dey Committee of the Toronto Stock Exchange (two years later.) Since the 1990's, reform governance codes have been adopted widely around the world. These codes now include the Combined Code (U.K.), the CSA National Instruments (Canada), the Sarbanes-Oxley Act (U.S.), the King Code (South Africa), and many others.



Under the reform model of governance, boards use a small number of committees (1 to 4) to undertake specifically delegated diligence work in the board's most time-consuming and complex areas of oversight.

Key features of the reform committee model are:

- Committees do not approve decisions; they undertake major aspects of the board's due diligence work in oversight, then report and recommend to the board which has final approval.
- Therefore the board generally does not use an Executive Committee.
- An Audit (or Audit and Finance) Committee is responsible for financial oversight.
- A Governance (or Governance and Nominating) Committee is responsible for overseeing the board itself, including the selection and evaluation processes, committee and meeting functioning.
- A Human Resources (or Compensation) Committee is responsible for overseeing the CEO employment relationship, and also executive and incentive compensation plans in general.
- About 30% of corporate boards also have an Environment, Health and Safety (EHS or SHE) Committee of the board to oversee these areas of risk – predominantly in the energy, utilities and related sectors.
- A subtle but important aspect of this reform model is that board committees, through their chair, are the primary reporting mechanism to the board on areas of their responsibility, while management provides back-up expertise and resources – in the traditional model of board committees, management provides most of the reporting and presentations at both the committee and board levels (often resulting in duplications and overlaps of presentations and discussions at both).

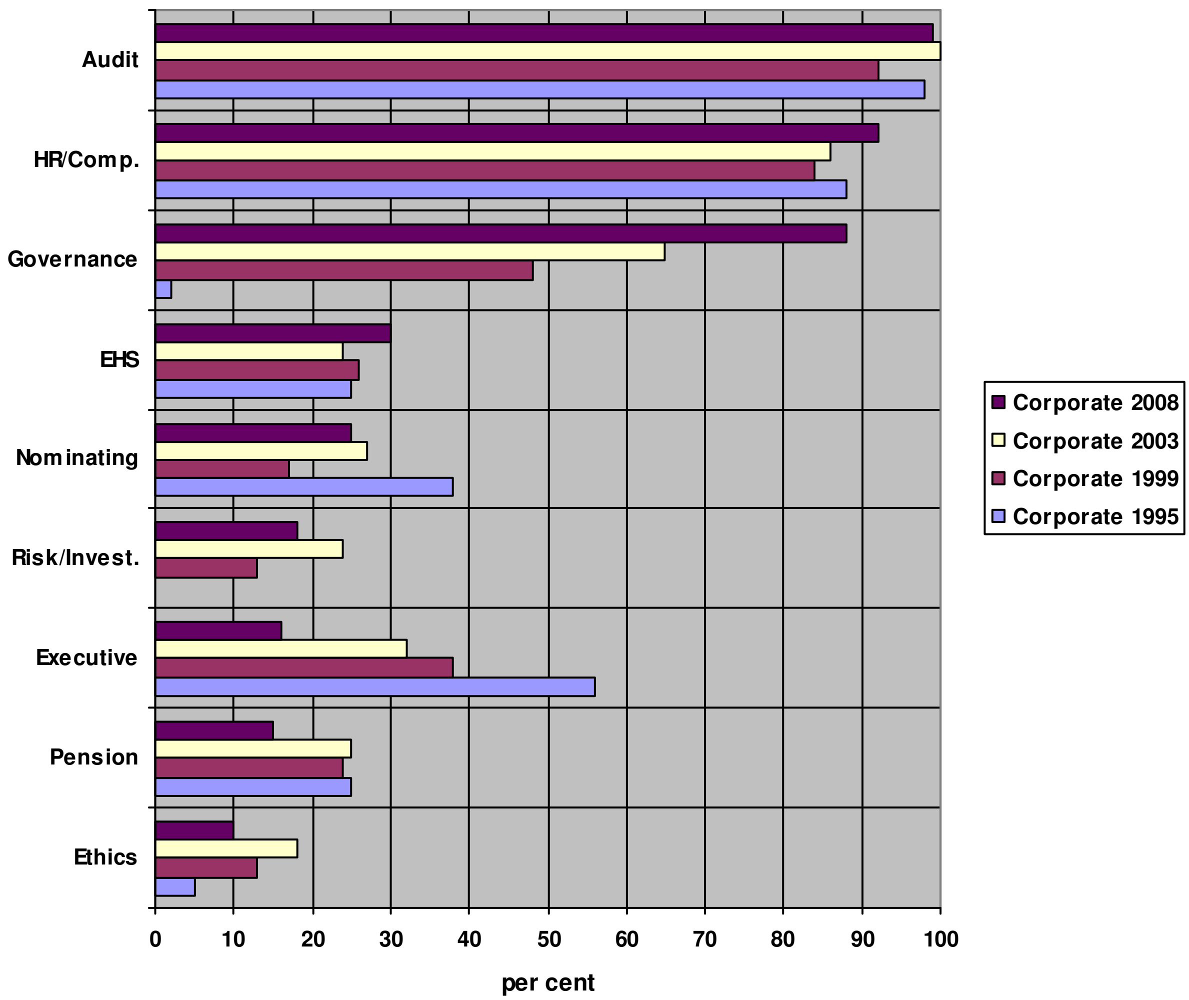
The distinctive feature of the reform committee model is “who owns the recommendation when it comes to the board?” – the committee does. In the traditional model, management still “owns”, presents, explains and defends the recommendation when it goes to the full board for approval, even if it went through a board committee first.

In the reform model, the committee chair presents and explains their recommendation, and other board members begin by questioning the committee chair and members about their rationale, and to ensure they have conducted “due diligence”: received the right information, asked the right questions, and undertaken the right review process. Management and consultants are still there at the meeting, but their role is largely one of expert support, to provide clarifications on facts and complex details, not to present again their presentations and reports to the full board.

Trends in Board Committees: Canada's Corporations

Since the Dey Report, Canada's private sector boards have overwhelmingly adopted the reform model of committees, at least in terms of which committees of the board they choose to use (see Chart One.) Many of these have gone the distance and also adopted the reform committee principle that the committee, not management, owns and presents the recommendations to the full board.

Chart One: Trends in Corporate Board Committee Use[2]



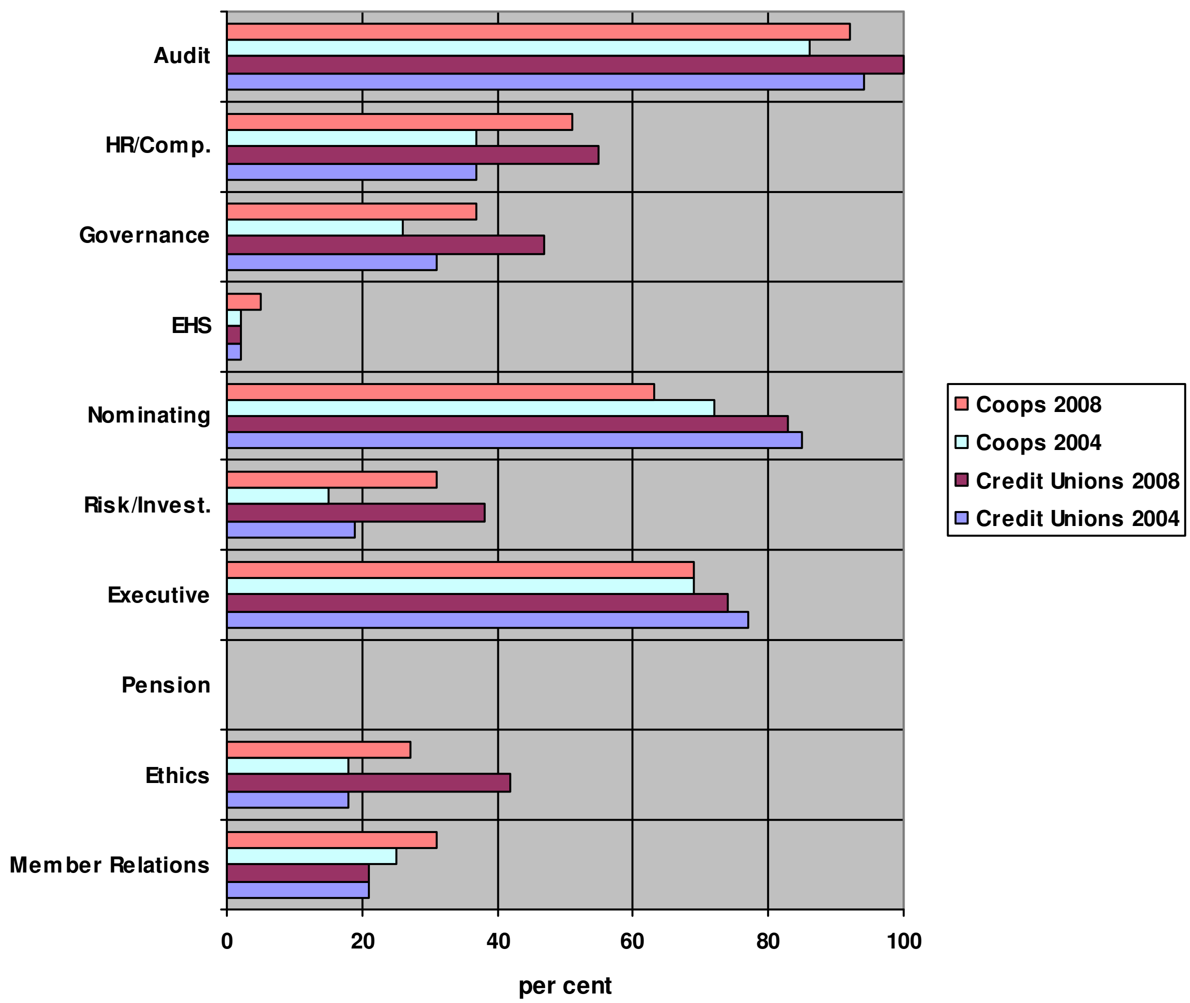
The most dramatic changes are in the almost universal adoption of a Governance Committee, and the concurrent elimination of the Executive Committee.

[2] Source: The Conference Board of Canada and Patrick O'Callaghan & Associates, and The Canadian Co-operative Association and Brown Governance Inc. Co-operative Sector Research 2008

Trends in Board Committees: Canada's Co-operatives and Credit Unions

Co-operative and credit union boards across Canada do not show the same consensus on adopting a committee model. While the overwhelming majority of co-operatives (97%) indicated that they have board committees in place, there are significant differences between the corporate sector and the co-operative sector in Canada (see Chart Two):

Chart Two: Trends in Co-op and Credit Union Board Committee Use[3]



- About 40% of co-op boards have adopted the reform model of board-committee governance (up from about 30% in 2004)

[3] Source: The Canadian Co-operative Association and Brown Governance Inc. Co-operative Sector Research 2008

- About 60% of co-op boards continue to use the traditional model of board-committee governance, or a hybrid between the two models:
    - Relying on an Executive Committee to oversee the employment relationship with the CEO, including the CEO's evaluation and compensation.
    - This Executive Committee is often delegated approval authority to make decisions on behalf of the board between board meetings (e.g. leases, purchases, large transactions.)
    - A separate Nominating Committee is used for the board nomination process, this committee is often struck with different members each year solely to focus on ensuring that enough candidates are nominated for the board for election at the AGM, and this committee's work is often concentrated in the months leading up to the AGM.
    - An Audit Committee is used, although it may (or may not) have approval authority over certain items (budget, capital expenditures, financial reports) rather than recommending them to the Board.
    - Other Board Committees may also be used depending on the needs of the co-op and its board: co-ops are more likely to have a board-level Member Relations Committee (31%), Investment or Risk Committee (31%), Ethics or Conduct Committee (27%), or other board committees (39%) than corporate boards, where these responsibilities are more likely to be incorporated with one of the three core oversight committees (e.g. ethics and conduct with Governance or Audit, risk with Audit), or left with the board as a whole (e.g. risk, investment).

The differences between the two sectors are illustrated further in Table One:

Table One: Contrasting the Use of Board Committees[4]

	1995 Corporate Sector	1996 Corporate Sector	2003 Corporate Sector	2004 Corporate Sector	2007 Corporate Sector	Cooperative Sector (All)
Executive	56%	36%	32%	14%	**9%**	**69%**
Governance	2%	58%	65%	89%	**93%**	**37%**
Audit	98%	99%	100%	100%	**100%**	**92%**
HR & Compensation	80%	81%	86%	86%	**94%**	**51%**

[4] Source: The Conference Board of Canada (Corporate Sector Results) and Patrick O'Callaghan & Associates, and The Canadian Co-operative Association and Brown Governance Inc. Co-operative Sector Research 2008

Choices Ahead for Co-op Boards

Co-operative and credit union boards definitely do *not* need to adopt corporate practice simply because private sector corporations have. But they do face choices about the optimal mix of board committees, and so here are some closing observations on these choices:

- Have you had a conversation recently about **which governance model suits** your co-operative or credit union best? On which committees ought to be kept, and which changed, and why? Sometimes boards operate committees simply because they have in the past, and they have no compelling reason to stop – or haven't really evaluated whether they continue to add value.

- If you have chosen to adopt a **hybrid model**, customizing your committees to suit your own needs (which is an excellent idea), are you clear on where the lines are? In other words, are committee chairs, members and managers clear on the line between governance (direction and oversight) and operations? Are they clear on where information goes and presentations are made? And on "who owns the recommendation" coming out of committees? Sometimes, a "hybrid" model, using reform oversight committees (Audit, Governance, HR) but retaining the Executive (and often Nominating) Committee, means that committees can make decisions, and often management still brings recommendations through committees and ultimately also to the board. This can lead to some confusion over committee roles, responsibilities and accountability lines, particularly between Executive and HR Committees (since it is easier for Nominating and Governance Committees to draw a clear line between their roles.)

- If you still have an **Executive Committee** of the Board, is it still adding value? Executive Committees of corporate boards have become a convention of the past for a number of reasons – a subset of "insiders" on the board have the full board's authority, yet all board members share responsibility and liability, and there are fewer practical reasons to require an Executive Committee today, as operational matters are usually better delegated to management, and the full board can convene quickly, even by teleconference, to deal with urgent matters. However, there are situations when they do add value. See the last issue of *Governance Matters* for a discussion on the merits of using an Executive Committee of the Board.[5]

- If you are not using a **Governance Committee** of the Board, where is this work taking place? How are you checking your governance practices and policies to ensure that they are fresh, appropriate and updated? How are you evaluating your Board, Committees

[5] http://www.coopscanada.coop/pdf/Governance/Publications/GMFeb09.pdf

and Chairs to seek opportunities for training, development and improved effectiveness? Who is keeping up-to-date on the rapidly changing world of governance, risk and compliance?

- If you are not using a **Human Resources Committee** of the Board, who is responsible for establishing and monitoring the employment relationship between the Board and its one employee, the CEO (General Manager or Executive Director)? Is this the Board Chair, and if so, how does the rest of the board know how effectively this is being done? Who establishes the CEO's performance objectives each year? How is the CEO evaluated against these? How do you know if you're paying your CEO too much – or too little – or the wrong mix? How do you know where your next CEO will come from, especially if the change happens without warning?

- Are the **rest of your board committees** dealing with high level, priority matters that are appropriate to the board and adding value to the co-operative or credit union? Or are some of the committees, or some of their agenda items, weaving over the management line into operations? Examples can sometimes include Member Relations Committees and Community Investment Committees.

- If you are using a **Nominating Committee**, is it as effective as it could be? This committee's composition and roles are probably the most unique to co-operatives and credit unions, because of their democratic member control. In the next issue of *Governance Matters*, we will take a closer look at the co-op's Nominating Committee and explore the pros and cons of different choices for these.