

Challenges and Changes

Focusing on Long-Term Performance In the Face of Short-Term Pressures

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The credit crisis and recent market turbulence forced many management teams to focus on short-term survival. Boards of directors play a valuable role in overseeing management's efforts in this area, but provide even greater value by ensuring that the long-term interests of the company are not neglected.

Directors can help prepare the company to survive and thrive in the post-recession business environment. This new business environment may include corporate governance reforms and changes to regulatory regimes, new forms of government intervention in the marketplace, and increased complexity and interrelation of business risks.

Boards should consider issues such as:

- what the future business environment may be and how to prepare for it;
- how to identify and take advantage of new opportunities;
- how to avoid unintended long-term consequences of decisions taken in the interests of short-term survival; and
- what lessons can be learned from the market crisis about the company's strategy, business and assets, including its people.

An excellent resource to help directors is the Long Term Performance Briefing authored by Alan Willis, CA for the CICA's Risk Management and Governance Board, available at www.rmgb.ca. It highlights a number of areas that directors should address and provides questions which they can ask. The areas covered are established elements of the board's oversight role, but merit particular attention in order to maintain focus on the corporation's long-term interests despite the immediate pressures of the economic downturn. Much of this article is based on the Briefing.

Business Strategy

The company should have a business strategy which goes beyond the immediate to address the company's long-term future. Existing strategies should be considered in light of the future business environment. Different scenarios, even extreme ones, should be contemplated and their probability evaluated. This process can form the basis of an enterprise-wide business strategy that addresses both risks and opportunities.

Directors should ask management about assumptions regarding the future state of the economy, capital markets and the risk environment which underpin the business strategy. If the strategic plan is based on a specific scenario, it is important to know how that scenario was selected and what its implications are for the company in terms of operations, capital projects, new opportunities, risk management, access to capital and availability of resources.

Valuable lessons can be learned from the company's experience during the recent market turmoil regarding the validity of assumptions underpinning the current business strategy and the company's ability to adapt to changing conditions.

Risk and Risk Oversight

Management of risk is inextricably linked to strategy and can be determinative of a company's long-term viability. Risk oversight is a critical component of the board's role and is key to enhancing the company's long-term performance.

The financial crisis highlighted the complexity and interrelation of business risks in the global economy, and the need to revise traditional thinking about risk and uncertainty. Risk management must now also take into account global issues with potentially widespread impacts such as climate change, disease and pandemics, and terrorism.

Risk oversight should include open discussions at board meetings in addition to review of management reports and presentations. Directors should review the process used by management to identify and assess significant business risks and consider whether there are other risks critical to the successful execution of the company's strategy which should also be addressed.

Directors should also consider whether management's conclusions as to the risks the company is prepared to accept are in line with the company's risk tolerance level, taking into account the risk management strategies to be employed and the returns anticipated.

Finance

The credit crunch highlighted the importance of access to capital and management of liquidity, issues which will continue to be significant for Canadian companies in the long term. There are valuable lessons from the recent crisis which can be used to inform or improve future strategies.

Directors should receive information from management regarding:

- the company's sensitivity to exchange rate fluctuations;
- the implications of volatile equity markets and/or increased cost of borrowing on financing strategies;
- the company's credit ratings and ability to meet the terms of debt obligations and refinancing requirements as necessary; and
- the advisability of liquidating investments in order to strengthen the company's financial condition.

Organization and Workforce

Workforce reductions and realignment of business units may be necessary to cut costs, but may not be in the long-term best interests of the company. Such decisions present an extraordinarily difficult balancing act.

When focusing on the company's long-term performance, directors must consider whether sufficient human resources will be available to achieve long-term goals, and whether the company's compensation strategy will allow it to attract and retain key employees. Directors should also assess whether the company's present organizational structure will be appropriate for the nature and scale of business operations in the post-recession business environment.

Directors should satisfy themselves that sufficient efforts have been made to advise employees of changes to the company's strategy and to align them with the new direction, particularly if downsizing or reorganization has occurred.

Stakeholder Relations and Trust

Stakeholder relations and trust are important intangible assets which can enhance long-term business value. Corporate reporting and external communications are key tools for relationship-building and the board should not limit itself to oversight of compliance with regulatory disclosure rules, but should encourage forthright communications and the fostering of trust.

Directors should consider whether management's strategic plan takes into account the value of key stakeholder relationships over the long term, and whether sufficient attention is being paid to building and maintaining those relationships.

Leadership

Boards have an important role to play in mentoring CEOs, and directors may contribute valuable experience in leading companies through recession. Directors must satisfy themselves that the leadership team is dealing effectively with the challenges presented by the financial crisis and global recession.

However, boards must also plan for CEO succession in order to safeguard the company's long-term interests. The company's leadership needs will change over time, and different skills sets will be needed in different situations. Today's CEO, selected several years ago under different business circumstances, may not fit well with the company's future direction, particularly if strategy is undergoing substantial change.

Executive Compensation

Executive compensation is currently under intense scrutiny by stakeholders and regulators as the economic crisis has exposed cases of excessive risk-taking motivated by incentive pay.

Aligning executive pay with performance is important to an effective compensation program, and the choice of which performance measures to use is critical. Tying incentive compensation to short-term performance indicators can encourage excessive risk-taking and be detrimental to the company's long-term health.

Directors, particularly those sitting on compensation committees, should review executive compensation practices in light of the lessons learned from the financial crisis. Incentive programs should be calibrated to motivate executives to enhance company performance and should align their pay with sustainable long-term results.

Entity-level Controls

Entity-level controls can reduce the likelihood of management or employees focusing on short-term performance to the detriment of the company's long-term interests, or engaging in unethical actions or actions that could jeopardize the company's reputation. Board oversight of entity-level controls such as codes of business conduct and the "tone at the top" will reinforce a long-term perspective in all aspects of doing business.

Directors must satisfy themselves that the focus on long-term performance is pervasive throughout the organization, and that appropriate entity-level controls are in place to protect the company's reputation and long-term interests.

Board Dynamic, Structure and Processes

The mindset of directors and the dynamic of the board, as well as board structure and processes, can help foster a long-term perspective.

The backgrounds and experience of directors can affect the board's disposition to think long-term or short-term, as well as the likelihood of achieving an appropriate balance. The board chair and governance committee should factor these dynamics into their recommendations when nominating new directors.

Committee structures and mandates and the manner in which issues such as risk and strategy are included on the board's agenda will also affect its ability to adopt a long-term orientation. Directors should consider whether changes to the dynamic, structure or processes of the board would help focus on the company's long-term performance.

Conclusion

Paying attention to the topics discussed in the *Long Term Performance Briefing* and asking the right questions will help directors safeguard the long-term interests of the company and position it for success well beyond the current economic crisis.

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