TONE at the TOP®

Providing senior management, boards of directors, and audit committees with concise information on governance-related topics.

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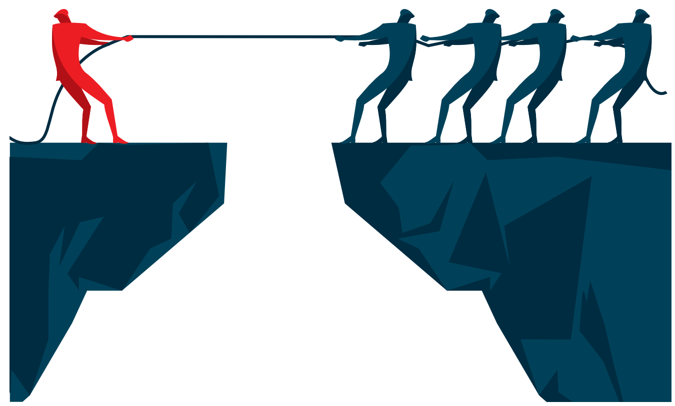
Can Boards Meet the Challenge? 2020 ACGI Results

Boards are falling short when it comes to challenging management. As a result, they may not be gaining all the information they need for sound corporate governance.

The Institute of Internal Auditors recently published the 2020 *American Corporate Governance Index* (ACGI), which asked chief audit executives (CAEs) to grade board members' assertiveness in offering opinions that conflict with the CEO's. The overall rate was a 76, a middling C. Only 66% thought board members would object if the CEO wanted to postpone reporting negative news. Boards also scored poorly when it came to asking whether the information presented to them was accurate and complete, receiving an even more troubling grade of 68.

A candid exchange of opinions — even contradictory ones — is beneficial for an organization. But this is difficult to accomplish if boards are not pushing back on questionable decisions or don't know if they are getting the full picture on critical issues.

"Entities and their key stakeholders are better served when directors effectively challenge management's judgments, explicitly consider alternative perspectives, and engage management in frank and open discussions," according to a COSO report on *Enhancing Board Oversight: Avoiding Judgment Traps and Biases*.



A More Dynamic Approach

There are a number of reasons why boards should consider whether they are too hesitant in their engagement with management.

Constructive debate leads to better decisions. Conflict or rancor are not productive, but robust engagement can motivate each side to consider and articulate their information or opinions and, perhaps, re-evaluate them in light of the questions they are asked or the answers they receive. Being tough doesn't have to mean being confrontational, a National Association of Corporate Directors (NACD) report points out.[1] It is possible to disagree while remaining respectful and collaborative.

Boards need to avoid being drowned out. If directors aren't proactive, they may find themselves taking a back seat to other opinions. Given high levels of shareholder activist campaigns in recent years, "chances are that if the board isn't challenging management on the status quo, others will," according to a 2018 EY report.[2] Shareholder activism is expected to bounce back in 2021 after a decline in 2020, Bloomberg reported.[3]

About The IIA

The Institute of Internal Auditors, Inc. is a global professional association with more than 200,000 members in more than 170 countries and territories. The IIA serves as the internal audit profession's chief advocate, international standard-setter, and principal researcher and educator.

The IIA

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Skepticism is a valuable asset. Questioning data — even good news — and requesting explanations for surprising outcomes can help illuminate problem areas. That doesn't mean playing devil's advocate or asking uninformed questions for no reason, as the NACD report notes.[4] "It's about understanding the industry and the business, applying your business acumen to the subject matter, and requiring logical responses to relevant, well-formed questions."

Tough times underscore the importance of boards' engagement. "Everyone knows what boards should be: seats of challenge and inquiry that add value without meddling and make CEOs more effective but not all-powerful," according to a *Harvard Business Review* article.[5] The disruptions and uncertainty of the past year have shown how important this role can be during difficult times.

More Key Details From the ACGI

Despite the uncertain time for organizations and the economy created by the COVID-19 pandemic, there was a modest improvement in overall corporate governance in 2020, according to ACGI. But there still is work to be done in some key areas.

CAEs, who provide organizational leaders with independent assurance and advice on critical concerns, gave corporate governance in 2020 an overall score of 82, or a B- grade, up three points from 79, or a C+, in 2019. The ACGI survey asks CAEs to grade their organizations based on a series of statements related to each of eight Guiding Principles (see *American Corporate Governance Index: Making Strides Amid Crisis* for more details).

Some of the key lessons learned from the 2020 ACGI include:

During a crisis, being regulated can be beneficial. Companies in regulated industries, such as financial services, transportation, and utilities, scored better on governance considerations. Larger unregulated companies (with total revenues of more than $10 billion) received better governance scores than smaller ones.

At many organizations, governance may be stronger when there are more direct management reporting structures overall and specifically for internal audit. If material issues make their way to the CEO fairly easily, the company is substantially more likely to have high governance grades and less likely to have low ones, according to ACGI survey data. The data showed that CAEs who report administratively to the audit committee or CEO were more likely to give high overall governance grades to their organizations than were those who report to the CFO. The data suggested this correlation for companies reporting revenue under $10 billion.

Tone at the top may not be filtering down. While CAEs thought their organizations' board and CEO exemplified a strong tone at the top that would pass any ethical test (they scored this statement a 94), they were less confident that this tone was communicated to and embodied by all levels (only an 82). (See the chart on page 4 for more perspective on culture.)

More work is needed on the ways boards evaluate corporate governance. The grade in this area was a solid C. While CAEs thought organizations were doing a slightly better job of discussing governance and seeking feedback on it, formal evaluations are not as common as they should be.

Looking Ahead

The quality of corporate governance appears to have held firm during a particularly challenging time, but it's unclear what the long-term impacts of the pandemic will be on companies and the economy, and on workplace culture and governance. It is now up to boards and management to determine how best to build on the strengths and address the weaknesses revealed during the crisis. Leaders can use the ACGI to review their own situations and map a path forward in uncertain times. Most important, they should take an active role in ensuring that they are having candid conversations with management and receiving the information they need for good governance.

Guiding Principles of Corporate Governance

PRINCIPLE	2020	2019
Principle 1: Effective corporate governance requires regular and constructive interaction among key stakeholders, the board, management, internal audit, legal counsel, and external audit and other advisors.	B (83)	C+ (79)
Principle 2: The board should ensure that key stakeholders are identified and, where appropriate, stakeholder feedback is regularly solicited to evaluate whether corporate policies meet key stakeholders' needs and expectations.	B (86)	B- (81)
Principle 3: Board members should act in the best interest of the company and the shareholders while balancing the interests of other key external and internal stakeholders.	B (85)	B- (80)
Principle 4: The board should ensure that the company maintains a sustainable strategy focused on long-term performance and value.	C+ (79)	C (75)
Principle 5: The board should ensure that the culture of the company is healthy, regularly monitor and evaluate the company's core culture and values, assess the integrity and ethics of senior management, and, as needed, intervene to correct misaligned corporate objectives and culture.	B (86)	B- (82)
Principle 6: The board should ensure that structures and practices exist and are well-governed so that it receives timely, complete, relevant, accurate, and reliable information to perform its oversight effectively.	C+ (79)	C+ (78)
Principle 7: The board should ensure corporate disclosures are consistently transparent and accurate, and in compliance with legal requirements, regulatory expectations, and ethical norms.	B (85)	B (83)
Principle 8: Companies should be purposeful and transparent in choosing and describing their key policies and procedures related to corporate governance to allow key stakeholders an opportunity to evaluate whether the chosen policies and procedures are optimal for the specific company.	C (75)	C- (72)

QUESTIONS FOR DIRECTORS

- Do board members question or challenge management as necessary?
- Is there healthy debate and discussion, or do directors accept management information without much question?
- Does the board ask for details about the accuracy or completeness of the information it receives?
- Who does the board turn to for assurance on the accuracy or completeness of the information it receives?
- Does the organization have clear and effective management reporting structures and internal audit reporting lines?
- Does internal audit have direct and unfiltered administrative reporting lines to the audit committee or CEO?

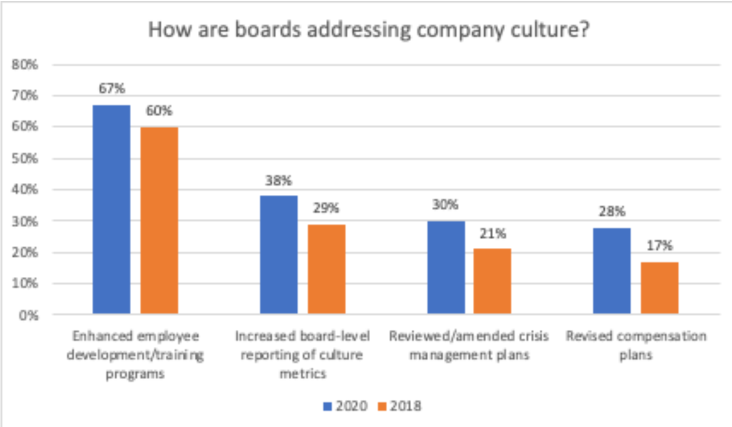
[1] "Honing Skepticism," *NACD Directorship*, National Association of Corporate Directors, January/February 2013.

[2] "What Boards Should Prioritize in 2019," EY, December 18, 2018.

[3] "Shareholder Activism Poised to Rebound in 2021 After Tough Year," Scott Deveau, Bloomberg, December 16, 2020.

[4] "Honing Skepticism," *NACD Directorship*, National Association of Corporate Directors, January/February 2013.

[5] "Building Better Boards," David A. Nadler, *Harvard Business Review*, May 2004.



Sources: PwC, 2018 Annual Corporate Directors Survey, October 2018; PwC, 2020 Annual Corporate Directors Survey, September 2020.

About the ACGI

The ACGI, now in its second year, is a collaborative effort by The Institute of Internal Auditors and the Neel Corporate Governance Center at the University of Tennessee Knoxville's Haslam College of Business. It surveyed 131 chief audit executives (CAEs) of publicly listed U.S. companies on how well their organizations performed on meeting eight Guiding Principles of Corporate Governance (see the box on page 3). The results can help boards, audit committees, and other stakeholders gain perspective on common governance problem areas.

The index is based on responses to a survey by chief audit executives, or those best positioned for an independent, unbiased, and enterprisewide assessment of a company's governance practices. The Guiding Principles are based on a compendium of relevant guidance and principles advanced by experts in the field. The index gauges the extent to which companies are effectively achieving each of the Guiding Principles. It goes beyond the publicly observable aspects of corporate governance to provide an internal perspective on the effectiveness of corporate governance throughout the organization.

Quick Poll Question

In what way is your board most likely to respond to information from management?

- ❑ Regularly questions management in a constructive manner.
- ❑ Sometimes challenges management or the information it receives, but not often.
- ❑ Generally accepts management's information with few questions.

Visit www.theiia.org/Tone to answer the question and learn how others are responding.

QUICK POLL RESULTS

Does your organization formally evaluate the full system of corporate governance on a regular basis? (Respondents could only choose a **single** response.)