Corporate Governance is about the way organizations are directed and how stakeholders' needs are taken into consideration. The practice of corporate governance is not new. Every organization or even informal group of individuals that have ever been created have certainly always outlined a kind of governance code determining the roles and responsibilities of the participants. Why are we then still discussing about this 'new' topic?

We can of course argue that our complex and fast moving economic environment, along with the trends towards further globalization create needs for a more sophisticated governance agreement. We can however wonder whether the kind of (financial) scandals that are often given as examples happen more frequently now than in the past.

What really changed can probably be reflected in the words 'communication' and 'confidence'. Enhanced communication channels create more transparency for better informed and educated stakeholders. They are no longer satisfied with information about the existence and composition of the Board of Directors. They also want to make sure that this Board really cares about important matters and that there is a well performing and efficient internal control and risk management system in place to safeguard stakeholders' interest.

This was surely the main reason behind creation of the whole series of new regulations, guidelines and standards that have been developed over the last years, such as the Turnbull report (UK), KonTraG law (Germany), the Sarbanes Oxley act (US) and the IAS/IFRS financial reporting standards. More recently, (May 2003) the European Commission issued an Action Plan for Corporate Governance. Member states are expected to translate this Action Plan and adapt it to the particularities of each country. This has already been done in some countries such as the Netherlands (Tabakblatt code) and France (Loi de Sécurité Financière). In Belgium, a project for a new Code for Corporate Governance has been issued in June this year (www.corporategovernancecommittee.be). After a public consultation period, the final version of the Code will be published by December 9th this year.

A series of questions still remain open about the applicability, the impact and advantages of the new guidelines and laws that define a renewed risk management and communication landscape.

Below we have summarized our opinion about 7 misunderstandings that seem to be major discussion points. Some of these topics remain of course open for further discussion and I will be happy to exchange views about it.

**Misunderstanding 1:**
"The new Corporate Governance code concerning internal control increases risks for Board members and Directors":

Most international Corporate Governance codes require from the Board to take appropriate measures to establish and maintain an adequate system of internal control. However, the new codes and guidelines can help Board members and Directors in organizing their defense in case of crisis. As no business will ever be managed without taking risks, Board members and Directors will need to show evidence that all reasonable measures have been taken to deal with these business risks. This may be very hard to do without a clear Governance Code that reflects local best practice.
Misunderstanding 2:
“Corporate Governance codes on risk management have no impact on non-listed companies”.

Apart from some exceptions (for example, the Loi de Sécurité Financière applies to all S.A.) most international guidelines on Corporate Governance indeed apply to listed companies only. Pressure from stakeholders will however force non-listed companies to follow the move. Lending banks will, within the new Basel II context, require more assurance concerning the capability of companies to manage their business risks; customers (who sometimes have to comply themselves with new guidelines) will require more insight in risk management and business continuity matters; insurers will increasingly consider risk management capabilities in issuing (e.g. directors’ & officers’ liability) coverage.

It is easy to understand that the voluntary application of the governance guidelines may represent an advantage, even to non listed companies. Smaller companies will transform compliance in an opportunity to demonstrate their reliability as a business partner.

Moreover, we can expect courts to rely on best practice guidelines when judging on the liability of non listed companies’ Directors. Showing evidence of compliance will facilitate their defense.

Misunderstanding 3:
We do not have to care about Corporate Governance evolutions in other countries:

Over 40% of Belgian stock exchange capitalization is in hands of foreign (mostly Anglo-Saxon) institutional investors. Our economy is highly oriented towards foreign markets and business partners. These foreign stakeholders will increasingly evaluate the soundness of local companies upon criteria they know and benchmark their corporate governance capabilities with their best practice guidelines.

Moreover, new corporate governance codes are issued in response to US initiatives (mainly the Sarbanes Oxley Act) and the action plan of the European Commission (May 2003). We can expect local guidelines and legislation to evolve towards further harmonization. Countries and companies that anticipate this harmonization will certainly benefit from being better prepared to these new evolutions.

Misunderstanding 4:
“There is no need for quantifying business risks”:

Management ‘intuition’ about the likelihood of occurrence of a future event may indeed well orient decisions in quite a lot of circumstances without having to rely on complicated quantification exercises. But no targets can ever be fixed and no follow up of the achievements can be organized without some quantification work. Some will say “unmeasured is unmanaged”.

Risks will be measured on a ‘semi-quantitative’ scale in terms of ‘impact’ of a possible event and ‘likelihood’ of its occurrence. The results will guide management in prioritizing controls and treatment efforts.

Risk quantification will also help Board members understand the nature of the business risks. Their requirements in terms of risk quantification and monitoring will increase as a consequence of their control responsibility within the renewed definition of corporate governance.

New IAS/IFRS financial reporting standards will also require more quantification of uncertain events. Provisions for future events will have to be based on a more detailed ‘likelihood’ analysis. Financial risks (currency, interest rates risks) management will require more quantitative research; risks elements will increasingly determine the evaluation of company assets.

Moreover, shareholders require an increasing amount of information about the risk profile of a company. They want to analyze more closely the risk/return ratio of their investment. An interesting notion for measuring this is the ‘Risk Adjusted Return On Capital’ (RAROC) ratio, adopted by the financial sector. RAROC combines three ‘value creation’ components: return, capital used and the underlying risk level. The same ratio can be used for structuring business decisions.

Misunderstanding 5:
“Higher risk related transparency leads to higher share price volatility”:

In order to comply with the new IAS/IFRS financial reporting standards, listed companies will soon have to establish their consolidated accounts based on ‘fair value’ estimates of assets, liabilities and off-balance items. This will undoubtedly result in a higher volatility in reported earnings and equity? Recent studies (e.g. from SG Securities) have established that, apart from the immediate effects of the integration of the new standards, the effects of the increased transparency will tend to reduce the ‘risk premium’ in such a way that it compensates the
effects of the higher earnings volatility. Evidence of these findings can be found in the analysis of share price volatility in markets where the same kind of transparency has already been installed (US market). Investors are increasingly professional in their judgment. They are no longer satisfied with information about quarterly operational results and fear the effects of current benefit management’ practices; they require a better insight of the earning potential and a more reliable valuation of the company’s assets and liabilities. The challenge for the companies will be to satisfy these requirements in a realistic and cost-efficient way.

**Misunderstanding 6:**

"There are no limits to the benefits of a higher risk disclosure”:

Some international ruling makers sometimes tend to adhere to this principle. According to the new mandatory ‘Operating and Financial Review (OFR)’ British quoted companies will, from 2005 on, have to report on all risks that could impact business performance in future or that may influence stakeholders’ judgment. Whereas most corporate governance guidelines invite companies to report on the existence of a risk management and internal control system, the OFR requests qualitative and detailed information about all key business risks themselves (?). Confidentiality is clearly the most obvious limit to this principle, as competitors are clearly the most vigilant analysts of companies’ annual reports. Moreover, other stakeholders and financial analysts are not always sufficiently informed to draw the right conclusions out of poorly standardized and sometimes highly technical information.

The same could be said about the implementation of some IAS/IFRS reporting standards. IAS 37 requires for example an assessment of provisions related to the expected outcome of litigations and court judgments. Litigation counterparties could find this information highly useful in determining and organizing their position.

Risk communication should not result in a full disclosure of all sensitive information. A well-performing risk communication system will enable selective access to this information within the organization and a clear strategy for disclosure which takes into account the expectations of all stakeholders and the position of the company within its environment.

**Misunderstanding 7:**

“Risk management and internal control are primarily cost functions, as opposed to entrepreneurial management functions”

Quite a lot of risk management efforts failed because they were considered at the opposite of entrepreneurial management, depicted as a restriction to productivity and being taken care of by people without access to the strategic levels of the organization. This is obviously not the best way for a company to acquire confidence from its stakeholders.

For more efficiency, risk management should become a permanent concern of all managers in the organization. ‘Risk self-assessment’ techniques help identifying risks and find ways to mitigate them. Managers will rely on the risk management practice to enhance business processes, to detect new business opportunities and to create the assurance required for the implementation of the strategic orientations.

The key for success lies in the development of a sound ‘risk culture’. The acceptance that risk taking is inherent to any business initiative is essential. Risk, entrepreneurship and value creation are part of the same business reality.