Corporate Governance Is Changing: Are You a Leader or a Laggard?

By Marc J. Epstein and Marie-Josée Roy

Tragedy struck when 29 miners died in an explosion on April 5, 2010, at a Massey Energy-owned coal mine in West Virginia. Shortly after the explosion, the discussion of responsibility and corporate governance began. Within the month, large public pension funds directors criticized the company for Don Blankenship's dual roles of CEO and chairman that severely compromised board oversight. They also argued that the board had inadequately supervised management's handling of safety issues. One board member immediately resigned, and lawsuits have already been filed.

This is just one example of the changing expectations of corporate directors and the importance of focus on roles, responsibilities, evaluation, and improvement of corporate boards. The BP crisis in the Gulf of Mexico is certain to be another challenge to governance and supervision issues. With both companies, a history of violations will further complicate the cases.

These crises are tragic. Companies need to consider board oversight of the CEO's activities, the company safety record, and the division of responsibilities *before* such tragedies can occur. They should reexamine and evaluate their corporate governance practices and performance now to determine any changes that would help them fulfill their roles and responsibilities more effectively. This applies to all companies—small and large, local and global, based in North America or elsewhere. It's about improving board performance to provide improved accountability (including governance and transparency) to improve corporate performance.

Current Status

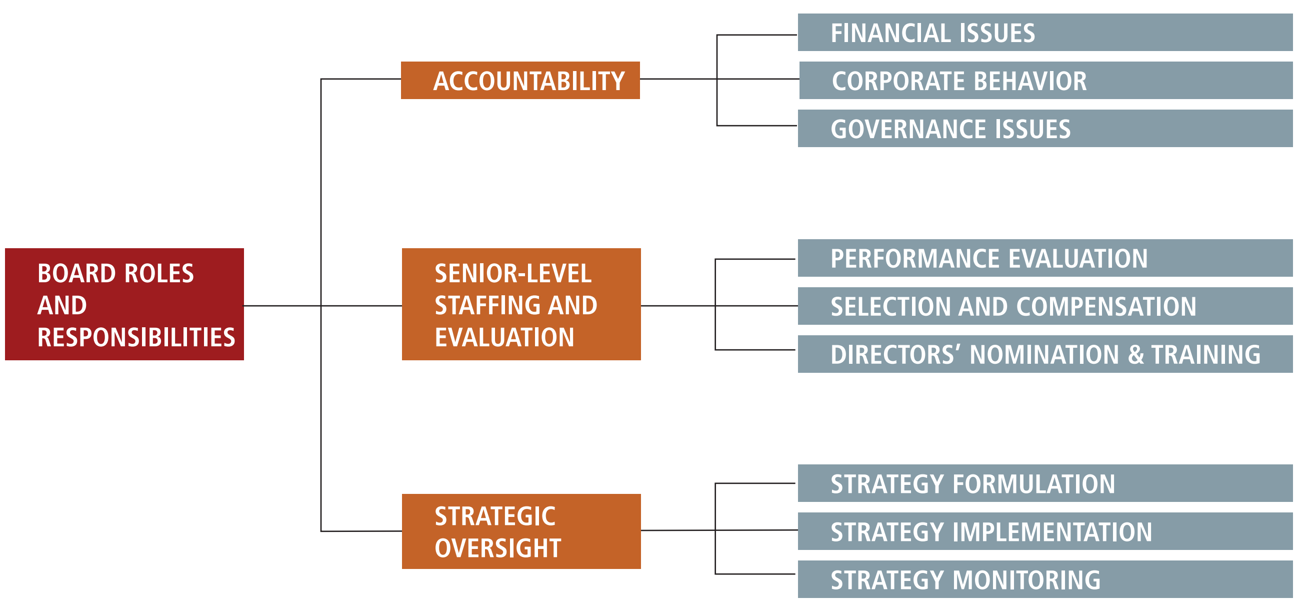
The Sarbanes-Oxley Act of 2002 (SOX)—along with regulations adopted by the stock exchanges and others shortly thereafter—did cause some improvements in corporate governance practices. Yet much more needs to be done—not to increase regulation, but to improve corporate performance. Shareholders, senior leaders, and corporate boards must focus on improving board performance *now*.

One company board recently faced the following challenge. The board asked the CEO to provide a succession plan, and the CEO responded that he had no plans to depart the company—and no plans to die. After numerous requests, the board was at an impasse because they wanted to keep the CEO but also recognized the need for a succession plan. What to do?

Another company board had an average tenure of more than 12 years. This included numerous board members who were making very few comments in meetings and seemed unprepared. In some cases, it appeared that they no longer had the skills and knowledge to keep up with the significant changes in the company and industry. It was time to make some changes in the board, but what evaluations were appropriate, who was going to communicate that to the board members, and what skills, knowledge, and capabilities would be desired in new board members?

In another company, several board members believed that the current direction of the strategy was wrong. Although members liked the CEO, they disagreed with some recent choices on strategic direction, and their estimate of the strategic risk was far greater than the CEO's. They didn't want to micromanage the company or alienate the CEO but did want to exercise their duty of strategic oversight. They were conflicted about what to do.

Figure 1: Board Roles and Responsibilities



Source: M.J. Epstein and M.J. Roy, *Strategic Management of Information for Boards*, Society of Management Accountants of Canada, American Institute of Certified Public Accountants, and Chartered Institute of Management Accountants (U.K.), 2007.

These anecdotes are examples of many issues facing senior leadership teams and corporate board members. To support the boards, the various board committees, and the senior leadership, corporate financial executives are often responsible for designing and implementing processes and measures to aid in more effective board governance. Some companies have made substantial progress—others haven't.

These and other recent events have emphasized the critical importance of immediate action to improve board governance. They highlight the importance of identifying both risks and opportunities, improved strategic oversight, better talent management and succession planning, and better management of corporate accountability. Many financial executives recognize the central role that they should play in this process but often don't know where to begin. Some companies have found the following approach helpful to measure, manage, and improve the performance of corporate boards and board members.

Roles and Responsibilities

As Figure 1 illustrates, corporate boards have three primary responsibilities: corporate accountability, senior-level staffing and evaluation, and strategic oversight.

Corporate accountability

Corporate boards have responsibilities to ensure that the company discloses relevant and reliable financial and nonfinancial information to various internal and external stakeholders. Systems should be in place for improving governance, transparency, and ethical behavior. This includes reviewing policies and practices related to internal controls, risk management, disclosures, compliance, codes of ethics, and board governance.

Senior-level staffing and evaluation

Boards are responsible for the selection and compensation of senior executives and board directors, and they set goals and evaluate the performance of board members and senior executives. Boards also have primary responsibility to ensure that an effective succession-planning process is in place.

Strategic oversight

Although senior managers have primary responsibility to formulate and implement corporate strategy, boards have a significant responsibility to review and approve strategic plans, risk-management policies and practices, and major capital investments. Boards also oversee implementations that often include systems, annual budgets, and effectiveness.

Table 1: 10 Keys to Superior Board Performance

CRITERIA FOR BOARD MEMBERSHIP

- Competence
- Ethics
- Diligence
- Independence

BOARD PROCESSES

- Committee structure
- Productive meetings
- Effective performance-evaluation systems
- Information availability
- Effective succession-planning system
- Open communication and reporting system

Source: Adapted from M.J. Epstein & M.J. Roy, *Measuring and Improving the Performance of Corporate Boards*, Society of Management Accountants of Canada, 2002.

There's much agreement about these three board roles and responsibilities, but the challenge is in execution. How does a company get the right board members, the right board processes in place, and the right support processes inside the organization to facilitate excellent board performance? By identifying the keys to superior board performance, we answer these questions and show how companies can help boards measure and improve their performance.

Keys to Superior Board Performance

Compliance with various government regulations and industry standards is certainly necessary, but this is about far more than that. Corporate managers and board members must improve board performance to provide for excellent corporate performance. By focusing on the roles and responsibilities we've already identified, along with the 10 keys to superior board performance in Table 1, managers and board members can significantly improve performance. Companies must address four criteria (competence, ethics, diligence, and independence) for board membership when considering both new board members as well as ongoing ones. With careful attention, both managers and board members can effectively manage these criteria along with the six board processes. In many cases, such as through providing information needed for board decisions, the corporation's senior financial managers can have a major impact on board and corporate success.

Superior board performance often mandates asking basic business questions that are separate from regulatory requirements. For example, a primary question about board independence is whether a board member will diligently analyze board proposals and corporate issues and act in the corporation's best interests—even if it's contrary to other board member or CEO positions. In too many cases, board members, though technically independent, just follow the CEO's lead in approving actions. To fulfill their responsibilities, they must independently analyze the proposals and vote in the corporation's interests.

To achieve productive meetings, the CEO shouldn't set the agenda—an independent board chair or lead director should do so. Setting the board agenda and determining what the board will discuss—and how it will be presented and discussed—have a significant impact on the outcomes. Most meetings of some boards are simply the executive team presenting corporate status and new proposals with little time for discussion or questions. Leading board practices include far more discussion and even a presentation of contrary points of view.

For example, an executive team requested board approval for a billion-dollar capital investment. The managers presented the reasons that it should be approved, but no one presented alternative viewpoints to analyze the risks, alternative investments, etc. Board members must hear contrary points of view from those not on the management team to more completely fulfill their responsibilities to the shareholders and corporation. Increasingly, external experts provide these contrary viewpoints for more thorough consideration by the board.

The focus must constantly remain on the board's responsibilities and how to collaborate with the CEO yet maintain independence. Thus, board members should be asking the tough questions and are likely to disagree with the CEO on occasion, but they should be focused on their core responsibilities of corporate accountability, senior-level staffing and evaluation, and strategic oversight.

Focusing on balance, skills, and competencies in board composition is important to ensure that the board effectively—and independently—analyzes and evaluates proposals to provide the strategic oversight that's necessary. The required skills and competencies often change over time. Either board members must improve their competencies, or new members must replace them. A best practice in board leadership includes providing opportunities to evaluate needed and existing skills and competencies along with the training programs available to improve them.

Expectations of board members have changed significantly in the past decade. The number of hours spent on board activities (including preparation) has increased dramatically, so members participate on fewer boards. This is one SOX benefit that has encouraged board members to devote more time to their board activities and improve both their independence and diligence.

Evaluating Board and Board Member Performance

Companies often have comprehensive systems in place to evaluate corporate performance (including business units and functions) and the performance of employees at all levels (including senior managers). Only one group of corporate leaders is typically excluded from the comprehensive performance-evaluation process: corporate boards. This must be improved *now*.

It's common for senior financial professionals to be involved in the process of implementing these performance-evaluation systems. As you know, measuring performance is usually a critical element of improving performance. It isn't surprising that many CEOs and board members object to implementing significant board-evaluation processes since it's often uncomfortable to be evaluated if the process isn't mandated. If done well and constructively, this is a critical element of improving board and corporate performance. It's important to evaluate the board's effectiveness, and numerous useful measures are available.

The list of selected metrics in Table 2 illustrates that metrics are available to aid in the evaluation process. Since outcome or results measures are typically inadequate as sole measures of performance, various input, process, and intermediate outcome measures are also included. The input measures in Table 2 evaluate performance of the criteria for board membership in Table 1. The processes are measures of the board processes in Table 1. Measures are important, but don't use too many. Boards should select a small set of measures to separately evaluate board and individual board member performance.

By improving the inputs that impact board performance and the effectiveness of the systems and processes in place to improve board decisions and performance, the

Table 2: Metrics for Evaluation of Boards and Board Members: An Abridged List

BOARD'S PERFORMANCE-EVALUATION SYSTEM: INPUTS

- Level of compliance of corporate definition of independence with NYSE's definition
- % of independent members
- # of hours spent on preparation
- Overall attendance at meetings
- # of boards directors serve on
- # of visits to company sites by individual directors
- % of directors "financially literate"
- Diversity of board—race and gender (% represented)
- # of hours of training for directors
- Results of ethics audit

METRICS FOR BOARD'S PERFORMANCE-EVALUATION SYSTEM: PROCESSES

- Leadership of the board (CEO, or lead director, independent chairman)
- % of meetings without CEO (executive sessions)
- # of days in advance that agenda and material are sent
- Average duration and number of meetings
- % of meeting time allocated to opposing points of view
- % of meeting time for discussions
- Annual report on succession planning
- Interim CEO identified
- # of ethical/legal violations
- # of risk audits performed and results
- Existence of communication channels with board
- # of hours spent on long-term strategic issues
- Evaluation systems include nonfinancial data
- Evaluation systems include external and objective data
- % of compensation linked to performance
- % of compensation linked to stock ownership

METRICS FOR BOARD'S PERFORMANCE-EVALUATION SYSTEM: OUTPUTS

- % of projects accepted by board that met or exceeded projected ROI
- Risk profile (industry audit)
- # of complaints (employees, community, customers)
- Credit rating
- % of major projects that met or exceeded projected ROI
- Turnover rate among senior executives
- Revenue per employee
- Earning growth trends

METRICS FOR BOARD'S PERFORMANCE-EVALUATION SYSTEM: OUTCOMES

- EVA®
- Stock price
- ROI
- Earnings (overall and per business units)

Adapted and abridged from: M.J. Epstein and M.J. Roy, *Measuring and Improving the Performance of Corporate Boards*, Society of Management Accountants of Canada, 2002.

outputs (improving board performance) and outcomes (corporate performance) are typically improved. The way that the board prepares, deliberates, and makes important decisions is affected by the board's composition and affects the board's success in fulfilling its roles and responsibilities and improving board performance (outputs) and corporate performance (outcomes).

Providing the Information Boards Need

We commonly hear board members complain that they receive a large stack of papers the day before a board meeting and can't prepare adequately. If we want board members to perform well, providing the necessary information in a timely manner is critical. They need to have enough time to prepare adequately for board meetings and the decisions that will be made. It's important that the information be relevant, clear, and complete—including opposing points of view—and concise to avoid information overload.

Recent surveys have indicated that both the availability and the use of the information need to be improved. In many cases, the information may be available (as in the previous example), but board members don't use it—either because it's presented ineffectively or there's information overload. Financial professionals often play this critical role. Meeting the criteria for the provision of information to the board can make a significant difference in both the availability and use of the information and, therefore, a board's effectiveness.

Information quality is also important to ensure adequate preparation for board meetings. Having high-quality information also facilitates more active board discussion, especially when the discussion is based on an agenda that encourages more questioning and discussion rather than presentations. Adequate and timely access to information that's properly presented can also indicate other information, experts, and advisors that would be helpful before the meeting or at

Table 3: Strategic Information Required for Corporate Boards: An Abridged List

Topic	Minimum Frequency
BOARD INFORMATION FOR CORPORATE ACCOUNTABILITY	
Financial statements of the company	Quarterly
Reports/updates on critical accounting policies, judgments, and alternative treatments	Annual
Reports from internal auditors (quality of the audit process/internal controls and issues raised during audit)	Quarterly
Reports from external auditors (quality of the audit process/internal controls and issues raised during audit)	Quarterly
Reports on complaints received (including whistleblower program)	Annual
Reports on major risk exposure	Quarterly
Reports on social/environmental performance and compliance with business standards and codes of ethics	Annual
Press clippings—stakeholder management issues	Annual
Reports on company disclosure	Annual
Reports on current significant litigation	As required
Reports on board's performance (including individual directors and committees)	Annual
External report on board's practices	Annual
BOARD INFORMATION FOR SENIOR-LEVEL STAFFING AND PERFORMANCE EVALUATION	
Report on compensation policy—including performance targets and objectives (CEO and top executives)	Annual
Benchmarking report—executive compensation package	Annual
Report on succession planning	Annual
Report on management development activities	Annual
Report on board compensation	Annual
Report on board performance (including individual performance)	Annual
Report on directors' orientation and educational programs	Annual
BOARD INFORMATION FOR STRATEGIC OVERSIGHT	
Industry information and trends (key success factors)	Annual
Competitor intelligence (major initiatives and positioning)	Annual
Technological forecast	Annual
Competitive positioning of the company—benchmark (market share, pricing, quality)	Annual
Reports on major risk factors	Annual
Report on major capital expenditures, acquisitions, and divestitures	As required
Annual strategic plan (corporate, major business segments)	Annual
Operating plans (major functional supporting initiatives)	Quarterly
Alternate strategies considered and rejected	Annual
Reports on major policies/management systems and organizational structure	Annual
Progress report on strategic plan—reports on operating variances (deviation/shortcomings from original plan)	Quarterly
Reports on financial performance (for every major business segment of the company)	Quarterly
Reports on corporate operating performance (for example, productivity or quality data) for every major business segment of the company	Quarterly

Adapted and abridged from: M.J. Epstein and M.J. Roy, *Strategic Management of Information for Boards*, Society of Management Accountants of Canada, American Institute of Certified Public Accountants, and Chartered Institute of Management Accountants (U.K.), 2007.

the meeting to improve board deliberations.

Not Just for Large Companies

Although most corporate governance discussions focus on large, publicly held companies, the issues also apply to small, publicly held companies and privately held companies. Increasingly we see privately held companies and small, closely controlled public companies appointing unrelated board members so they can have one or more independent voices on the board. In family-controlled corporations, many family members, especially adult children, often don't provide feedback when they disagree with a proposal. Then an independent voice is often quite useful.

Recently we were meeting with a board that had adult children on it who knew little about the business. When the CFO discussed changes in both depreciation and tax policies, these members were lost. We proceeded to educate them about the business so they could actively participate in the meetings now—as well as when they eventually take over leadership responsibilities. This gave them adequate background support and preparation for future board meetings so they could more actively participate and be adequately prepared for any likely votes.

Improving Corporate Board Performance

Financial professionals should be critically involved in improving corporate accountability. This requires participation by many executives throughout the organization and a central role for corporate board members. Corporate accountability has two important elements: corporate governance and corporate transparency.

Corporate governance

Providing information for internal decision making is a central role of management accountants. This information supports functions and decisions throughout the organization. It also includes material needed at various organizational levels—including the corporate board. As we discussed, the board has critical informational needs, and many organizations aren't currently providing the information boards need to adequately fulfill their three roles and responsibilities: corporate accountability, senior-level staffing and evaluation, and strategic oversight.

Corporate transparency

Central to the corporate accounting and finance functions is the reporting of information to external users that's useful for decision making in addition to the mandatory disclosures required by regulators. But CEOs and CFOs constantly report that the financial analyst community isn't valuing the company fairly. Often there are opportunities to better communicate corporate value by disclosing additional financial and nonfinancial information.

To better understand corporate operations, analysts want leading indicators of performance in addition to the lagging ones they traditionally receive. They want additional information that permits them to better forecast future cash flows, which may include data on customer satisfaction, product quality, risk-management systems, and social and environmental management processes in place. These voluntary disclosures usually can rely on existing data accountants already provide to management for decision making. A subset of this data is often useful to external decision makers. Corporate financial professionals and corporate boards should focus more on providing additional transparency to better communicate company operations and value to stakeholders. This approach will better communicate the corporate story.

Leaders or Laggards?

Improving corporate governance is critical for success. As we mentioned earlier, recent events have again illustrated inadequate corporate governance processes and practices can lead to corporate disaster. Corporate leaders must assess whether their corporate governance practices make them a leader or a laggard. Financial professionals and other corporate leaders along with corporate boards must address these issues now before it's too late.

Massey Energy and BP are just two recent examples of boards reexamining their processes after disasters. We can all recall many, many others on a long list that might include Enron, WorldCom, etc. Corporate managers and board members must have the measures and processes in place so that their name doesn't make its way onto this list. **SF**

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