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The Power Corporate Directors Now Wield

By John Rehfeld

The previous installment discussed the first three of the six key tools of corporate governance: the lead director and regular executive sessions, governance/nominating committee empowerment, and compensation committee empowerment. This installment explores the final three tools: audit committee empowerment, regular CEO performance evaluation, and regular board performance evaluations.

Empowering the Audit Committee

The audit committee draws power from its independence and expanded scope of authority. The best audit committees follow industry best practice standards and meet at least four times a year to evaluate quarterly reporting. The audit committee chair, rather than management, should set the meeting's agenda. Each of the meetings should be regularly attended by the committee's independent directors and designated financial experts. Allocate sufficient time at the end of each meeting for executive sessions.

Outside Auditors and the Audit Committee

When it comes to the annual financial audit, the audit committee has overall authority. They should act to ensure the true independence of the audit firm (and any other financial advisors) according to the American Institute of Certified Public Accountants' requirements and by ensuring there is no history of past, current (or promise of future) work for the management team that could be used as leverage.

The audit committee must establish a formal and independent relationship with the outside auditors. The relationship is between the *entities*—the audit committee and the public accounting firm—not between management and the public accounting firm, as was once practiced. This strong, formal relationship between the board and the financial reviewer provides the vehicle for considering things, such as accounting treatments, which the independent auditors may disagree with, but which do not in the aggregate prevent them from issuing an unqualified opinion. If disagreements occur too frequently, the audit committee may want to look more closely at the company's accounting practices.

Editor's Note: This article is the second in a two-part series. Part one appeared in the November 2006 issue.

Director Summary: The author continues his examination of the increasing power and independence of corporate boards by discussing the final three key tools of corporate governance: empowering the audit committee, CEO performance evaluation, and board performance evaluation.

Whistleblower Communications

Establish procedures that make it easy for those with concerns over matters related to the company's finances to bring them to the audit committee's attention. The 2004-issued final regulations for the whistleblower provisions of the Sarbanes-Oxley Act of 2002 provide broad protection to employees of public companies for internal complaints of allegedly fraudulent conduct. Compliance with the Act requires specifically stated whistleblower procedures.

Having all whistleblower communications go directly to the audit committee or through the head of internal audit (who works for the audit committee) creates a conduit for critical communication. Often, this involves a toll-free telephone number or e-mail address linked directly to the audit committee chair, though some companies use an independent firm to capture any whistleblower communications and forward them directly to the audit committee chair.

CEO Performance Evaluation

One of the most important things boards can do is to give constructive feedback to CEOs to help them improve their performance in leading the company. After all, most boards contain in a single room a wealth of experience specifically pertaining to the company that cannot be duplicated anywhere else.

True CEO 360-degree evaluations include not only the full board, but also the CEO's direct-reports, selected service providers, and at least one member of the advisory board (if one exists)—everyone who has extensive and continuous interaction with the CEO should be involved. This requires a very secure CEO.

The first step in making the CEO evaluation a success is to empower the board with complete authority over its design, conduct, conclusions, and resulting actions. Usually, the board appoints one of its committees to conduct the project—often it's the governance/nominating committee or the compensation committee—though sometimes independent consultants are engaged to do the actual work and advise the committee.

Next, agree on the evaluation instrument. The most effective ones are usually in the form of a survey that highlights particular CEO traits that the company needs in order to achieve its goals. There are a number of good surveys available from experienced consulting firms, or boards can create a custom evaluation survey, specific to their own needs. The important factor is to make sure the same instrument is used by all evaluators in order to maintain consistency of results.

Once all parties have completed the evaluation, the results should be analyzed. The board should discuss the results in executive session, and then one or two board representatives should discuss the findings with the CEO. If the environment truly encouraged honest communication, then the result of this discussion should be a plan to correct any deficiencies in the CEO's performance over the next evaluation period.

To complete the feedback loop, boards often ask the CEOs to comment on what they heard and learned. This reflection and two-way communication is often the most valuable part of the project. When done correctly, evaluations can create a new level of trust and directness among the CEO, the board, and the executive team.

Board Performance Evaluation

Boards draw their power from competent directors performing their duties with consistent excellence. Regularly evaluating the board's performance as well as that of its committees, then making adjustments where necessary, ensures that performance enhances the board's credibility and power.

The governance/nominating committee often undertakes responsibility for conducting a serious performance evaluation of the board and its various committees. If necessary, hire an independent consultant skilled in quantitative board and director evaluation.

Who Participates?

To produce the most constructive results, the board

Unadulterated communication without time-wasting political caveats and chain of command filtering is essential.

and committee evaluations should be conducted not only by the directors themselves, but also by those members of management having regular contact with the board. Some of the most effective board evaluations include participation by key members of the senior staff.

What Information is Needed?

As with the CEO evaluation, use a standard, anonymous evaluation form so everyone's responses are counted the same way. Some boards use exhaustive questionnaires having 100 questions or more. Others take a simple approach by focusing on a few key drivers of the board's and its members' performance.

Possibly the most valuable part of this process is the constructive dialog built among the directors themselves and between the directors and the CEO. This interaction not only helps the directors work together, but it also assists in helping the board work as a unit with the CEO in building shareholder value. (Ed. Note: Sample questionnaires and board evaluation tools can be found in *NACD's Blue Ribbon Commission Report on Board Evaluation: Improving Director Effectiveness*).

Future Trends

The power directors now wield has increased, and will continue to do so, as boards better understand how to use all six tools of governance. To be sure, the press will continue questioning why anyone would want to be a director in light of the potential financial liability and all the negative corporate news their reporters unearth. The answer is that we now have lead directors and independent board chairs; qualified and effective committees; and rigorous methodologies to evaluate CEOs, entire boards, and their committees. We have the authority to get information, set the board's agenda, and make changes where and when they are needed without asking the CEO's permission: we have the right tools and are learning how to use them effectively. ■

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