The Conference Board

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In the Wake of Enron

Does Your Board Have an Effective Management System of Its Own?

By Carolyn Brancato

Developing case law has stripped corporate directors of the wide protections they once enjoyed, and now requires them to be increasingly proactive to ensure that corporate compliance programs are in place. Directors must question management if "red flags" arise or if they, as directors, should reasonably have been expected to have known that such "flags" would lead to deeper problems. This report reviews the key areas directors should focus on to ensure they meet their increasingly stringent fiduciary liability.

Failure Is a Team Effort

The cases almost always come as a surprise. Sunbeam. Cendant. Waste Management. Enron. When the facts finally emerge, it seems like the abuses were taking place in a corporate culture devoid of certain legal, ethical, or moral rules. The litany of problems invariably gets longer: accounting fraud; insider dealing; side compensation packages benefiting a few top executives; economic activities far afield of the core business sector; and joint ventures and transactions with off- balance sheet and income statement implications. The first response is to blame the accountants. But accountants don't act in isolation. It takes a board, management, legal counsel, and a host of others to create some of these spectacular failures of corporate governance.

All boards want to work collegially, but it is important to examine whether this collegiality impinges on the board's ability to effectively manage itself. *Boards should re-examine how they manage board oversight processess to minimize corporate risk and prevent destruction of shareholder value.*

Asking the Right Questions

Boards should ask themselves the following:

Short-Term Issues:

- What quality controls does the Board institute to ensure that it effectively performs its oversight role?
- How do the various committees, such as the audit and compensation committees, function to provide oversight? How can a board member know when things aren't right?
- Are these board management systems adequately designed to uncover "red flags," which might warn the board of impending disasters in areas such as accounting and regulatory compliance?
- What checks and balances exist between the Board's committees and outside experts such as accountants and consultants?

Long-Term Issues:

- How does the board oversee the strategic direction of the company?
- Does the board have its own performance measurement system to track its effectiveness?
- Has it developed key measures of its own management processes and success as a Board (similar to the measures of success management institutes to track overall company growth and profitability)?
- Does the board assess its own overall performance? contributions of individual members?

Demanding Accountability

Many of the classic corporate disasters have occurred at companies where the trappings of good corporate governance seemed to be in place. They had outside "independent" directors and directors who owned stock, and therefore had their interests "aligned" with those of shareholders. They had audit committees that met the new Blue Ribbon Committee's Recommendations and the New York Stock Exchange's Listing Requirements for audit committee independence and competence. Weren't these initiatives enough? What went wrong?

While it is difficult to uncover premeditated and outright management fraud, boards can and should be more proactive in demanding accountability. Boards should treat the current focus on Enron as an opportunity to review their short-term compliance systems. But they should do this not merely to enact short-term quick fixes; rather, they should engage in an overall and comprehensive review of their Board Management System to ensure that they have the most effective short- and long-term approaches to carrying out their fiduciary responsibilities.

Legal Rationale for Directors to be Proactive

According to noted legal scholar Charles M. Elson, the board's role in ensuring corporate compliance with applicable law has expanded significantly in the past few years. The Delaware Court of Chancery, in its now infamous 1963 ruling in *Graham v. Allis-Chalmers Manufacturing Co.* [188 A.2d 125 (Del. 1963)], confirmed the traditional view that the board of a large enterprise was merely a policy-making entity and had no legal duty to enact a legal compliance program in the absence of certain warning signals. Today, the board's responsibilities in this respect are viewed entirely differently.

Boards that fail to establish effective corporate compliance procedures may face substantial liability. Two important factors are now causing boards to act prophylatically to ensure corporate legal probity:

- the creation of the federal Organizational Sentencing Guidelines, which impose more lenient treatment on companies having compliance manuals and programs; and more importantly
- the Delaware Chancery Court's landmark 1996 ruling in *Caremark International Inc.*, which imposes an affirmative duty on the board to create a compliance mechanism.

In *Caremark*, Chancellor William Allen essentially overruled *Graham*, holding that a board, as part of its duty of care, has an obligation to "exercise a good faith judgement that the corporation's information and reporting system is, in concept and design, adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations." As the eminent corporate commentator, Charles Hansen, has pointed out, the facts of *Caremark* suggest that some form of "information gathering and reporting system be established at a very minimum. (See decision in re Caremark International Inc. Derivative Litigation, Civ A .No. 13, 670, 1996 WL 549894, at #8 (Del. Ch. Sept. 25, 1996)).

Board Self-Assessments: A Three-Step Process

In the short term, the most important facet of a board management system is to establish a series of best practices to deal with compliance issues. Then, the board should perform an overall assessment to determine if it has the capabilities and strengths to get the company where it wants to go in the future. Finally, the board should address the contribution of individual board members.

Short-term Compliance Review: Does our board follow prudent and best practices in key areas such as auditing, disclosure of related party transactions, and reporting for special transactions?

Overall Board Assessment: Do we have a board which will get us where we want to go? Do we have a process for measuring the board's performance?

Individual Member Assessment: Do we have the right mix of skills on the board? Are we satisfied with individual member contributions?

This three-part board management system will:

- Ensure that the board is meeting best practice in the compliance area
- Focus the board's agenda more on strategic planning
- Clarify the role and responsibilities of the board
- Help the board identify its strengths and weaknesses
- Improve the board's efficiency and time management
- Improve communication/relations among directors, management and external shareholders

Short-Term Compliance Review

The central focus of a short-term compliance review should be the company's auditing policies, processes, and procedures; and the board's oversight role. The Enron case will likely add to case law by addressing when the directors should have known that red flags were present and that, if pursued, would have enabled them to uncover deeper problems. Regardless of how that case is adjudicated, however, boards should address the following:

- As a matter of corporate policy, how "aggressive" should the accounting practices be, especially for innovative accounting procedures such as off-balance-sheet accounting and accounting for various special purpose entities?
- For how long has the principal auditor performed the company's audit, and should the company consider changing auditors every seven years? What are the relationships between the audit partner and the company?
- When was the most recent peer review or audit of the auditor performed by another accounting firm?
- Does the audit committee have sufficient access to internal and external auditors? outside the presence of the CEO?
- As a matter of company policy, how should the company deal with contracting with an audit firm for both audit and consulting services? Does the accounting firm audit its own consulting or internal audit work?
- What should be the relationship between the internal and external auditors? To whom are they accountable, and what is the oversight role of the board?

- Does the board have specific policies for permitting, disclosing, and accounting for related party transactions?
- What are the board's ethics policies? What are its compliance mechanisms to ensure these policies are carried out?
- As a matter of company policy, the compensation committee of the board, with the approval of the full board, should engage in an overall review of executive compensation. The board should pay particular attention to the following: equity of compensation to executives; extent and terms of stock options; fairness of windows for selling stock held by executives *vs.* stock held by general employees in 401(k) plans.

Overall Board Assessment

Every board needs to approach its own work not just in a collegial manner, but in a professional management context. Just as corporate management is responsible for devising a tracking system to measure its success, boards should devise ways to track and measure their own successes and challenges. Boards should begin to adopt and apply to their own processes some of these management tools that measure overall performance goals and assessments, with this key question in mind: Does our board have the strengths it needs to help the company achieve its goals for the future?

To track their success, managements often use a "dashboard" of performance measures. These are a few key indicators, like those found on the dashboard of a car, which show that a company is likely to get to its destination. Measures can be financial such as profit margins and return on equity, as well as nonfinancial such as customer satisfaction, quality control, and environmental compliance.

Each measure has a "target" and "actual" indexed amount, which focuses management's attention on which areas are performing and which need attention. By "drilling down" into the components used to construct each major dashboard measure, the dashboard can also be used to uncover red flags underneath these major areas in the event that certain sub-areas are not meeting performance expectations or are out of compliance.

Companies are increasingly tracking "nonfinancial" performance measures to assess their strategic direction. These "nonfinancial" objectives—new product and service development; information technology; the company's ability to attract and retain motivated talented people; and its expansion into new markets—are chosen because they will ultimately affect the company's profitability, although perhaps over a longer period than the more immediate quarterly and/or annual financial objectives.

Boards first need to agree on their role *vs.* management. While the board's role is heavily influenced by fiduciary law, boards still have considerable latitude to define their oversight role and to specify their mission and goals. Having done this, the board should then construct its own dashboard measures to track those areas under its control, including:

- approval of long-term strategic plans;
- oversight of strategic plan implementation;
- CEO succession;
- executive compensation;
- information flow;
- compliance and risk assessment;
- board structure;
- meeting effectiveness; and
- the nomination process

Agreement to track four or five key indicators will produce valuable dialogue as boards clarify their role, decide upon their expectations of success, and measure their own performance against these expectations.

In determining the board's overall assessment, boards should address the following:

- What is the overall structure of the board, its size, and committee structure? Are these effective or should they be changed?
- What are the qualifications for directors? Are there any age or term limits? Are these appropriate?
- How are independent directors defined? What is the proportion of independent *vs.* related directors and should this be reviewed?
- How do the various classes of directors relate to each other? What is the information flow? access to management and accounting information?
- What qualifications are represented on the board? Does the board need additional expertise in various areas? Should this expertise be obtained by new board members or by adding an advisory board?
- What are the key functions of the board with regard to the company's strategic plan and to its long-term growth?
- What is the relation of the board to the CEO in terms of setting board meeting agendas, information flow, meeting outside the presence of the CEO, setting CEO compensation, and establishing CEO succession?
- What inputs do outside auditors, compensation consultants and legal counsel have to the board? Are these auditors, consultants and attorneys properly accountable not just to management but also to the board?

Individual Board Member Assessment

Once a board has addressed key issues relating to its overall assessment and has determined that it has professional processes in place to track and improve its overall performance, it can turn its attention to individual member assessment. Relatively few boards proceed to this step for fear of disturbing the collegial balance. There are, however, a number of approaches that minimize this concern.

Individual assessments can be performed by asking board members to fill out questionnaires rating the board and individual members. These can be compiled internally by a board member (perhaps the chair of the nominating/corporate governance committee) and the results given to the board members privately and with anonymity. Sometimes an external facilitator compiles these questionnaires and presents the results to board members. The goal is to uncover strengths and challenges so the board is in a better position to provide the required expertise and oversight.

The Conference Board's Global Corporate Governance Research Center addresses many of these issues in various programs. It is initiating a major working group project entitled *A Blueprint for Board Practices in a New Era of Director Responsibility: Early Warning Systems for Boards to Gain Control and Prevent Corporate Disasters*. This project will convene three roundtables with high level discussion among directors, top corporate executives, regulators, and experts in law, accounting, and corporate governance. From these discussions, a blueprint for processes and procedures in the boardroom will be developed and presented at the third roundtable.

The Governance Center has also established a series of meetings for Chief Governance Officers. The May 22-23 meeting in New York City will address some of these compliance and ethical issues. Finally, a number of Governance Center publications also address various facets of board effectiveness.

For further information on publications and programs, see our Web site **www.conference-board.org** or contact: Donovan Hervig at email donovan.hervig@conference-board.org or telephone 212-339-0347.

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