financial executive

By Ellen M. Heffes

There is a decidedly new tone in most U.S. boardrooms — and an enhanced seriousness and attention to details. Have the rules improved boards or merely added to directors' responsibilities and worries?

It's common wisdom that the roles and responsibilities among boards of directors have changed significantly, a consequence of the scandals of the early 2000s and the new rules promulgated by the stock exchanges and the U.S. Securities and Exchange Commission (SEC). Changes in how things are done — from more executive compensation disclosure to including financial experts on boards and even dictating the composition of boards (tightening the definition of "independence" for director) — have taken hold.

But, are the new rules like slick advertising slogans that tout a new package on an old product, only to sell it as "new?" Or, are the rules not only new, but have they also improved the performance of boards?

For sure, directors are now working more hours and have added responsibilities. They also have bigger paychecks — along with bigger worries and looming personal legal liabilities, should the proverbial "shoe" drop on their watch.

Yet, despite the intensified attention on the work of boards, there seems to be no shortage of those willing to serve, albeit on fewer boards than they could previously. Thus, the search for directors may take longer. And while what goes on in the boardroom is being held up to higher scrutiny, structures, procedures and operations are undergoing change.

These changes are being felt in the relationship between boards and the top executives, as those in C-suite-positions continue to experience more uncertainty. A main role of the board is to hire — and fire — top management, and boards are indeed showing their muscles as they remove and replace those C-suite executives.

A study released in February by executive services firm Tatum LLC warns about record turnover again for CFOs during 2007. That follows a record 2,302 CFOs having left their positions in 2006, according to independent research firm Liberum Research.

For CEOs, the story is similar. As of last December, 72 companies, representing 14 percent of the S&P 500, had appointed a new CEO in 2006, according to executive search firm Spencer Stuart. That was up from 60 in 2005 and 67 in 2004.

Changes are also occurring in relationships among board audit committees and outside auditors, as well as between management and their outside auditors. And, while the highest levels of tension followed the first-year implementation of Sarbanes-Oxley's Section 404 internal controls requirements, the former "partner-with-your-auditor" relationship is not likely to return in the foreseeable future.

Two Contradictory Roles

Ralph Ward, publisher of Boardroom Insider, describes the normal tension in a board's behavior towards management as a sliding scale that defines the role of boards and slides between two contradictory roles. One, he says is the mentoring role, and one the monitoring role.

As mentor, the board works with the CEO as a sounding board — a "kitchen cabinet with management" — while keeping separation and delivering "tough love," should there be a screw-up. In the monitoring role, the board focuses more on its strict legal duties, overseeing compliance and financial controls. Currently, the board's mentor/monitor sides are battling with each other as to which is best for shareholders, explains Ward. And, in the wake of increased regulation, boards are sliding more toward the monitoring side. Boards are indeed working harder, but, he wonders, "Are they more effective?" The answer, Ward says, is "up for grabs."

Sharon L. Allen, chairman of the board of Deloitte & Touche USA LLP, says she is seeing differences, both in her own (Deloitte) board, as well as on client boards. With $8.77 billion in revenues in the year ending May 2006, Deloitte had the largest revenues of the Big Four in the U.S.

"The general changes taking place in Corporate American boardrooms have a renewed focus on governance, best practices and the importance of not only independence [of the board members, per se] but independence in attitude." This, she explains, as the "independence of thought and willingness by board members to ask the tough questions, put issues on the table — with executives and others — that might not always be comfortable."

In her role as chairman (elected in 2003 and recently re-elected for a second term), Allen is responsible for the governance of the organization, as well as overseeing the firm's relationships with a number of its major multinational clients.

Additionally, Allen indicates an increased "willingness to pursue the active understanding of issues in more depth and more broadly, and to become better educated as to the risks facing the business and the success of the organization as a whole."

Is this new focus in board behavior Allen refers to driven by the new regulations or simply a pull-back from what has often been referred to as a "too-cozy" relationship between management and boards who forgot their main role — to represent the shareholders?

Allen says she believes actions in the boardroom are not unlike the results in other parts of the capital markets system, where "perhaps a few lost their way, and the results have had a much broader implication on the many." She opines that it's hard to judge what really happened in boardrooms "if we weren't there." However, she notes, individuals and analysts have concluded that perhaps the questions weren't asked at the level of detail or the independent challenge wasn't sufficiently exercised as it might have been in some of those situations. The resulting impact, she believes, in most cases, is "a healthy change in the corporate boardroom to have a renewed focus on the obligations and responsibilities of board members and their fiduciary roles."

Role Confusion?

SEC Commissioner Paul S. Atkins was a keynote speaker in January at "Directors, Management and Shareholders in Dialogue," presented by the Corporate Directors Forum. He reminded his audience of a long-recognized challenge: that the interests of management are not always completely aligned with those of the shareholders.

He went on to quote Adam Smith, writing about the agency problem of management, from Wealth of Nations: when it comes to money, managers "cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private [partnership] frequently watch over their own." Therefore, "negligence and profusion… must always prevail, more or less, in the management of the affairs of such a company."

He argued that "in the face of such potential for managers' conflicts of interest, directors must guard the interests of shareholders and ensure that managers do their jobs. They also must perform an extremely important advisory role to management. The widespread dispersion of ownership in a modern corporation makes the role of directors all the more important."

Rick Steinberg, founder and principal of Steinberg Governance Advisors Inc., in Westport, Conn., who formerly led PricewaterhouseCoopers' corporate governance practice, believes that boards have always understood that they are the representatives of shareholders. Yet, there is no doubt that "in the past too many boards were very passive and not providing the real monitoring and, in some cases, needed direction to management."

Steinberg advises on corporate governance issues and serves on several advisory boards. He was the lead project partner in developing the Committee of Sponsoring Organizations of the Treadway Commission's (COSO) landmark Internal Control — Integrated Framework, released in 1992, which is recognized as the standard for internal control.

Board members, he explains, were often hand-picked by the CEO — primarily colleagues and friends — causing a great many of them to be passive. That has changed, he insists, due to the new regulations.

Indeed, he says, boards have moved from passivity to becoming much more involved. Also, he says, many boards he works with have come back to a more moderate approach. Some have gone from an extreme to a much better balance between the monitoring role and providing effective advice, counsel and support to the CEO, especially on strategic issues.

Board Makeup: Friends or Foes?

As to what comprises an effective board, there are many diverse opinions, but that doesn't necessarily translate into actual "diversity" in the composition of boards themselves. For some, diversity — of gender, race, culture, age, etc. — is key. To others, it's giving dissident shareholder a seat at the table.

Certainly, following the scandals of recent years, shareholder activists have become more emboldened and, among other things, have been demanding — and often getting — board seats. At The Home Depot Inc., for instance, dissident shareholder Ralph Whitworth — having successfully forced the departure of former CEO Robert Nardelli — now sits on the board.

Following the Enron, WorldCom and other scandals, shareholder activists were outraged — understandably, says Steinberg. He notes that since a number of rules have been passed to improve board performance, the activists' focus has moved to other areas, two of the most important being CEO compensation and, as a subset of that, shareholders driving to have more say in director elections. There's a push for majority voting and other avenues to enable shareholders to have a greater say as to who sits on boards.

Steinberg says the best boards he's dealt with are what he terms "collegial" boards. "When board members know each other well and get along and respect each other, that's a plus. They can come to consensus much more easily and provide a single voice to management that can result in better corporate performance."

In his experience with shareholder activists, as well as with constituent boards — where directors are elected or appointed by specific constituent bodies — he finds that the resulting boards have been highly ineffective. "They've been confrontational among the board members, and have not provided — nor are they in positions to provide — the right and appropriate oversight to management." He voices "grave concerns about shareholder activists sitting on boards where they have a single issue or narrow focus."

Allen says that while she can't assess what kind of board member an activist individual would be, she cautions, "It is a challenge to have a board member who might have a particular interest, a single focus, representative of a single set of shareholders." Such a board member, she says, could potentially be focusing more on a short-term rather than a long-term objective.

Conversely, Allen believes there's real benefit in a boardroom where there's the "appropriate level of challenge, discussion and healthy debate, but one that is not an adversarial environment."

She offers, as example, her board at Deloitte. When the members vote on a particular strategy or issue, it typically results in a unanimous vote. She explains that getting to that point in the process can often take several months and follows a proposal having been discussed and debated, with insights and suggestions, as well as pushback.

Regarding board makeup, many extol the virtues of diverse boards, but is it really happening? Allen says she's seeing increased numbers, in both women and individuals with diverse backgrounds, but that "the numbers are still pretty slow in coming." So, while most boards have added at least one woman and one person of "diversity, there continues to be a shortage of women and people diversity generally on boards across corporate America," says Allen. And that's unfortunate.

"Diversity of views in the boardroom provides a greater level of strategic thinking when it's effectively utilized." She believes diversity offers "experiential views that add to the strength and experience level of the board as a whole."

Additionally, Allen says there continues to be a high demand for people with operating experience and sitting CEOs and COOs. However, she believes individuals with operations experience, strong finance skills, talent and development and resource skills, international experience or technology backgrounds "have their place at the table in a boardroom that is focusing on the broader organization." It's the combination of the group's combined strengths and experiences.

"I watch the individuals in boardrooms who have those backgrounds and capabilities and find they do bring a great sense of perspective and experience that is valuable," Allen notes, referring to the financial expertise of a sitting, retired or former CFO and those from accounting and other financial environments. She sees a rising demand for retired partners of the accounting firms to serve as directors, and encourages those seeking board members to "cast a broader net to find appropriate individuals."

A survey conducted in 2006 by The National Association of Corporate Directors' (NACD) research arm, The Center for Board Leadership with Mercer Delta Consulting, found that roughly 65 percent of public and private companies reported women present on their boards, in contrast with 97.7 percent of non-profit organizations. Additionally, more than half of the directors from public and private boards claimed a lack of ethnic diversity among their members. In fact, more than one-third of respondents do not believe that gender and ethnic diversity are important criteria for recruitment.

Steinberg believes it's often very helpful to have diverse composition in the boardroom, especially when it impacts on the operations or customer base of an organization. For example, "a company that produces and markets products primarily to women would want a number of women in the boardroom to bring that perspective." That said, however, he's "much more interested in seeing the right background, experience and skill sets in the boardroom."

Rules, Rules, Rules

With the stock exchange listing rules and those spawned by Sarbanes-Oxley, the past five years have seen a significant change in the focus and priorities of most boards. Those rules range from compliance, to having a majority of independent directors, independent nominations, executive compensation, expanded audit committee responsibilities and board annual assessments.

Steinberg notes that while many rules apply only to public companies, even private companies and nonprofits are "focusing on these rules as best practices."

Among other new rules, Steinberg lists: the requirement for private sessions of the board and presiding directors; service by directors (reviewing service on boards of more than three public companies); protocol for handling complaints or concerns (the "whistleblower" rule); prohibition of loans to directors; the right to advisors and all the certifications (the CEO and CFO certifying financial information, internal controls over financial reporting disclosure and procedures under section 302 of Sarbanes-Oxley); as well as having a financial expert on the audit committee.

And, he adds, many rules have been specifically aimed at the audit committee. Among those: appointment, compensation and oversight of the external auditor by the audit committee; resolving disagreements on financial reporting and approving non-audit services; timely reporting of key accounting policies; discussing alternative generally accepted accounting principles (GAAP) with management; the preferred auditor treatment, and so on.

It's no wonder directors are spending more time on board activities. The NACD/Mercer Delta survey found that directors on public boards spent an average of 209.7 hours a year on board-related matters, including time spent outside the boardroom; that is up from 190 average hours in 2005. Involvement for directors on private boards increased from an average of 150.6 hours in 2005 to 161 hours in 2006.

Immediately following enactment of the rules, Steinberg says, boards and audit committees moved from an advisory role to management to much more of a monitoring role, focused on compliance and a "check-the-box" approach. In dealings with the CEO, boards moved from a somewhat passive to a more structured approach. Thus, early on, he says, the change in dynamic likely caused some conflicts and tension, especially for a CEO who had had free rein and then found himself/herself under the board's scrutiny.

Is 'New' Also 'Improved?'

So, have the new rules improved board performance and thus restored some of the lost investor confidence that immediately followed the scandals? There's no simple answer. However, as boards are adapting to the new regulations, results are apparent in varying degrees in boardrooms across the U.S.

Steinberg says boards are more involved. "There is better discussion, better information coming to them that is more timely, and there's true debate in the boardroom." Regarding risk, he says boards became risk-averse immediately after Sarbanes-Oxley and the stock market listing rules were enacted. "They were concerned, and some certainly still are, about their personal reputation and liability."

He points to Enron's highly complex structure and many transactions, some hidden, some not. Directors had nightmares about a company whose board they sat on ailing, or imploding, on their watch.

However, he notes, they've come to understand that companies are in business to take risk. Further, that's pushed the notion of companies developing an enterprise risk management (ERM) process to identify risks before they become issues or problems, and to manage them appropriately. This, he notes, has sparked a significant change.

They understand it doesn't mean companies must avoid risks, but understand them and place their bets in the right places, tied to their strategy. However, Steinberg is concerned that "a number of companies have pockets of risk management activities in their organizations, but they fall far short of a true ERM process."

Allen concurs there are a lot of pains in the regulation, compliance requirements and additional responsibilities placed on boards (and audit committees, in particular, and more recently compensation committees). She says her view into boardrooms is most frequently through the audit committee.

Certainly during the early years following Sarbanes-Oxley's passage in 2002, there was a great deal of focus on compliance and the processes and appropriate levels of oversight provided to that entire project. That continues to get more ingrained as part of an organization's ongoing control processes and operating environment.

While there might have been some distraction for a period of time — and there certainly is still a concern about compliance risk — she believes there's real encouragement for refocusing the organization and board on strategies for the future. Allen says, "Organizations are more observant about the compliance-oriented side of the business, which in and of itself, probably does add a dimension of risk-averse.

"Generally, [boards and directors] really put high on their list the concern about risk across the organization. So you can say that they are being more risk-averse, or "maybe they're just being more observant about the broader risks to an organization."

As boards (and audit committees) learn more about the notion of enterprise risk, she adds, they have a greater appetite for knowing more about it and understanding what it means. Ultimately, they'll have a better process and structure as they hold their organizations accountable for enterprise risk assessments and what those risks mean to the company.

Continuing Changes

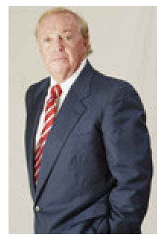
The NACD/Mercer Delta survey revealed that despite the increased oversight and scrutiny of U.S. corporate boards, approximately 50 percent of the 1,400 boards it surveyed considered themselves less than effective in the area of CEO succession, and roughly half currently have a succession plan in place. Among the other highest concerns for boards are strategic planning and corporate performance.

Going forward, Steinberg believes there will be a continuing and increasing demand for tying CEO pay to performance. “There has got to be better pay for performance,” he argues, adding that it needs to be a mix of internal and external measurement factors. The best board compensation committees are aligning compensation to strategy — the long-term performance of those internal and stock-price measures, he says.

Has the threat of personal liability deterred individuals from taking board seats? Allen says that while there were a couple of one-off situations where there was an effort to hold directors personally liable, she believes that “individuals take their roles and responsibilities very seriously” and are proving they are willing to serve.

Finally, Allen says one area that can be uncomfortable to deal with, and is an important component of a board’s responsibilities, is succession planning. She urges dialogue with top executives on the question: “What if something happens tomorrow?”

Pendulum Is Swinging Back



As one who has served on several boards over the years, Robert W. MacDonald has perspectives on some of the changes. After retiring in 2002 as CEO of Allianz Life of North America, and as chairman in 2003, in 2006 he started and serves as chief executive of Minneapolis-based Allianz Income Management Services (AIMS). Since 1980, he’s served on boards of public and private companies and nonprofits. He’s currently an independent member of three boards, one of which is the restaurant chain Buffalo Wild Wings.

MacDonald says while it might’ve been more fun, he’s never served on a so-called “country club board.” Rather, he’s been on boards that took their responsibilities seriously. Since Sarbanes-Oxley, however, he says, there’s been an enhanced seriousness and commitment to the responsibilities of board members, as well as a significant rise in the level of involvement, awareness and concern. “It forced boards to get serious about what they were doing, and management to get serious about their dealings with the board.” That, he says is “a positive.”

Referring to Section 404 of Sarbanes-Oxley, he says it was put in place to accomplish three things: to make sure the numbers released are correct, to be able to verify the numbers produced are correct and that everyone is on a level playing field to get those numbers. While a painful process, he says, “It’s not something a good company wouldn’t want.”

Previously, he says, many good companies attempted to accomplish those objectives and had a good relationship between the CEO/management/and the board. Sarbanes-Oxley, he says, has quantified and put a system in place to accomplish that working relationship and achieving those objectives that were not there. Good companies did it because it was the right thing to do, and it’s made the relationship better and stronger. The shareholder, he says is the “ultimate beneficiary of all this.”

The problem, he says, is that the pendulum had swung too far in the other direction — with a laissez-faire approach toward board supervision and a coziness with outside auditors. With Sarbanes-Oxley, as with new rules in general, he opines, “it always swings too far the other way, and that causes pain.”

When he was CEO of Allianz, he says, he believed the company was run pretty well, but the inability to verify that those numbers were correct and the potential problems or weaknesses that were identified “was amazing to me. We were flying blind; things could’ve happened we didn’t want to happen. By being forced to go through that painful process to validate and prove we knew what those numbers were, and they were right, makes management better and gives the board an opportunity to play a meaningful role in the overall management of the company.”

The pendulum is now swinging back towards the center, he says. “It was part of the learning process.”

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