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Six Priorities for Boards in 2006

Ira M. Millstein, Holly J. Gregory and Rebecca C. Grapsas
From Weil, Gotshal & Manges LLP

As the flurry to institute the governance reforms of recent years settles down, boards of directors have an opportunity to refocus their attention on their fundamental mandate, which is to "direct the affairs of the company." The first and fundamental responsibility for a board in "directing" is to determine and prioritize just what it is the board should focus its attention and efforts on, given the unique circumstances of the particular company. With the strong caveat that the details will vary for each company -- and generic compliance checklists won't provide significant guidance -- we nonetheless suggest that in 2006 boards consider the following priority issues, which we believe are of importance to most companies:

1. Taking charge of the board's own focus, agenda and information flow. Boards need to develop their own sense of business priorities and their own view of the matters that are most important to the success of the enterprise. Doing so enables a board to provide management with meaningful guidance and support. It also helps the board focus its attention appropriately, determine its own agenda and obtain the information it needs to make objective judgments. Obviously, the board needs to dig down and really get to know the business of the company and the competitive environment in which it operates, in collaboration with – but not unduly dependent on – management. Even the best managers will have potential conflicts or blind spots about performance, strategy and/or risks. (This is why boards matter in the first place.)

2. Ensuring that management not only performs, but performs with integrity. Selecting, monitoring and compensating management and, when necessary, replacing management, continue to lie at the heart of board activity. Directors should assess management's integrity not only at the outset in their hiring decisions, but also continuously thereafter when:

- Considering matters proposed and presented by management;
- Assessing management performance;
- Determining management compensation; and
- Planning for succession and management development.

Management integrity is the first defense to director liability. Equally if not more important, management integrity is key to building relationships of trust with customers, suppliers, employees, regulators and investors. Integrity and trust can be difficult to assess, and are not subjects conducive to "box-ticking." But directors can assess whether the CEO and her team: invest real effort (not lip service) in setting the tone at the top (see item 3, below); are attentive or reactive (as well as aggressive or conservative) in areas of legal compliance, accounting and disclosure; embrace or resist efforts to adopt and adapt best practices in various disciplines (including but not limited to corporate governance); and exhibit basic decency in their treatment of others. Directors can take a close look at how senior executives approach issues in which they have a considerable personal interest, such as compensation, potential related-party transactions, perquisites, etc. (Remember that by its very nature the board is designed to attend to areas where senior management may have a blind spot or a potential conflict.) Directors can also assess whether management is "straight" with the board – forthcoming in helping to identify key issues and provide unbiased information about important matters. This is the foundation for the board's trust in management and the basis for effective board oversight.

3. Setting expectations about the tone and culture of the company. Related to its ongoing assessment of management integrity, the board has an important role to play in assuring that management is promoting an appropriate ethical culture within the company. Only the board is positioned to assess whether senior management is setting the appropriate tone and culture, both in the messages management sends throughout the company and as exhibited in management behavior. The standards of ethics and business conduct that are followed – or not followed – throughout a company impact the bottom line in many ways. "Tone at the top" should be a priority throughout the company and not viewed simply as a compliance matter.

4. Formulating corporate strategy with management. Once the board has hired the best and most trustworthy management team available, it should challenge the team to propose and continually fine-tune the corporate strategy. Directors should apply a healthy skepticism in questioning assumptions behind the strategy. After agreeing to a stra-

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tegic course with management through an iterative process, the board should determine the benchmarks that will evidence success or failure in achieving strategic objectives and then regularly monitor performance against those objectives. As boards look beyond reform implementation, the key challenge is to get down to business, focusing not only on corporate strategy and its execution but, in particular, on understanding the key risks to the drivers of corporate performance, and how management is controlling for such risks. This all requires significant understanding and information about the company, its industry and competitive conditions, and it requires active control by the board of the board's agenda and the information available to it. It also requires the development of a clear understanding between the board and the senior management team of just what issues are board-worthy and in what time frame and under what circumstances the board expects to be informed of a critical emerging issue.

As boards look beyond reform implementation, the key challenge is to get down to business, focusing not only on corporate strategy and its execution but, in particular, on understanding the key risks to the drivers of corporate performance, and how management is controlling for such risks.

5. Ensuring that the corporate culture, the agreed strategy, management incentive compensation and the company's approach to audit and accounting, internal controls and disclosure are consistent and aligned. Active engagement in strategic oversight and knowledge of the key drivers of corporate performance and the corporate culture position the board to ensure that the company's approach to compensation, financial disclosure, internal controls, risk and compliance all complement one another. "True and fair" should be the goal with respect to all of these issues. Boards should consider whether incentive compensation truly rewards performance in line with the agreed strategy. Consider whether incentives, coupled with pressures to provide the market with guidance, may put undue pressure on management to go beyond legitimate earnings management. A concerted focus on the future by the board, together with efforts to align compensation policies with strategic objectives, and board sensitivity to the complexities and pressures surrounding the provision of earnings guidance may all help to lessen undue emphasis by management on quarterly results.

6. Helping management understand the expectations of shareholders and regulators. Boards add significant value when they help management cope with the complex context in which the company operates, and when they support management in focusing on the long-term interests of the company and its shareholders. Managers tend to work in the here and now and often don't have the time or inclination to fully learn how the world at large views the company. Boards can help put the company's corporate governance ratings and securities analyst reports in perspective, encouraging credible ratings and reports to be attended to -- particularly credible analyst reports -- because they may provide insights about how the company is viewed, while at the same time, recognizing that ratings and reports don't define what effective governance or performance is. Slavish adherence to recommendations derived from box-ticking is just as bad as ignoring credible analysis in the first place. Boards can also help management recognize that shareholders have a legitimate interest in more meaningful input into the board selection process, in terms of both nominating procedures and voting methods. Similarly, boards can help management recognize and address the concerns that excessive compensation raises among shareholders, regulators, rating agencies and others.

And this takes us right back to integrity.

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The article first appeared in the *Corporate Board Member Magazine*.

Board Independence: *Striking the Right Balance*

Robert L. Heidrick and Dayton Ogden
From National Association of Corporate Directors

Three years since the wave of governance reform swept in the Sarbanes-Oxley Act and a slew of new exchange listing requirements, corporate boards have adapted thoroughly to the new governance landscape.

Most directors have embraced their expanded role and responsibilities with a strong sense of purpose and dedication to their fiduciary role. Beyond the "boxchecking" inherent in satisfying the regulatory requirements, boards undeniably are stronger and more independent from management than they were just five years ago. Independent directors now meet regularly in executive sessions, often at every board meeting. Audit committees comprising outside directors have assumed a greater role in approving financials and external financial communications, identifying potential risks to the organization, and ensuring that management is addressing those risks. Compensation committees are coming to grips with the details of CEO compensation plans, even bringing in their own external consultants to help them understand the true costs of compensation plans. In short, boards are more knowledgeable about their companies, more engaged, and in a stronger position to probe and question suspicious activities than in the past.

Through our work, we at Spencer Stuart also have observed a dramatic change in the way boards approach new director recruitment. In the past, a board vacancy may have been filled by a friend of the CEO; today's board nominating committees have assumed the primary responsibility for director recruitment. Most have adopted methodical and transparent recruiting processes with the goal of assembling a board of directors that will add the greatest value to the company.

Unintended Consequences of Governance Reform

All of these developments have reinforced the independence of corporate boards, which was essential in the wake of the scandals that spurred the creation of the governance regulations. But the dramatic increase in directors' responsibilities and personal liability associated with board service has created unanticipated problems for many boards.

One of those challenges is a sharp rise in the difficulty of recruiting new members as the demand for new directors vastly outpaces the supply of the most experienced, knowledgeable, and tested corporate leaders. This has occurred as demand for new directors has grown in response to new governance reform requirements. Boards are having to recruit directors who meet the tightened definition of "independence" and also have the qualifications to serve on key board committees—the audit, compensation, and nominating committees—which must be wholly independent in public companies. Board turnover also has increased as directors continue to pare back the number of board commitments they make.

On the supply side, the most notable change is reduced availability of CEOs for board service. CEOs traditionally have been highly valued as board directors for their general management experience, big-picture view, and knowledge of current business challenges. At the same time, CEOs willingly made time for outside board assignments in the past because they provided opportunities to network and observe different industries.

In the past several years, however, CEOs have been curtailing their outside board commitments. In 1998, CEOs of S&P 500 companies served on an average of two outside directorships. The average today is about one. The 2005 Spencer Stuart Board Index, an annual study of the board composition and practices of S&P 500 companies, found that, among newly recruited directors, about a third were active CEOs and chief operating officers. In 2000, just over half of all new directors served in these roles. Given their own demanding schedules, most CEOs simply do not have the time to serve on outside boards. And, increasingly, boards are limiting their CEOs from serving on more than one outside directorship, if not outright banning outside board service altogether. This is bad news for companies, which benefit from the exposure CEOs get to other industries, business issues, and leadership styles through outside board experience.

In response to the shortage, boards are turning to retired executives, as well as nontraditional board candidate pools—such as direct reports to the CEO, and academics. The Board Index found that 13% of new directors were retired CEOs or chief operating officers, compared with 9% in 2000. Divisional and functional leaders made up 11% of new directors, compared with just 6% in 2000. Academic and nonprofit leaders represented 10% of new directors, versus a mere 2% in 2000.

These individuals can bring valuable perspectives and experience to the board, yet boards considering tapping non-traditional sources for new directors must understand the tradeoffs. In particular, CFOs and other senior functional leadership do not control their calendars and may not have the flexibility they need to fully meet their board commitments. Director candidates from lower levels of an organization or from academic and not-for-profit circles may not possess the depth of management experience or the broad senior-level perspective of CEOs. Finally, retired CEOs, chairs, and COOs are highly experienced, but potentially less current on the critical business issues of the day.

The sheer volume of responsibilities has created other challenges and potential pitfalls for boards. As meeting agendas become more packed with compliance-related issues, some directors have expressed concern that boards have less time to engage in strategic discussions and counsel with the CEO. And as they become more vigilant and steeped in the business, directors must guard against becoming too operationally focused. Directors who go too far—beyond active oversight of management to active management—risk alienating senior leaders and disrupting the optimal board-management relationship. As they grapple with their growing set of new responsibilities, boards must be active, independent voices in governance, without overstepping the boundaries of the role.

Striking the Right Balance

How can boards maintain their independent posture and ensure that the benefits of governance reform continue to outweigh the consequences? Boards should make sure they have the right composition, guard against overstepping their role, and maintain an independent, but collaborative posture with management. They can do this by adopting several strategies.

Attract and keep the right people. First, boards must attract and retain the very best directors. This begins with a director nominating process designed to identify the skills and experience needed on the board in light of the unique character and strategic goals of the organization, and recruit directors best suited to those needs.When helpful, boards should consider engaging outside experts and human resources professionals within the organization to help with this process.

Nominating committees should take the lead in director recruitment, but they must approach the process in partnership with the CEO. No qualified director candidate will be willing to join a board without being confident in and comfortable with the CEO. Further, a new director who has the confidence both of the board and the CEO will be in a better position to contribute effectively from the start.

All of these developments have reinforced the independence of corporate boards, which was essential in the wake of the scandals that spurred the creation of the governance regulations. But the dramatic increase in directors' responsibilities and personal liability associated with board service has created unanticipated problems for many boards.

Finally, boards should recognize that, while director candidates still regard board service as prestigious, they nevertheless are more cautious about accepting new directorships. Candidates are conducting careful due diligence aimed at assessing the strength of the business and the integrity of the organization before joining. By setting expectations about the company's values and behavior that are lived and disseminated by management, boards also can improve their chances of attracting the most experienced and effective leaders to the board.

Manage the board's time effectively. The most highly qualified candidates want to join boards where their time and participation will make a real difference. Boards are more likely to attract and retain these outstanding directors if the board and its committees operate efficiently and effectively.

With so much on their plates these days, board and committee chairs must be diligent about running meetings efficiently and focusing on priorities spelled out in their charters. Materials should be distributed well in advance so directors have ample time for review and can focus meeting time for unscripted discussion about top issues. Board and committee chairs also should continually review whether meeting time is being used appropriately.

Leverage the lead director. A lead director or nonexecutive chairman can play an important role in improving the communication among directors and between the board and the CEO. One of the key roles of the lead or presiding director is to run executive sessions of the board, which provide opportunities to surface director concerns and ensure that feedback is shared in a timely way with the CEO. While executive sessions used to be a relatively rare practice among boards, today independent directors are required to meet once a quarter without management—and many conduct an executive session in conjunction with every board meeting.

The lead director also typically has a role in reviewing the agenda in advance of meetings with the CEO and ensuring that directors receive materials well in advance so they are prepared for meaningful discussion at meetings. The lead director should be a strong and trusted board leader who is willing and able to spend the necessary time on these duties.

Make the most of board evaluations. When done right, board evaluations provide a forum for directors to review and reinforce appropriate board and management roles and ensure that issues brewing below the surface are addressed promptly. These can range from operational complaints about meeting length or the composition of the agenda, to larger, potentially thornier issues concerning the board's role in strategic decision making, gaps in knowledge and competencies on the board, and executive and director succession planning.Well-planned and executed evaluations give the board an opportunity to identify and remove obstacles to better performance and to highlight what works well. The board must commit to reviewing the results of the evaluation and be dedicated to addressing issues that are raised through the process.

Offer ongoing director education. Director education and training can help new, less experienced board members understand their role and governance requirements, and ensure that they have the tools to be effective. Accountable in ways they have not been before, even longtime board members should not hesitate to demand training on company processes and risks, as well as key regulatory developments.

Conclusion

The dramatic changes in the regulatory environment and the shift in investor expectations during the past few years have had the effect of making boards reflect more "technical independence." They also have become more independent in practice. As directors take on new responsibilities and more actively monitor management, they are in a better position than in the past to identify and address potential risks. Boards that act with integrity and independence, and provide candid and constructive feedback to management without overstepping their oversight role, are likely to achieve the benefits of governance reform, without falling victim to its unintended consequences.

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The article first appeared in the *Corporate Board Member Magazine.*

Disarming the Value Killers: *A Risk Management Study*

Online Exclusive

Investors and executives share a mutual desire for the success of their company, but they also harbor a common fear: a precipitous drop in share price that results in restricted credit, impeded growth, decimated pension plans, and reduced competitiveness. Unfortunately, unlike many concerns, this phobia is grounded in reality. Steep market drops affect a significant percentage of companies, encumbering them with negative repercussions that can last for years.

Indeed, over the last decade, almost half of the 1000 largest global companies suffered declines in share prices of more than 20% in a one-month period, relative to the Morgan Stanley Capital International (MSCI) World Index. By the end of 2003, roughly one-quarter of these companies had still not recovered their lost market value. Another one-quarter took more than a year for their share prices to recover.

Although each of these companies experienced unique circumstances that contributed to their loss of value, there are several common underlying risk factors that resulted in a negative effect on value. Deloitte Research, a part of Deloitte Services LP, analyzed the factors underlying these major losses in value from 1994 to 2003, with the goal of identifying strategies that companies might take to manage risk and better protect shareholder value.

Key Findings

Manage Critical Risk Interdependencies

Critical Concern: Eighty percent of the companies that suffered the greatest losses in value were exposed to more than one type of risk. But firms may fail to recognize and manage the relationships among different types of risks. Actions taken to address one type of risk, such as strategic risk, can often increase exposure to other risks, such as operational or financial risks.

Recommended Response: Companies need to implement an integrated risk management function to identify and manage interdependencies among all the risks facing the firm.

Proactively Address Low-Frequency, High-Impact Risks

Critical Concern: Some of the greatest value losses were caused by exceptional events such as the Asian financial crisis, the bursting of the technology bubble, and the September 11th terrorist attacks. Yet many firms apparently fail to plan for these rare but high-impact risks.

Recommended Response: Firms should employ "stress testing" to ensure that their internal controls and business continuity plans can withstand the shock of a high-impact event. Companies should proactively plan and acquire the strategic flexibility to respond to specific scenarios.

Foster a Strong Ethics and Control Culture

Critical Concern: Corporate cultures and incentive systems that set high premium for returns without complementary controls can lead to major value and brand losses.

Recommended Response: Senior management needs to create a culture emphasizing the central importance of ethical behavior, quality control, and risk management. Compensation incentives should be aligned with long-term value creation and brand protection.

Provide Timely Information on Control Factors

Critical Concern: A number of organizations lacked access to current information required for senior management to respond quickly to emerging problems.

Recommended Response: Firms need to improve their internal information systems, and communication mechanisms to ensure that senior management and boards of directors receive accurate, near real-time information on the causes, financial impact, and possible solutions of control problems.

Given the frequency of sudden and dramatic drops in share prices, even the largest companies need to take a serious look at current risk management practices. Companies that go beyond traditional methods to take a more integrated and comprehensive approach to risk management may reduce the likelihood of suffering major losses in value.

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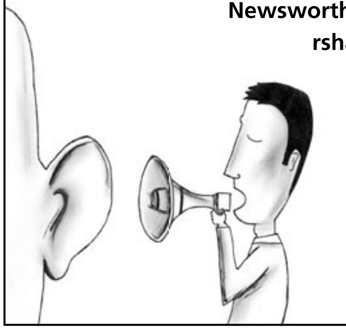

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