

GOOD GOVERNANCE

“The lack of sound corporate governance in the public and private sectors has enabled bribery capitalism and corruption to flourish throughout the world, suppressing sound and sustainable economic decision.”



In the Cone Corporate Citizenship Survey they asked what consumers do when they hear reports of bad corporate citizenship.

- ❑ 91% consider switching to another company's products or services
- ❑ 85% speak out against that company among family and friends
- ❑ 83% refuse to invest in that company's stock
- ❑ 80% refuse to work at that company
- ❑ 76% boycott that company's products or services

Good Corporate Governance characteristics include:

- ❑ Transparency
- ❑ Accountability
- ❑ Probability
- ❑ Protection of minority shareholders

“Good corporate governance requires management in both the public and private sectors to obey not only the letter, but all the intent and spirit of the law, using sound ethics and moral judgment to ensure long-term organizational sustainability as opposed to short-term personal gains.”

Unknown Author

The Board of Directors is a very valuable resource, but too often they turn into puppets and lose their value-added properties. The value of an independent board that is capable and assertive

enough to challenge management has been vividly demonstrated by organizations like Enron. The results of poor management of the Board of Directors has focused the world's attention on corporate governance. It is also was one of the factors that caused the world's stock markets to drop so drastically in 2002, costing the average U.S. family approximately \$60,000 per year.

We all have the capacity for good and evil. Genetics accounts for about 50% of our behavioral tendencies like our personality and moral behaviors. The remaining 50% is defined by our culture and environment. Dr. Michael Shermer, author of "The Science of Good and Evil", stated, "As adults we are particularly influenced to do good or evil by the immediate social context and community. When you're surrounded by co-workers all hyped about a get-rich-quick pyramid scheme, it is truly hard to resist." This means that even the best organization's need to have adequate checks and balances placed upon the executive team.

As important as our executive team is to the organization, they need to have some checks and balances applied to them. This is the job of the Board of Directors. Too often today's boards do not have the courage to stand up to the executive team. They take the easy way out and just "rubber-stamp" the executive team's recommendations. Even more, many Board of Directors are mostly made up of members of the executive team or people that executive team can easily control. For example, when IBM started its downhill journey, John Ackers became president and chairman of the board at IBM.

Sanjay Kumar, CEO of Computer Associates, said, " In the post-Enron days governance has become critical". We feel that this statement, although correct, is an understatement. The truth of the matter is that good corporate governance has always been critical to the success of any organizations. All organizations need to have Board of Directors that are watchdogs and too many of these boards are lapdogs.



Today's board members have to have a high degree of personal ethics and values. They need to understand the business and the validity of the data they are using to approve the organization's operations. They need to be as ethical as Babe Didrikson Zaharias, the late golf champion. She once disqualified herself from a tournament because she hit a wrong ball out of the rough. When a friend asked, "Why did you do it – no one would know?" Babe simply answered, "I would have known."

“The teams at Goodyear are now telling the boss how to run things. And I must say, I’m not doing a half-bad job because of it.”

Stanley Gault

Chairman

Goodyear

Because organizations around the world have done such a poor job of Corporate Governance, governments are beginning to pass more stringent laws. In the U.S. Congress passed, and President Bush signed, the Public Company Accounting Reform and Investor Protection Act. The act requires that CEOs, CFOs, and the board members to personally certify all financial statements. This act, called the Sarbanes-Oxley Act of 2003, calls for:

- ❑ An increased degree of transparency in corporate accounting and reporting
- ❑ The personal responsibility of top executives and board members for the accuracy of financial statements their companies release; and
- ❑ A greater emphasis on, and a new structural framework around, efforts to prevent, detect, investigate, and remediate fraud and misconduct.

The question of the legality of this act has been challenged by Richard Srusky, the past CEO of HealthSouth, who is charged with masterminding a \$2.7 billion swindle. The challenge is based on the grounds that it is unconstitutional to hold officers of an organization accountable for signing on something that he/she did not prepare. We believe, as Dwight Eisenhower did when he said, "The buck stops here."

In light of the new laws and loss of public confidence, it has become a requirement that the board members become educated related to the increased risk associated with being a board member. Board members need to understand their fiduciary, ethical and legal oversight responsibilities. The basic job description for board members has been rewritten and it includes much higher expectations and penalties. Board members are now under increased pressure and intense public scrutiny. They are required to improve organizational value and performance as well as acting in the best interests of the organization's shareholders. All board members are faced with greater legal liability for the organization's financial reporting accuracy and its performance. The board members need to become valuable contributors to the organization's growth.

Fortune Magazine evaluated the Fortune 500 firms to assess the quality of the Corporate Governance structure. The stocks of organizations that had the best Board of Directors, stock prices outperformed the worst organizations by 2 to 1. The retained earnings of the best Corporate Governance organizations were 51.7%, while the worst organization was -12.9%. The following is a list of organizations that were classified as having the best Board of Directors.

- 3M
- Apria Healthcare
- Colgate Palmolive
- General Electric
- Home Depot
- Intel
- Johnson & Johnson
- Medtronic
- Pfizer
- Texas Instruments

The following is a list of 2003 Board of Directors that needed to improve.

- Apple
- Conesco
- Dillard's
- Gap
- Kmart
- Qwest
- Tyson Foods
- Xerox
- AT&T
- Ford
- HP

What principles guide good Corporate Governance? The organization for Economic Cooperation and Development released “OECD Principles of Corporate Governance”. These principles provide some good guidelines for organizations to evaluate their Corporate Governance structure. It consisted of five major headings.

- ❑ The Right of the Shareholders – the Corporate Governance framework should protect shareholders’ rights
- ❑ The Equitable Treatment of Shareholders – the Corporate Governance framework should insure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.
- ❑ The Role of Stakeholders in Corporate Governance – the Corporate Governance framework should recognize the rights of stakeholders, as established by law, and encourage active cooperation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.
- ❑ Disclosure and Transparency – the Corporate Governance framework should ensure that timely and accurate disclosure is made all material matters regarding the corporation, including financial situation, performance, ownership, and governance of the company.
- ❑ The Responsibilities of the Board –the Corporate Governance framework should ensure the strategic guidance of the organization, the effective monitoring of management by the board, and the board’s accountability to the organization and the shareholders.

Although all five principles are important to good Corporate Governance, we will discuss only the fifth principle, the responsibilities of the board, as the board is a primary resource that is extremely important to Organizational Excellence.

The Board of Directors is primarily responsible for monitoring managerial performance and achieving an adequate return for the stockholders, while preventing conflict of

interests and balancing competing demands on the organization. They are also responsible for insuring that the organization's systems and processes are designed so that the organization will be in compliance with applicable laws, including tax, compensation, labor, environmental, equal opportunity, health, and safety laws. In order to live up to these responsibilities, the members of the Board of Directors must be substantially independent from the organization's management team. It is easy to see that the board members must be working members. The common view of a board made-up of fat cats that come in two to four times a year to smoke cigars and have a good meal is a misconception. In order for the board to function satisfactorily, it requires its members to do a great deal of preparation before the meeting and have an extensive background in the organization's operations and the related legal and financial requirements.

In order to have good Corporate Governance, the Board of Directors:

- ❑ Act on a fully informed basis with good faith and due diligence and care and in the best interest of the organization and its shareholders
- ❑ Must consider the needs and wants of all stakeholders and treat them fairly
- ❑ Needs to insure that the organization is in compliance with all applicable legislation, taking into the interests of the shareholders
- ❑ Should approve corporate strategies, major plans of action, annual budgets and business plans, which includes major capital expenditures, acquisitions, and diversifications
- ❑ Should set performance objectives, monitor implementation of the planning process and measure corporate performance
- ❑ Monitor the performance of key executives and determine what relative compensation should be awarded to these key individuals. If necessary, they must take action to replace individuals who are not performing at an acceptable level. They are also responsible for insuring that an effective succession plan is in place and that the individuals are being developed as necessary.

- ❑ Develop a formal and transparent board nomination process, reviewing the performance of each board member to insure that they are living up to their responsibilities.
- ❑ Insure that corporate assets are not being misused.
- ❑ Manage potential conflicts of interest between management, Board members, and shareholders.
- ❑ Validate the integrity of the corporate and financial reporting system, including the independent audits
- ❑ Insure that the disclosure and communication process is working effectively
- ❑ The make-up of the board should be such that it can exercise objective, independent analysis related to corporate affairs without undue influence by the management team. The make-up of the board should insure an appropriate balance of power insuring accountability and insuring the capability of the Board for independent decision-making. The board should be kept between 5 50 15 people. Mr. H. Carl McCall, the past chairman of the compensation committee at the New York Stock Exchange, pointed out that the exchange's board is too unwieldy with its 27 directors. He suggested that a board of 10 to 12 members would be more efficient.
- ❑ Only non-executive board members should be assigned to board sub-committees, covering areas of potential conflict of interest (for example, financial, nominating, and executive and board remuneration)
- ❑ Board members must receive accurate, relative and timely information related to the organization's activities. This is necessary for them to fulfill their responsibilities and ensure they make knowledgeable decisions.

The following are some useful guidelines, which will help the organization maintain a good Corporate Governance Board of Directors structure.

- ❑ Independency

- No more than two company executives on the Board or no more than 20% of the board, whichever is less
- None of the members of the board should be doing business with the organization (for example, providing consulting or legal services)
- The Audit, Compensation and Nominating Committees should have no company executives on them
- The Chief Executive Officer or Chief Operating Officer should not serve as Chairman of the Board
- Stock Ownership
 - Each director should have a minimum of \$150,000 US equity stake.
 - An exception to this would be a new board member who will build up the equity stake within a two year period
 - Board members should be restricted from selling stock until they are off the board
- Quality of the Directors
 - One independent director with experience in the core of business
 - One who is a CEO of an equivalent-size company
 - One should be a Performance Improvement Expert
 - None of the Directors should be on more than four boards
 - Retired Directors should be on no more than seven boards
 - All Directors should attend a minimum of 75% of the meetings
 - The board should evaluate each member's performance each year and provide formal feed back to each board member
 - A training program is strongly recommended for new board appointees insuring that they are abreast of the relevant laws, regulations, business environment, changing commercial risks, organizational structure, and the organization's products and services
- Board Activities
 - The board should meet without management's presence at least once a year
 - The Audit Committee should meet at least four times per year

- The board should be frugal with executive pay
- The board should develop a very robust CEO and COO succession plan
- The board should be quick to react to troubles

Don Peterson, retired CEO of Ford Motor Company, stated, “The place that the longest amount of continuity that is achieved among leadership in any organization is at its Board of Directors and it is essential that they have an ingrained appreciation for the benefits of quality and value proposition that it offers to the organization for the long-term.”

Good board members are getting hard to find, particularly for small and start-up organizations. Today board members are required to do more stringent overseeing that can mean putting in up to 200 hours annually. For example, Home Depot expects all of its board members to visit and report on 12 of the company’s stores outside of their home state each year. Shareholder lawsuits are increasing and the members of the Board of Directors can be personally liable and financially responsible for the judgments and court costs. These risks need to be offset by outstanding stock options that act as a lure and the board members need to be motivated by the intellectual challenge of being part of a growing organization.

“Money should not be a prime motivator for board service; if it is, then you have the wrong person.”

Bruce E. Beebe

Editor of Directorship Newsletter

In Ram Charan and Julie Schlosser article in *Fortune Magazine* on November 10, 2003 they pointed out 10 questions that board members should ask. We feel they present a simple, but good starting point. They are:

- ❑ “How does the company make money?”
- ❑ Are your customers paying up?
- ❑ What could really hurt – or kill – the company in the next few years?

- ❑ How are we doing relative to our competitors?
- ❑ IF the CEO were hit by a bus tomorrow, who could run the company?
- ❑ How are we going to grow?
- ❑ Are we living within our means?
- ❑ How much does the CEO get paid?
- ❑ How does bad news get to the top?
- ❑ Do I understand the answer to 1 through 9?"

When we first read this article, we thought the questions were so basic that we would be embarrassed to ask them, but I agreed to try them at the next board meeting I attended. The results were very gratifying. The meeting took on new dimensions. The CEO power point missed the mark in most cases. I was asking simple questions that the management team was having a hard time answering. It was obvious the CEO was uncomfortable trying to answer some of these questions. It wasn't just what he was saying, but it was what he was not saying and how he was trying to avoid some of the important issues. I thought I understood the CEO's and COO's total compensation package. I knew what his salary was but grossly underestimated his performance related bonuses. We all remember the shock wave that went through the stock market when Dick Grasso was granted \$139.5 million in compensation package. All too often the board members do not really know what the key executives' compensation package is really worth.

A number of the other questions also hit home, like succession planning and risk management. Although these questions are not intended to be a comprehensive list of things that the board members should understand, it does provide a starting point that can stimulate additional questions. And to get the most from all your questions, remember to ask **“why” five times.**

