

BOARDROOM CHALLENGES

Effective boards: an oxymoron?

BY THOMAS L. DOORLEY, III AND JOHN R. GAULDING

Once again, with the implosion of credit markets in the United States and around the globe, the questions arise: “Where was the industry leadership? Where was the board of directors of the institutions? Where were the auditors and financial advisers? Where were all of those who were supposed to watch out for us, to be cognizant of the risks? Where was the oversight?” In short it asks what happened to governance this time, again. After the Enron and WorldCom and other not too distant disasters, it seemed governance processes would tighten up; we would be spared for a long while from capital markets-sapping, confidence-shaking blows. While a complex set of interrelated factors led to this round of failures, governance broke down again. Sadly this, too, could have been avoided if the institutions involved had invested in effective oversight. This note sets out the shape of oversight, governance that is effective and works, as it should to protect the interests of both investors and the society at large.

At the core of effective corporate governance is the recognition and embracing of the true role of the board. It has two parts. Both of which transcend national cultures and regulations. Part one is the need to maintain (or now to regain) trust. Often called transparency, it is as straightforward as reporting accurately how the enterprise is doing, what risks it faces; and doing so in a manner that outsiders can analyze and derive a reasonable opinion of the state of affairs. This role, the compliance side, was intended to be strengthened in the US through the force of law, e.g., Sarbanes-Oxley (SOX). As well meaning as SOX is, without a reinforcing, effective governance culture and embedded processes, the extensive, check-the-box approach failed to deliver. But, it is the second role for boards, to contribute to the performance of the enterprise, to make it better through their contribu-

tions, which will drive the kind of effective behaviour required. This element influences the first. It requires a public and integrity-rich commitment by boards and leadership teams to the principle of transparency and unimpeachable honesty; it requires diligence and rigorously independent oversight by boards and their advisers; and it requires a working chemistry between boards and management, often forged in times of extreme adversity that fosters problem identification before crisis, effective solutions before industry contamination, abject honesty before expediency. It requires the director to invest the time and energy to be knowledgeable enough to engage in an informed debate around the issues. In our experience many boards have not embraced the full sweep of this responsibility. Thus, they are not adequately prepared to ask the important questions that just might have raised the flag this time around before the near melt-down. What we have seen thus far in the current crisis is the worst practice both in the creation of the collapse of our financial systems, and in the attempt of management, regulators, and legislators to explain how this could happen in a time of supposed enlightened oversight.

How then to ratchet up the effectiveness of corporate governance? The answer: by following the leading practices of those who are effective. They do exist. Effective boards are in place and operating, albeit not broadly enough. This means, first of all resetting the charter of the board in recognition of its dual role with an extra measure of focus on the performance element. In tough times, management and the board must be able to make their decisions, faster and better. Leading practice is to design the board as a ‘decision-ready’ team. While the best operate in this context, it is not too late to adjust. To do so, the board and management must build a con-

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sensus that contributing to performance is the board’s role and this is its charter. With this agreement in hand, here’s how to proceed.

The CEO and other members of management must commit to bringing the board into the strategic dialogue early in the process; at first light as it were. This requires the CEO to open up in terms of potential ideas and initiatives in the early stages. At one of our boards, we’ve observed the CEO using a white board to sketch out how an acquisition might develop, the status of inventory risks, and even leadership team issues. He has confidence enough in his board to be able to expose his thinking well in advance of the decision-making stages. Recently one of the acquisitions he had been discussing came alive. The board was able to react quickly. The deal was closed with enough speed and energy that other pos- ►►

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sible suitors were caught off guard. By adopting the first light concept, his board was decision-ready, able to act. Further, by fostering an open dialogue with his directors both he and they could discuss any concern, any issue. They trusted each other. Operating in this context would have muted if not totally avoided the current crisis.

The second lesson centres on sharing of knowledge about how the business works. Again, unfortunately too many boards operate in the tone of the recent Deloitte/Economist research report, which investigated the level of knowledge held by directors. It was first done in 2004 and repeated in 2007; its title 'In the Dark' underscores the conclusion. That is, they do not have a solid handle on how the business works. In the words of one director, "I never knew as much about the company as I did when the consultants and investment bankers came in to pitch us about selling the company." How sad is that? Instead, leading practice builds depth of knowledge by demanding a serious time commitment, for example, in the range of 350-400 hours per year for a mid to large cap company, with 8-10 meetings annually. Further, they do annual strategy off-sites taking place at important customer or operating locations, not upscale resorts, to make the company's products, services and processes tangible. Like our 'white boards' CEO, this too requires a confident leader with trust in and of his board.

Lesson three lifts the level of dialogue. That is, it focuses on the major issues the organisation faces. The chairman of one board muses on the difficult issue of honouring the boundaries between the governance/oversight role of the board and the management/operations role of the leadership team. "It seems we spend nearly as much time debating whether this is a strategic issue and one we need to get involved with, or a tactical issue that is man-

agement's job. We're wasting a lot of time." Leading practice avoids the semantic debate by characterising the issues facing the board in terms of the 'big things' the organisation is facing. Thus, a major new product development is as viable a topic for review as is the risk of an operations problem at an important production facility. Further, the best know that the demarcation of roles and responsibilities is murky, not crisp, thus the dynamic of the ongoing relationship is also messy. To be effective, CEOs and the boards redefine and renegotiate those boundaries consistently.

Fourth, ensure that the 'tone at the top' is pushed throughout the organisation. Without question the troops do look to leadership, including board members, for guidance on values and ethics. Yet the voyage from the senior levels of the organisation into the far reaches is not straightforward. Few directors have any insight at all about how they might determine if the lofty tone impacts daily life. Diagnostic tools exist to track behaviour and compare the level of alignment of the day to day with the formal tone. Few take the time to connect the dots. It is a natural role of the board to monitor this connective tissue. If these tools had been in place and working within the now failed banks and Fannie/Freddie, early signals of a disconnect would have been identified and would have been difficult to ignore.

Finally, the board has another natural role, which is to review major initiatives and incidences after the fact to address two questions. How did we do? That is, if the review is of an action, the board asks whether it worked as planned, whether it returned its cost of capital. The second question is "What did we learn?" These two questions define the role we call 'validation'. It is an above-the-fray task squarely within the bailiwick of the oversight responsibility. Over time, many of

us have analysed major corporate decisions to search for patterns of success. The merger and/or acquisition decision is one where the consensus says only one of three succeeds. In our work we found a sharp difference in success rates when we looked at the post-acquisition process. Successful acquirers performed some form of validation process, which provided a powerful insight into the conduct of future transactions. Those with low success rates rarely did so. Similarly, we find in effective, decision-ready boards an assertive validation process intended to identify mistakes and create actions to avoid them in the future; and categorise what works and promote them as well. At best, during this round of disappointment, we all hope that a rigorous analysis of what happened and why would target the breakdowns of process and responsibility. A true test of the effectiveness of this ex-post act of governance will be whether it generates a full measure of blame across the all of the actors, as it sets out to reform.

Effective governance, oversight that works, is possible across a larger number of institutions than exhibit such behaviour at present. It takes commitment, effort and a willingness to change how management and boards act, and how they embed the governance culture throughout their organisations. Effective boards can and do exist. As the dust settles on this round our hope is it triggers a new set of initiatives designed to lift the bar on expectations and heighten the impact of governance. ■

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