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Board Success Demands Better Organizational Structure

By Gerald M. Czarnecki

Independence Is a Good Start But...It Is Not Enough

Legislators, regulators, and the investing public are all placing high expectations for better governance on the mantra of independence criteria for directors. Director independence, supported by selection criteria, processes for nomination and election, and standards of behavior are expected to result in much needed improvement in board objectivity, diligence, and board effectiveness.

Director independence may be a necessary condition for success, but it is not a sufficient condition. Effective governance also requires that directors take responsibility for the success and failure of the companies they serve. When directors embrace their accountability, they will realize they have to organize and structure themselves to form an independent, goal and task-setting entity called the board.

The Board Must Not Be Dependent on Company Management

The scale of organizational structure, resources, and thought leadership is overwhelmingly tilted toward management. If the board is to direct, verify, and oversee the activities of a sophisticated and complex organization, then it must itself have a sophisticated organizational commitment, or it runs the risk of ceding "control" of the company to the management. Sole use of the support functions of the management organization makes the board reliant on the management organization. When the board relies solely on management for information and analysis, directors may be fully independent, but the board as a whole will be fully "dependent."

In the same way that staff organizations provide information, boards must have fully functioning organizations that assure the board's ability to perform its separate and distinct jobs. An independently supported board organization is the only way the shareholders can be sure that corporate management manages to goals that are congruent with shareholders' interests.

Boards must do more to protect the shareholders, not just themselves. The excuse of "I had no idea what was going on and management failed to give us a complete story" may protect directors' financial assets and keep them out of jail, but it does nothing to prevent future abuses. Directors must move oversight to the next level and establish an organizational structure that is fully independent of management.

What Makes an Organization?

Any group of individuals forming an organization must have a clear mission, strategies, tactics, and action plans, as well as the ability to understand and assess the threats, risks, and opportunities to the corporate organization. A permanent structure, adequate staffing, division of work, standards of performance, processes, information systems, and communication mechanisms all provide the basis for execution. In most corporations most of these are already in place; however, they are in place to serve the management organization, not the board. Yet the board organization must have all these if it is to be an organization.

The most important barrier to this goal is the board itself. Few boards have accepted the fact that such structure and discipline are required for the role; even fewer are willing to tell management what they believe is required. Many directors are concerned that if they create "too much organization" they will usurp the role

Director Summary: If boards are to oversee management, which usually comprises a sophisticated organization, boards themselves must develop a sophisticated organization. Directors should have their own staff resources, as well as access to independent sources of information about the company and the relevant industry.

of management. Yet if boards do not substantially increase their commitment to organizational discipline and process, board ignorance will once again lead to the tragic governance failures of the past several years.

Legal Requirements Are Forcing the Board to Start Organizing

Sarbanes-Oxley and stock exchange rules have created a few important requirements with the objective of moving the board toward establishing an independent board organization. Unfortunately, many boards have responded by complying with the letter of the requirements instead of embracing the objective of an independent board organization. New requirements include the following:

- Executive sessions of the independent directors are already having a profound effect on boardroom culture. The conversations that occur in executive sessions, without management present, are stunningly different, even in more passive boards.
- The requirement that audit committees of public companies have hire/fire authority for the public accounting external auditor is already changing both the functioning of audit committees and the activities of the auditing profession. Audit committees are being forced to become organizations as they assume greater, "hands-on" responsibility for the audit and the auditor function.

Best Practices Should Encourage Improved Organizational Behavior

Assertive leadership will change routine behavior and move boards to create an organizational mindset. Assertive leaders will create a disciplined culture at the board level and will force the board to have processes that ensure better governance. More often, poor leaders will take the title and additional compensation and avoid leadership by failing to establish an organization to lead. Some examples of real proactive leadership are:

Lead director. An attempt to establish a clear distinction between the management organization and the board organization. Although the better solution is a non-executive chairperson, title is not important. Separating the leadership of the board and leadership of the company, recognizing two distinct organizations with separate responsibilities, is important. However, a lead director is unlikely to be effective without an organized and structured organization to lead.

Agenda. The setting of the agenda must be by the board, not just for the board. The board organization will accept management's input to the board's agenda, not the other way around. Setting the right agenda requires the knowledge and resources to identify potential risks, problems, and issues in multiple disciplines. This requires an organization.

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Plan. The corporate board must have a plan if it is to succeed. Boards must set an annual calendar and establish meeting criteria, but be sufficiently flexible to address problems as they arise, often on short notice.

Structure. Boards must have structure reflected in the policies, practices, and procedures that guide its activities. Contrary to the protests of directors and managers who want to preserve the ineffective status quo of unorganized boards, these attributes do not imply bureaucracy, but rather disciplined process.

Trust. Members should not sit on a board where they cannot trust management, yet trust cannot be allowed to deteriorate into the abrogation of control. The board must independently verify representations by management. Trust, but verify. If management is offended by the independent verification, start worrying.

Consensus. Best practice nomination processes will add more members with unique backgrounds, knowledge, skills, and attitudes. But diversity and independence lead to more board debate, and potentially conflict. Working as an organization does not require unanimity, but it does require consensus.

Evaluation. Boards must have performance standards and self-evaluation, but not a perfunctory annual effort. Every board must develop a process that is effective and generally non-threatening to individual directors, while supporting the board's organizational objectives.

Structural Changes Are Required to Complete the Organizational Transformation

Structural changes will allow boards to change the traditional "rules of engagement" for corporate board governance. Clearly these structural changes will require boards to have the financial resources to acquire their own support staff functions. Historically, management has controlled the corporate purse. To address today's

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governance challenges the board organization must have its own recognized ability to pay for independent support systems:

Independent information systems. The board cannot rely entirely on the internal systems of the company. Duty of care requires that the board must have all reasonably available information from management and from independent sources. Under Sarbanes-Oxley, the audit committee is required to exercise this level of diligence and care; the entire board must do the same. Most now agree that compensation committees must hire their own consultant; but the board would also benefit from independent sources of information and advice to the board about strategy, financial analysis, business risk, competition, technology, and so forth. It will be expensive, but this independent source of insight must be available for the board to understand the business issues and make sound judgments on its own terms.

Staff support. The board must have its own staff, either internal or outsourced. Because the urgency and amount of work varies tremendously as a function of the challenges faced by companies and boards, most boards will develop a blend of both, but the staff must be able to carry out duties, responsibilities, and tasks independent from the conflicting priorities of management. A senior vice president of governance, as part of the management team, will not do.

Technical business competence. The irony of the independence movement is that many directors with the knowledge that might help shape strategy or tactics will be prevented from sitting on boards that are closely associated with their own business. The board must be technically competent in the core business issues and directors must understand the operating and financial dynamics, risk, and success drivers, and performance criteria of the specific business. Training and development for directors must go well beyond governance education. Education must be industry and company specific and it must provide viewpoints from external sources in addition to the views of the management organization.

Set strategy. Best practices documents always tell us that the board must participate in strategy setting for the corporation. Unfortunately, few boards are equipped to deal with these discussions. Most members do not have the direct, specific experience or knowledge to be able to make judgments on strategy for large corporate enterprises. There is only one way they can have an independent strategy perspective and that is to have independent counsel on strategy. The board must understand the issues and the choices that are available to the company, not simply the ones presented by management. Boards must know and understand the rationale for the strategy and must endorse it.

A board budget. The requirement for financial resources to support these needs suggests that the board must establish a budget. This is not just symbolism. Since we expect management to follow budgeting disciplines, so must the board. It is impossible for management to plan if it lacks a clear understanding of what the board will spend. The expenses of the board must be seen by management as the cost of doing business and protecting shareholders just as their organizational expenses are seen to be the cost of executing the strategy approved by the board. There must be some reasonable limit to these expenses, but the board must get over the "guilt" of increasing corporate expenses and recognize that it has substantial fiduciary duties to the shareholders and it must have the resources to carry out those duties.

Protecting Shareholder Value Demands Organization of the Board

Good governance cannot be done "on the cheap." Corporations must make certain that the board has independent access to all the resources that it prudently needs to exercise its duty to the shareholders. Had more boards taken this duty of directing more seriously and challenged management to explain and justify its actions, billions of dollars of lost shareholder value probably could have been saved. The new and high costs of compliance would have been avoided if directors had invested in the organization, expanding the resources required to fulfill their duty of care to shareholders. Following widespread governance failures, shareholders will have to endure both the costs of better governance and the costs of compliance. Only when boards are operating as effective governing organizations will corporations no longer need the high compliance costs. That will make the cost of an independent board organization a small price to pay. ■

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