THE
BOARD
MINDSET™

The vital attribute of exceptional boards

A CFO'S GUIDE TO CORPORATE GOVERNANCE

Corporate governance describes the set of protocols, processes, and procedures that controls the way a board operates. Governance underpins the board's ability to do all the aspects of its job. While strategy and succession planning address specific "What?" questions, governance deals with the "How?" questions. It includes, but is not limited to, decisions about the board's size, frequency of meetings, director selection, shareholder relations, and social responsibility. When a board has a governance committee, the members initiate action plans with specific timelines for implementation of recommendations, and they should have the authority to shape and recommend policy and structure. While CEOs and board chairs will always steer directors toward making pivotal decisions, to ensure maximum effectiveness, CFOs need to play a bigger role in the processes.

Why is Corporate Governance Important?

The primary responsibility of any board member involves giving advice that will drive the business. However, shareholders and stakeholders have started to expect *nonfinancial* measures of corporate value too, particularly related to enhancing the company's reputation in the industry. Therefore, corporate governance now involves overseeing the *intangibles* as well as the *tangibles*.

Further, with new government regulations, the definition of "governance" has evolved, becoming broader in its meaning to include both *internal* board operations and *external* stakeholder relations. The connection between corporate governance and corporate performance has never been more critical—or more complex. The presence of good governance practices can dramatically contribute to economic strength, and the absence of them will compromise it.

What Should the Governance Committee Do?

Although each director should assume responsibility for the overall governance of the board, every board should also create a formal governance committee that oversees the structure of the board, and an independent chair should head this committee. Once committee members have outlined the policies and procedures for the board, often in the form of a charter or by-laws, they need to address three ongoing concerns:

1. Choosing new directors for the board defines one of the most important responsibilities the governance committee will face. Therefore, the search for new directors should be ongoing, even when no vacancies exist. The committee will want to adjust the criteria for new directors based on the current and emerging strategic needs of the company.

2. The governance committee should evaluate itself and spearhead the overall board assessment process. Sometimes the committee will handle this evaluation process itself; at other times members will decide to hire an external consultant who specializes in evaluations and giving feedback.

3. The committee should orient new directors as soon as they accept their roles and provide continuing education for them and the entire board.

General Best Practices for Board Governance

In addition to assessing the general qualifications of each potential candidate, the governance committee will want to ensure that existing directors' skills and talents align with the organization's strategy and determine whether collectively directors offer the expertise to take the company into the future.

It all starts with mission and strategy. Why do we exist? What do our customers expect from us? What do we want to accomplish in the next 3-5 years? These questions will set the stage for the board to do its best work and to offer the highest caliber of guidance. The answers may also imply a need for one of the following:

- A turnaround expert
- An international expert
- Government procurement experience
- Manufacturing or industry-specific expertise
- Legal insight
- Public relations specialist
- Marketing support

Of course, the governance committee will want to write by-laws that explain director elections, their term of service, and their conditions for service. But that's just the start. Effective governance demands more. The CFO and governance committee should also evaluate the integrity, judgment, strategic thinking, performance standards, and financial literacy of each potential candidate. Obviously, evaluation of current and potential directors will be one of the most daunting, but most critical, of the committee's responsibilities.

The governance guidelines *must* also address the following for companies listed on the New York Stock Exchange:

- Director qualification standards
- Director responsibilities
- Director access to management
- Director compensation
- Director orientation and continuing education
- Management succession
- Annual performance evaluation of the board

Whether they work with a board of a privately-held or publicly-traded company, the real challenge for directors and executives isn't regulatory compliance—it's high performance.

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Best Practices for CFOs Related to Governance

As mentioned previously, one of the most overwhelming obligations of the governance committee involves making decisions about *who* has the expertise to guide the strategy. Once directors have established that, with the CFO's help, their responsibility will be to make sure those candidates have the financial knowledge to put the strategy into motion. Working with the nominating committee and chair of governance, CFOs will want to consider skills in these areas:

- Reading financial statements
- How to use the numbers to evaluate risk
- How to use the balance sheet to evaluate assets, liabilities, and shareholder investments
- How to use income statements to evaluate sales, operating costs, expenses, and earnings
- How best to use and protect cash
- How to assess company strengths and liabilities regarding profitability, asset management, liquidity, debt management, and market value
- Specific knowledge or experience related to tax, mergers and acquisitions, auditing, etc.

Once the CFO and the committee members have decided on the criteria they consider most critical, the next step is to submit their suggestions for board approval.

Another key CFO responsibility necessitates taking a lead role in setting and revising director compensation, which usually involves a mix of cash and equity awards—restricted stock, deferred stock, and stock options and helping decision-makers determine appropriate percentages of each. To align directors' interests with the long-term good of the company, director compensation should include long-term equity grants (not just options).

Helping Define Your Company's Future Success

We can help you formulate a strategy that works:

- Defines the choices a company is making about who is and who is not a customer
- Doesn't serve as a rationalization for budgets
- Challenges assumptions
- Seeks to reduce risk, not avoid it
- Serves as a framework in which adjustments are expected and can be accommodated

We advise on any unaddressed issues to help the board and the company move forward. If you have any questions about **The Board Mindset**, visit www.theboardmindset.com or contact us.

Play an Active Role in Evaluating the Audit Committee

Another form of general governance involves oversight of all committees but the CFO's knowledge and expertise will align most directly with the duties of the audit committee. Therefore, in addition to playing a role in the functioning of the audit committee, most CFOs could improve their governance roles by becoming more actively involved in evaluating both the directors on the audit committee and the committee itself. The following is a ten-part review for the audit committee.

Audit Committee Evaluations

On a scale from 1-10, with 10 representing top performance, rate the following:

1. The audit committee members have the right background and skills to provide effective input.
2. The committee's actions reflect independence from management.
3. The audit committee meeting packages are comprehensive and received well in advance of meetings.
4. Reports to the full board reflect significant recommendations, not just explanations of activities and meetings.
5. The audit committee sets clear expectations and provides feedback concerning the competency of the company's CFO and senior financial management.
6. Audit committee members give appropriate recommendations about the company's risk and internal controls.
7. The committee gives appropriate recommendations about the company's external financial reporting (including the annual report, quarterly filings, and press releases).
8. The committee takes direct responsibility for the appointment, compensation, and oversight of the work of the independent auditor.
9. The committee requires and tracks ongoing education for audit committee members.
10. The audit committee engages in yearly self-evaluations.

With 100 points available, score the committee.

Conclusion

The key to better board performance lies in the working relationships among directors and executives, in the dynamics of board interactions, and in the competence, integrity, and constructive involvement of individual members. Most people understand what boards should be: sources of challenge and inquiry that add value without meddling—champions of the organization that make CEOs and CFOs more effective but not all-powerful.

The high-performance board is competent, coordinated, cohesive, and focused. Such entities do not simply evolve, however; an exacting blueprint of corporate governance must guide their construction. CFOs have both the opportunity and the obligation to act as the architect of the blueprint and the foreman of the construction. They must oversee anything that touches finance, which touches everything either directly or indirectly. Therein lies stellar performance and corporate governance.

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