NOTES FROM COUNSEL

Investing in a corporate governance audit

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Ten questions CEOs should be sure every board member can answer.

Andrew Jack's article on corporate governance audits suggests an objective test of board effectiveness and outlines the steps of a corporate governance audit aimed at making your board more effective.

Today's business headlines increasingly herald mistakes and/or misconduct by public companies of all sizes. Whistleblower statutes, stepped-up government enforcement, nightly television news magazines, issue-focused activists, talk radio and, yes, the internet all contribute to a business landscape that demands increasing diligence to avoid events that can devastate a public company's image, management reputation and share price. Avoiding such events is even more difficult in today's environment of demanding institutional shareholders, increasing global competition, rapid technological advancement and, in many industries, significant changes in government regulation.

Wanted: A board with "systematic curiosity"

The CEO and senior management must shoulder primary responsibility for navigating a company through this landscape. However, the management team rarely will succeed without the support of an appropriately active board of directors. An active board should engage in what might be called *systematic curiosity*—a combination of board procedures, ethics and expertise that fosters a comprehensive and constructive dialog with management in order to chart the company's strategic course and avoid potential impediments to corporate progress.

A board that can best perform its role will be comprised of individuals with diverse talents and experience. "Systematic curiosity" will leverage the unique skills of each director and help educate the entire board and senior management regarding many diverse subjects.

Does your board pass the test?

The following ten questions should be answerable by any director serving on a board practicing "systematic curiosity" or by any general counsel or corporate secretary advising such a board. CEOs, directors or board advisors who cannot answer at least nine of these questions (and their companies) may benefit from a corporate governance audit.

1. What is the Black-Scholes multiple for your company? How is it determined, how is it used, and how can you be misled by it?

2. How are your company's data networks protected against tampering or theft (either from outside or from within)? How would the company know if data security had been breached? Would discovery be timely enough to permit corrective measures?

3. Who are the stock analysts that follow your company? What are the current "street estimates" and "whisper estimates"? What policies govern CEO/CFO/investor relations officer discussions with stock analysts? How is compliance with these policies monitored?

4. What are the off-hours hobbies and habits of your company's CEO? Is the CEO's lifestyle one that might diminish the CEO's capacity or lead to conflicts between the CEO and the company?

5. What non-audit services does your company receive from its independent auditing firm? How significant are non-audit billings compared to audit billings? If the auditing firm provides substantial tax planning advice, is there any independent review of the financial statement effects of these tax planning strategies?

6. What risks do your company's liability insurance policies cover and not cover? Who are the insurers and what insolvency risks do they face? Are your company's insurance premiums fairly priced?

New Feature

"Notes from Counsel" is a new feature intended to alert our readers to legal matters of special interest to the senior managers of publicly held companies. Drawing on the expertise of the Association's general counsel, Covington & Burling, "Notes" will be a regular feature. Please give us your thoughts and comments.

7. Does your company have adequate “takeover defenses” that would maximize the board’s ability to respond appropriately to an unsolicited purchase offer?

8. What are the three most significant risks facing your company? What is management doing to mitigate these risks? Would management and the board give the same answer to this question?

9. Is management well prepared to handle an unexpected crisis (e.g., product tampering, toxic chemical leak, natural disaster, terrorism or violent criminal act)? Who will be the primary media spokesperson?

10. What are the major goals your company plans to achieve in the next one, two and five years? What is the board’s role in setting or adjusting these goals? What were the major goals one, two and five years ago? Were they achieved? If not, why not?

If the CEO, directors or board advisors of a company cannot satisfactorily answer these questions, then that company should consider investing in a corporate governance audit.

Benefits of a corporate governance audit

A well conducted corporate governance audit (drawing on the analogy of preventative medicine) combines the benefits of an annual medical checkup, healthy diet and regular exercise program. Such an audit identifies problems at an early treatable stage, before irreparable harm befalls a company. It also helps ensure that a board receives the essential vitamins and nutrients—information—needed to make critical business decisions, without ingesting excess calories and fat—extraneous information—that can diminish decision-making efficiency. And it establishes a regimen that both maintains a board’s fitness and challenges a board to continuously improve.

A good audit should not be costly or intrusive. One or two governance experts, usually corporate lawyers, will begin by reviewing company documents, including articles of incorporation, bylaws, SEC filings, annual director and officer questionaires, board and committee minutes, committee charters, auditor’s reports, management letters, marketing materials and major company policy statements. The focus here will be to gain an understanding of the company’s business and strategy, to briefly assess structural “takeover defenses,” to evaluate the breadth and quality of written policies and procedures and to review documents (particularly compliance policies, minute books and SEC filings) from an evidentiary and liability perspective.

Investing in a corporate governance audit arms a board with a valuable tool to maximize its contribution to corporate success.

Next, the auditor or audit team should observe a shareholders meeting, two or three board meetings and at least one meeting of each board committee. This “fly on the wall” approach permits the governance expert to evaluate written materials and other information conveyed to the board, assess the group dynamics and culture of the board, and gauge the quality of board deliberations and meeting minutes. If social functions are scheduled around board meeting dates the governance expert should attend these events as well. These informal settings provide valuable insights into the board’s group dynamics and offer opportunities for directors to become better acquainted and more comfortable with an outside observer.

Another aspect of the governance audit will be a board self-evaluation. Over the last few years a significant, but still minority, percentage of public companies has implemented some form of board self-evaluation. One result of this trend is the existence of many different evaluation forms and processes. A governance expert retained by a company can sift the myriad evaluation types and, after attending one or two board meetings, help tailor an evaluation form and process that will best suit the client company’s needs. In virtually all cases, the evaluation will entail some form of questionaire that will request each director to rate the quality of different aspects of board effectiveness (e.g. information flow, management succession planning, strategic planning, crisis management, business ethics and so forth). It also may entail interviews with each director to expand upon or clarify responses to the questionaire. Additional questions may be posed to the CEO regarding his or her assessment of various aspects of the management/board relationship. Other company executives who regularly interact with the board also may be consulted.

After compiling the evaluation results and completing other aspects of the governance audit, the audit team will discuss its findings with the board. If well led, the discussion should elicit suggested modifications or enhancements to board practices and procedures that are appropriately tailored to the business and culture of the company. The board may then draw from this “suggestion box” to establish specific improvement goals and over time monitor its own progress toward attaining each goal. Having been guided through this process once by an outside expert, the board should then be able periodically to reexamine its governance practices with a more studied eye.

Making the investment

Effective corporate governance cannot completely immunize a company from every possible event that could damage a company’s business, share price or public image. Bad things do happen to good people. However, effective and continuously improving corporate governance can ward off many such events and mitigate the damage when they do occur. Investing in a corporate governance audit arms a board with a valuable tool to maximize its contribution to corporate success. This is an investment that every public company should seriously consider.