A CFO's Guide to Corporate Governance

By

Linda D. Henman, Ph.D.

Few people can define "governance" in concrete terms, yet it remains one of those all-encompassing words that people use frequently. The dictionary defines governance as supremacy, domination, power, or authority. When used for corporations, it usually means general board oversight.

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?" 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 should have the authority to shape and recommend policy and structure. I use this definition:

Corporate governance describes the set of protocols, processes, and procedures that controls the way a board operates.

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 too—or more complex. Therefore, the presence of good governance practices can dramatically contribute to economic strength, and the absence of them will compromise it.

Because the increased workload of boards forces the delegation of many responsibilities to committees and individuals, the CFO now has more opportunity and obligation to play a stronger role in both setting and overseeing processes and procedures. Also, shareholders now want more voice in the selection of directors. Therefore, they will need dispassionate information

about potential directors in order to make better-informed decisions. The CFO can provide those data.

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 will 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. Sometimes a director will leave unexpectedly; at other times a person's tenure on the board will expire. In either case, having identified potential members in advance will reduce the time it will take to find replacements and get them up to speed. 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 you need to add 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 following address some of the other duties of the governance committee:

- Decide about CEO continuation on the board after retirement
- Decide about CEO and senior officer membership on other boards
- Address director conflicts of interest
- Establish policies about director attendance
- Articulate expectations about director conduct / ethics
- Set protocols for director stock ownership
- Educate yourself and the directors about changes to compliance regulations, tax, etc.
- Review the directors' and officers' (D & O) insurance policy to make sure the protection is adequate, both for the board and the individual directors

The governance guidelines *must* also address the following for companies listed on the NYSE:

- 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 you 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. To achieve it, directors and executives need to systematically examine the five constructs of a successful, stellar board and to understand the role governance plays in ensuring top performance.

Leadership

Too often directors assume the role of sponges who simply absorb that which you put in front of them. As the CFO, part of your leadership duties requires you to prepare financial questions that will stimulate dialogue. If the data remain in the heads of the directors, what good is it? You need to guide the process of making the implicit explicit—of making knowledge pragmatic advice.

Rapport with the CEO

Board success starts with the relationships between the directors and the CEO. You can do two things to foster these relationships. First, prepare the CEO for the financial part of the meeting. Second, formulate questions for the CEO to ask the board. The CEO should regularly disagree with the board, and robust debate should occur, but never at the expense of good rapport. Embrace tension, not conflict.

Focus on Strategy

Stellar boards don't formulate strategy, but they maintain a clear focus on it, and they assess and critique it. CFOs face the challenge of making sure directors have all the necessary financial information to do their job.

Succession Planning

Keep the board apprised of who's on your bench, who's facing retirement, who might leave. Let them know your long-range plans for retirement, short-term replacement, and eventual successor. They will be a good source of referrals and recommendations.

Governance

Create policies and procedures that make sense for you and your board. Above all, put issues on the table. Find out what your directors expect. Only then will you be able to address the specific best practices of the CFO.

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 you have established that, your 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, develop criteria for evaluating those skills. You'll want to consider some of these:

- 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 asses 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 you and the committee members have decided on the criteria you consider most critical, the next step is to submit your suggestions for board approval. You will then want to

evaluate current and future directors to determine whether they meet the criteria. Note which areas could use improvement or reinforcement.

Probably the fastest and easiest way to evaluate directors is to develop a behavioral interview question for each of the criteria you've identified. For example, you might ask, "Tell me about a time you …." Of course, this method involves a great deal of subjectivity, but usually responses will indicate both whether potential candidates have ever had experience in a certain arena and whether you consider their actions advisable.

Or, you can use scenario questions. This interviewing format involves you creating a situation and asking their opinions: "If you were to see the numbers on this income statement and needed to make a decision about X, what would you recommend?" When possible, use exact reporting formats with made up numbers to see how quickly candidates can learn to extrapolate meaning from numbers.

Once you have completed this step, work with the CEO and chair to summarize strengths and weaknesses of both current and future directors. Try to use all available data to draw your conclusions. Consider interview results, experience with the person, and observation.

Then, using the following matrix, identify the criteria you consider important on the left side of the table, and then rate each person on a scale 1-10, with one indicating low expertise or experience and ten indicating advanced proficiency. This matrix does two things. First, it shows clearly where the company needs help, and second, it forces a ranking of directors.

	Jones	**Smith**	**Davis**	**Total**
Ability to read financial statements	4	9	5	18
Skills for evaluating risk	8	7	7	22
Knowledge of tax	2	3	1	6
Experience with acquisitions	1	10	9	20
Individual Totals	15	29	22	

Once you've completed these steps, report findings and recommendations to board. Note areas of current board deficiencies when considering potential board members.

Another key to good governance lies in better leveraging your directors' contributions. Therefore, encourage directors to communicate regularly about their experience and expertise. You should know how to pull this from the directors when you need it, but if you have never formally gathered this kind of information in the first place, it won't exist in a time of emergency or decision-making. Constantly evaluate whether the directors' skills, talents, and experience support the current strategy.

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. Help 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). As you look at the total compensation package, I recommend you implement policies that directors remain independent—they should receive no pay as consultants.

Play an Active Role in Evaluating the Audit Committee

Another form of general governance involves oversight of all committees but as the CFO, your 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. You can substitute other statements that reflect the challenges and issues of your organization, but this offers a general look at the audit committee's function.

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.

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, like the high-performance team, 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.