THE WHOLE PERSON PROJECT
WHERE GOALS ARE ESTABLISHED AND ACHIEVED

PROVIDES REALISTIC OPPORTUNITIES FOR INCREASED TOTAL SALES

April 28, 2003

ACHIEVING EFFECTIVE BOARD PERFORMANCE

By Ann M. Butera, CRP, the President of The Whole Person Project, Inc.

One of the Committee of Sponsoring Organization's (COSO) major contributions was to underscore the importance and impact of the control environment on business operations and risk management practices. The control environment, which was described as the "tone at the top", emanates from the Board of Directors and the Executive Committee and permeates the entire organization.

THE STAKES ARE HIGHER

Clearly, the Board's role is powerful. Its ability or inability to act can literally make or break a company's strategic performance. In the aftermath of Enron and Worldcom, a fact that has not gone unnoticed by directors is the increased liability. A 2002 McKinsey study of 200 directors serving on 500 boards indicates that:

- 84% of directors said the risk of being held personally liable as a director was very much or somewhat higher and 82% believed this threat had increased somewhat or very in the past year.

- Directors rate 45% of their colleagues as average to low performers, and state that as for themselves, they are willing to be evaluated. 20% consider any third party evaluation completely inappropriate.

- Many companies have seen their D&O insurance soar 300-700% in the past year and the number of insurance carriers has decreased.

It seems that those in boardrooms as well as executive offices are feeling the effects of poor past governance and the impact of Sarbox, causing the comfort zone to narrow on a daily basis. Essentially, Sarbox mandates what ethics should have demanded from effective corporate governance.

MORE THAN A GOVERNANCE COMMITTEE IS NEEDED

As energy and effort is focused on documenting disclosure controls, there are other aspects of Sarbanes Oxley that require attention. These changes include requiring all members of the audit committee to be independent. To be independent, the director may not accept any consulting, advisory, or other compensatory fee from the company (excluding directors' fees), or be an "affiliated person" of the company or any of its subsidiaries. An affiliated person is defined as any officer or employee and any other person who owns 5% or more of the voting securities of the company or any of its subsidiaries. In January, the SEC proposed a rule that would delist companies that do not have outside directors sitting on their board.

Audit committees are now required to establish procedures for hearing complaints about internal auditing, accounting practices, internal accounting controls and reporting, and conduct executive sessions with auditors without management present. For some organizations, this means a major change. For others, Sarbox merely mandates what has already been a standard operating procedure.

Sarbox also tasks the audit committee with direct responsibility for selection, retention, compensation, and oversight of external auditors, and requires audit committee to pre-approve audit and non-audit services. To perform these responsibilities, audit committees will need to have and manage a budget of their own.

Sarbox mandates the disclosure of audit committee members' financial expertise. A "financial expert" would have professional financial or accounting experience, an understanding of generally accepted accounting principles (GAAP) and financial statements, experience in the preparation or auditing of financial statements, and experience with internal accounting controls.

Simply put, creating a governance committee is not enough.

THE HALLMARKS OF EFFECTIVE BOARDS

Effectiveness is doing the right thing, the first time, every time. In order to be effective, the Board requires a clear charter and goals, as well as a method for evaluating progress against these targets.

Typically, board members know why they were individually selected to serve and they understand the value of their specialty. However, the goal should be to harness the mental diversity of the entire Board, ensuring that all members feel comfortable contributing, *even when the subject is not in their specialty area*.

At some board meetings, you can predict a director's background based on when this person contributes. If this person is silent until technology becomes the topic of discussion, one can safely assume that the director has a background in IT. Similarly, those with finance backgrounds come alive when investments or asset liability management are the topic of discussion. While no one wants to listen to uninformed contributions, the solution is not to allow board members to remain entrenched in their areas of expertise. Board effectiveness depends on finding ways to share the various perspectives, thereby raising the bar for collective board performance.

ACTIONS TO TAKE TO PROMOTE INCREASED BOARD EFFECTIVENESS

1. <u>Set the right tone by personally embracing change</u>. Abandon the "if it's not broken, don't fix it" mentality. With the passage of Sarbox, and the latest SAS and SEC rulings, now is not the time for complacency. Increasingly, boards are relying on their internal audit departments for advice and help. Now is the perfect time to solidify audit's role as a risk management organizational change driver. If the changing role of the audit committee has not yet made its way onto a meeting agenda, bring up the subject with your audit committee chair. Get the discussion started because awareness always precedes action.

2. <u>Start with what you can affect in your role as an auditor: the audit committee's effectiveness</u>. Make sure that you have an effective, open working relationship with your audit committee chair. Ensure that your audit committee has a clear sense of purpose and that your internal audit department has a charter describing its scope and purpose. Since it is often easier to edit than it is to write, base your department's charter on ones that other departments are using. Similarly, provide your audit committee with examples of charters that other audit committees are using. Simply discussing the contents of other charters stimulates thinking and foments change.

3. <u>Encourage the audit committee to benchmark itself against other effective boards and perform a gap analysis to identify the areas that warrant change and transformation</u>. The benchmarking process will help the committee members to acquire ideas for increased effectiveness. Once the gap analysis is complete, the committee can prioritize the actions it needs to take and then formulate implementation plans.

4. Accept that organizational change of this nature will require 18-24 months to initiate. Right-sizing the audit committee and ensuring that the appropriate people fill the director positions is not something that occurs rapidly. During this process, which admittedly can be painful, minimize the personal aspects associated with the changes by suggesting that audit committee selection criteria be developed and written to support the company's strategic plans. By using the company's strategic plans as the context for defining the profiles and competencies of the new directors, you create opportunities for the outgoing directors to preserve their self-esteem.

5. Develop a method to orient your audit committee and provide on-going training. Pre-empt objections that directors are too busy or too experienced for training by positioning board training as a development opportunity. Make sure that all directors know how to ask for and get the information they need for decision-making. Use executive coaches and external facilitators, as needed, to provide your directors with support. At a minimum, make sure that your board members receive guidance concerning:

   - The roles and responsibilities as directors
   - How governance differs from operational management
   - Strategic Planning and strategic performance management
   - How to read and analyze financial statements, with emphasis on the warning signs of financial trouble
   - The fundamentals of asset and liability management
   - The essentials of risk management
   - The key business drivers, products, services, and distribution channels
   - Security and IT
   - Key Performance Indicators

6. Assist the audit committee chair in ensuring that time is set aside each year to assess the audit committee's performance. How effectively is the committee able to:

   - Understand and approve the company's long-term, central strategies
   - Understand the issues, forces, and risks that define and drive the company's business
   - Oversee and manage the company's audit function

One final thought: I can recall thinking twenty years ago that a most dangerous situation exists when the general auditor and the audit committee chair are both inexperienced. Each would depend on the other to lead and the consequences would be dire for the organization. This situation would be the antithesis of the desired state in which the Board functions effectively as a strategic business partner to the CEO. The risk is still real and the time to act is now. Let me know how you fare as you use these approaches to increase your board's effectiveness.

Ann M. Butera is President of The Whole Person Project, Inc., an organizational development consulting firm, which specializes in developing audit methodologies and teaching ways to audit for greater results. She serves on an audit committee for a financial services firm. When she is not working with internal auditors, she can be found assisting managers in control self-assessments and Enterprise Risk Management initiatives. If you have specific questions or comments, please call Ann Butera at The Whole Person Project, Inc. (516) 354-3551 or e-mail her at AnnButera@cs.com.