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The current rage of assessing the effectiveness of corporate boards of directors using a number of criteria that focus on structural and compliance checklists will not by itself prove to be the Holy Grail when it comes to measuring board performance. To be sure director independence is important. The state of incorporation, the existence of poison pills, and whether or not stock options are expensed may have some bearing as well.

As has been proven in the recent past, dream team boards are not necessarily great boards or even good boards. Receiving a grade of 100 from Institutional Shareholder Services will not provide absolute assurance that a particular board is a good board or that it is functioning effectively in looking after the best interest of its shareholders.

The real indicia of board effectiveness and performance are those factors that are subjective in nature. Ultimately, the quality of corporate governance at a particular corporation can only be measured after the fact by evaluating: the actions taken and decisions made by its board; the willingness of its board to “do what is right regardless of the pressures”; the ability of its board members to dig a little deeper to gain a full understanding of the issues irrespective of time pressures; the ability of its board to challenge and say no without creating chaos and anarchy in the boardroom; and in the end, the quality of decisions made.

As a society, we have become accustomed to looking to a set of rules to follow when making decisions or judgments about a particular issue, yet it is how the board conducts its affairs throughout the course of its existence that really matters.

Assessing and evaluating expected board performance is best accomplished by looking to recent board actions, to the extent that they become public knowledge, and evaluating those decisions in the context of accepted good governance stan-

dards. For example, the approval of egregiously excessive executive compensation is certainly an indicator of the failure of a board to provide effective governance on behalf of the corporation’s shareholders. Approving the resetting of stock option prices to accommodate a management team that has failed to perform is another indicator that the board is not acting in the best interests of shareholders.

The work of the committee that is responsible for selecting new board members can be assessed in similar fashion by evaluating the quality of the nominees to the board. The fact that all of the members of the nominating committee are independent has little to do with the quality of their work product.

There are other areas of board functioning that unfortunately are much more difficult to assess. For example, how can we know the level of trust among board members or the quality of their debate on critical issues? Will we ever know of the hidden agendas that may exist at board meetings, or the actual level of preparedness of individual board members, or for that matter, the level of understanding of the business that they possess?

When it comes to audit committees, there are a number of objective criteria that are considered in the rating process. These include director independence, the size of audit fees and their approval, whether the audit firm meets the tests for independence, and auditor rotation policies. None of these factors have any bearing on whether the audit committee members understand the internal controls of the company, if they have thoroughly reviewed the company’s liquidity and cash flows, whether they understand the application of critical accounting policies, or even if they know the trend of the company’s order backlog.

The objective cookbook approach alone will not provide us with a

Your Voice Viewpoint: The Missing Element in Corporate Governance Ratings

By **Diedrich Von Soosten**

meaningful rating of the expected performance of a board of directors. The codification of generally accepted accounting principals (GAAP) led to loophole accounting practices. The attempt to provide a corporate governance scorecard by measuring compliance with objective criteria will inevitably lead to attempts by some corporations to game the system in order to improve their corporate governance score. Notwithstanding the fact that corporate governance ratings are more form than substance, corporations will take the necessary steps to maximize their corporate governance scores. The investment community and the class action bar will certainly punish those that do not.

Subjective criteria are a terribly important measure in considering how a board will perform. Until these criteria are also considered in the rating process, corporate governance scorecards should be viewed with caution.

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