

# SMOCK ♦ STERLING

## *Strategic Management Consultants*

### THE CORPORATE BOARD IN 2005

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Corporate governance has been a topic of recent focus by the business press and management experts – both as a result of some highly visible and publicized board of director fiascos and the emerging recognition that board effectiveness is directly related to company performance. Smock♦Sterling Strategic Management Consultants has seen boards and directors become more directly involved in the development, implementation, and evaluation of strategy. In assisting our clients in strategic management and related areas, we find we are interacting more with directors on strategic issues, not just top management. Further, recognizing a need, at the board level, for the type of specialized counsel we have historically provided management, we have formally established management counsel and defined professional services to boards of directors as a distinct practice focus.

This monograph presents our view of the present state of the corporate board and the trends that will affect the behavior, foci, and makeup of corporate boards in the year 2005.

#### **THE PRESENT STATE OF CORPORATE GOVERNANCE**

Corporate boards of directors are evolving to more questioning, decisive, and positively influencing governance bodies, a trend predicted by a small, but vocal, group of governance experts for years.

- There is a growing, widespread belief that an effective board can contribute to continuing, solid performance by a company, although there is not yet irrefutable evidence on that score. But, respected studies are beginning to support that assertion. For example, a recent McKinsey study reported that portfolio managers were willing to pay a 20% stock price premium for a company that has acknowledged “*good governance*” and an “*effective board.*”
- Recent examples of boards of directors’ ineptitude (e.g. - Morrison-Knudsen and Quaker) have received broad media coverage. While some have called the subsequent changes “*improved governance by embarrassment,*” it appears that many of these improvements have come about as a result of conscious initiation by savvy boards and managements.
- Boards of directors are operating more and more under some generally agreed principles of behavior or “*best practices.*” The National Association of Corporate Directors (NACD), Business Week, and corporate governance experts agree that the best boards:
  - Evaluate performance of the CEO annually in meetings of independent directors
  - Link their CEO’s pay to specific performance goals
  - Review and approve long-range strategy and one-year operating plans
  - Regularly assess the performance of the board and individual directors
  - Pay fees to directors in company stock and require directors to own significant amounts of company stock
  - Have no more than two or three inside directors

- Place limits on the number of other boards on which its directors can serve
- Ensure that the audit, compensation, and nominating committees are composed entirely of independent directors
- Ban interlocking directorships, the “*I’m on your board, you’re on mine*” syndrome.
- Boards are experimenting with ways to improve governance effectiveness. They are introducing more formal CEO evaluation and board of director self-evaluation processes, establishing and using strategic planning committees, continuing the trend to outside directors, using stock as director compensation and stock options to reward director impact on company performance, and dealing much better with the issue of CEO and management succession.
- Boards are being used more effectively by CEOs and management as an advisory resource. CEOs are becoming not only comfortable, but anxious, to bring questions to their boards.
- The “*all CEO board*” is heading for extinction. NACD’s Corporate Governance Survey reported that a solid majority of companies responding (61%) had less than a majority of present and former CEOs on their boards.
- Probably the greatest recent improvements have taken place among privately held companies. Many of the trends seen among publicly-held company boards are also occurring in private company boardrooms.

But, there are still a number of significant opportunities for improvement in the boardroom.

- Boards will often succeed in the compliance areas, but fail in the more important areas where the experience and competence of the board members add real value to the company (such as CEO evaluation; input to strategic decisions; and providing experienced, objective advice).
- Boards are doing a better job of appointing people with the experience and qualifications to be “*good directors.*” But, as shown with the Waste Management Board, individual good directors can often be ineffective as a group and fail to protect their shareholders’ investments.
- Board members are often picked for the wrong reasons and boards of directors can be poorly constructed. For instance, it was reported that no IBM director, at the time of critical policy decisions a few years ago, even owned a personal computer. In private companies, family members consider board appointment their birthright and usually add very little to the board.
- Celebrity boards still exist, more often than not in financial institutions. Beverly Sills (albeit quite a talented person) recently sitting on the American Express Board is a prime example.
- While much has been said about there being less and less CEOs’ “*cronies*” on boards, the practice still exists - the interlocking relationships that exist on the Nation’s Bank Board and its very obvious lack of independence is a prime example.
- The power of the CEO can and often does overwhelm boards. For instance, Disney’s Board has, as a full member, the director of Michael Eisner’s childrens’ Montessori School. How can anyone think this individual would ever disagree with Mr. Eisner, even on minor details?
- Business Week articles on executive pay have described examples where boards have committed to not only gargantuan present compensation (for relatively minimal performance), but for hundreds of millions of dollars in future payments (e.g. - Michael Eisner has \$364 million in non-exercised stock options in his pocket). We believe that these irrational compensation packages are skating on thin public policy ice and are giving Congress an opportunity to demagogue the issue, probably in and around both the 1998 and 2000 elections.

## **FUTURE TRENDS AND CHANGES - THE BOARD IN 2005**

Although abuses still exist and the recent flap on executive pay may bring Congress and the regulators more directly into boardrooms, the overall trends are very positive. By the year 2005, we predict that the following things will have occurred or will be occurring among public and private company boards.

- There will be broader recognition - both among boards of directors and the business press - of the boards' direct responsibility to direct and manage the company. It is incorrectly assumed that this responsibility lies with management - it does not, if management has that responsibility, it can only have been delegated to it by the board. The Delaware statutes state that "*the business and affairs of every corporation...shall be managed by or under the direction of a board of directors.*"
- Boards will be more firmly focused on adding value to their companies, rather than just merely complying with the legal requirements of boards of directors. This will include conducting strategy reviews, evaluating overall company effectiveness, evaluating the CEO's effectiveness, reviewing and approving specific succession plans, deliberating and providing input to major strategic decisions, and providing sage counsel to the CEO and other key managers.
- While many of the improvements called for by those who promote good governance will be implemented, the resulting boards will not necessarily look alike - one size will not fit all.
- Director compensation will rise and it will continue to adjust from primarily cash (although stock compensation is rapidly overtaking cash) to primarily equity.
  - Boards will be partially or totally paid in stock or, for private companies, paid in a class of stock unrelated to ownership rights.
  - The reward structures for board members will be set so that long term shareholder value increases are rewarded. Stock options for board members will increase and board members will be encouraged to accumulate major stock holdings.
  - The golden handcuffs, such as pension and benefit programs for directors, that are believed to directly compromise director independence, will be eliminated.
- There will be little difference between the foci of public and private boards, because the way they add value to a company - using the experience and expertise of board members - is essentially the same, regardless of ownership structure.
- There will be firm proof that the better the board does its job of adding value, the better the company will perform. The reverse will be evident - ineffective boards will have a negative impact on the stock price and shareholder value.
- The relationships between CEOs and their boards will evolve to more of a productive partnership. As boards become stronger, fewer powerful CEOs will be able to neuter their boards, as F. Ross Johnson did at RJR Nabisco and Anthony O'Reilly has done at Heinz.
- There will be higher CEO turnover. In fact, if CEOs continue to receive their current high level of compensation, their job security will be considerably more at risk. Performance hurdles will be raised, so that CEOs cannot become very rich based on mediocre performance.
- Boards will be considerably more active in decision-making and, or perhaps more importantly, in actively seeking information. They will be more visible within the company - with management and with shareholder groups.

- Boards will be more thoughtfully designed, so that directors will have complementary skills and strengths. Board recruiting will become much more strategic - looking for the right person, rather than just an available, high profile CEO.
- Diversity will remain important and become even more so. But, today's narrow "*politically correct*" definition of diversity (i.e. – solely focused on race and gender) will expand to a broader sense of diversity that reflects and affects a company's business.
- There will be major changes in the structure of boards and directors. Most executive committees will be abolished. Committees will do the "*work*" of the board now done by specific committees and the full board will focus on issue deliberation. There will not be two classes of board members - the executive committees and others - but only one class in which all board members are equal. The average size of boards will stay at about twelve members, but may be reduced slightly below that. Boards will evaluate their own performance and, importantly, the performance of individual directors (and directors will be "*fired*" for lack of performance).
- Boards will be provided more and better information. The current trend to a "*balanced scorecard*" of information reporting will continue and it will be designed to more relevant information to boards of directors. Additionally, the financial and operational information will be structured to measure and compare shareholder value improvement (or lack of improvement).
- Board members will be on fewer boards, as the time required for each director will go up. Boards will limit the number of boards that their own CEO can sit on and there will be a maximum set for board membership of individual directors, with two becoming the norm. Many board seats will be open and the better boards will go further down into organizations to find competent directors with needed skills.
- Boards will be rated. This has begun to happen with the Business Week's ratings and TIAA-CREF's continuing rating of the governance of the 1,500 companies in which it invests. As with Campbell's Soup, the really effective boards will be visibly celebrated and emulated (e.g. – the Chairman of Campbell's was honored as the NACD Director of the Year).
- In all likelihood, government will step in some way to deal with the executive pay issue (although their latest attempt with the \$1 million threshold backfired). This could have an impact by making boards more compliance-oriented and by taking their attention and time away from value-adding activities.

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