Evaluating the Board of Directors

By Troy Segal Updated Mar 27, 2020

You can learn a lot from looking at the disclosures made about a company's board of directors in its annual report, but it takes time and knowledge to pick up clues on the level of quality of a company's governance as reflected in its board's composition and responsibilities.

In theory, the board is responsible to the shareholders and is supposed to govern a company's management. But in many instances, the board has become a servant of the chief executive officer (CEO), who is typically also the chair of the board.

The role of the board of directors has increasingly come under scrutiny in light of corporate scandals such as those at Enron, WorldCom, and HealthSouth, in which the directors failed to act in investors' best interests. Although the Sarbanes-Oxley Act of 2002 made corporations more accountable, investors should still pay attention to what a corporation's board of directors is up to. Here we'll show you what the board of directors can tell you about how a company is being run.

Key Takeaways

- Look at the size of the board and whether it has enough members to function properly, including keeping conflicts of interest at bay, or whether it's too cumbersome and therefore less effective.
- See if the board includes independent outsiders—experienced business leaders who have no direct connection to the company, such as a retired former employee or a relative of a current executive.
- Consider the structure and effectiveness of the four most critical board committees—executive, audit, compensation and nominating.
- Understand what time constraints and other responsibilities board members have beyond the board and determine if there are inherent issues as a result of these other commitments.
- Finally, look at any transactions between the company, and the executives and directors, and see if anything raises any red flags by suggesting a conflict of interest or other problems.

The Checklist

According to a 2003 *Wall Street Journal* article, a checklist was developed by the Corporate Library to help investors evaluate the objectivity and effectiveness of a corporate board. According to this checklist, investors should examine:

1. Size of the Board

There is no universal agreement on the optimum size of a board of directors. A large number of members represents a challenge in terms of using them effectively and/or having any meaningful

individual participation. According to the Corporate Library's study, the average board size is 9.2 members, and most boards range from 3 to 31 members. Some analysts think the ideal size is seven.

In addition, two critical board committees must be made up of independent members:

- The compensation committee
- The audit committee

The minimum number for each committee is three. This means that a minimum of six board members is needed so that no one is on more than one committee. Having members doing double duty may compromise the important wall between audit and compensation, which helps avoid any conflicts of interest. Members serving on several other boards may not devote adequate time to their responsibilities.

The seventh member is the chairperson of the board. It's the responsibility of the chairperson to make sure the board is functioning properly, and the CEO is fulfilling his or her duty and following the directives of the board. A conflict of interest is created if the CEO is also the chairperson of the board.

To staff any additional committees, such as nominating or governance, additional people may be necessary. However, having more than nine members may make the board too big to function effectively.

Understanding the structure of a company's board of directors can provide a better understanding of the company overall, its strengths and weaknesses, and how it's run.

2. The Degree of Independence: Insiders and Outsiders

A key attribute of an effective board is that it is comprised of a majority of independent outsiders. While not necessarily true, a board with a majority of insiders is often viewed as being stacked with sycophants, especially in cases where the CEO also chairs of the board.

An outsider is someone who has never worked at the company, is not related to any of the key employees and has never worked for a major supplier, customer or service provider of the firm, such as lawyers, accountants, consultants, investment bankers, etc. While this definition of independent outsiders is clear, you'd be surprised at the number of times it is misapplied. Too often, the "outsider" label is given to the retired CEO or a relative when that person is an insider with conflicts of interest.

The *Wall Street Journal* article found that independent outside directors made up 66% of all boards and 72% of Standard & Poor's (S&P) boards. The larger the number of outside board members, the better. This makes the board more independent and allows it to provide a higher level of corporate governance to shareholders, particularly if the position of chair of the board is separated from the CEO and is held by an outsider.

3. Committees

There are four important board committees: executive, audit, compensation, and nominating. There may be more committees depending on corporate philosophy, which is determined by an ethics committee and special circumstances relating to a particular company's line of business. Let's take a closer look at the four main committees:

- *The Executive Committee* is made up of a small number of board members that are readily accessible and easily convened, to decide on matters subject to board consideration that must be decided on expeditiously, such as a quarterly meeting. Executive committee proceedings are always reported to and reviewed by the full board. Just as with the full board, investors should prefer that independent directors make up the majority of an executive committee.
- *The Audit Committee* works with the auditors to make sure that the books are correct and that there are no conflicts of interest between the auditors and the other consulting firms employed by the company. Ideally, the chair of the audit committee is a Certified Public Accountant (CPA). Often, a CPA is not on the audit committee, let alone on the board. The New York Stock Exchange (NYSE) requires that the audit committee include a financial expert, but this qualification is typically met by a retired banker, even though that person's ability to catch fraud may be questionable. The audit committee should meet at least four times a year in order to review the most recent audit. An additional meeting should be held if other issues need to be addressed.
- *The Compensation Committee* is responsible for setting the pay of top executives. It seems evident that the CEO or other people with conflicts of interest should not be on this committee, but you'd be surprised at the number of companies that allow just that. It is important to check if the members of the compensation board are also on the compensation committees of other firms because of the potential conflict of interest. The compensation committee should meet at least twice a year. Having only one meeting may be a sign that the committee meets to approve a pay package that was created by the CEO or a consultant without much debate.
- *The Nominating Committee* is responsible for nominating people to the board. The nomination process should aim to bring on people with independence and a skill set currently lacking on the board.

4. Other Commitments and Time Constraints

The number of boards and committees a board member is on is a key consideration when judging the effectiveness of a member.

The following chart from the survey shows the time commitments of board members of the 1,700 largest U.S. public companies, according to the study's 2003 data. This indicates that the majority of board members sit on no more than three boards. What this data does not specify is the number of committees to which these people belong.

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You'll often find that independent board members serve on both the audit and compensation committees and are also on three or more other boards. You have to wonder how much time a board member can devote to a company's business if the person is on multiple boards. This situation also raises questions about the supply of independent outside directors. Are these people pulling double duty because there's a lack of qualified outsiders?

5. Related Transactions

Companies must disclose any transactions with executives and directors in a financial note entitled "Related Transactions." This reveals actions or relationships that cause conflicts of interest, such as doing business with a director's company or having relatives of the CEO receiving professional fees from the company.

The Bottom Line

The composition and performance of a board of directors say a lot about its responsibilities to a company's shareholders. A board loses credibility if material shortcomings in this checklist

compromise its objectivity and independence. Substandard governance practices poorly serve investors.