Corporate Governance Consultants: The Issue of Qualifications

By H. Stephen Grace Jr. and John E. Haupert

Today's increased focus on corporate governance means that boards of directors, managers, and others need advice in the development and evaluation of governance structures and processes. The demand for these services has been driven by corporate managers and boards interested in improving governance, satisfying shareholders and regulators, and preventing lawsuits. On the other side, judges, jurors, arbitrators, and mediators need governance experts to help them understand the nuances of governance practices and the way they relate to management.

Arthur Levitt's landmark "Numbers Game" speech of September 1998 called for boards to engage independent professional and legal advisors. Levitt offered further insights on the governance challenges facing boards with "In Defense of Sarbanes Oxley," an op-ed he co-authored with Paul Volcker in the June 14, 2004, *Wall Street Journal*. Levitt and Volcker went beyond the earlier proposition that a breakdown in "tone at the top" was the primary cause of business collapses, and pointed to the breakdown in "corporate checks and balances." Inherent in these checks and balances are the assignment of responsibilities, the requirement for accountability, and the existence of consequences.

Levitt's recognition of the value of professional advisors, and his emphasis on checks and balances, has expanded the role of corporate governance consultants. With this expanded role comes the need to clarify the "qualifications" that should be expected of those who would represent themselves as *qualified* corporate governance consultants.

This article establishes a set of expectations—a common body of knowledge—for qualified corporate governance consultants. This definition is made more critical by the absence of licensing or other professional standards in the field. The common body of knowledge requires working with legal and accounting specialists, building on the professional and academic literature, and drawing from the knowledge, skills, and experience of executives and directors.

The development of a common body of knowledge is neither novel nor unique in the practice of business management. Almost 50 years ago, another group of business professionals addressed a similar need. The Association of Consulting Management Engineers (ACME), now known as the Association of Management Consulting Firms (AMCF), recognized that the growing demand for management consulting services led many people to enter the field—some were qualified, others were not. The ACME established qualifications for management consultants in its 1957 publication, *Common Body of Knowledge Required by Professional Management Consultants*.

The mission of the ACME study was to closely examine the elements of "managing." The ACME study was built on well-understood principles solidly embedded in business practices and business literature. The ACME study did not consider the oversight role of the board of directors and board committees a matter of critical importance today. Nevertheless, the ACME study provided an excellent framework for setting out a common body of knowledge for corporate governance consultants. The ACME study contributed significantly to the discussion of management structures and processes that follows.

A Common Body of Knowledge: Overview of Basic Principles

What type of education, training, experience, and other capabilities should such advisors have in order to consult in the area of corporate governance?

The two basic components of the common body of knowledge (CBOK) for qualified corporate governance consultants are: 1) an understanding of, and experience with, management structures and processes, and 2) an understanding of, and experience with, governance structures and processes. Before addressing these basic components, the CBOK addresses certain other fundamentals.

A qualified governance consultant must be able to evaluate the functions of management and the board; a consultant must also be able to evaluate the relationship between the two entities. A corporate governance consultant must contribute to the development of the governance structures and processes with the required checks and balances.

Corporate governance consultants may benefit from experience with noncorporate business structures. General partnerships, limited partnerships, joint ventures, and other noncorporate forms often present valuable governance lessons.

Corporate governance consultants should have a healthy suspicion of "best practices." Knowledge of what has worked well for others can be useful; however, corporate governance consultants must understand that the division of labor is specific to each company. Widely different checks and balances may need to be built into the governance structures of seemingly similar entities. A company's need for checks and balances may also change over time.

Corporate governance consultants must be able to communicate effectively with boards and management in addressing governance issues. Today's boards of directors are increasingly independent and proactive. Some are now comprised of a majority of outside (independent) directors, with either a lead director or a nonexecutive chair. These boards are qualified to provide oversight and are committed to doing so. Directors are now charged by shareholders and regulators with establishing and maintaining a governance system. The director's role is substantive, and a failure to do the job efficiently and transparently can have serious consequences for the director. While many professionals can contribute specific knowledge to assist a board, board members expect corporate governance consultants to be experienced with, and share a deep understanding of, the range of issues facing boards.

Management Structures and Processes

A qualified corporate governance consultant must possess a level of knowledge of, and experience with, management structures and processes similar to that of an experienced senior executive. This familiarity contributes to the consultant's understanding of basic management principles regarding organizational structures, relationships, and policies.

An understanding of "the structures and processes of managing" and its constituent elements enables a consultant to evaluate how "managing" is integrated into a company's governance structure and processes. This understanding is built upon knowledge of, and experience with, the act of managing, often defined by a three-step procedure that includes planning, implementing, and monitoring. (In the ACME study, these three steps were called establishing objectives, directing the attainment of objectives, and measuring results.)

To properly evaluate a company's management, a qualified corporate governance consultant must generally be knowledgeable of the primary activity areas within a company. The ACME study describes these as being: 1) research and development, 2) production, 3) marketing, 4) finance and control, 5) personnel administration, 6) secretarial and legal, and 7) external relations. While all of the activity areas contribute to operations, the ACME study describes the first four as basic to getting work done, while the final three influence the climate in which work is done.

Within each of these primary activity areas, multiple functions and subfunctions must be understood. Each function and subfunction has developed processes and procedures. Proper evaluation can be very difficult, if not impossible, for those unfamiliar with management or the activity areas. A qualified corporate governance consultant must possess general knowledge of each activity area as well as understand how the alignment of functions and subfunctions may differ from company to company, not only across industries but within industries, within corporate families, and even within a single entity over time.

The organizational structure of a company is defined by the manner in which it divides its labor into specific tasks and achieves coordination among these tasks at a given point in time. A consultant must understand both the formal and informal organizations in place; an examination of the informal organization may reveal a considerably different picture that could impact the success or failure of governance. There is a proper or logical location of each function and subfunction in line with the economic and other considerations that make up the company's operational framework. In addition, the emphasis placed on the various functions shifts over time and with the nature of the business.

A qualified corporate governance consultant must possess the knowledge and experience necessary to understand the following concepts:

■ Generalized sets of activity area charts, represented as best practices, do not necessarily reflect the "ideal" grouping of activities and functions for a specific company. The activity area charts simply show a logical, but arbitrary, grouping of functions. A consultant should understand that each company organizes and integrates the various activity area functions according to variations in markets, products, methods, tradition, people, and many other factors.

■ There are no packaged solutions to management, and the same is true for governance structures and processes. Each company must be dealt with on its own merits, including the manner in which the management structure and processes have been integrated into the governance function. A consultant should be familiar with the relationship between the management structure and processes and the governance structure and processes. A qualified corporate governance consultant must be able to fit the general principles of management or governance to the specifics of a given company at a given point in time.

■ The dynamics of the formal and informal structures within an organization may determine where and how a management or governance function takes place. For example, a corporate governance consultant should be able to distinguish control systems in a "management" sense from control systems in a "board" sense.

Governance Structures and Processes

A great deal of consideration has been given to governance structures and processes in recent years, although the issue is not new. Governance structures and processes have evolved over time, and directors and managers must now be much more directly involved and take responsibility for damages resulting from a failure of governance oversight.

The protection of shareholders' interests is seen as a primary responsibility of a board of directors. In addressing this responsibility, boards must make sure that the governance process is effective. This can be extremely complicated, which is why directors have sought the assistance of experts. This practice of retaining outside assistance must be handled with care. A board cannot be too quick to rely on expert assistance as proof that it has carried out its oversight role. The board bears full responsibility for proper governance. It cannot claim that the use of an outside expert was sufficient to abdicate its responsibilities.

The selection of a corporate governance consultant and management of the assignment must be handled by the directors, who must evaluate the qualifications and independence of the consultant. The directors must also set an agenda and timeline for progress reports. All of the recommendations must be evaluated by the board and accepted or rejected based on hard facts. To do this properly, the directors must understand governance and how to use the services of experts while not relying upon them blindly.

Despite the emerging consensus that "tone at the top" is important to governance structures and processes, a consultant must see the reality behind the façade. To be meaningful, the tone at the top must be extended through a rigorous set of checks and balances within an environment characterized by transparency. (See James N. Clark, R. Hartwell Gardner, H. Stephen Grace Jr., John E. Haupert, and Robert S. Roath, "From 'Tone at the Top' to 'Checks and Balances'," in the March 2002 *CPA Journal*.) Unfortunately, in the cases of companies that have experienced major governance breakdowns, their ethical code was attractive on the surface but ineffective at preventing malfeasance. (See H. Stephen Grace Jr., "Effective Governance in an Ethicless Organization," in the May 2005 *CPA Journal*.) A rigorous set of checks and balances in an environment characterized by transparency would: 1) encourage everyone to work in conformity with the announced tone at the top, 2) support those inclined to work according to the guidelines, and 3) deter those who might be tempted to go outside the guidelines. (See H. Stephen Grace Jr., "Building Ethical Behavior into an Organization: An ESD Approach," an address delivered at Baruch College's Ethics Week Forum on April 13, 2005. See also "How to Make an Ethics Program Work," co-authored with John E. Haupert, in the April 2006 *CPA Journal*.)

Thus, one of the first things a corporate governance consultant must determine is whether there is an ethical tone set for the organization, supported by a proper set of checks and balances. To do this, a consultant must understand and be experienced with threats that undermine governance structures and processes. Consolidation of power is a paramount threat. If an individual or a small group of individuals within an organization has too much power, they may be able to shroud their activities and intimidate or manipulate others to achieve their desired goals. Lord Acton captured this danger in his now famous quote: "Power tends to corrupt, and absolute power corrupts absolutely." The opening words in his essay "Nationality" (*Home and Foreign Review I*, July 1862) discuss the tendency of some individuals to see as a solution to a political crisis the creation of an ideal "all-powerful" governance structure. Even if these individuals have the best interests of society in mind, governance structures that rely upon concentration of power will ultimately fail, and at a considerable cost to all involved. A system of checks and balances works to counter efforts to concentrate power.

A corporate governance consultant should recognize that the checks and balances required will vary between organizations and within a single organization over time. Likewise, a working environment characterized by transparency further helps counter efforts to concentrate power.

A qualified corporate governance consultant understands the board's role in representing shareholders and serving as a link between ownership and senior management. A consultant must be familiar with the external financial reporting processes and other corporate communications, including annual filings, interim filings, proxy statements, other SEC filings, and SOX requirements. A consultant must assess the board's processes for interacting with management, internal auditors, and external auditors. Furthermore, a consultant must understand the board's responsibility to achieve legal and regulatory compliance, including the development of corporate codes of conduct. A qualified corporate governance consultant must assess the corporate processes and board oversight of systems for risk management, including internal controls.

Most of a board's work is to ensure good governance takes place through committees. A board's primary committees include the nominating/governance committee, audit committee, compensation committee, executive committee, and perhaps a compliance committee or risk assessment committee. A qualified corporate governance consultant understands that committees change over time depending upon their members and the issues being addressed. A consultant should focus on whether the committees are effectively discharging their primary functions.

A consultant must have meaningful experience working with boards and show tact in the sensitive area of a board's relationship to management. Examples include the selection of new independent and qualified board members and the question of whether to separate the CEO and the chairman of the board positions (See H. Stephen Grace Jr., "Reflections of a Non-Executive Chair," in *The Corporate Board*, May/June 2005).

An important test of a governance consultant's expertise is knowledge of and experience with audit committee operations. The audit committee is normally the workhorse of the board's oversight and control and, as such, is critical to the board's guardianship of shareholder value and ethical behavior. The audit committee is responsible for ensuring that the financial statements are timely and fairly reflect the company's economic or financial position.

A qualified corporate governance consultant understands the importance of a board's oversight and control systems at different points in time. As a company grows or its operations shift, the appropriate oversight and control systems may have to change. Such systems go well beyond the income statement and balance sheet and must focus on operating cash flows, capital expenditures, and key value drivers. To do this properly, audit committees must have qualified directors and access to expert help. A consultant should understand the succession and rotation of members of the committee, how the committee should manage its relationship with outside auditors and staff, and, most importantly, how the committee ensures its independence.

A qualified corporate governance consultant must be familiar with compensation committees. The compensation committee must review executive compensation packages and determine whether a company's compensation structure ensures the shareholders of a satisfactory return after any performance-based awards for management and others. A consultant must be familiar with how options, restricted stock, and bonuses should be handled and recognized in financial statements. Finally, termination and retirement packages for senior staff must be carefully evaluated. Compensation arrangements must possess adequate transparency to withstand investor and regulatory scrutiny.

Somewhat broader in scope, but closely aligned with executive compensation, is the need for the compensation committee to deal with staff compensation. Not every company will need to focus on nonexecutive issues, but there is a growing realization by boards that this focus can bring about improvements. If a committee needs to expand its work, a consultant can advise on structural changes in the committee, staff support, the costs and benefits of the expanded work, and other issues that might be handled. These would include succession planning, management contracts, union contracts, overseas allowances, and the equity of benefit plans.

There are other committees that might be required and other specialized assignments that would require a governance consultant. Organizations have formed new board committees, such as risk assessment, employee and property security, and information technology, to deal with emerging issues. They also use ad hoc committees to deal with major losses, regulatory investigations, and other serious problems. A qualified corporate governance consultant can help boards wrestling with alterations to their committee structure. A consultant should have the knowledge to examine each new committee's function, its responsibilities, its size and knowledge requirements, and its operating procedures.

A qualified corporate governance consultant must be able to communicate findings in complete and understandable reports that committee members and boards can easily understand. It is imperative that boards and their committees be able to provide comprehensive documentation supporting their actions if they are challenged.

Current Issues

Qualified corporate governance consultants should have the capability to work on a broad range of issues that face today's boards. The following are two current issues that a qualified consultant should be equipped to handle.

Litigation. Shareholders, unions, activists, employees, and governments seem to increasingly use litigation to redress the perceived failings of a company, even those attributable to market forces or other external factors. Plaintiffs' attorneys are often willing to take on even the weakest of cases because companies often choose to avoid a lengthy, expensive case by offering a substantial out-of-court settlement. Plaintiffs often accuse directors of not providing the necessary oversight. This is a particularly dangerous area for defendants because they are charged with so many responsibilities for governance, many of which are not clearly defined, that it is easy for the defendant to look bad. Consultants experienced with these issues can explain the roles played by management, the board, or various directors in the events giving rise to the litigation. The consultant's communication skills must be excellent, his credentials must withstand careful scrutiny, and he must be able to serve as an authoritative expert witness.

Mergers, acquisitions, buyouts, and bankruptcies. Perhaps the most important area in which directors are involved are changes brought about by mergers, acquisitions, buyouts, and bankruptcies. Because the results can have such a dramatic impact, handling these changes requires objective and judicious oversight by directors. These matters usually involve attorneys, existing creditors, new lenders, investment bankers, rating agencies, and regulators. While all of these parties should be working toward the best outcome, they often have interests to protect and may come to different conclusions. Ultimately, the board must decide which direction to take to ensure the best overall outcome for all the constituencies involved. Mistakes made in dealing with fundamental corporate changes are a major cause of lawsuits claiming directors did not provide appropriate oversight. A qualified corporate governance consultant can help prevent or mitigate the effects of such litigation. A consultant can help directors understand their responsibilities and deal with legal and technical issues. A consultant can also help the board prepare documentation to support its conclusions, assure the board that there were no insider benefits or dealings, and confirm that compensation for the parties involved was equitable and reasonable.

Qualified corporate governance consultants should have the capability to work on a broad range of issues that face today's boards.

Selecting the Governance Consultant

The selection of a corporate governance consultant must be a well thought out process. For example, the board of directors must decide how potential candidates are to be selected. Typically, staff members develop a list of potential candidates and recommend a selection. This may work fine in most cases, but board members should be wary of independence issues, particularly if a consultant has other assignments with the company's management. The board should also ensure that the consultant has no conflicts of interest attributable to a relationship with key staff, suppliers, creditors, or directors.

A better way to ensure independence and competence may be for the board to make its own selection, using staff only for technical assistance. The selection process can be difficult and time-consuming, so board members may find it more efficient to appoint a special committee or specific directors to manage the process and recommend a candidate.

The selection committee members must assure themselves that any candidate has certain basic attributes that will help ensure success. These include the background and experience to evaluate the functioning of management and the board as well as the relationships between them. The potential corporate governance consultant should also demonstrate an ability to relate and communicate effectively with boards and senior management. Today's boards will want a clear understanding of what a consultant has done and is recommending, as well as a clear delineation of possible risks. In short, board members have the right to expect qualified corporate governance consultants to be experienced with, and share a deep understanding of, the range of issues a board may face. This is what the special committee must deliver when it recommends a potential consultant.

A selection committee should also define the work to be performed, oversee preparation of the consulting agreement, require interim progress reports, and report progress to the full board regularly. This committee must be able to evaluate the consultant's findings and recommendations and present them to the board, making sure board members have a full understanding of all of the issues.

In the final analysis, the qualified corporate governance consultant must possess the knowledge and experience necessary to evaluate the governance structure and processes objectively. This knowledge and experience, combined with an understanding of governance under a variety of conditions and a familiarity with integrating the management and governance processes, give a qualified corporate governance consultant the credentials to provide sound advice. A qualified corporate governance consultant can guide directors and officers as they address the problems specific to their company. ❑

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