Chapter 7: BOARD COMMITTEES

The board has been sized, recruited, and is ready to go to work. However, unless it is a small board that has made the decision to act "as a committee of the whole," another ingredient is necessary. To carry out its duties and responsibilities, the board must establish and document its own infrastructure in the bylaws. It must organize itself so that it can work effectively, as well as efficiently.[1]

As with many real-world questions there is no one right solution to the question of infrastructure. Organizational leadership and structure — that is, officers' and committees' decisions—must reflect the enterprise's traditions, political and operational needs, the size of the board, statutory, regulatory, and accreditation requirements, etc. It also should mirror the good experiences of similar organizations—and guard against the bad.

Design and structure choices can—and should—be changed as new demands are placed on the enterprise.[2] The goal, however, of both the initial design and any subsequent changes must be the same. The enterprise must structure itself in a way that enhances its ability to pursue its mission.

COMMITTEE STRUCTURE

While there are no absolutes with respect to committee structure,[3] there are several general points that offer useful guidelines.

First, committees should be used to make the full board more efficient, not replace it. Therefore, as a rule of thumb the number of committees should be kept to the productive minimum. The actual number obviously will differ from organization to organization, depending on the issues being faced and the size of the board. A small board will organize itself and work differently than a twenty-five person board. Both boards can, and ultimately will, develop solutions that are workable and acceptable.

Second, corporate law permits directors to rely, in terms of meeting their duties and responsibilities, on the work of board committees so long as the following requirements are met:

- The purpose, powers, procedures and limitations of the committee are clearly defined in the corporation's bylaws or in an appropriate board resolution;
- The committee maintains and distributes minutes of its meetings and other records appropriate to its charge;

- The committee regularly reports its deliberations and work to the full board;
- The composition of the committee is appropriate to its task;
- The committee is meeting and addressing matters appropriate to its charge.

Third, the membership of any specific committee should be structured so as to assure that it reflects the full composition of the board. To this end, care must be taken to assure that there is neither the reality nor the perception of different classes of committees or committee members. To do otherwise is to open the full board to potential divisiveness. The most pragmatic way to avoid this is to assure that committee membership reflects the character and mix of the full board, particularly in terms of tenure and overall experience, and to make it clear that all board members are welcome to attend the regular meetings of any committee.

Fourth, board committees can be thought of as falling into one of two categories: either special committees or standing committees.

Special committees can have a variety of titles: working parties, task forces, ad hoc committees, and so on. They can also be advisory, with no power to bind the enterprise, or have limited powers specific to their purpose. Regardless of title they are all typically intended to have both a limited charge or purpose and a limited life. That is, they are created to address a specific or special purpose/issue, such as a building project, a merger offer, a fund raising initiative or revising the bylaws. Once that task is completed, the committee's work is ended and it is dissolved.

Special committees are useful devices. They provide the organization with a vehicle for addressing particular issues without creating governance overhead that can get in the way of board efficiency. To be effective, their charge or objectives and expected duration (life cycle) must be defined as precisely as possible.

The enterprise's bylaws should specify how special committees are established. They should make clear whether committees can be appointed by the chair of the board or if their creation requires the action of the full board. The bylaws also should specify whether special committee membership is to be limited only to current board members or if it can be composed of a mix of members and nonmembers. If non-board members are eligible to serve, special committees can provide a substantive and organizationally valuable way to keep past board members and friends of the organization involved in the affairs of the enterprise.[4] They can similarly also provide a way to introduce potential future board members to the enterprise - - and evaluate their readiness, interest and fit.

Ideally, the bylaws should be drafted to provide as much flexibility as is practical. The chair of the board should be able to appoint special committees and their chairs and committee members. Committee membership in turn—unless the committee is by design an advisory, nonmember group—should allow for a mix of members, so long as the majority consists of current board members. Obviously, all actions of the board chair are subject to the review and ratification of the full board.[5]

In contrast to special committees, standing committees are the core of the corporation's infrastructure. Standing committees should be specified in the bylaws, including their charge, membership size and mix, i.e., if non-current board members can serve, as well as the committee's chair, identified by office or position, i.e., treasurer as chair of the audit committee. A standing committee also continues to function until it is eliminated through a change to the bylaws.[6]

Except for stock exchange requirements that listed companies have audit committees composed of independent directors, a corporation is free to create as many or as few standing committees as it wishes.[7] Most for-profit corporations have one to five committees. Nonprofit enterprises typically have more, as they have larger boards and more stakeholders to accommodate.

Practice and practicality suggest that there are three basic standing committees (see Exhibit 7-1 and Appendix 6): audit, compensation and governance.[8] The first two, audit and compensation, reflect the need to "follow the money." As is discussed below, the audit committee must assure that the enterprise's resources are being properly focused on pursuing its mission. The compensation committee is responsible for assuring that management is equitably paid—neither underpaid nor paid more than the market and actual performance fairly justify. The committee on governance's focus is on assuring that the board not only fulfills its duties and responsibilities, but also does so in a manner that results in continuously improving its own performance.

Exhibit 7-1

COMMITTEE STRUCTURE

Percentage of Companies Having:*

Audit Committee	100%
Compensation Committee	100%
Committee on Governance/Nominating	84%
Executive Committee	70%
Finance	38%
Corporate Responsibility	20%

*Source: American Society of Corporate Secretaries, *Survey of Board Committee Practices,* June 1998

Beyond these core committees the number and nature of additional standing committees are determined by the enterprise's traditions and business needs. For example, a hospital would be expected to have a quality assurance committee, a medical staff relations committee and a community relations committee. A health insurer likely would have a finance or investment committee. A museum would have a development or major gifts committee and an acquisitions committee. The possibilities are nearly limitless. Nevertheless, as noted earlier, the number of committees should be limited to the productive minimum—not the imaginative maximum.

AUDIT COMMITTEE

In the wake of governance scandals at United Way of America, Red Cross of America, Enron, Global Crossing, WorldCom and others, the audit committee well may be the most critical of all the board's committees. When things go well and there are no public financial disclosure problems, an audit committee's work attracts little attention. When matters go bad, and the community feels deceived, the performance of the audit committee and the actions of its individual members (and those of the full board) cannot sidestep the spotlight of public and potentially governmental/legal scrutiny.[9] To assure that things do not go bad, the audit committee must play a central role in corporate affairs, acting as the assertive guardian of the community's financial and philanthropic/social welfare interests.

Operationally, the audit committee has two basic functions:

1. to oversee the corporation's financial reporting process and the resulting financial reports;
2. to oversee the corporation's internal control processes and systems.

The two functions are different in perspective—one looking outward, the other looking inward. They are similar, however, in that they have the common objectives of avoiding both the misuse of corporate resources and organizational embarrassment.

The committee's external role of assuring valid and reliable financial data is the accountability that is best known to the general public. Here the committee's goal is to protect the enterprise from accounting irregularities, i.e., financial accounting abuses that require the restatement of financial reports.

To carry out this accountability with public confidence, the committee first must be composed entirely of financially literate, independent directors. The standard of having only outside directors is generally not an issue for nonprofit enterprises. The question of independence is potentially, for both nonprofit and for-profit corporations, a more sensitive matter. Independence requires that a committee member neither be an employee of the enterprise nor have significant business, advisory or consulting transactions with the enterprise.

Independence also requires, at a minimum, that the committee:

- have clear access to the enterprise's management, including financial and legal staff;
- have the authority, as necessary, to retain external advisors if their guidance is needed;
- select and engage the external auditor, assuring both competence and independence, i.e., have no business including consulting engagements with the firm that might be perceived as compromising or appearing to compromise the integrity of the audit;[10]
- meet with the auditors both in open and executive session to:
  - review and approve the scope of the audit and audit work plan;
  - review the results and findings of the audit;
  - review and approve the annual financial statements;
  - receive and follow up on the findings of the auditor's management letter;
  - assure that management is cooperating with and supporting the auditors;
- meet with the auditors in executive session to discuss:
  - the quality of the enterprise's accounting practices;

– concerns or potential problem areas;
– areas of disagreement with management.

In addition to its accountability for assuring the validity and reliability of the corporation's financial statements, the committee:

- serves as the final arbiter of any changes in the corporation's financial accounting practices and procedures for preparing and publishing financial statements;
- generally provides oversight to the corporation's code of conduct and other compliance programs.

This last responsibility deserves further comment. With increased scrutiny of corporate behavior, compliance programs and compliance monitoring have become mandatory activities. As discussed earlier, the enterprise must have in place a conflict of interest disclosure program and a code of conduct and compliance program. It also must have a designated compliance officer who is responsible for assuring that the programs are in place and being followed.[11]

The compliance effort and officer may, depending on the organization, be a stand-alone function or be included with other assignments. Regardless of how it is structured, the audit committee and the full board should, at least annually, receive a conflict of interest and compliance report. The compliance officer should also have the ability to meet directly, either in open or executive session, with the committee. Finally the audit committee should periodically review the conflict of interest and compliance programs and satisfy itself that they are adequate and fully implemented.

In simplest terms, the audit committee is responsible for making sure that the community receives financial information that is truthful, comparable from year to year, and understandable. Assuring that financial data are prepared in accord with generally accepted accounting principles is necessary. However, by itself, it is not enough if the result creates a materially misleading impression of the firm's performance and financial condition. The committee must assure that the financial data, taken as a whole, portray the understandable truth.

It would be disingenuous not to recognize that there is a degree of tension in this three-sided relationship of auditor, management, and board committee. The audit committee must recognize this and assert its accountability and subsequent authority. While the auditors are paid by the enterprise and work with management, they are responsible to the committee. The committee engages them and, if dissatisfied, can terminate them. The auditors are not retained to offer creative rationalizations for, or guarded opinions of, management's decisions and performance. They are retained to validate unequivocally, to the committee and the public, management's data and reports. Anything short of this is unacceptable.

The audit committee's inward-looking role is to oversee the enterprise's internal audit program. Small enterprises may not have the resources to support their own internal audit function. In such instances, the committee must rely on the external auditors for examining the adequacy of the internal control systems and assuring that neither blatant fraud nor abuse is going undetected.

If reliance on the external auditors is the approach that is taken, it should be included as part of a multiyear audit plan and, as appropriate, be addressed in the management letter provided by the independent auditor to the board. Obviously, this added work increases the cost of the audit. Therefore, it must be negotiated as part of the audit engagement—and because of the potential size of the expense, be judiciously handled. Frankly, complete internal control certainty is beyond the practical means of any active, complex enterprise. Business judgment must be used to find the proper year-to-year cost and benefit.

Larger organizations should have an internal auditor as part of their staffs. Enterprises such as hospitals, health plans and the United Way agencies should go even further. They should have an internal audit department.

From a governance perspective the internal audit function is responsible for assuring that the enterprise's financial control systems and its operational procedures are designed, implemented and functioning efficiently and effectively. Given this, the internal auditor is responsible for making sure that resources are being used appropriately to pursue the enterprise's mission and are not being diverted due to inefficiency, bad judgment or fraud.

The internal audit function must protect the enterprise, its board and management from public embarrassment. The job of the audit committee is to provide the oversight and environment needed to allow this to happen. To this end it must be clear that the internal auditor has direct and unencumbered access to the committee. The committee should meet, at least annually, with the internal auditor to review the corporation's risk assessment and the resulting internal audit plan. The committee should also periodically meet in executive session with the internal auditor to assure that there is a candid and frank review of the enterprise's risks and performance. (See Appendix 6 for an example of Committee Charters.)

A point should be noted regarding unencumbered access. While both the compliance officer and the internal auditor must have the unfettered ability to meet directly with the committee, the committee must recognize its obligation to act once notified of an issue or even a potential issue.

The committee chair, when approached, must bring the matter to the committee and assure that the committee addresses the issues(s). For the chair either to try to resolve or deflect the issue by his or herself, or for the committee to stonewall staff's concern, is a patent mistake—one that will never pass the test of public scrutiny.

The principal staff to the audit committee should be the chief financial officer (CFO). The internal auditor, like the compliance officer, should report to—not serve as staff to—the committee and should be independent of the CFO.

COMPENSATION COMMITTEE

The compensation committee is the second core committee. It is responsible for the approval and subsequent oversight of the enterprise's compensation program, benefit policies and management development programs. The committee is also typically charged with: setting the chief executive's compensation and benefits, evaluating chief executive performance, providing oversight to the administration of the incentive compensation plan (if one exists), establishing board compensation (if the board is paid) and reviewing management's staff development and succession plans. (See Appendix 6 for example of Committee Charters)

In terms of governance, the goals of a compensation committee are threefold:

1. assure that the policies and programs are in place to insure that the enterprise's general levels of compensation and benefits reflect market rates and standards;
2. assure that policies and programs are in place to insure that individual compensation reflects performance;
3. assure that policies and programs are in place to insure that the enterprise has an adequate supply of qualified people.

To accomplish the first, the enterprise must periodically survey the relevant labor market (local, regional or national) from which key jobs likely will be recruited and, as necessary, revise its pay ranges and or benefit programs. To do the second, the committee must assure that the compensation system measures and rewards actual performance results. This requires that the enterprise have an operating plan that includes specific, quantified objectives. The third goal requires that the committee assure that a formal employee education/development program and a succession management process are in place.

The need for quantified operating objectives goes back to one of the board's principal functions—approval of the enterprise's strategy, and the resulting operating plan and quantified performance measures/objectives. Without belaboring the obvious, the interlocking character of how the pieces fit together should begin to have more clarity. The enterprise's strategy drives its operating plan, which in turn defines performance objectives. Performance objectives (expected results/accomplishments) become the basis for measuring individual results and setting individual pay.

This is not the place for a discussion of compensation theory and practice. (See Chapter 13 for a more in-depth discussion of compensation.) The responsibility of the board, through the work of the compensation committee, is not to be technical compensation and benefit specialists.[12] Rather it is to assure that the enterprise has compensation, benefit, and personnel development policies and systems; that they are being used; and that they result in equitable employee compensation and a skilled, continuously improving workforce. Equitable compensation is pay and benefits that reflect both market forces and individual performance. A skilled, continuously improving work force is a management and staff group that is always learning and developing, enabling both the enterprise to meet its human resources needs, and individual employees to fulfill their personal potential and work goals.

To this end several principals should be recognized:

- General pay levels always should reflect what is happening in the appropriate labor market (the labor market from which a successor to the incumbent would be hired);
  - The enterprise should never allow itself to lose competent employees because they have been underpaid—just to then have to go out into the market and pay their successors what the incumbents were asking for, or even more.
  - To assure compensation "market relevance," the committee should periodically review labor market survey data, along with management's recommendations for necessary compensation structure adjustments.
  - Admittedly the numbers, particularly for senior management, may be high. Competent management, however, is an enterprise's "least cost" strategy. Underpaying employees is a false economy, resulting in higher turnover, leadership gaps, recruiting expenses—and, likely, higher eventual salaries.
- At least annually, all employees should have a formal performance review. The committee's obligation in this regard is generally twofold. First, it is to assure that the corporation's overall compensation system includes an annual, formal, written evaluation component. Second, it is to assure that the chief executive has an annual evaluation.

The chief executive's evaluation can be accomplished in a variety of ways. Some organizations rely on the chair of the board to do it. Others might assign the task to the executive committee, if one exists. No single solution is better than another. However, logic suggests that it be handled, or at least led, by the compensation committee.

Chief executive evaluations should typically include, in some form, three elements:

1. **COACHING AND COUNSELING**—an on-going process where the chair of the board and/or the chair of the compensation committee provides real-time advice and counsel directed toward continuous performance improvement.
2. **FORMAL BOARD ASSESSMENT**—annual review by the full board of the chief executive's performance.
3. **QUANTIFIED PERFORMANCE REVIEW**—annual review of performance against the quantified objectives of the operating plan. (While the full board should participate in some form of chief executive evaluation, quantified performance review is objective and can be done by the committee or the board's chairman.):
   - As a corollary to the above, the chief executive's performance should be evaluated on basically a pass/fail basis. If the chief executive, or for that matter any senior manager, can be motivated to work harder or better for more pay, then the enterprise needs a new chief executive. Conversely, to keep staff from leaving, pay must be based on market factors—so that staff does not feel that they are subsidizing the organization;
   - The organization should have a formal professional development system for all employees, including senior management. An explicit, formal succession management system also should be in place for all key positions, along with plans to develop the identified staff. The committee should assure itself that the system is in place and working, and should periodically review the succession plan. (See Chapter 14 for a discussion of succession management.)

The committee's annual work cycle begins with approving the translation of the operating plan's quantified objectives into performance targets. It ends with converting actual performance, by assessing the quantified results that were achieved vs. the performance targets, into actual pay. Along the way it must:

- assure, through independent survey data, that compensation reflects market rates;
- meet regularly with the senior human resources officer to assure that performance measures are in place and operationally meaningful;
- provide the chief executive with ongoing performance feedback.

The committee also should meet at least annually, in executive session, with the full board to report on its activities and actions.

Both the committee and the board must recognize the public's sensitivity to compensation matters. Everyone has an opinion regarding someone else's compensation (and seldom is it believed to be too low). Therefore, the committee must be scrupulous in assuring that compensation is based on market rates and clearly reflects actual performance. Anything short of this leaves the enterprise vulnerable to criticism and potential public embarrassment.

The compensation committee, like the audit committee, should be comprised of independent directors. The principal staff to the committee should be the senior human resources officer.

COMMITTEE ON GOVERNANCE

The third core committee is the committee on governance. In the past this committee often was called the nominating committee. Consistent with its name, the nominating committee's responsibilities were relatively narrow in focus; identifying and recruiting new board members and recommending a slate of directors for election. In the current environment, this role, while still necessary, is too limited. The community's expectations of board performance and accountability are constantly increasing. To meet these growing expectations, the board needs more than a nominating committee. It needs a committee that is also focused on assuring not only that the board and its individual members are carrying out their duties and responsibilities, but also that governance performance is continually improving. (See Appendix 6 for an example of Committee Charters.) This is the basic role of the committee on governance.

By whatever name, the committee is responsible for:

- assessing the needs of the board;
- identifying and recruiting new members;
- proposing a slate of directors for election;
- evaluating individual director performance and providing appropriate coaching and counseling;
- assessing the general performance of the board as a whole;
- recommending actions to improve overall performance, including oversight of educational programs for individual board members, board committees and the full board.

The committee on governance is the committee that makes sure that the board and governance system works. Given its responsibilities, the committee should be composed entirely of independent board members, with a majority having significant board experience. Additionally, if it is the practice of the enterprise board to have past chairs remain on the board, then either a past chair or the current chair of the board should serve as the committee's chair.[13] This choice of chair provides an advantage, because it adds both credibility to the committee's work, and provides leadership and insight into the background and the interpersonal chemistry needed for new board members—as well as the standards that the board's performance must meet.

Principal staff to this committee should be the chief executive. This is purely a pragmatic reality. The chief executive works for and reports to the board. If the chief executive is to have a great board, he or she must nurture and encourage its growth. The vehicle for accomplishing this is the committee on governance. The chief executive should therefore work with and directly support this committee.

While the audit committee may be the most visible and vulnerable when things go wrong, it is the compensation committee, through its evaluation function, and the committee on governance that are the keys to making sure that the pieces and processes are in place to prevent things from going wrong.

EXECUTIVE COMMITTEE

While perhaps not a core committee, the larger the size of the board the more likely it is to have an executive committee. Executive committees, though they may be a common feature of large boards, are more a device to enable the board to function efficiently than a standard element of governance infrastructure. They are different from other board committees because, within the parameters of any bylaws or legislative limits, they can act as the board. They also can address any matter not delegated to another committee. For example, the executive committee might be charged with handling operational performance oversight, i.e., performance against the operating plan, or non-policy ministerial functions, i.e., general salary line adjustments. It also can handle ad hoc assignments, such as chief executive transition and acquisition review.

Regardless of the specifics, because the executive committee has the ability to function as the board, it also has the potential to create tension between itself (and its members) and the full board (and the remaining members). Despite this risk, if properly managed, an executive committee can be a useful organizational device, particularly for an enterprise with a large board. However, it must not be allowed to supplant, either in appearance or reality, the powers and prerogatives of the full board. Board members must not feel that board discussions and actions are simply a formality—with the real decisions having been already made by the executive committee. To protect against this, the committee's role must not be allowed either to slip over into new policy decision making or approval of the organization's strategy and operating plan.

The membership of the executive committee should consist entirely of board members.

The chair of the committee generally should be the chair of the board. This is necessary to assure both that the executive committee does not overreach in its actions and that decision making is consistent. The principal staff to the committee, as well as to the full board, should be the chief executive.

LEADERSHIP

As noted earlier, depending on the requirements of the enterprise, other committees may also be needed. Moreover, it is not unusual for some committees to do double duty, i.e., finance and audit, compensation and human resources.

While there is no limit as to how many committees can be created, three represent a core group. Two focus on money (audit and compensation). They are necessary to assure that the public has confidence in the enterprise. The third (governance) is necessary to make sure that the board and its committees not only work, but also continually improve.

The guiding principal is simply that structure, i.e., board size and composition, the number and charge of committees, and the detail of the bylaws, must follow function.

Structure is not the "end," rather it is the means to the "end"—an effective and efficient enterprise.

However, for structure to provide the mechanism to be able to accomplish this, one other factor must be added. The animating catalyst that turns structure into the achievement of purpose is leadership.

Chapter 7

Questions for consideration and discussion:

1. How often should board members have contact with the enterprise through either board or committee meetings?

2. If the enterprise has an executive committee, how should its role be defined and managed?

3. Do members of the audit committee face additional financial and legal risks because of their membership on that committee? If so, would the potential of these risks hinder committee membership recruitment? How can both perspective and reality of these risks be managed?

4. Should the full board know all the details, including compensation, of the chief executive's employment? What are the risks of full disclosure? Of managed disclosure?