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Board's Independence Most Valued Governance Practice, But May Be Compromised When Fulfilling Reputation Oversight Role

A Report on the 2005 FD/Directorship Board Survey

Financial Dynamics (FD), in cooperation with *Directorship* magazine, organized a survey of directors of publicly traded US companies during the summer of 2005. The goal of the survey was to determine these directors' perspectives about their role in the oversight, monitoring and management of the intangible asset called **corporate reputation**.

The survey's premise, based on FD's extensive experience working with C-level executives and *Directorship's* intimate knowledge of board behavior and attitudes, was that well-publicized corporate ethical issues lapses in the last few years had caused directors to take a closer look at their own role in reputation management. The point of this additional scrutiny was to determine whether directors felt there was reason for the board to become more intrusive in challenging senior management to effectively manage this asset.

More than 200 directors of publicly traded companies participated, representing one of the most senior and highly qualified samples ever surveyed about board attitudes:

- Seventy-nine percent serve on a board of a publicly held company with $1 billion or more in annual revenue;
- Eighty-seven percent serve on two or more boards, and 67 percent serve on three or more boards;
- Sixty-three percent have served on boards for more than six years; and
- More than half hold chairman, or "C-level" titles.

The survey revealed that "integrity" is the characteristic these directors most associate with corporate reputation. A full 39 percent mention this trait as top of mind when they think about reputation (fig. 1). They also – in overwhelming numbers – consider perceived independence from senior corporate management to be the governance practice most likely to have a positive impact on a company's reputation. The directors evidently see independence as the quality that will most likely ensure that the company acts with integrity and is seen by the outside world to do so.

Measurement Ad Hoc, Anecdotal
This informal approach to information gathering is reflected in board members' responses about how they monitor and measure the CEO's performance at managing corporate reputation. Almost three-fifths of directors (59 percent) say their companies have a formal mechanism in place for monitoring the CEO's performance as a reputation manager; but the way they actually execute this process feels more ad hoc than formal. Directors' primary means of evaluating the CEO's reputation management efforts is of the compensation committee (1 percent) or the head of another committee (5 percent) (fig. 3). A full 30 percent of the survey sample is either unsure where the responsibility lies, or consider it to be "none of the above" (8 percent and 22 percent respectively). FD believes that this lack of clarity belies the importance that the directors say that they place on reputation management oversight.

Key Finding

Directors Rely on Inside Sources and Ad Hoc Metrics for Assessing Reputation Management Efforts

Independence, or Qualified Dependence?
However, the directors' true independence seems questionable when it comes to discharging their role as overseers of management's reputation stewardship efforts. Directors overwhelmingly believe that having a board that is independent of the CEO is the most critical governance practice supporting corporate reputation. Yet the directors are remarkably dependent on inside sources like the CEO (92 percent), senior management (70 percent) and board books (63 percent) to acquire their information about the companies on whose boards they sit (fig. 2). This leads to the question: if independent directors purport to exercise truly independent judgment, shouldn't they more aggressively seek outside sources of information as a "check" on company management's own perspective about itself? Reading media coverage about the company would provide some check and balance; yet less than a third (32 percent) of directors say they do that, and only 13 percent actively seek information from outside stakeholder groups.

"informal feedback from stakeholders," which they rank low on the scale when asked where they get their information about the companies on whose boards they sit. Formal customized research is cited by only 13 percent, and directors seem to be impervious to media coverage of a company, as only 2 percent cite this activity as a way of judging a CEO's reputation management performance. Corporate governance rankings, which might have been considered a primary yardstick given the sensitivity about governance reform in the wake of Sarbanes-Oxley, was cited by only 15 percent of respondents.

Where Oversight Lies Uncertain
Connected with this fuzziness about how to evaluate CEO performance is a lack of clarity as to where reputation management oversight resides at the board level. Twenty-nine percent say it is with the governance committee and 21 percent say it's with the "lead director," but beyond that, responsibility could be with the non-executive chairman (12 percent), the head of the audit committee (3 percent), the head

Results and Figures

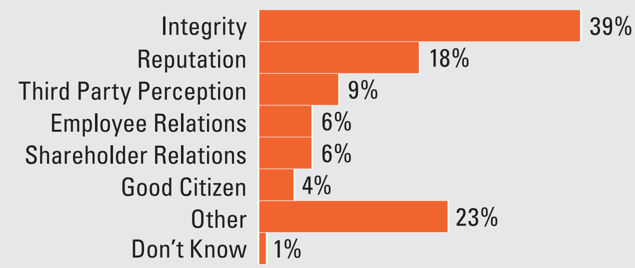

Fig 1. **Perception of the meaning of "Corporate Reputation"**

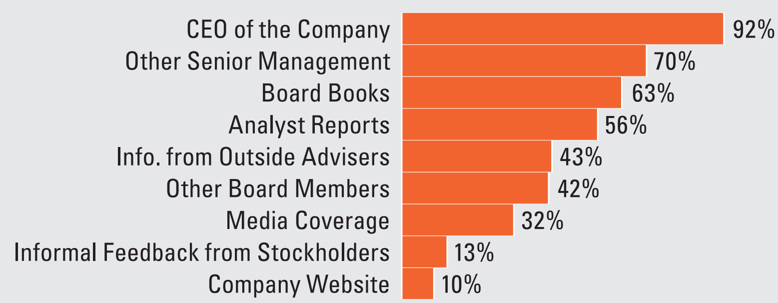

Fig 2. **Sources board members rely on most for information about the Company**

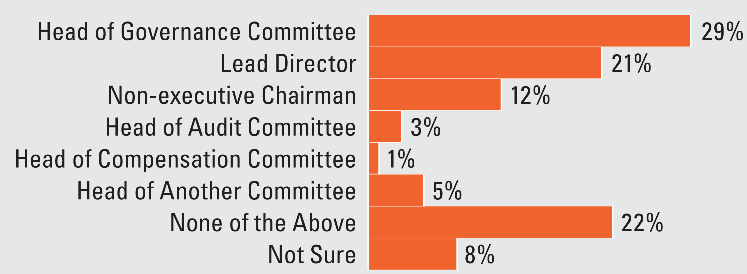

Fig 3. **Board member most responsible for overseeing the Company's corporate reputation**

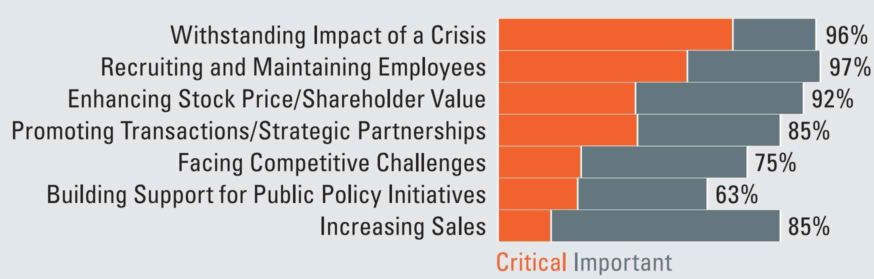

Fig 4. **Corporate reputation's importance in these situations**

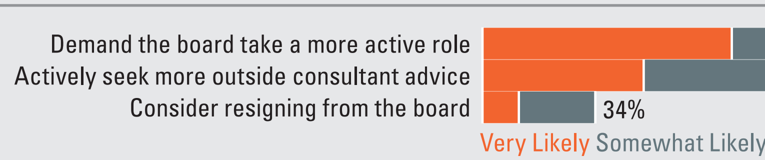

Fig 5. **Likelihood of taking specific actions if Company faced serious risk to corporate reputation**

Among some of the noteworthy and sometimes contradictory findings, directors reveal that while they believe strongly in the value of reputation as an intangible asset, they also feel some ambivalence and conflict about their own role in monitoring, overseeing and holding CEOs accountable for reputation management. Here are some of these perspectives:

Crisis Trumps Shareholder Value as a Reason to Get Involved
Predictably, the board members believe that the time for them to get most actively involved in overseeing reputation management efforts is at a time of alleged ethical lapses, reflecting the impact of past ethics issues on the board members' current thinking. This preoccupation with ethical lapses is reinforced by the directors' response to a survey question asking which corporate objectives reputation plays the most critical role in fulfilling. much of a need to step in and play a more intrusive role in reputation oversight when there is a steep drop in share price, as they do when a company's integrity is on the line. It is clear that integrity is the reputation "coin of the realm," in the directors' minds; and their willingness to intervene the wake of an ethics violation stems from their desire to ensure this coin isn't devalued.

Directors are Fairly Sanguine About Current Management Performance, But Want Active Involvement in Reputation Management.
By and large, directors are satisfied about the performance of senior management in handling reputation management responsibilities. Almost two-thirds (63 percent) express "a great deal of confidence" in management's ability in this area. Boards also are currently happy with their own level of involvement in overseeing management. reputation oversight, not reputation management. That said, it also believes that its ongoing role is to be "actively involved on an ongoing basis" in reputation management (77 percent), which might reflect some level of mental conflict on directors' part over letting senior management do it alone.

We're OK; It's Other Companies that Have Problems
While board directors are almost unanimous in their support of senior management's efforts to handle reputation chores, they do, to some degree, see problems with other companies. In fact, more than one-third of the directors have lived through a situation where their company has been able to take advantage of a reputation problem experienced by a competitor. The unresolved issue is whether the directors are accurate in perceiving this disparity.

Other Key Findings

"Withstanding the impact of a crisis" was considered the number-one role of a strong corporate reputation – a clear reflection of the integrity issues that have generated so much commentary over the past several years (fig. 4). "Enhancing shareholder value," generally perceived as a main preoccupation of any board, ranked only third in importance, as just 44 percent of directors felt that reputation's link to share price was "critical," compared to the 71 percent who cited crisis protection and 67 percent who cited "recruiting and maintaining employees" as critical. In fact, directors don't generally feel as ment, and do not feel more oversight is needed; whether this is because of an absence of solid metrics for evaluation is not clear. Nor do directors believe there is much of a role for them in publicly supporting management in addressing reputation issues, even in light of increasing public scrutiny of board performance in this regard. Almost three-fourths of those surveyed (74 percent) believe their current role is appropriate. And only 13 percent report having a lead director or other director publicly speaking for the company. Clearly, then, the board believes its role is

Staying the Course Preferred to Cutting and Running
Directors demonstrate a great deal of fortitude when an ethical crisis hits. Even with the increasing specter of director liability and the real possibility of being held responsible financially for issues facing the company, they are much more likely to stay and take on an activist role in times of trouble than to abandon ship. At a time of reputational risk, almost two-thirds of the directors would be "very likely" to insist on taking a more active role in reputation management, while only 11 percent would be very likely to resign

Visible Board Leadership Cited as Leading Factor in Determining Board Reputation Management Effectiveness

from the board (fig. 5). Half of those surveyed would also be very likely to actively seek more advice from outside consultants, which suggests to FD and *Directorship* that it's in times of crisis that directors are most likely to eschew internal sources as their primary sources of information and begin to cast a wider net in their effort to understand what's going on at the company.

GE, J&J Outdistance the Pack in Board Reputation Management Performance

We asked the directors on an unaided basis whose boards were doing the best job in this area. General Electric (37 percent) and Johnson & Johnson (31 percent) – longtime favorites in published reputation polls like the *Fortune* "most admired" – far outdistance other companies in the directors' unprompted assessment. The next-highest vote getters were IBM (13 percent) and Procter & Gamble (11 percent). Reasons the directors provided for giving high marks to these companies included "the display of visible leadership" (59 percent), "transparent communications" (56 percent) and "holding management accountable" (55 percent). When contemplating the companies whose boards have done the least effective job of overseeing reputation, the directors cited as key reasons "lack of independence from the CEO" (68 percent), "personal relationships conflicting with duty" (53 percent) and "lack of transparency" (50 percent). The board directors' assessments again underscore the perceived importance of communications in board performance on this issue. In addition, again, the concept of independence – or lack of it – looms large as a governance practice that bears directly on reputation.

FD and *Directorship* offer these findings as insight into board dynamics with regard to corporate reputation, as well as a benchmark for assessing board behavior and attitudes on this issue going forward.

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