

Enron's Real Lesson: Strengthen Board Culture

By
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The failure of the Enron Board of Directors to challenge management and possibly avert that corporation's downfall has unleashed a growth industry of corporate governance advice and triggered some needed housecleaning.

In recent months, many boards, including those at hospitals and health systems, have shored up loose oversight processes, especially for audit and executive compensation. At the same time, a lot of trustees have con-

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vinced themselves that "we're not like Enron," so the rest of the board's business goes on pretty much as usual.

That could be a costly mistake. The real lesson of Enron is not that boards need better structures and stronger processes, although many do. Enron had in place many sound board structures, and it followed practices recommended by corporate governance gurus. It was well organized, knowl-

edgeable and experienced, and it populated the audit committee with independent directors. It is hard to fathom that those directors did not know the right questions to ask or where to find independent experts to help them.

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The lesson of Enron is that while board structure and process may set the stage for effective governance, it is the culture that determines whether board members can apply their skills to the fullest.

Governance Culture

A corporate culture may be loosely defined as "the way we do things around here." Corporate culture is a product of formal rules and unspoken dicta, fables and heroes, and the behaviors that are rewarded and punished.

A governing board's culture may be passive or assertive, complacent or diligent, accepting of rationalizations or demanding of results. The board may be inclined to accept average performance or to challenge management to achieve stretch goals.

Hospitals and health systems today need a board culture in which directors do their jobs with rigor, challenge

management to pursue benchmark performance, give frank advice, heed red flags and demand accountability. They need a culture that allows board members to carry out their responsibilities respectfully but also to put organizational good before friendships and professional relationships.

The Acquiescent Board

Every board, no matter how well-intentioned and honest its members and management may be, needs to make a frank assessment of its culture. The same factors that produced the Enron board's culture of acquiescence exist to some degree on many good boards, including most hospital and health system boards.

Individuals join boards for the chance to contribute expertise and offer counsel, and they enjoy the prestige and the camaraderie. Most board members respect and like the CEO, the management team and their fellow trustees; they want to be supportive. Retreats and social outings cement personal relationships.

Board members prefer collegiality to confrontation. They accept their legal responsibilities, but they didn't sign on to be the neighborhood tough guy. Oversight of corporate compliance, audit, executive compensation and so forth are legal necessities, not their motivation for serving.

Most of all, directors don't want to be the "skunk at the lawn party" who stands alone to challenge the prevailing wisdom. When savvy executives report solid financial returns, many directors don't want to appear "soft" by questioning whether a company's management is following ethical and legal

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rules to the letter.

Yet every courageous stand begins with one voice. Often, one director's willingness to contradict the group or to ask for help understanding some-

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thing opens the gates of inquiry that lead to insight, wisdom and better decisions. A CEO is well served by a probing board that challenges, learns and enriches high-level decisions.

A Culture of Accountability

Boards need to build a culture of accountability, not acquiescence. An accountable board takes seriously its ultimate responsibility for the organization's performance. Accountability is the cornerstone upon which all the rest of governance is built.

A culture of board accountability is characterized by five observable, mutually reinforcing behaviors: commitment, independence, trust, diligence and candor.

1. Commitment

Accountability and commitment go hand in hand. No matter what their roles are outside the boardroom, the members of an effective board must

be fully committed to the organization and to its mission, vision and values; and to each other as members of a cohesive team.

2. Independence

Several years back, a Washington, D.C., bank used this line in its advertising: "We never forget whose money it is."

Similarly, directors can never forget that the corporation belongs not to the board or management but to the owners—its shareholders. The board of a not-for-profit organization is accountable to the public, which includes the stakeholders and constituencies that benefit from its good works. First and foremost among the stakeholders are the patients and the community.

As the single body that is accountable to the owners, the board has to conduct itself with a certain degree of independence to ensure that management is serving the stakeholders well. That doesn't mean the board should

be suspicious or adversarial, but rather, it should act in ways that embody independence and accountability.

For example, the independent board selects the auditors and the executive compensation consultants, meets with them in executive session, asks blunt questions and doesn't hesitate to request further information. Some boards, such as Catholic Healthcare Partners of Cincinnati, take this a step further, scheduling an executive session of just the board and CEO — with no other management — at every meeting.

In the past, many CEOs wanted the board to be supportive, and little more. Today, chief executives recognize that an informed, engaged and independent board is their strongest ally in challenging, competitive times.

3. Trust

Without trust in and respect for each other and for management, boards that

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The Board's Role in Enron's Collapse

A U.S. Senate committee report concluded, "Enron's multi-billion dollar, off-the-books activity was disclosed to the Enron board and received board approval as an explicit strategy to improve Enron's financial statements. In fact, Enron's massive off-the-books activity could not have taken place without board action."

For example, Enron's board allegedly waived the conflict-of-interest policy to allow the chief financial officer to head up a company that

did business with Enron, and then it failed to monitor the high-risk situation it had authorized. It didn't ask tough questions about related party transactions, off-balance sheet enterprises and other high-risk areas, including those flagged by external auditors. Reportedly, the board didn't fully understand many of Enron's complex transactions and never tapped independent experts who could have shown them to be complicated shams to prop up sorry financial performance.

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flex their muscles and assert their independence may descend rapidly into personality conflicts, friction and factionalism. When trust is absent and assertive directors raise probing questions, management naturally gets defensive. At the same time, inquiring trustees may be labeled “disloyal” and shut off from information and influential committee positions.

Trust is the glue that unifies the many voices of independent directors into a cohesive team. Board members and management need to trust that everyone in the room is working in good faith toward a common goal, the good of the organization.

Trust cannot be assumed; it must be earned. One thing management can do

to merit the board’s trust is to support the board with information that is accurate, timely and complete.

“The CEO is always going to want to turn the board meeting into a pep rally,” says corporate governance critic Nell Minnow. Busy board members have got to say, “I don’t have time for the good news. What I need for you to tell me is the bad news.”

In the same vein, to earn the trust of management, boards need competent members who appreciate the complex issues facing the organization, understand the difference between governance and management, and know how to offer constructive criticism. Trustworthy directors shun personal agendas, fully disclose any conflicts of interest and keep confidential information to themselves. How can a CEO

be candid when everything he tells the board is all over the country club and the medical staff lounge at a rival hospital the next day?

Good information builds trust, surprises do not. When a board has objective and contextual information in advance of meetings, discussions are more likely to be focused and productive. Balanced scorecards allow directors to quickly see the organization’s performance on key indicators and probe any troubling variances. The Sisters of Charity of Leavenworth Health System tracks 30 high-level indicators (see the September 2002 issue of *Trustee* magazine).

The CEO is the board’s chief educator but shouldn’t be its sole source of information. Boards should have access to independent information when they need it to make judgments, especially about major transactions and financial risks. Reports from bond rating agencies, strategic planning firms and accreditation surveys can give the board objective analyses, as can reports from the external auditors, legal counsel and compensation consultants.

4. Diligence

The days of coming to meetings, listening to reports and voting “aye” are over. Board members have to do their homework, take advantage of educational opportunities and use meetings to learn by actively participating and engaging in discussion. The expectation that board members participate, question and challenge should be part of their written job description, communicated at orientation and reinforced by the board chairperson.

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A Sampling of Post-Enron Governance Wisdom

“Enron’s directors protest that they cannot be held accountable for misconduct that was concealed from them. But much that was wrong with Enron was known to the board, from high-risk accounting practices and inappropriate conflict of interest transactions to extensive, off-the-books activity and excessive executive compensation.”

—*The Role of the Board of Directors in Enron’s Collapse*,
U.S. Senate report, July 2002

“The auditors told board members that Enron was following high-risk accounting and no one drilled deep enough to learn the details or object.”

—John A. Byrne, *Business Week*, July 29, 2002

“What is alleged to have happened within Enron and other companies can certainly occur within other non-profit corporations.”

—Health lawyers Michael W. Peregrine and James R. Schwartz,
“Enron and the Duties of the Health Care Trustee,” *Trustee*, September 2002

“Directors know relatively little apart from what management tells them.”

—John Smale, former CEO of General Motors and chairman of General Motors,
quoted by Ram Charan and Jerry Useem in “Why Companies Fail,”
Fortune, May 27, 2002

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5. Candor

Candor should permeate all board and board committee meetings, which are the playing field where commitment, independence, trust and diligence are put into action.

The board chair sets the tone for candor by encouraging inquiry, active participation and constructive dissent, and by establishing agendas that carve out time for substantive discussions of the most important issues facing the organization.

The executive goal-setting and appraisal process provides another forum for frank, constructive, board-CEO dialogue.

Structurally, meeting agendas, timing and length can either encourage or limit candid discussions. When meetings are too short and agendas are packed from beginning to end with reports and routine business, there's little time for learning, questioning and in-depth deliberations. The board member who wants to raise a sensitive topic or question can't find room to do it

constructively.

Board members will often remark, "We have great discussions at retreats but board meetings are just routine." With planning, the things that make retreats so stimulating — such as the focus on several big issues and a mixture of presentation and interaction — can be replicated at board and committee meetings.

Routine business items can be condensed into a consent agenda. The CEO's report can be brief and zero in on a few key items.

Annually, the board can establish its own goals that define the major issues of future-oriented strategy and policy on which it plans to focus its work in the year ahead. Throughout the year, the board can take an active role in choosing items for agendas. The board should function like a learning organization that continuously expands and applies its knowledge to vital issues.

Working on the Culture

The Enron experience, along with less dramatic governance failures, underscores the importance of board

culture. The board's self-assessment process provides a constructive, non-threatening opportunity for directors to have a conversation about governance and to adopt steps that will strengthen both their formal structures and their culture.

Taking assessment one step further, boards can benefit every few years from inviting an outside expert to examine their structures, reports and procedures and to interview board members about the culture. Like objective, outside evaluations of the organization's strategic position, financial health and quality of care, an outside evaluation of governance gives the board an informed and objective basis on which to continuously improve itself.

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