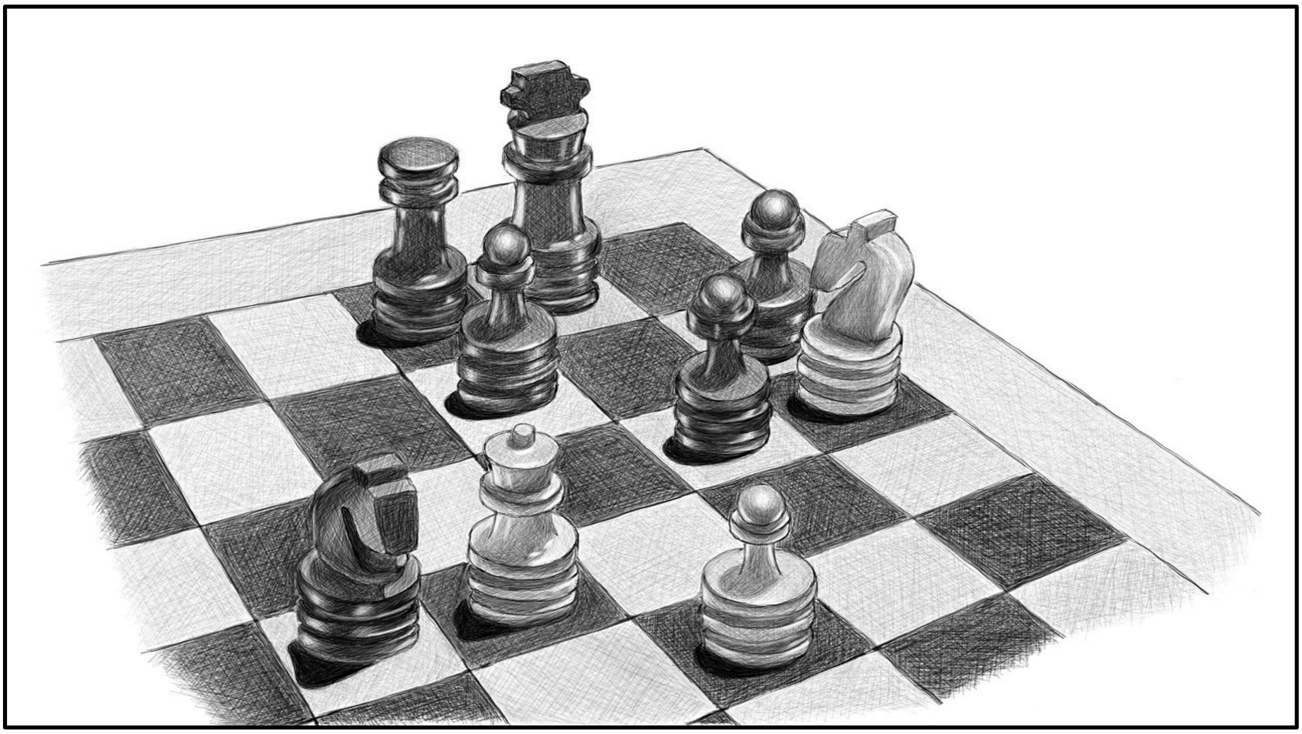

DO BOARD EFFECTIVENESS EVALUATIONS ADD VALUE?

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Introduction

Board effectiveness evaluations have become a standard part of annual board cycle routines since the Cadbury report was published in the UK In 1992 [Cad92]. The report contained a number of recommendations for improving the governance of boards of directors, of which evaluation of performance was a key aspect. While recognising the legal status of the board as a whole, the different contributions of executive and non-executive directors were highlighted. One of the key responsibilities ascribed to non-executive directors was reviewing the performance of the board and of the executive. Ever since this introduction, board effectiveness evaluations have evolved to become the responsibility of the full board. It also regularly contains extended elements, such as evaluating the chairman, committees, effectiveness of individual directors and depending on specific jurisdictional requirements, inter alia, the Company Secretary. Evaluation processes have matured significantly over the past number of years and have become a regular feature, with many codes of good corporate governance internationally recommending an annual self-evaluation by the board with external assistance every second or third year, so as to also ensure some periodic objectivity in the processes.

Given that virtually all large and listed companies are now adhering to annual effectiveness evaluations, a valid question to be asked is whether these evaluation processes add value to the work of the board, or whether it has simply become an exercise to be noted in the annual or integrated report to make sure investors do not ask tough questions.

Current best-practice

With evaluation processes having matured, there are a number of readily available frequently used tools. Practically, all evaluations kick off with a set of questionnaires focusing on the subjects of the evaluation (board, chairman, etc.) with the themes of interest to the particular board at that particular time. Once a report has been drawn up based on the survey results and shared internally with the board this is usually where an internal self-evaluation is concluded. The board may then contemplate an action plan to address the outcomes. In some cases, such internal processes may include one-on-one interviews between the chairman and individual directors.

In the case of independent external evaluations, various additional elements are added; mostly this would include interviews with individual directors to extract context on the responses given during the questionnaire stage. This also allows the discussion of more sensitive topics that are difficult to address in a questionnaire. Other elements often include the observation of meetings and benchmarking exercises.

One criticism of meeting observations is that this may cause artificial behaviour by participants, knowing the meeting and its participants are being 'examined'. If the observer is professional and experienced this should not influence the issues observed, as these should be more structural by nature, such as whether comments are made through the chairman or mobile phone-checking is tolerated, team dynamics, etc.

Benchmarking exercises may include formal issues, such as how the particular board compares to other similar boards in terms of, inter alia, size, composition and structures. Extensions to this can include an evaluation of the skills / strengths of individual directors and a comparison with other specific boards.

Practical example of benefits:
In a recent evaluation of the board of a large construction company, during the benchmarking process, it became clear that other boards in the same industry had started to appoint more directors with a legal background and experience.

The client board recognised this immediately as the result of most construction companies seeking more international contracts and opportunities and in a multitude of disciplines, such as toll-gate operations. Such an expansion and diversification strategy places an increased burden on the contractual and legal implications and understanding different jurisdictions, hence the increase in the particular skill and knowledge base of the benchmarked boards.

This provided the client board the opportunity to decide on how to respond to this particular trend. Had a benchmarking process not been completed, they may have completely missed this trend and business need.

Some pitfalls in evaluating performance: take due care

The obvious danger of an annual evaluation is that it is treated without due care. Except in cases where there is conflict or other personality issues, most boards are quite comfortable with the way the board is working. Therefore, even if there are areas of potential improvement, any such outcome may disturb the balance on the board and may result in a barrier from the board to allow uncomfortable outcomes in such a process. Experience has shown that indeed an evaluation process not applied with due care can result in destabilisation or lead to conflict on boards. Obviously, boards will attempt to avoid this outcome and may therefore avoid an in-depth, open and frank process.

Secondly, with an annual evaluation of a board, only having possibly met about four times in a particular year, it may seem too regular an exercise for members. The statement is often made that little has changed during the last year, hence the status quo is acceptable. In all human interactions there is resistance to changing ways of interacting, unless prompted by a crisis or something similar.

Thirdly, boards may simply go through the motions in any case; ensuring that stakeholders are made to believe that the board is actively keeping a finger on its own pulse and will diagnose any unhealthy trend, as well as respond to it.

In some rare cases boards or individual directors may want to use the external party performing an independent evaluation as a change-agent on their behalf.

Why might board members want to "use" an external party to fight their battles?

- Board members not able to convince a powerful chairman to step down before the appointment of a new CEO of the company: the evaluators were asked to bring this message subtly into the process.
- Similarly, evaluators were asked to include a message to reign in a powerful CEO by inserting a cautionary in the evaluation report.

In both these cases the desired outcome was achieved, but at high cost for the boards as it led to significant conflict on the board, taking a long period to return to balanced operation.

The components of a good board evaluation process

Given the survey-based platform of any evaluation process, the exercise may be akin to an 'audit' process, rather than an introspection of strengths and weaknesses and an honest measure of activities, both as teams and individuals. Often statements such as: 'The board meets often enough' are encountered in standard evaluation questionnaires.
The outcome desired is often explained as finding out if all critical issues are adequately dealt with in a timely fashion. The question should be rephrased to ask exactly that, otherwise the outcome may not yield any real information of value, or a multitude of questions need to be asked to get to the full answer.

Similarly, many questions may relate to compliance issues only (also similar to an 'audit approach'). These may include questions such as: 'Does the board report on all compliance issues in a timely fashion'. As important as the topic is, and there is nothing against including it in an evaluation process, this can only lead to a 'yes' or 'no' kind of response.

This lacks the richness of a contextual statement where opinion and thought are required in response to a question such as: 'What should the chairman do more of?' In this case the respondent has to venture an opinion based on his / her experience in the boardroom. Even though a wide range of responses may be the result, any particular trend, if present, will be measurable and implementable.

Given the two dimensions of governance, those of conformance and performance, often the question is asked if one of these should be prioritised during a review process, and if so, which one and why. This begs the question on what the important aspects of governance are that would result in boards creating value. An insight comes from the research of Booz and Company (now Strategy&) [Boo05 and Boo12].

There are many studies of successful companies attempting to establish the reasons for success. In these Booz & Company studies, the biggest losers were as follows: companies globally that, in one way or another, have failed to either keep up with the industry, or failed in absolute terms over a 10-year period, attempting to establish the reasons for failure.

Where does it go wrong? The researchers looked at four possible reasons for failure:

1. Declines resulting from external shocks that were natural, political or regulatory in circumstances in which the external event could not be controlled or easily anticipated.
2. Fraud, accounting problems, ethics violations, and other failures to comply with laws or standards.
3. Major operational problems, such as supply chain disruptions, customer service breakdowns and operational accidents.
4. Major strategic blunders (e.g., new product or new market failures) or a company caught by a major industry shift, including failed M&A, as well as dramatic shifts in major enterprise value drivers.

The researchers were surprised by the results of the initial 2005 study, which was post-ENRON and other highly publicised failures related to that period of the global economy pointing to serious compliance failures. For this reason, they repeated the study in 2012, post the biggest impact of the global financial crisis. They were once again surprised that the results remained virtually unchanged. The outcomes are depicted in Figure 1 below.

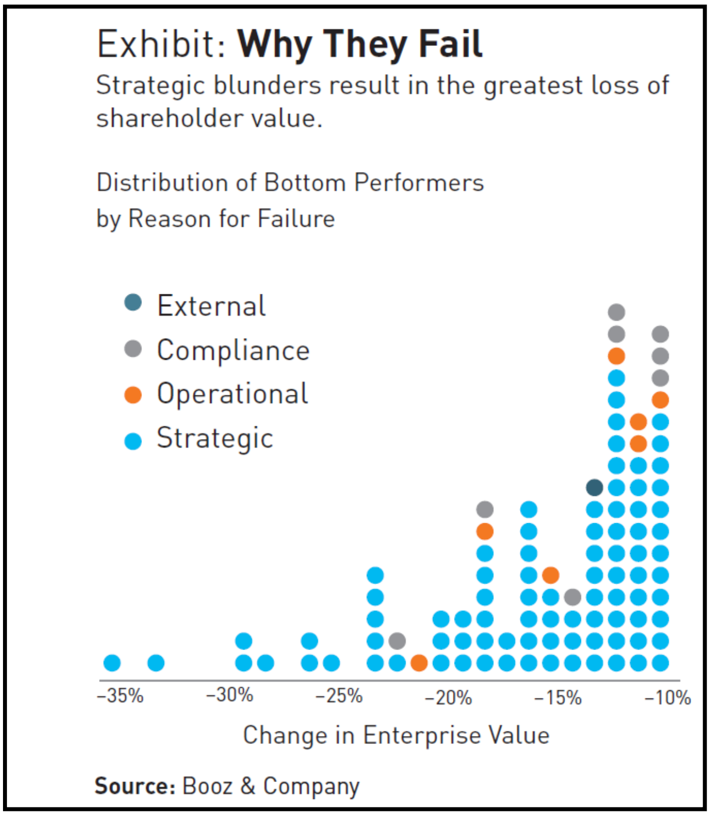


Figure 1

In numbers this indicates the following: 84% of companies failed due to major strategic blunders; 7% due to operational issues; 8% due to illegal conduct and 1% due to unexpected external shocks. The reason for the surprise is the fact that most publicity is given to illegal conduct, such as fraud, ethics violations, accounting issues, etc. while a relatively small number of companies fail because of this.

One has to take care to extrapolate these results to the role of the boards involved, but at least the statement that the board is 'in full control of the company' indicates that it may not be totally unfair to at least assign some responsibility to these boards of failed companies. If that argument holds, it begs the question on where boards should spend most of their time.

Failed strategy and execution of the strategy combined are far worse than anything else. It is important for the company to comply with all laws, regulations, codes and policies and the board must enforce measures, processes and structures to ensure such compliance. This is a large part of the license to operate, but compliance is not nearly sufficient, or a guaranteed recipe, for success. Success takes real strategic insight and sharing with dedicated implementation and follow-up. In short, success depends on the board applying their minds to the really difficult issues facing them.

The three recommendations from the Strategy& study are:

- **Broaden awareness about uncertainty.**
- **Integrate risk awareness directly into strategic decision making.**
- **Focus on strategic resiliency.**

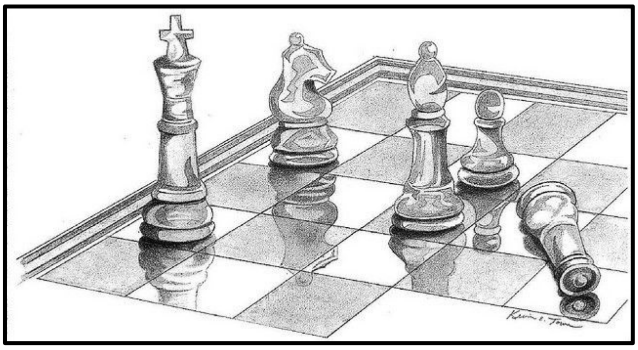
This greatly assists in answering the question on which aspects of the board's work should receive focus during the evaluation process.

A second aspect (implicitly linked to the work of Booz & Company) of what should form part of the evaluation process is addressed by the work of Ram Charan [Ram05]. With this (admittedly American focus), Charan addresses the purpose of the board and considers the key tasks in order of importance. His analysis:

1. The right CEO and his / her succession.
2. CEO remuneration / motivation.
3. The right strategy.
4. The leadership gene pool.
5. Monitoring health, performance and risk of the company.

If these tasks and the order of importance are accepted, an evaluation process should aim to establish if the board indeed spends most of its time and effort on the appropriate matters of importance.

A third insight is provided by the work of Boris Groysberg in 'Chasing stars' [Gro10]. Groysberg analysed the influence of some distinct factors on organisational performance, namely the economy, CEO, industry or the specific firm.
While keeping in mind that the research was focused on the US financial services industry and may not be universally applicable, the results remain surprising. Expressed as the percentage of contribution of a particular factor:



Factor	% Contribution to Organisational Performance
Economy	5.20%
CEO	13.50%
Industry	15.50%
Firm	32.80%

Table 1: Contribution of distinct factors on organisational performance

If one accepts the assumption that there is some universal truth in the analysis of Groysberg, the following holds:

- Boards can do very little about the economy.
- To move or diversify into other industries is neither easy, nor fast.
- Hence the board only really has control over less than 50% of what determines the performance of the organisation. Of that, the largest contribution comes from the company itself; the board has mostly access to the organisation in terms of, inter alia, culture, succession and training through the CEO and other executives interacting with the board. The CEO as a person contributes to some extent, but his / her main influence is through aligning the organisation for optimal performance. Again, this points to the priorities of board interaction with the CEO and indirectly with the organisation and consequently what should be measured during a board evaluation.

How best to approach a board evaluation process

During the years where boards perform an internal self-evaluation the person responsible, usually the Company Secretary, should ensure access to current thinking and best-practice in terms of self-evaluation processes. Because self-evaluations are almost entirely questionnaire driven, this means access to professional providers who can supply best-practice thinking and tools to support the board's process.

There are service providers catering for the full internal self-evaluation process through the means of software tools, allowing the board to complete the process without external consulting. These software tools allow the use of best-practice questionnaires with the ability to customise the questionnaires to suit the particular needs of the company. The evaluation process is automated, i.e., emails with links, login details, passwords and instructions are sent out automatically, progress of completion can be checked, reminders sent and ultimately should produce an on-line automated and editable report based on the data gathered through the survey process.

Some internal processes are supplemented by requesting a service provider to write the report on behalf of the board, allowing an independent analysis of the data, as well as the addition of recommendations based on the experience of the service provider.

Where the company wishes to utilise a full external independent evaluation process, the choice in consultant / service provider is critical; inter alia, preferably with international experience in order to truly incorporate global best practices in the process. References should be provided by the service provider and verified by the Company Secretary before accepting any proposal.

Board evaluation processes are generally of the 'grudge-buy' type, i.e., boards often do not focus on what can be gained through the process, but merely go through the motions to limit risks at the lowest possible cost of an evaluation process. While it is important not to simply buy the services of the most expensive provider, care should be taken not to waste the opportunity to obtain value-for-money. Experienced service providers should be able to provide insights from other boards, industries and jurisdictions and the result should give the board the appropriate recommendations with the sensitivity required for the board to be able to improve the way it is working and ultimately better enable the success of the organisation.

References:

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