

SENSE, SENSIBILITY AND INTUITION

What to Expect from an External Board Evaluation

May 2011

Introduction The views of UK regulators regarding board evaluation have changed significantly over the last eight years. From Sir Derek Higgs' gentle suggestion in 2003¹, first outlined in the Combined Code on Corporate Governance - "the board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors" - the guidance was developed by Sir David Walker in the Walker Report² in 2009 - "the board should undertake a formal and rigorous evaluation of its performance, and that of committees of the board, with external facilitation of the process every second or third year". This has most recently resulted in the provisions outlined by the UK Corporate Governance Code³ in 2010 - "the board should state in the annual report how performance evaluation of the board, its committees and its individual directors has been conducted. Evaluation of the board of FTSE 350 companies should be externally facilitated at least every three years. A statement should be made available of whether an external facilitator has any other connection with the company" - and the FRC's Guidance on Board Effectiveness⁴ in 2011.

It is worth noting that long before the UK regulators had decided to recommend a three year external evaluation for listed companies, the market had already determined this interval for itself. Formally introduced in 2003 as a process which should add value to the way in which chairmen considered and improved the board's performance and effectiveness, the regulators did not at the time recommend any particular methodology; it is, therefore, a significant change to suggest that every two or three years the board should use an external reviewer to conduct a board evaluation. Not surprisingly, this has created uncertainty in the UK marketplace; board evaluation is a relatively new discipline, there are very few experienced reviewers, and many chairmen⁵ and directors are unfamiliar with the advantages and disadvantages associated with different approaches.

The Importance of External Board Evaluation A well conducted external board evaluation encourages directors to step back from the day-to-day business of the board, providing them with a rare but legitimised opportunity to 1) question board approach and expectation, 2) objectively interpret the board's impact and contribution to the long term health and success of the company, and 3) unite and prepare themselves for the challenges ahead. The process is intended to provide an opportunity for the board to recognise and reflect on the current and future needs of the company, and offer an important catalyst for discussion and change.

Clearly this is not a compliance function; the effectiveness of the board is influenced by a combination of interactions and processes that are dynamic by nature, and which are difficult to assess. There can be no template; the role of the board, and its issues, are complex, and directors are intellectually demanding, occasionally defensive and often sceptical. The evolution of the board's approach and modus operandi will have been influenced by, inter alia, changes in the company's lifecycle and the impact of history, its external landscape and the speed of change, corporate structure, and board composition, culture and process.

¹ See HIGGS, D. (2003) Review of the Role and Effectiveness of Non-Executive Directors. London, DTI.

² See WALKER, D. (2009) A review of corporate governance in UK banks and other financial industry entities. HM Treasury.

³ See FINANCIAL REPORTING COUNCIL (2010) UK Corporate Governance Code. London.

⁴ See FINANCIAL REPORTING COUNCIL (2011) Guidance on Board Effectiveness. London.

⁵ The terms chairman and chairmen appear in this paper as a role description, rather than an indication of gender.

Engaging an external reviewer is a critical decision; the ability to gather and analyse reliable evidence, to communicate difficult messages in a constructive way, to have a level of comfort and familiarity within a boardroom environment, and to foster strong and trusting relationships whilst remaining independent, is an uncommon combination of skills. The impact of an evaluation, which has investigated a broad range of influences and identified strengths and weaknesses, can be significant, either enhancing a board's performance and effectiveness or, if badly conducted, damaging its confidence and cohesiveness. In order to add considerable value, therefore, an evaluation demands maturity and courage from the board, wisdom and skill from the reviewer, and integrity and legitimacy from the process.

There are several benefits:

- 1) an honest examination of the board's ability to achieve its objectives allows directors to question their approach to, inter alia, the development of strategy, the oversight of risk and control, the management of performance, leadership and succession, and the consideration of shareholder and stakeholder views. It provides an opportunity to explore the positive and negative influences of the board's culture and dynamics, the quality of its debate, the contribution of individuals and the board as a whole, the impact of leadership roles such as the chairman, senior independent, committee chairmen and CEO, and the board's size and composition. It also encourages an assessment of the board's processes, its calendar and agendas throughout the year, the quality of board and committee information, and the strength of its secretariat support.
- 2) a well conducted interview process is an effective and flexible methodology which can produce high quality evidence. A thoughtful and relevant interview, which is conducted within a confidential forum, encourages directors to talk openly about issues and concerns on an anonymous basis, to consider answers to questions that may not have been posed by the chairman, colleagues or shareholders, and to continue the consideration of issues after the interview, and often the evaluation itself, has finished. The intimacy of such an interview, and the benefits thereof, depend on the confidence in, and the confidentiality of, the reviewer, but provide a unique opportunity to discuss the performance of the board, its culture and dynamics, and the use of its time.
- 3) depending on the approach taken, the findings and recommendations from an evaluation can relate to a variety of influences on the board's effectiveness, and can be communicated in a number of ways; written documents, board presentations, individual meetings, collective discussions, and workshops present a variety of opportunities for constructive criticism and objective debate.
- 4) an experienced reviewer can add valuable context and judgment within both the written work and in discussion with the board. An objective and knowledgeable view, rather than a simple regurgitation of data, can add significant long term value to the board through high quality analysis, appropriate contextualisation and constructive criticism, a meaningful identification and separation of perception and reality, and the provision of relevant recommendations. The reviewer, for a brief period of time, can become a critical friend to the board, investigating and challenging sensitive and confidential issues with only the board's best interests, and its contribution to the company's success, on the agenda.

Given that the effectiveness of the board is ultimately the responsibility of the chairman, this paper is aimed at exploring the questions chairmen may have when considering how to maximise the value of their external board evaluation. Questions covered in this paper include:

- 1 when shall I commission the evaluation?
- 2 what approach should we adopt?
- 3 what advantages do interviews offer?
- 4 should I allow board observation?
- 5 who will participate in the evaluation?
- 6 how should the findings be communicated to the board?
- 7 what should we disclose in our annual report?

1 When Shall I Commission The Evaluation?

An external evaluation will take more time to organise and conduct than an internal review, and the chairman will need to plan the process within the board calendar. Although there is often pressure to conduct an evaluation around the timetable of the company's published annual report and accounts, it is more important to work backwards from a date during the year when the board will have adequate time to discuss its findings and recommendations. Given that most evaluations are taking a snapshot, it is useful to conduct the interviews and the observation within a limited and defined period; this enables directors to draw on the same experiences, and refer back to the same occasions e.g. the last board meeting, remuneration committee or strategic awayday. There are often logistical difficulties with directors' diaries, and therefore forward planning is vital; it is helpful to arrange the interview schedule two or three months in advance of the beginning of the review.

Although it is usually the chairman who commissions the evaluation, it is important that all directors are supportive of the process; good communication with the board regarding the approach and purpose, the process and time commitment, the necessary level of candour, and the feedback methodology, will enhance the quality of input and level of engagement. Occasionally potential reviewers are invited to present to the board, or a smaller group including the senior independent director and committee chairmen, before the evaluation begins, providing an opportunity for the reviewer to address directors' questions and concerns.

2 What Approach Should We Adopt?

Following the publication of the Combined Code in 2003 there were very few external reviewers, and consequently a limited range of methodologies available to chairmen; today there are a number of different approaches, which vary from the sole use of an online questionnaire, to an in-depth psychoanalytical assessment. The approach taken will partly depend on why the evaluation is taking place – to be compliant, to respond to external pressure, to benchmark the board's performance, to facilitate change, or to enhance the board's long term effectiveness. It will also influence a number of factors, including:

- 1) the way in which the reviewer interacts with the board before, during and after the evaluation;
- 2) the disclosure of board papers and related documents;
- 3) the number of participants, and the time they will need to invest in the evaluation;
- 4) whether the board and its committees are observed;
- 5) the time taken to complete the evaluation, and its place within the board calendar;
- 6) the way in which the findings are communicated to the board collectively and individually;
- 7) the cost of the evaluation;
- 8) the nature of disclosure within the annual report, and to shareholders and stakeholders;
- 9) longevity of the value and impact of the evaluation.

It is important that the chairman has the right to choose, in consultation with colleagues, the appropriate methodology for the board, and has the opportunity to assess the skill, experience and chemistry of the reviewer. Reviewers will have different interpretations of their role, the way in which they conduct the evaluation, what topics will be covered, and what questions asked. Some will work with a template, which predetermines the role of the board and best practice for directors; others will design a bespoke evaluation for every company. Some will attend to the historic and/or current effectiveness of the board; others will be forward looking, testing the board's preparation for the future. Several methodologies will be focused on tangible, visible outcomes such as board papers, processes and structures, others will explore less tangible influences such as behaviour, relationships, culture and dynamics. The chairman will need to decide, inter alia, to what extent the focus of the evaluation is on the board's current performance, and/or its future needs, whether individual contribution is assessed, whether the effectiveness of committees is included in the evaluation, and how the findings from previous evaluations are to be incorporated. There are no right or wrong methodologies, but there are different and decisive board needs, levels of engagement, required skills and competencies, and board outcomes.

Although some external board evaluators will base their assessments on a measurable process, often through the use of questionnaires and scores, many will incorporate aspects of qualitative research through the use of interviews and observation; the chairman will be interested in the latter approach, knowing that the effectiveness of the board depends on intangible as well as tangible factors, and is difficult to measure quantitatively. It is important that all the evidence gathered during an evaluation is objective, reliable and verifiable; this does not mean that it is necessarily based on reality and fact – much is based on perception, opinion and recollection – but that the approach should have integrity, legitimacy and robustness.

In many companies it is the company secretary who is asked to prepare a short list of potential reviewers and methodologies, and make an initial recommendation to the chairman; although this can be helpful, it is imperative that the chairman does not delegate the final decision. Experience, skill and chemistry are important, and the chairman has to be comfortable that an individual or firm will be able to maximise the long term benefits of the evaluation to the board and the company, and satisfied that the reviewer can conduct the work with a sufficiently objective and independent view. It is helpful to have the support of all the directors, and the chairman may decide to ask a potential reviewer to meet additional directors, such as the senior independent director, and/or the board as a whole before making the final decision. Chairmen should also reference the quality of the work of the reviewer with previous clients if possible.

3 What Advantages Do Interviews Offer?

Board contribution arises from a combination of interactions and processes that are dynamic by nature, and which are difficult to assess; a well conducted interview process is an effective and flexible methodology which can produce high quality evidence, gathered over a defined period of time. Interviews work well on a semi-structured basis, where the interviewer has a framework of topics to be covered (and therefore a basis for comparison between directors), but enough flexibility to vary the emphasis. This framework should be discussed with the chairman at the beginning of the review; major influences include, inter alia;

- the company's stage in the lifecycle, its size and its geography;
- current and future issues facing the board, the company and the sector;
- board size, composition changes, and individual director profiles;
- the degree to which individual contribution will be assessed.

The length of the interview will vary according to the number of topics covered, but in a comprehensive review participants should assume that the interview will last between one and two hours.

Although widely used in evaluations, the quality of information given and retained within an interview depends heavily on the interpersonal skills and experience of the interviewer. A properly contextualised interview requires substantial forethought; the interviewer should know enough about the company, the external environment within which it is operating (for example, the impact of changing regulation a fast moving competitive landscape, or a sector in decline), the director's background, and role within the board, to be able to maximise the relevance of the questions, and understand the context of the answers. An experienced interviewer will help directors to feel at ease at the start of the interview, usually by explaining the context of the review, the framework for the discussion, and the parameters of confidentiality and anonymity. The skill of the interviewer is key; the ability to listen to what is said and what is not said, distinguish certainty from uncertainty, and understand the range of factors shaping nuance and interpersonal dynamics, is vital if sensitive material and candour are to be handled correctly. In assessing the suitability of a potential individual or firm, the chairman may want to consider the following questions:

- 1) has the reviewer worked or studied in relevant fields, which involve information gathering, analysis and presentation? In a comprehensive review, a huge amount of evidence is gathered, demanding high quality analysis, and skilled written and verbal presentation;
- 2) can the reviewer communicate difficult messages in a constructive way? Most boards demonstrate areas of both strength and weakness, and the emergent themes need to be presented in a way which encourages the directors to discuss issues and agree resolutions;
- 3) has the reviewer spent a significant amount of time in board and committee meetings, either as a director, an attendee or an advisor? It is helpful for directors to know that the reviewer understands the context within which they are operating, is knowledgeable about the topics, and can empathise with the issues that arise;
- 4) is the reviewer independent and objective? Ongoing business relationships with the company, or ties with particular board members, most importantly with the chairman, may inhibit directors from candid discussion, and influence interpretation of the findings.

4 Should I Allow Board Observation?

A comprehensive evaluation will often include observation of the board and committee meetings, and/or a strategy day; this helps the reviewer observe the board dispassionately (rather than relying solely on personal accounts), triangulate the evidence given during the interviews, and prioritise strengths and weaknesses. It also facilitates important observations concerning, inter alia, the physical characteristics of the boardroom, the interplay between directors, and the relationship between the quality of information provided to directors in advance of the meetings, and the related discussion.

Occasionally directors are concerned that colleagues will behave differently whilst being observed; this is rare, as most board meetings include the presence of external advisors and attendees, and directors are not usually self-conscious. More important is the ability to trust the reviewer with private and often highly sensitive information; confidentiality is paramount, and the chairman needs assurance that the information will be used only within the context of the evaluation.

5 Who Will Participate in the Review?

The majority of information given in a board effectiveness review usually comes from the board directors (both executive and non-executive) and the company secretary; this ensures that all the participants have an holistic and comprehensive view of the work and dynamics of the board. However, if there are very few executives on the board – some boards have only the CEO and CFO as executive representatives – it can be helpful to include one or two key executives below the board, particularly if they have good exposure to the directors. Retiring, or newly appointed directors, can also offer useful perspectives.

Very occasionally it can be useful to include other executives, such as the head of internal audit or HR, and external advisers, such as the external auditor, major shareholders and regulators; this can offer an additional perspective regarding perceptions of those in the boardroom, particularly non-executives, derived from those outside of it, and an assessment of levels of engagement, visibility, and stature. However, the views of those who do not regularly attend board meetings, or do not have good exposure to all the directors, will probably be too narrow to add an holistic view.

6 How Should The Findings Be Communicated To The Board?

Having gathered reliable and verifiable evidence, the reviewer will be expected to analyse, prioritise, and present the board with an objective view. The chairman will need to consider how the reviewer's findings are best communicated in the interests of improving the board's effectiveness, and whether;

- the evidence should be presented to the directors as an unadulterated mirror image, or as a view to which the reviewer has contributed context, judgment and recommendations;
- quotes are used in specific contexts and maintain appropriate anonymity;
- the reviewer should offer recommendations and/or an action plan;
- concerns regarding individuals are identified (not normally recommended).

Although written documents are an important reference point for the board, a collective board discussion provides a valuable catalyst for directors, as it allows them to discuss any issues within a confidential and constructive forum. The success of this discussion depends on the chairman; an effective chairman can engage directors in an open and honest debate, and facilitate the identification of priorities, agreed actions and timeframes.

The length of a collective discussion is often difficult to determine at the beginning of an evaluation; occasionally very few issues arise, and the discussion can be quite short. In some cases, evaluations reveal two or three significant themes for debate, and warrant several hours. The chairman can choose whether a short conversation at a board meeting, or a lengthy discussion over dinner, is the right forum to maximise the value of the evaluation. Confidential feedback to individual directors can also be helpful, particularly if issues arise relating to, for example, contribution and approach, the effectiveness of delegated committees, or interpretation of the board's most senior roles.

7 What Should We Disclose In Our Annual Report?

There are a variety of evaluation methodologies available, which increases the need for reporting clarity and transparency. Although there is guidance relating to disclosure within the UK Corporate Governance Code, the most comprehensive guidance is in the Walker Report:⁶

“The evaluation statement should either be included as a dedicated section of the chairman's statement or as a separate section of the annual report, signed by the chairman. Where an external facilitator is used, this should be indicated in the statement, together with their name and a clear indication of any other business relationships with the company and that the board is satisfied that any potential conflict given such other business relationship has been appropriately managed...

the evaluation statement on board performance and governance should confirm that a rigorous evaluation process has been undertaken and describe the process for identifying the skills and experience required to address and challenge adequately key risks and decisions that confront, or may confront, the board. The statement should provide such meaningful, high-level information as the board considers necessary to assist shareholders' understanding of the main features of the process, including an indication of the extent to which issues raised in the course of the evaluation have been addressed. It should also provide an indication of the nature and extent of communication with major shareholders and confirmation that the board were fully apprised of views indicated by shareholders in the course of such dialogue.”

Part of this disclosure is easily communicated in writing, specifically the name of the individual and/or the firm conducting the review, any existing relationships with the company and the board (and potential conflicts of interests), and a description of the process undertaken; this is often disclosed in the chairman's statement and the corporate governance section. It is often more difficult to describe any confidential or sensitive themes which have emerged, particularly if they relate to individual directors (which may include the chairman), and the culture and dynamics of the board. The chairman and the senior independent director may decide to give major shareholders and regulators a verbal update on these issues, and any agreed changes, when appropriate; occasionally the reviewer may be asked to contribute to these meetings.

⁶ the Walker Report is directed at relevant financial institutions and not at quoted companies as a whole.
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Conclusion

Although there has been much progress made, these are early days; even the most experienced external reviewers in the UK have been practicing for less than a decade, and best practice is still emerging. However, there is growing evidence that external board evaluation can act as a valuable catalyst for improving the board's effectiveness and its preparation for future challenges; the ability to construct a private and confidential forum, in which directors can speak frankly and without fear of inappropriate disclosure, and yet which provides an objective and contextualised view, is unique. As this new discipline develops and differentiates, chairmen and their boards, together with their shareholders, stakeholders and regulators, will become more knowledgeable and discerning regarding the range of options available, and the integrity and value of the process.

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