INDEPENDENT AUDIT LIMITED

Time well spent?

A practical overview of board evaluation

What's it all about?

It appears that the world is divided on the subject of formal evaluations of board effectiveness. There are those who think it's a good idea, and those who think it's a pain in the neck.

Actually, it's not quite as clear as this. Almost all directors agree it's a good idea, every now and then, to stop and think about how well a board is working and whether it could be made better. The pain-in-the-neck factor tends to arise when the Combined Code and box-ticking come up.

But let's stick with first principles. The reason the Code suggests that board effectiveness should be reviewed is to help boards improve their performance. Which means the issue for boards isn't compliance with rules or putting ticks in boxes. Nor, though we hate to say it, is it about providing a regular source of income for professional advisors.

Board effectiveness evaluation is the starting point for thinking about how the board's collective performance might be improved, not only to make a greater contribution to the company but also to see if life in the boardroom can be made more productive and more enjoyable.

Is it worth the effort?

If a good effectiveness assessment can help to make directors' work more efficient and more fulfilling, then it must be worth doing for its own sake. The crucial thing is to make sure the assessment is indeed a good one, so that the time spent does produce results. This paper contains some suggestions on how to get the best out of both self-assessment and independent evaluation.

A more debatable question is whether it's worth spending time on effectiveness assessment for someone else's sake, especially if "someone else" means box-tickers in and around the investing community.

There might be early signs of some movement away from box-ticking towards a greater emphasis on comply or explain, but it's too early to be sure this will come to anything.

More persuasively, investors do seem to respond to the general pattern of behaviour by companies. We recently surveyed a number of leading investment institutions, and there was a consistent theme. Boards which consistently show that they take their shareholders seriously – and having a thoughtful and constructive attitude to the Code is part of that – will have greater allowances made for them if things go wrong.

Boards which are offhand or dismissive are likely to be jumped on as soon as the business shows signs of faltering. It isn't very hard to think of recent examples of this. So careful communication of good governance sounds like an investment that could pay off in the long run. A sideways look at board reporting is on page 3.

What does "good" look like?

In theory, the effectiveness of anything should be judged by reference to what it was supposed to be effective at – whether objectives have been achieved and reasonable expectations met. In practice, of course, this doesn't work very well for boards.

A board's objectives can be hard to define and are frequently not very measurable ("setting the tone at the top" is a particularly fine example of something which, like a camel, can be recognized more easily than described). Even when success can be defined, timing is often a problem: it can take years for the consequences of some decisions to come through.

Given these difficulties, most approaches to assessing board effectiveness go back a stage, and instead of looking at a board's achievements will concentrate on the things that, if working well, should put it in a position to be able to achieve something useful. The most important things, of course, are the quality of the people on the board, and how they work together.

But that isn't the end of the story. The Code itself, in giving illustrations of the sorts of things that need to be looked at when assessing board effectiveness, suggests not only board composition and team dynamics but also a comprehensive additional list of other things. These include board process; engagement with strategy and risk management; information and communication; and the interaction with committees. Boards perform best when all of these things work well together.

"...and this week all boardroom tables come with a free, titled, non-executive director."

The most thorough look at a board's effectiveness would take an even broader look and consider how the board engages with the rest of the organisation and with shareholders. In practice, the scope of a board assessment is rarely extended so far, although it can be useful.

Self-assessment

Some of the best boards and their chairman have used self-assessment to good effect over a period of years (perhaps this isn't entirely coincidental!) and have a well-established routine in place. Even the most enthusiastic supporters of external evaluation have to admit that it can make good sense for a formal self-assessment to be done as a precursor to an independent review.

Quite rightly, directors often say that they are well-placed to know if a board is functioning well, and how it could be improved. To get them talking constructively together about how to improve board performance, it's usually necessary to kick-start the process. Questionnaires are commonly used for this purpose. Some companies have acquired them from consultants or even created their own versions, but the most common way of getting a questionnaire is to take one that's been used elsewhere and adapt it. With directors often sitting on multiple boards, one can usually be scrounged from somewhere.

Questionnaires work particularly well for smaller companies and for boards that haven't previously given much thought to assessing their effectiveness. They're relatively inexpensive and unthreatening, which makes them the easiest first step in effectiveness evaluation. And they're the easiest way to pick the low-hanging fruit and find the most straightforward ideas for improvement.

Individual performance

The performance of the board as a whole is obviously very dependent on the performance of the chairman and the individual directors. Nonetheless, the Code makes it clear that assessments of individuals are something distinct from the overall board evaluation. A wide divergence of practice can be seen: a few companies go to the extreme of having psychometric assessments of directors, while the annual reports of a sizeable number appear to confuse the individual evaluations with that of the board as a whole.

Evaluation of director performance is a prime responsibility of the chairman and should not be swept up in an overall board assessment. Similarly, evaluation of the chairman is something that the directors have to do, usually under the leadership of the SID. The board evaluation process can provide a mechanism for gathering information on the performance of directors and chairman, but does not relieve them of their responsibilities in this regard.

The real value from a questionnaire comes from the discussion that takes place around it. So much so, in fact, that some companies skip the questionnaire part altogether and just have a facilitated discussion. Facilitation involves a third party structuring the discussion and guiding the debate to achieve its desired outcomes, while not directly participating in it. Its value is very dependent on the strength of the facilitator. Academics can be good at this, although some have been criticised for (wait for it) being somewhat academic...

Some people think that the best form of self-assessment is to combine the use of a questionnaire with a facilitated discussion. With a good facilitator, a well-thought out questionnaire and a co-operative board, this can produce good valuable insights; without these, it can be a rather laborious and time-consuming way of arriving at fairly unsensational conclusions.

Quite apart from the general benefits of facilitation, it's better to have a discussion of board effectiveness controlled by someone other than the board chairman, no matter how open-minded he or she might be. Their chairing is after all a particularly important influence on the board's effectiveness.

"Just for the minutes did anyone manage to catch the chairman's parting words?"

Even with good facilitation, self-assessment doesn't stand up well to repetition. It's hard to get fresh insights from the same process, especially if the board membership changes only slowly, as is usually the case. No matter how good a self-assessment might be, after a while it tends to lose its oomph.

Consequently, an increasing number of those companies who are practised at self-assessment are thinking of trying an independent evaluation. There's not necessarily much difference in the time and effort required, but having the different perspectives can be valuable. A fair guess is that some sort of cycle will develop as the norm, with self-assessment alternating with external reviews of the board, audit committee and other committees in different years. Mixing the two sounds quite reasonable and we suspect that the governance industry will be cruelly disappointed in its hope of a new annual tax on business.

Although self-assessment is a valuable tool when used well, it makes shareholder communication a bit trickier. Self-assessment is also the technique of choice for those who are determined to view the whole thing as an exercise in box-ticking. If you've been putting a lot of care into your board's self-assessment, it will be worth making a special effort to distinguish yourself from those who are just going through the motions.

How to write a really bad board report

With skill and diligence, it is possible to report on a board's activity and effectiveness in a way that complies with the Combined Code but communicates almost no meaning apart from a disdain for the reader. There is an increasing number of informative and credible board reports coming out – following the tips below will help to make sure yours isn't one of them.

- Eschew any description of actual activity in favour of a restatement of the terms of reference. This device is particularly favoured by audit committees, but boards can get considerable mileage out of their reserved matters.
- Always use the present tense. "The board reviews its effectiveness by means of self-assessment" is cunningly phrased so it can remain a good intention. The past tense turns this into a definite statement of having accomplished something, which obviously should be avoided.
- Emphasise that a board effectiveness evaluation was done, but leave the reader to speculate whether self-assessment means a systematic questionnaire and several hours of facilitated debate or a ten-minute chat over cocktails before dinner.
- If the board evaluation involved external help, either suppress the fact altogether or make an oblique reference to an anonymous consultant. Making an effort to add credibility to your report could arouse suspicion.
- At all costs do not give the slightest impression that the board assessment resulted in concrete, identifiable changes for the better. This might imply that things were less than perfect beforehand and lead to class action suits or, worse, comment in the Daily Mail.
- On the other hand, saying that things were perfect already might sound a little complacent. Like a saint confessing her gravest sin and by its triviality convincing us of her sainthood, offer up one or two things that show your ceaseless striving for perfection. Training directors in IFRS, for example, or imaginative action to improve attendance at meetings…
- Conflate the evaluations of the chairmen, the directors, the committees and the board as a whole. Readers don't want to be bothered by separate descriptions of what are supposed to be separate activities when they can get it all over and done with in one paragraph, or even one sentence.
- Avoid burdening the reader with unnecessary explanations on matters such as why a director in his twentieth year of office is nonetheless independent. A bald statement that the board has thought about it is quite sufficient and makes a significant saving on paper and printing.

"That's the first time I've seen all the Board members together since I can't remember when."

Independent evaluation

The Code's good practice guidance says that "the use of an external third party to conduct the evaluation will bring objectivity to the process". This has led to a remarkable outbreak of entrepreneurial activity and it is now quite difficult to throw a brick in the City or in Mayfair without hitting a board evaluation consultant. At the present rate, it won't be long before there are more of them than there are boards (unless of course their numbers are culled by a few well-aimed bricks).

Consequently, there is an impressively large and varied assortment of suppliers vying for your business. The diversity of supply is matched by diversity of approach: headhunters, company secretaries, academics and the rest all naturally tend to emphasise that aspect of board effectiveness which corresponds to their various skill sets.

Quality, unfortunately, is not consistent. Ask any group of non-executives about their experience of external assessment and you are likely to get answers ranging from "extremely useful, you should do it" to "a total waste of money, don't touch it".

So how do you choose? In the first place, it has to be someone you trust. This makes it tempting to use someone already known, but discretion is required. It's not usually a good idea for the chairman to choose his or her best buddy. Good board evaluators should be free from prejudices, preconceptions and partiality, unless of course the entire object of the exercise is to confirm the chairman's prejudices and preconceptions...

"All those opposed signify by the usual sign."

Rather than use someone who isn't independent, it's better to ask around for recommendations. And good advisors will offer good references.

In addition, you need confidence in their discretion, the depth and nature of their skills, and the breadth and relevance of their experience. We've found that understanding boardroom and organisational life is more important than industry knowledge. But nonetheless it helps to know your way around the industry.

Reasons for using external advisors vary widely. Some see it as developing best practice and don't want to be left behind. But most choose it because they feel that an independent perspective will be a useful way to build on their own efforts and to make sure that there aren't any blind spots.

Sometimes a fresh look is what's needed to help directors see the wood for the trees. A smart outsider can question the assumptions that come to be shared by all the insiders.

And of course there are some issues that it's easier to tackle if an outsider will take the blame for raising them…

"I wish we'd just given him stock options like everyone else."

When choosing your advisor, it helps to define your goals before you specify the most relevant skills. Do you want particular emphasis on a specific topic such as people or board process, or do you want a more wide-ranging approach? If committees are to be looked at, what specialist skills might be needed?

In our experience, it's best not to categorise board effectiveness as being solely about composition and dynamics. A board's performance is influenced by factors such as the quality of information received, differing understandings of priorities, and the extent and nature of interaction with management. A spot of systems thinking is needed.

Yes, it's the people on the board who make the processes work – but on the other hand their behaviour and ability to contribute is affected by the processes that surround and support them.

What's involved?

Approaches vary, but most external evaluations of board effectiveness involve individual interviews with directors. Some advisors preface these with questionnaires, some don't. We find that examining the board papers for the previous year is the best preparation for discussion, as well as placing less of a burden on the directors.

Experienced interviewers with a good understanding of board effectiveness and business issues are able to build a picture quite quickly, so interviews should not need to last more than an hour or an hour-and-a-half. The interviewee directors can find the experience stimulating and enjoyable – but only if the interviewers know their stuff. Using two interviewers from different professional backgrounds adds cost but often gives a more stimulating and insightful discussion than with one person working alone.

It's also very helpful if the external advisors can watch the board at work by observing a board meeting. Perhaps surprisingly, this doesn't seem to have any noticeably disruptive effect on the meeting – directors are used to having assorted hangers-on in attendance and quickly forget there's an unusual presence amongst them.

The results of the review usually come in the form of a presentation to and discussion with the board, or a formal written report, or both. In any event, it should be discussed with the chairman first.

Sensitive matters should be dealt with in private discussions, so the quality of the work can't always be judged from the formal reports.

So it's important to look not only at how directors perform in the boardroom together, but also at how well the company does its part towards making it easy for the board to be effective and efficient. Even if shortcomings aren't so bad as to render a board ineffective, they can make it heavier going than it needs to be. An all-round look gives the best chance of ensuring that board meetings remain both productive and enjoyable.

Even the minimum effort to comply with Combined Code requirements takes time, and doesn't yield much. Doing the job well, which can produce real benefits for busy directors, takes more enthusiasm, but only a little more time.

Independent Audit Limited specialises in working with companies to get value out of governance. We help boards and their committees solve problems and improve their effectiveness, and we advise on governance mechanisms such as audit or risk management frameworks.

If you would like to discuss any of the ideas contained in this paper, or would like additional copies, please contact us:

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