Board Evaluation: From Bogus to Brilliant

By Donna M. Hamlin, Ph.D.

The obligation of boards to evaluate performance

A rush of corporate scandals, corruption and shocking transgressions has resulted in a new business atmosphere – investors, shareholders and creditors have finally had enough. Across the globe, they have banded together in special interest groups and are now insisting on legal regulations and reforms to protect their rights and interests.

Shareholder activism has created more reforms in the last two years than in the last two decades. Investor group influence now shapes the way boards set policies in such far-reaching topics as diversity, compensation, terms of director service, and director eligibility.

One practice emerging from this wave of reform is the annual board evaluation. Whether mandatory or recommended, the intent is clear: a board of directors has an obligation to review its overall performance, provide transparent disclosure about how it operates, and continuously adopt practices to improve its overall contributed value.

Investor and shareholder insistence on 'pulling back the curtain'

Investors and shareholders expect – and demand – a right to 'pull back the curtain' and evaluate the governance quality represented by a company. The fundamental value at work here is to create open and consistently accurate information about how a company governs its operation and strategy.

Obviously, openness and disclosure create a huge opportunity for companies to improve. When called upon to conduct board evaluations, however, reactions from boards of directors run the gamut from ludicrous to lofty. We see a continuum here, from the worst to the progressively avant guard.

Many types of board evaluations don't work

Some boards pretend to perform evaluations. Others do it half-heartedly. Still others take an aggressive approach that creates huge conflicts of interest. Here are some of the more common types of board evaluations that simply don't work.

Scofflaw. This type of board is insulted by 'over-regulation' and ignores the evaluation process. They take a 'wait to see if we get caught' approach. Their directors doubt that they will suffer serious consequences for refusing to do it, and some plead ignorance when caught. Some even expect that the requirements for self-evaluation will disappear in time.

Perfunctory. This type of board asks its general counsel to make a checklist of compliance steps and items to be disclosed. They then assign the General Counsel to ensure that a proxy

statement includes this information. In other words, their directors trivialize the effort by turning it into a minimal checklist delegated to legal counsel.

Back-Slappers. This type of board allocates a five- minute slot on the agenda called 'Board Evaluation'. At the designated time, the director asks the group: "How did we do this year?" People nod, declare they did well and congratulate themselves. The chair then says "Pat your neighbour on the back for a job well done," and they immediately go on to the next item on the agenda. In other words, this group completely mocks the purpose of the evaluation process.

Controllers. Some boards perform their own evaluation by assigning the task to one director. The director interviews all the others, compiles the input, identifies recommendations and reviews the findings and recommendations with the board. This is entirely subjective, and often highly compromised. We know of one company chairman who insisted on conducting the evaluation himself. When confronted by the CEO about the honesty and objectivity of this approach, he simply said: "Tough. There is no law that says I can't do it. We're doing it my way."

Conflicted. Some boards ask a third-party to conduct the evaluation, but then contract a company with a direct conflict of interest. Imagine, for example, a board that hires an executive search firm to conduct the evaluation. This firm does so, and then says: "Your board is missing a distinct set of skills, but we can find the person you need". Firms that provide services should not also provide evaluations. There should be no conflict of interest.

Half a Deck. Some well-intended boards conduct an evaluation, but do not do a thorough job. They may focus on processes, structure, committee composition and skill sets. But they may ignore group dynamics, board behaviour, committee leadership effectiveness, and information symmetry between committees or between supervisory and executive boards. They mean well. But they are playing with half a deck of cards when looking at their overall performance.

So, if some boards use such poor practices, what works?

Other types of board evaluations work much better
Boards which take an honest and open approach to evaluations fare better in terms of improving their performance, whether this means making incremental changes or accelerating change over time.

*Personal Best**.*** This type of board does an earnest job of evaluating its performance, year after year. It looks at what it can do to improve, based on its own progress and relative only to itself. What they learn is: "Here is how we did last year. Here is how we did this year." Like an athlete hoping to take a few more seconds off their time, a board can make incremental changes and improvements with this approach.

Normative Best Practices. Other boards conduct evaluations that include a common core set of key performance criteria. That way, they can look at their own performance and compare it to a norm within their industry peers or similar sized companies. They can also learn about best practices used by other companies that may accelerate improvements for their own board. Our board evaluation tool therefore includes thirteen core areas with metrics used across companies in all industries and countries. This maximizes the amount clients can learn about their results and best practices the world over, year after year. Boards who take this approach tend to have directors with a deep commitment to performance improvement and an earnest intent to learn and share.

The best boards use a structured approach to maximize potential and value
Boards that really want to uncover ways in which to match strategy with performance and add true value are much more committed to performing evaluations that demand true accountability. These are the Pushers.

Pushers. Seriously committed board directors are challenging themselves with new ways to measure their performance. They push for true accountability metrics. For example, Sasha Schmidt and Matthias Brauer (Strategic Governance, Volume 14, #1, 1/2006) advocate measuring the consistency between a company's resource allocation and its announced strategy, as well as a set of related strategy consistency measures as indicators for a board's effectiveness in guiding strategy execution.

At Intrabond Capital, we are Pushers. We challenge our clients by using a mix of corporate performance metrics, and then tracking the correlations between their board performance and corporate outcomes. Directors in this group are truth-seekers, dedicated to maximizing their potential to add value and make a difference.

A five-level approach to board evaluation
We use a structured approach, evaluating board effectiveness at five increasingly accountable levels.

Level One – Board Essentials: Infrastructure. This level addresses thirteen 'essentials', including board structure, processes, composition, information, and committee and board management. Are standard board processes enough to get the job done? Is the mix of experience and backgrounds appropriate? Are board roles and responsibilities clear?

Level Two – Effectiveness: Processes and Group Dynamics. This level evaluates board dynamics and the abilities of directors to work effectively together and with management in terms of quality and effectiveness. Effectiveness often has less to do with formal structure than with the quality of directors themselves and how they interact. Do board members work well with each other and with management?

A good understanding of levels one and two make the performance of Level Three much easier.

Level 3 – Alignment: Coalition and Strategy Development. This level is extremely important, because it focuses on the board's ability to align with management to define strategy and contribute to successful execution. Is there clear understanding about the appropriate metrics of corporate performance? Is there ownership of performance improvement and evaluation?

Level 4 – Synchronization: Business Issues Management. This level considers the board's use of clear and viable accountability metrics as it synchronizes to shape models for both its business and governance. This can be difficult, and requires the right corporate governance attributes for predicting performance. Does the board articulate clear key drivers? Does it communicate to stakeholders about corporate performance? Does it anticipate and help to shape future business models and strategy that are in sync with shareholder interests?

Level 5 – Convergence: Corporate Issue Management. This level considers the sustainability of the board's approach to governance and what it contributes to corporate results, shareholders, stakeholders and society. The highest level considers a board's broader role in society. This can be challenging, and requires boards to overcome the asymmetry of information that often occurs between committees and supervisory and executive boards. Do activities converge to create critical, forward-looking leadership and influence with government, community and the environmental? Do members share common goals?

Intrabond Capital believes compliance with all of these levels can be achieved with the right motivation and commitment. It assesses boards by combining these quantitative and qualitative measures – based on international and industry best practices – to deliver reliable information that a board can use to evaluate improvement opportunities.

Boards which do not take evaluation seriously risk realignment by force

While reactions to board evaluations appear wide-ranging, one thing seems certain: shareholders are demanding that directors sit up and take notice. The truth is that the focus on governance standards is not going away. Instead, it is being placed under hotter, brighter spotlights. Shareholders have the right to expect their boards of directors to scrutinize the ways in which they carry out their responsibilities and to relentlessly seek out ways to improve. Activist shareholders are taking a stand, as they move to become active in boards which do not take this responsibility to heart, and which fail to create sustainable shareholder value. Boards must take evaluation seriously or expect to be realigned by force.

As professional advisors, we have an obligation to admonish the scofflaws and the perfunctory directors, and to counsel the conflicted and controllers to learn from the personal best, the normative best practice boards and the pushers. We should insist that boards adopt methods for evaluation which support the true purpose behind it: value for all.

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