Board performance evaluation post-financial crisis

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- A culture of mutual respect and transparancy is most conducive to healthy and challenging boards
- The crucial ingredient is the quality of human interaction which is hard for outsiders, especially investors, to know and measure
- In a good board, evaluation takes place continuously rather than waiting for formal annual reviews

Over the last ten years, the practice of conducting performance evaluations of boards of directors has become commonplace in large corporations. Not only is the process widely established but it is seen as an essential tool in achieving better board performance and effectiveness.

Despite this, investigations into the causes of the global financial crisis have concluded that poor board oversight was a contributing factor in the collapse of many financial firms. Post-crisis, the regulatory spotlight has fallen, not for the first time, on boards of directors: their composition, skills and dynamics. As this article will discuss, although significant regulatory change in this area is unlikely in Australia, international developments will influence board evaluation practices in this country and the commitment and rigour surrounding board evaluation is only likely to increase.

Empirical findings

This article draws on the findings of our recent research aimed at capturing the state of play of board and director evaluation processes in Australia and overseas.[1] The research is highly relevant post-GFC, as it explores how board evaluation can improve board performance and effectiveness and how this value can best be communicated to investors. Organisations across the world have been examining the causes of the financial crisis, including the corporate governance failures that contributed to its severity. The emerging conclusion is that in the area of corporate governance four overlapping problems had arisen, particularly in financial firms.

1. Risks were complex and poorly managed.
2. Executive compensation schemes encouraged excessive risk-taking.
3. Boards were not exercising proper oversight.
4. Shareholders were not monitoring or engaging with companies effectively.[2]

It is the third issue that we focus on in this article: the role of a board, how boards can improve their performance and recent developments in the process of board evaluation. As well as the findings of our recent research conducted in conjunction with the Australian Council of Superannuation Investors, we examine the recommendations arising out of some of the many international investigations into the GFC. Although these reports deal mostly with the large financial firms at the heart of the crisis, their findings and the consequential regulatory changes are already spreading to encompass listed companies across all industry sectors.

We discuss the three main aspects of board performance and its evaluation: first, what makes a good board, second, how boards should be evaluated and third, how the results of such evaluation can best be communicated to investors.

Factors influencing board performance

Our research involved two stages: first, an analysis of information on board evaluation published by a sample of companies worldwide; and second, interviews with Australian directors and investors which explored the value of board evaluation in more detail. The interviews allowed the researchers to explore the key factors necessary for a board to function effectively and, on the other hand, the factors that directors had found to most hinder good board performance. Comments from those interviews are presented here to illustrate the key points.

In order to operate effectively, directors valued an honest, transparent board culture conducive to 'healthy, challenging' debate. Mutual respect for each other was seen as vital in order to create an atmosphere within which the board could function effectively as a team.

> You have to have differences of view. You get through the differences of view and come out on the other side with agreement. On the big issues you want debate, even disagreement. You do not want acrimony, but you do want differences of opinion.

A collegial board based on consensus decision-making was seen to be ideal, based on respect for colleagues and an appreciation of the diversity of thought and experience contributed by each individual. The ensuing frank dialogue in the boardroom was seen as vital for good board performance. The many comments on board diversity and its importance in effective board performance demonstrate the increasing awareness of this issue among directors. Since the CAMAC report in 2009,[3] this area has been under the spotlight.

For instance, CSA and Women on Boards jointly developed guidance to assist ASX-listed entities comply with the changes to the ASX *Corporate Governance Council's Corporate Governance Principles and Recommendations*.[4] The Australian Institute of Company Directors has introduced a mentoring scheme for female executives, seen as a very positive development by most directors. In addition, the Business Council of Australia has been active and provided a submission on the topic to the ASX Corporate Governance Council.[5]

Our interviews confirmed the role of the chairman as pivotal in creating an effective board. Most directors saw the chairman as the leader who sets the agenda and the culture of the board. An effective chairman, who can maintain a constructive relationship with the CEO, is seen as a tremendous asset to the company.

> You certainly need a good chair who encourages debate and draws out contributions from each of the members and doesn't allow the loudest voice to dominate. A chair who drives decisions to a consensus or makes decisions that the board will support.

Other factors contributing to an effective board include the infrastructure in place such as having good management information systems or having the 'right' number of committees and length of board papers.

Not surprisingly, a dysfunctional board culture is characterised by the direct opposites of a functional, collegial board culture. A board culture that does not allow transparent, open communication or that creates an adversarial environment can severely hinder board performance.

> Dysfunction in the board. You will know of cases in recent times. It becomes public and it directly affects the leadership of the company in many ways, not just 'do we know who the boss is?' It tears at the heart of the company and leads to poor performance. A chair of a dysfunctional board has a lot to do to fix it up. If there is a dysfunctional director, the chair has to act. It is not an easy thing, it is not just 'come and have a cup of tea'. A reshaping of the board can take up to three years. It can take an average of 18 months, if someone digs their heels in.

Directors interviewed had a clear idea of the elements that contribute to efficient and effective board performance, and the elements of board behavior that lead to dysfunctionality. Table 1 provides a summary of the key characteristics of effective versus dysfunctional boards.

In the UK, many of these characteristics were picked up by the 'Review of corporate governance in UK banks and other financial industry entities' (the Walker review) and the Financial Reporting Council's concurrent review of the Combined Code on Corporate Governance.[7] The final recommendations of the Walker Review were released in November 2009 and included an entire chapter on the functioning of the board and evaluation of performance. In particular the review examined the role of non-executive directors on the board, ultimately recommending that they be 'ready, able and encouraged to challenge and test proposals on strategy put forward by the executive'.[8]

As a result, a revised version of the UK Combined Code, now the UK Corporate Governance Code, was published in May 2010. Many of the changes to the Code were specifically directed towards improving board effectiveness and performance.

> To encourage boards to be well balanced and avoid 'group think', there are new principles on the composition and selection of the board, including the need to appoint members on merit, against objective criteria, and with due regard for the benefits of diversity, including gender diversity.
>
> To promote proper debate in the boardroom, there are new principles on the leadership of the chairman,

the responsibility of the non-executive directors to provide constructive challenge, and the time commitment expected of all directors.[9]

In Australia, the ASX Corporate Governance Council's guidelines were reviewed in 2009–2010 and amendments to the guidelines were announced on 30 June 2010. The amendments were designed to take into account the findings of three recent independent reviews which focused on issues related to corporate governance: CAMAC's reports *Diversity on Boards of Directors*[10] and *Aspects of Market Integrity*[11]; and the Productivity Commission's report *Executive Remuneration in Australia*.[12] Thus the amendments deal with diversity, remuneration, trading policies and investor briefings and do not deal directly with board performance evaluation.

Nevertheless, the expanded commentary on board diversity is relevant to succession planning and board performance in achieving diversity objectives. It makes it clear that nomination committees ought to consider the issue of diversity in their succession planning, regularly review the proportion of women employed at all levels of the company; and make recommendations to the board to address board diversity.

Table 1: Key traits of dysfunctional and effective boards

Factors	Dysfunctional board	Effectively performing board
Culture	Adversarial atmosphere Acrimonious discussion Conformity or groupthink Unquestioning or unmotivated Controlled by dominant shareholder Narrow vision Lost in detail	Collegial atmosphere Honesty, openness and transparency Mutual trust and respect Consensus, common purpose Opportunity to air differing viewpoints Professionalism Strategic insight
Chairman	Autocratic Weak Hinders debate Dominated by the CEO	Experienced — manages the agenda Encourages debate and contribution Professional relationship with the CEO Takes responsibility for effective board
Directors	Lack of business experience or appropriate skills Not genuinely independent Factional interests or conflicts Disruptive personalities Egos that get in the way	Diversity (of thought, skills and experience) Right fit for company Work as a team Constructive challenge
Senior management	Withholding information from the board Lack of transparency Lack of trust	Effective communication with board Ask questions and 'use' experience of board members
Processes	No process to solicit views No process in place to deal with conflict or issues Poor information flow Poorly structured meetings and papers Limited succession planning	Open discussion Good information flow Effective delegation to committees Board agenda papers (right length and time) Succession planning

Without doubt, in future, boards or their nomination committees, are going to be expected to spend a considerable amount of time assessing their overall composition and skill set. Our research found that Australian boards were already doing this but that there was definitely room for improvement in the use of tools such as skills matrices. Although very useful, directors acknowledged that skills matrices can be ignored by a chair or CEO who has a strong view on a potential new board member. Equally, overreliance on a skills matrix could cause a company to overlook someone whose input might be extremely valuable but not fall within the relevant categories.

> Different companies have different [requirements]. At one company the matrix includes the work experience of all the directors, overlaid with their knowledge. It's really tricky as you want to throw other things in that make people valuable. You can tick a box (eg international experience) but it might not be in the area you want. We do that in terms of looking at potential members.

Evaluation of board performance

Our interviews revealed that board evaluation is well entrenched in large Australian companies and has become routine practice over the last decade. The earliest board evaluation mentioned by participants was in 1996 with most companies starting in the early 2000s. An important change noted by the directors is that they are more comfortable with board evaluation now than years ago when board evaluation was in its infancy. This has resulted in a greater willingness to engage in more robust and meaningul board evaluation, which is oriented towards positive outcomes.

Another of the main changes to the UK's Corporate Governance Code involved a strengthening of the recommendations surrounding board evaluation processes.

> To help enhance the board's performance and awareness of its strengths and weaknesses, the chairman should hold regular development reviews with each director and board evaluation reviews in FTSE 350 companies should be externally facilitated at least every three years.[13]

The recommended standard of triennial external board evaluation is a fairly significant development in the area of board evaluation likely to reverberate more widely. Our research found that most large Australian companies conduct some sort of evaluation annually but they do not necessarily use the same process each year. It is becoming quite common for companies to alternate the procedure used such that they carry out an internal assessment one year and use an external consultant the next. Certainly most large Australian companies would not struggle to meet the UK's recommendation of external evaluation every three years, as many already use independent consultants at least this often.

In an ideal situation, the type of board evaluation chosen ought to reflect the issues facing the company at the time.

> How long the board evaluation takes depends on where the board is at: if there has been a significant changeover, up to half the people are relatively new, then you would adopt a different approach to an experienced board. You need to balance the approach with the longevity of the board — using a prospective evaluation if it is a new board, or a retrospective evaluation if it is an experienced board. The centre of gravity shifts depending on the longevity of the board.

Thus, as with all corporate governance processes, a performance evaluation process needs to be flexible and should be adapted to fit the company's changing circumstances. The general opinion is that the use of an experienced external consultant can be very valuable but may not be justified every year. External reviews are costly but may be particularly useful when the board is going through change.

The new UK Code emphasises the need to follow the spirit, not only the letter of the Code. In a novel attempt to overcome the problem of 'boilerplate' statements, chairmen are encouraged to report personally on how they have implemented the principles on the role and effectiveness of the board.

Another major change introduced in the UK is a requirement for directors of FTSE 350 companies to be re-elected every year. This may affect processes for individual performance evaluation of directors. Interestingly, our research found that directors were divided on the issue of whether board evaluation ought to include assessments of individual directors' performance. It seems that despite the ASX recommendation to assess directors individually, many companies do not do this on the basis that it can inhibit independence or whole-board dynamics.

> These people are elected and are meant to be independent. I think it is very important that there is respect for their independence so I don't engage in personal evaluations. I encourage them to be as different as they want to be, not push them to the average or the middle.

> At [company] it is clear that board evaluations are about the board, not individual directors. You can have the best people on the board, but it does not work. Or potentially you could have the worst people on the board and it works. The board is a team of rowers, or football players. We need to become the best team, to listen, to discuss and make decisions.

Disclosure regarding board evaluation

The practice of conducting board evaluations has developed over the last ten years, partly due to encouragement by regulatory authorities and stock exchanges worldwide, most of which now recommend that listed companies conduct regular performance assessments of their boards and also, in some cases, of each individual director. In addition, most exchanges require companies to disclose the details of their board evaluation processes in their annual report. The ASX Corporate Governance Council's guidelines state 'companies should disclose the process for evaluating the performance of the board, its committees and individual directors'.[14]

The guidelines also recommend that 'development of a process for evaluation of the performance of the board, its committees and directors' should be a responsibility of the nomination committee because:

> An evaluation of the range of skills, experience and expertise on the board is important when considering new candidates for nomination or appointment. Such an evaluation enables identification of the particular skills that will best increase board effectiveness. [15]

The guidelines recommend that reporting on board evaluation should include whether a performance evaluation for the board, its committees and directors has taken place in the reporting period and whether it was in accordance with the process disclosed.[16]

Comparisons on board evaluation

From an international comparative perspective, the first stage of our research revealed that disclosure on board evaluation is strongly influenced by the regulatory approach of each country. In the United States where a rules-based approach to regulation is prevalent, disclosure appears to be much more standardised and perfunctory. For example AT&T simply stated:

> Through a formal survey or other appropriate means, the Corporate Governance and Nominating Committee shall lead the Board through an annual self-evaluation process to determine whether it and its Committees are functioning effectively.[17]

In the principles-based jurisdictions including the UK, Australia and Europe there is the opportunity for richer disclosure although a common format is still apparent with only a few companies voluntarily offering more (or different) information. Of the 30 Australian companies reviewed only three gave information describing the valuable outcomes of their board evaluation process. For example, Santos stated:

> As a result of recommendations arising from the external Board review, a number of initiatives have been introduced; for example, increasing time spent on strategic issues and improving the style and format of Board papers.[18]

Most companies limited their statements to a confirmation of the occurrence of the evaluation and a short description of the process used. Some went into more detail than others on the process by giving details of the topics covered, for example Macquarie Bank stated:

> The questionnaire will be agreed by the Board and covers matters such as:
>
> - the Board's contribution to developing strategy and policy;
> - the Board's performance relative to its objectives;
> - interaction between the Board and management and between Board members;
> - the Board's processes to monitor business performance and compliance, control risks and evaluate management;
> - Board composition and structure; and
> - the operation of the Board, including the conduct of Board meetings and group behaviours.[19]

In voluntarily giving this additional detail, companies can at least give investors an indication of the areas where improvements might occur. We found that most UK companies gave this kind of detail on the content of the process and went on to confirm that the result of the evaluation was that the board was found to be performing effectively. This audit approach, particularly when involving an external evaluation, may give some comfort to investors but doesn't give a great deal of flavor in terms of the practical outcomes. The issue of how to provide more meaningful disclosure was discussed with both directors and fund managers in stage two of the research.

Directors confirmed that Australian companies tend to disclose the minimum recommended by the ASX Corporate Council guidelines unless they need to explain or justify a departure from recommended practice. Disclosure in this area can be difficult due to the potentially sensitive and/or confidential nature of performance assessments. There is a fear that the market could misinterpret information in an adverse way when it was intended to convey positive outcomes. For example if a company declared that as an outcome of the board review it had determined that the board should focus more on corporate strategy, this could be interpreted by the market as 'the board has lost its way!' An interesting point made was that if investors were to be told more about the outcomes of board evaluation this would be too late for investors to act, since any notable weakness identified would be addressed by the board as a matter of some urgency.

However investors are concerned that at least they know the processes that are taking place on boards. Overall, some directors were open to the concept of increased reporting on board evaluation including providing more detail on non-sensitive outcomes. Others were of the view that this was of little value in assessing board performance and, interestingly, the fund managers interviewed agreed. It seems that the institutional investors place little value on annual report disclosures preferring to assess board members based on their backgrounds and personal characteristics.

Outside, looking in

When asked how investors or other outsiders might assess whether a board was performing effectively several directors believed this to be a 'mission impossible'. All directors and fund managers understood that the link between board performance and company performance is complex and that even the best of boards can be hindered by factors beyond their control. Nevertheless indicators that can be helpful in assessing board performance include:

- willingness of a company to seek and respond to market feedback
- personal characteristics and credibility of directors
- professional history of directors
- company performance within the industry
- quality of board decisions, particularly in times of crisis.

For the fund managers, assessment of board performance is used selectively in investment decisions. While there is a broad perception of the relative quality of boards, and of their relative performance, it is generally not seen as a vital factor in investment decision-making because of the difficulty in obtaining information and ambiguity regarding its link to company performance. However, it can be valuable in 'screening' out boards that are perceived negatively.

> This area is not sophisticated enough that it drives our portfolios. There is not a single company where I could say we own it because it has got a great board. Having said that, there are some we would simply not own because their board and management are particularly poor.

The UK's Walker review strongly recommended regular board evaluations and better disclosure to investors regarding such evaluation.

> 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 appraised of views indicated by shareholders in the course of such dialogue.[20]

Conclusions

Sonnenfeld argues that it's not the rules and regulations but the way people work together on boards that make them great.[21] This is echoed by Daily and Dalton who state that board effectiveness is a matter of integrity.

> The performance of any board is a function of the character of the individuals that comprise the board. No structural remedy can overcome poor judgment or apathy. At the same time, no amount of individual character can overcome accountability without responsibility.[22]

That summarises the difficulty in assessing board effectiveness. A good board undoubtedly requires members with specific skills and experience, and its performance will almost always be assisted by good structure and process. However, the crucial ingredient is the quality of human interaction and this is much harder for an outsider, especially investors, to know and measure.

This is where board evaluation ought to have real value. Only the board itself can really assess its ability to work together, to make decisions efficiently and to identify any problems. As Sonnenfeld observes, a lack of evaluation and feedback can be 'self-destructive'.

> People and organizations cannot learn without feedback. No matter how good a board is, it's bound to get better if it's reviewed intelligently… If a board is to truly fulfil its mission, it must become a robust team — one whose members know how to ferret out the truth, challenge one another, and even have a good fight now and then.[23]

Our recent research confirms the value of board evaluation and the fact that, if done well, it can contribute greatly to effective board performance. It seems that directors of large corporations are much more willing to engage in board evaluation than they might have been some years ago and recognise its value, especially in times of change. Regulators around the world also recognise this, and stock exchange recommendations regarding board evaluation are becoming more stringent post-GFC.

Outcomes of board evaluation processes range from relatively minor amendments to board processes (such as meeting agendas, format of board papers) through alteration of committee structures (amalgamation or changes to committee charters), to significant changes in board orientation (for example, spending a good deal more time on strategic direction of the company and less on procedural rituals), to significant changes in board composition (to fill skill gaps or remove directors contributing to dysfunction). The process of implementing these outcomes of board evaluation is a crucial step that perhaps deserves more attention. It is a vital component in whether a board evaluation process actually leads to better

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board performance. Equally, the links between the process of board evaluation and other processes such as director re-election, succession planning and director education and development are becoming clearer and more formalised in practice and these ought to have a tangible impact on overall board performance.

An important point that emerged in the research interviews was that the formal annual board evaluation is not the only opportunity for boards to assess themselves and implement improvements. In a good board, evaluation is a continuous process — problems are ironed out as and when they are recognised. Many board members find that board effectiveness can be greatly enhanced if the board members, particularly non-executives, have a chance to get together outside of formal board meetings to discuss issues that might not fall within the formal agenda.

There is still reluctance among board directors to adopt greater disclosure of board evaluation outcomes, because of the risk of issuing market sensitive information, or, in trying to avoid this, issuing only valueless motherhood statements. There remains a clear preference towards more informal and direct communication between board members and investors.

Nevertheless, it is not impossible for firms to make balanced statements that are neither open to misinterpretation by the market nor descend into vacuous vanilla statements. At the very least investors have the right to know that a rigorous process of board evaluation has taken place and that the outcomes have been acted upon in effective ways to enhance the board's performance. It will be interesting to see how the UK move to encourage chairmen to write personal statements about board performance in annual reports works out in practice. It is important that the widespread practice of chairmen issuing standardised statements that appear to have been written by the public relations department of the company cease. Presenting empty rhetoric to investors is not appreciated, and does not convey any sense of vibrancy in corporate governance.

Following the financial crisis, the economic chaos resulting from inadequate board oversight has demonstrated the need for greater vigilance to ensure companies accountability. This is reflected in recent legislative and policy changes, particularly in the UK, which acknowledge the growing expectation that boards should monitor management as well as take full responsibility for the monitoring of their own performance. Investors, regulators and the general public will be interested to discover how well boards of directors improve their game.

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Notes

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