A Blueprint For Board Evaluation

by Susan F. Shultz

Though public company boards today are expected to perform evaluations, there is no rule saying they have to do it right. Many boards are finding their way through the evaluation process, often mired in process, perhaps asking the wrong questions or asking them the wrong way—and, not suprisingly, getting poor or indifferent results. What is an effective evaluation process? What structures bring the most candidness, the deepest insights, and the best clues for improvement?

As a rule, we learn how effective a board is when something really bad happens. How do we know before a crisis if we have a good board? We measure it—independently, confidentially and professionally.

If there is no assessment, no accountability, how can directors be confident they are doing everything within reason to be sure the board is the best it can be? How can shareholders know that the board is effectively representing them and doing its job? If we do not demonstrate the value of our boards through robust evaluations, the government is poised to do it for us.

We need only look at the "super boards" and "czars" designed for the bailout industries to see the looming threat to the traditional role of boards. These entities have final say on compensation, composition and, in some cases, hiring and firing the CEO and mergers and acquisitions—in effect, nullifying the traditional board. For example, if GMAC, the funding arm of General Motors, fails to pay the eight percent interest on the preferred shares for its $5 billion government loan for six or more quarters, the government will receive two board seats. Who selects those board members? How will that impact the current board?

At Citigroup, the Federal Reserve and the Office of the Comptroller of the Currency now apparently have veto power over the most critical strategic decisions, usurping and perhaps supplanting the role of the board and management. They could impose decisions about pay, acquisitions, and possibly board make-up. So, we have created, in essence, a shadow board of bureaucrats, who hold a 7.8 percent stake. The dangers loom large. Who is in charge? What is the role of the board? Where is the transparency?

Evidence increasingly proves that good boards mean good companies. Substantive board assessment is increasingly appreciated—and required—as an essential best practice.

Another threat to corporate board independence is the movement to allow shareholders to nominate directors directly to the proxy. Directors should encourage shareholders to nominate directors. However, to ensure independence, nominees must be folded into a professional process in which the director criteria have been agreed on and defined in advance. If nominees can bypass the independent board's filter, special interests could gut board value.

If nominees can be placed directly onto the proxy without board input, the process will be irretrievably politicized. Board make-up will be skewed; and allegiances will be pulled to special interests. Proxies will become political battlefields, expensive and confusing. Strategically recruited, "value added" boards will be a thing of the past. We will be likely to spawn a pool of recycled professional directors who may or may not be well suited to a particular board and may or may not prioritize the best long-term interests of the company.

Awareness of the need for excellence in corporate governance, especially at the board level, is at an all

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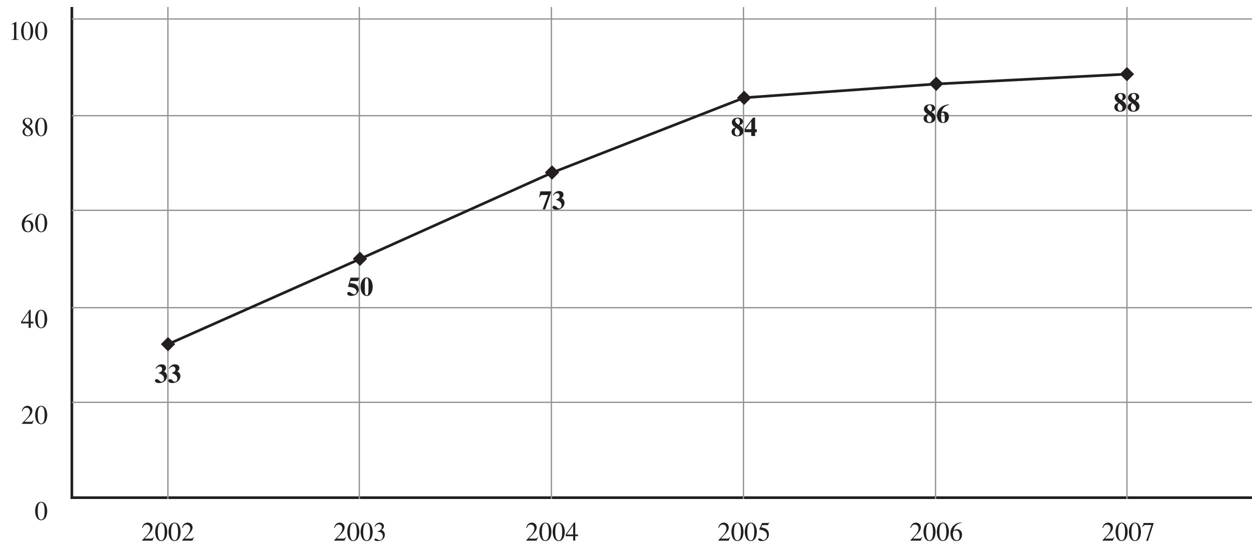

time high. Boards, as representatives of shareholders, have always been an essential element of the free enterprise system. However, confidence in our free enterprise system has been severely disrupted. It is up to corporate directors to demonstrate our value and help restore the trust that has been bludgeoned by the many glaring abuses in our system.

Evidence proves that good boards mean good companies. We already know that investors will pay a 20 percent premium for a good board. Eighty-eight percent of boards are now evaluated on a regular basis. Further, 79 percent of directors believe an effective board evaluation process is *the most important technique to ensure directors' effectiveness.*

Substantive board assessment is increasingly appreciated—and required—as an essential element of best practices. Evaluations are now mandated by the New York Stock Exchange, the Securities and Exchange Commission, most board charters, and rewarded by directors and officers (D&O) insurers.

Institutional investors, such as CalPERS, are making clear that board evaluations are a critical part of corporate governance. Rating agencies, such as RiskMetrics/ISS, score public companies higher on two counts of corporate governance: first, if a board conducts an annual board evaluation and, second, if a board conducts annual individual director evaluations. Finally, industry associations, such as The Conference Board, the Business Roundtable, and Financial Executives International, all advocate use of board evaluations.

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At one end of the evaluation spectrum is compliance, "check the box" mindset in which a chair might look around the boardroom and ask, "How are we doing?" At the other end is an active commitment to reinforcing good practice and recognizing and addressing areas to improve. In the mandates, there is little detail on how to conduct evaluations or what should be included.

A comprehensive, valid evaluation reduces the time and resources we need to spend on compliance and process. It frees us to focus on the business of the business and the productivity of the board. A robust evaluation provides a platform for creation of an action plan to continuously improve the effectiveness of the board.

What are the most important attributes of a good evaluation?

☐ Independence and objectivity. Questions and results are developed independently of the company and the board.

☐ Benchmarking internally, against good practice, and against peers.

☐ Ease of use.

☐ Professional methodology. The assessment asks the right questions in the right way.

☐ Clear, usable reporting that highlights strengths and weaknesses, and provides detailed, targeted information.

☐ Accredited, continually updated corporate governance education. This should be responsive to broad governance practice, and allow directors to fulfill education mandates during the assessment process.

☐ Anonymity, confidentiality, and security. In order to gain valid feedback, anonymity must be given to those who provide assessment information, as well as those who receive feedback. Research shows that people are less candid when talking to another person face-to-face rather than responding privately on the web or paper under the promise of anonymity. These conditions can be met with a third party who commits to never reveal individual assessment data. The third party uses a series of safeguards to assure that those who receive feedback are also protected with appropriate privacy.

☐ Customizable questionnaires that can be readily modified to include any key issues relevant to the company.

☐ A "board-centric" approach. The board has exclusive control of the process and its results, and determines what approach is used, who participates, how the results are shared and used, and any other issues relating to the evaluations.

☐ Qualitative and quantitative data is evaluated.

☐ May be facilitated internally or by a governance consultant.

☐ Separate evaluations for the board, the committees and individual directors are offered.

☐ Inclusiveness. Respondents, at the discretion of the board, include all board members together with others working with the board such as non-director officers, outside counsel, auditors, consultants and perhaps shareholders.

☐ Online or paper options are offered.

☐ The evaluations are informational, not prescriptive.

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Experience across many public and private organizations suggests that the evaluation process should meet four further tests. The process should be:

☐ *Fast*—taking a minimum amount of time.

☐ *Actionable*—providing valuable information that motivates action.

☐ *Simple*—easy to use and to understand.

☐ *Targeted*—yields strategic information for each director.

The front-end, confidential, evaluation questionnaire should address the composition and the structure of the board, its leadership, and its culture. Ask *quantitative* questions such as how often directors meet with key officers, advisors, and auditors.

Also, ask *qualitative* questions. How much time is spent discussing strategy and at what point are the board members engaged in those discussions? Who controls the agenda? Do directors actively participate? How does the board communicate with and respond to shareholders? Can directors describe the key financial metrics that drive the company?

What are the five most pressing risk factors? Do board members understand and approve of the pay packages? Do directors know how succession planning is being addressed, and do they approve of the process and potential outcome? Do the directors

know how the company goes to market and how it is perceived in the marketplace? What are the key components of the marketing plan? Is it effective? Do directors know what the revenue "pie" looks like? Where do they receive information about the company? Is the time spent in the best way on the right issues?

Every question should be carefully framed to eliminate bias and encourage anonymous comments in addition to a "rating."

Keep in mind that no one, except those in your boardroom, know how effective the board really is. What if the directors are simply dominated by management, bankers, attorneys, and other professionals who report, rather than engage? What if the committees control key decisions? What if directors are sleeping, texting, monopolizing, or wasting time on minutiae? What if the directors do not get along with one another or ignore or discount those who disagree with them? If the directors at Enron or other failed boards had an opportunity to express a concern or raise a question, privately, confidentially and anonymously, might things have been different?

Once the questionnaire is completed and the information gathered, personal interviews may then be conducted to drill down into areas that the board determines should be addressed. Drawing on the information in the questionnaire, confidential interviews may be conducted by the governance committee chair, the board chair/lead director, or a consultant with exclusive allegiance to the board.

A final board discussion stage of the evaluation in itself helps focus the board on the most important areas of corporate governance.

The final step is *boardroom discussion.* The board determines what, if any, actions should be taken to address any issues raised and to improve the board, its committees and the directors. The discussion itself serves to focus the board on the most important areas of corporate governance and tends to carry through the year.

Specific action may or may not be deemed necessary, but if it is, timelines and individual accountabilities help the board track results. The discussion may be facilitated by the board chair/lead director, the governance chair, the general counsel, or an outside counsel (to provide a potential layer of attorney-client privilege) or other board consultant.

The feedback session is a good time to consider new regulations, approaches and trends relative to corporate governance, and whether to integrate them into future practices. Also, it is a time to consider any potential changes to bylaws, charters, codes of ethics, and any other board guidelines as well as committee rotations.

Evaluations should be conducted annually or after a significant change always considering whether new issues or areas of emphasis should be incorporated.

Board members need reliable, high-quality information to assess, validate and improve. Benefits and examples of board evaluation outcomes include being able to attract the best directors, spending more time on strategic discussion, changing the way revenue recognition is realized, enhanced independence, improved transparency, better shareholder relations, emphasis on succession planning, better marketing strategies and more time devoted to interactive discussion.

Objective measures can also help justify moving directors off the board, especially those who obviously have outlived their usefulness. Finally, robust assessments provide a risk filter to the board, providing an important tool in demonstrating its intent, value and integrity.

Ultimately, the market will reward companies that embrace best practice by regularly using substantive, independent assessments to ensure that their directors and boards are the best they can be.

Assessment is a positive. The focus is where it should be—on good practices, improved communication and information, and better boards. Evaluation is as valuable for good boards as for those boards seeking improvement The opportunity is to move beyond compliance to a strategic board that adds value to the business. The time is now. ■

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