

## **TAKING BOARD EVALUATION BEYOND SIMPLE COMPLIANCE: DIRECTOR BEHAVIOUR AND BOARD PERFORMANCE**

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### **Context**

Main Principle Six of The UK's 2003 Combined Code of Corporate Governance states: *The board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors.* In Main Principle Five it has made clear already that the Chairman is responsible for the induction and development of their board.

Main Principle Six goes on to spell out a Supporting Principle: *Individual evaluation should aim to show whether each director continues to contribute effectively and to demonstrate commitment to the role (including commitment of time for the board and committee meetings and other duties). The chairman should act on the results of the performance evaluation by recognising the strengths and addressing the weaknesses of the board and, where appropriate, proposing new members to be appointed to the board or seeking the resignation of directors.*

It continues with a Code Provision: *The board should state in the annual report how performance evaluation of the board, its committees and its individual directors has been conducted. The non-executive directors, led by the senior independent director, should be responsible for*

*performance evaluation of the chairman, taking into account the views of executive directors.*

## **The Current Issues with Board Evaluation**

When the 2003 Combined Code was published and became secondary legislation many chairmen and directors expressed shock, especially with Main Principles Four to Seven which seemed to move the focus of the ultimate evaluation of board performance away from the final bottom line of the company to a revolutionary notion that both the combined and individual performance of the directors had a causal relationship with that bottom line and needed separate assessment. Moreover, now the dynamics of this relationship would need to be benchmarked and commented on annually. Many took this as a gross infringement of personal directoral privacy. No framework was offered in the Code. So surely the regulators were not serious?

They were, but before pressure was brought to ensure that this part of the Code was taken seriously in the UK the growing consequences of a massive disruption from the environment – US’s Sarbanes-Oxley Act (SOX) – distracted board’s attention for some years. This created so many time and cost pressures on any UK-listed company with even a minor interest in the US that this part of the UK’s Code was put firmly on the back burner. Admittedly, Chairmen still had to “comply or explain” at their AGMs but the happy combination of the preoccupation with SOX, their ability to use self-evaluation processes and shareholders who had little knowledge or interest in this board performance area has meant that there was little pressure to perform especially on Principle Six.

## **Simple Board Evaluation Compliance is No Longer Sufficient: We Need to Take A Developmental Approach To Board Evaluation**

Now, however, things are changing. After three years of simply reporting to the owners that the company has a formal and rigorous annual evaluation of its board performance in place more searching questions are beginning to be asked by the owners. Most of the current responses from Chairmen are at best unconvincing. The rise of more activist shareholders, trades unions concerned about perceived gross overpayment of directors and executives for debatable performance, a more inquisitive media, fund managers much more demanding of quantifiable director and board performance linked to added shareholder value, and others

concerned with globalisation mean that much greater interest is being given to board evaluation process and its outcomes. The launch of the *Seven Non-Exhaustive Duties of Directors* in September 2007 as an early part of the implementation of the 2006 Companies Act will reinforce strongly such questioning.

From my international work on board evaluation I find that Chairmen and Company Secretaries are beginning to feel that they cannot go more than one or two more Annual General Meetings under their present minimalist compliance conditions without growing criticism from their owners and the media. This is creating a number of new problems for boards who are seeking clarity to such questions as:

- What use is board evaluation anyway?
- Who should do the evaluation?
- Is there a model for good practice?
- How rigorous should it be?
- How much should they divulge publicly?

Let us look at each in turn because there are few easy answers.

### **What use is board evaluation anyway? Moves towards a developmental Approach**

This is a curious, yet common, question. In any other part of a business it is now the norm to have at least an annual performance appraisal for each member of staff. Why should the board be different? Indeed there are those, me included, who argue that the evaluation process must start with the board because it is their formulation of policy and business foresight, linked to their strategic thinking, which determines the ultimate business performance of the whole. That such an obvious answer needs to be given still highlights the problem that many boards see board evaluation as an imposition on them and, therefore, an unnecessary cost in time and money. I argue the converse – that regular and rigorous board evaluation set the benchmarks from which cost-effective gap analyses can be derived which then form the basis of a *developmental* approach to improving the effectiveness of the board, its committees and each individual director. This simple notion that there is a causal relationship between investment in the development of boards and the total performance of the business is only being accepted slowly. I argue that it is the key to adding sustained shareholder value and will come into sharper focus from September 2007 as the Seven Non-Exhaustive Director's Duties come into play and

directors realise their greatly increased personal responsibilities and liabilities.

### **Who should do the board evaluation?**

The ultimate responsibility for the board evaluation is the Chairman's. The chairman is the architect of the board and must accept responsibility for its structure and processes. Yet many chairmen are uncomfortable with accepting this role as they are unschooled in it, especially the behavioural aspects. They accept responsibility because they cannot avoid it. They know that the expectation from the 2003 Code is of a self-evaluation process which sounds less threatening than being assessed against a prescribed national\or international model but how do you do this? Most have opted for a simple statement of compliance against the 2003 Code agreed by all the directors. This is a classic "tick box" approach – minimalist and not cost-effective as it gives little detail on where the board, the committees and the directors are and where they need to be to ensure both compliance and board performance.

The matter is complicated by many directors outsourcing the board evaluation process to outsiders, usually the "branded" consultancies and head-hunters. This seems to have immediate attraction as the chairman can say that a big firm has done the job so the board is guaranteed compliance and it also allows them therefore to be able to bask in the reflected glory of the brand. However, it does throw up some deep problems, not least of which is potential or actual conflicts of interest in the outsource consultancy. If an big accountant or consultancy is already contracted to that company how can it ensure Chinese walls between its work and the board evaluation? This is the classic Enron-type problem which SOX tried and failed to resolve. For head-hunters it is also a major issue and despite strong "no poaching agreements" a few (but very few) have dropped out of board evaluation because they found it impossible to resolve their conflicted interests. As there are currently only a handful of specialist board evaluation consultancies this issue will take some time to resolve.

### **Is there a model for good practice?**

No. Which is why it is left to self-evaluation against the 2003 Code. But there are signs of change here as more creative, and behaviourally-based, models appear. It is noticeable that in the last few years both the DTI in its *Building Better Board's* book, the Institute of Directors in the final

oral examination for the Chartered Director national award, and the Association of Chief Executives of Voluntary Organisations have used Garratt's *Learning Board* model (the author declares an immediate interest) and especially its four tasks of the board:

- Formulating Policy and Gaining Foresight
- Strategic Thinking
- Supervising Management
- Ensuring Accountability.

Combined with the 2003 Code this can move the board evaluation forward from being just a tick box process as it is then possible to start gap analyses of each aspect of each task, and so set priorities and trigger board development processes. In its more advanced form such an evaluation will also include detailed behavioural analyses of board dynamics and each director.

This brings us to a much more contentious issue – the evaluation of individual directors. From the Four Tasks of the Board and the Board Dynamics questions a robust framework can be constructed for each director. In this area my practical experience is twofold. First, take only the two key board roles as spelled out under the Companies Act – the Chairman and the Company Secretary – and agree to evaluate them initially as part of the annual board evaluation process. In this way the other directors become used to the idea of individual evaluation and early issues can be dealt with quickly and without unsettling all of the board. Second, do not attempt to handle the individual evaluations at the same time as the whole board's. They need to happen after the board's and with a gap of three to four months. Many chairmen find this a novel process and are more comfortable with having a "quiet one-to-one" with each director. But an effective way is to run a 360 degree assessment of each member of the board. This can be started in a very simple way for one or two years. But it does need to be started, and in a rigorous manner. Only then can the necessary processes of individual director development, and ultimately, "director de-selection", or as the Code puts it more subtly "seeking the resignation of directors" be effective.

### **How rigorous should it be?**

Very. And it can only be rigorous if it is done on a regular basis, with the same or carefully evolving criteria, and with gap analyses which allow the present position and the future need to be crystal clear and so quantify

the amount of development needed to be agreed and costed easily. If outside help is used, then we have found it wise to allow them no longer than three annual evaluations before they are replaced. Otherwise they will become too close to those being evaluated.

### **How much should be divulged publicly?**

This is very controversial ground. Remember that the 2003 Code states that simply that *the board should state in its annual report how performance evaluation of the board, its committees and its individual directors has been conducted*. This can be a very public statement. However, as more pointed questions arise from the owners and stakeholders the need to go deeper and wider emerges and this requires careful judgement especially by the chairman. Some give a framework which they, or their consultants have used, without going into the results. I know of no-one who has given any detailed results. And you can see why as analysts and the media lurk vulture-like for such data.

However, I do know of companies who ask for a separate Consultant's Report which allows the consultant to go beyond the board's self-assessment and comment comparatively on other companies and countries using their wider experience. Although not disclosed to the owners except occasionally for any pro-board comments, these have proved invaluable in-company. But recently some issues have arisen with such independent reports. If there is any link to US investors, however small, then under their "Disclosure" processes it may be possible to get access to both the self-assessment scores and the consultant's report. To many in the UK this may seem a minor matter but for those directors with US connections this could prove traumatic if litigious shareholders sue for underperformance by the board and company, especially if this is a class action.

This area is contentious and we could all well do with guidance from the Financial Reporting Council on this aspect.

### **Is the investment worth it?**

As many large companies are spending around £100,000 per year for each of their listed companies and around £75,000 for each of their legal entities this investment does need careful consideration by the chairman and board. This is why I advocate the board development approach as a

better investment, as distinct from a simple tick box one. But whatever approach is taken one thing is certain. The current requirements under the 2003 Code will not go away. Indeed, shareholders and stakeholders are demanding board evaluation increasingly. Under the 2006 Companies Act these will continue to increase. So addressing the need for more professional evaluation and development of board performance will become increasingly important and central to board effectiveness in the future. It will no longer be a “nice to have” but a “need to prove”.

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