GRADING the BOARD

Board evaluations, based around recognised best-practice models, are widely seen as an important method for developing better corporate governance. by Iain McCormick

CORPORATE governance is defined by the OECD as the "structure through which the objectives of the company are set and the means of attaining those objectives and monitoring performance are determined".

The importance of good corporate governance has grown rapidly as a result of the scandal associated with American companies including Enron and WorldCom and in New Zealand with the failure of Feltex and a range of finance companies. This has stimulated the creation of legislation like the Sarbanes-Oxley Act in the United States, while agencies such as the New York Stock Exchange and the New Zealand Exchange have defined best practices in the hope of improving corporate governance.

Board evaluations, based around recognised best-practice models, are widely seen as an important method for developing better corporate governance. The New Zealand Exchange Corporate Governance Best Practice Code endorses regular board and director evaluation, an approach also adopted by others such as the Toronto, London and New York stock exchanges.

Higher investor expectations of corporate governance, together with globalisation and the need for international competitiveness, will continue to drive the importance of board effectiveness and the use of director evaluation.

Director evaluation involves board members undertaking a constructive but critical review of their own performance, identifying strengths and weaknesses, then writing and implementing plans for further professional development. The provision of feedback on board performance and governance processes is the most crucial element of the director evaluation method for stimulating board development.

There are many benefits to be gained from director evaluation. The process identifies weaknesses for skill development and strengths that can be further built upon. Evaluation enhances relationship building by encouraging open communication amongst board members and management. It increases performance by clarifying roles, expectations and responsibilities, and by fostering collaborative goal setting. Board evaluation leads to specific improvements in board focus, strategic planning, efficiency and time management.

Increased performance leads to increased board productivity. This has been confirmed in a survey involving 3000 of the largest US companies by recruitment consultancy Heidrick & Struggles together with business improvement organisation The Corporate Board. They found that nine out of 10 companies which undertook director evaluation said the evaluation made their boards more productive. Further evidence was reported in the *Harvard Business Review* in 2004, based on a survey of 200 large corporations, where director evaluation was found to be among the top activities to improve board performance.

The benefits of evaluation extend to the board as a whole and to individual directors. The benefits for individual directors include building greater levels of professional leadership, greater role clarity, teamwork, accountability, decision making, communication and more effective board operations.

Institutional investors clearly believe enhanced director performance is worth paying for. Consultancy firm McKinsey & Co surveyed more than 200 institutional investors in 31 countries in 2002 and found about three-quarters of investors were willing to pay more for shares of companies with good governance. They suggested price premiums averaged between 12 and 14 percent in North America and Western Europe, 20 to 25 percent in Asia and Latin America, and more than 30 percent in Eastern Europe and Africa.

The contents of director evaluation questionnaires are typically based on established governance frameworks principles and codes such as those from the OECD, the World Bank or the London Stock Exchange. The London Stock Exchange's *Practical Guide to Corporate Governance* is a particularly well written, clear and helpful guide. It is available free of charge from *www.londonstockexchange.com/en-gb/products/companyservices/Practical+Guides.htm*.

The first step in the process of director evaluation is for the board to be clear about why they are undertaking the assessment and what they want to get out of it. A board discussion about the process will help to build commitment to it from members. A very common reason for undertaking director evaluation is to assess the skills, abilities and processes of the board against a comprehensive best-practice model.

A common outcome of director evaluation is a 'Board Development Plan' which sets out the specific actions the board wishes to undertake to improve its governance practices. Typical examples of resulting actions are: to develop an annual board work plan or to develop a director induction process. Each action in the 'Board Development Plan' should have an owner, a completion date and a follow-up date at which time progress is assessed.

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The chair is typically responsible for the director evaluation process, however in some boards the governance or nominating committee may lead the process.

Before commencing any evaluation process, the chair should ensure all board members have copies of relevant director job descriptions and are clear about the board's expectations of them. The chair should also obtain agreement from each director about the need for evaluation, the timetable for completion and how the information will be used.

There are three main types of evaluation processes:

1. The consulting-based evaluation where a suitably qualified professional will interview the directors, review the board policies and papers, and produce a report with recommendations.

2. The web-based evaluation in which the board selects from a range of questionnaires: corporate board evaluation, not-for-profit board evaluation, chair evaluation, executive director evaluation, non-executive director evaluation, CEO evaluation and so on. The board members complete the online questionnaires and a series of reports is then automatically generated for the board to consider.

3. Paper-based evaluations are usually simple whole-of-board evaluations which are distributed to members and then the data collated and fed back to the board by the chair.

Each type of evaluation has advantages and disadvantages:

1. The consulting-based evaluation is typically the most comprehensive and the consultant can provide the board with a fresh perspective plus a range of advice and templates that are specially tailored to the board's needs. Interviews provide rich data and complex issues can be explored through probing open-ended questions. The disadvantage of this evaluation process is that it is typically expensive and time-consuming for the directors.

2. The web-based evaluation is typically the fastest and easiest system to use. The price of these evaluations ranges from about $3000 per report (whole of board, chair, individual director etc) to about $300 per report. The disadvantage of this evaluation type is that there is no personalised guidance for the board in the process.

3. Paper-based evaluations are usually free but typically the breadth of the evaluation questionnaire is very limited and the process of collation can be very time-consuming. Again there is no personalised guidance for the board in the process.

No matter what form of director evaluation is used, the issues that are raised in the feedback reports should be discussed, prioritised, assigned and managed in a timely manner. Lack of action following the evaluation will quickly undermine the whole process as it sends a message to directors that their input is not valued and that the board is not serious about its own development.

Directors should be careful to set aside the necessary time to read and digest the feedback reports before they are discussed. Feedback from whole-of-board evaluations is best discussed in a regular board meeting. Individual director evaluations are best handled in one-on-one meetings with the chair of the board. The chair should discuss his or her feedback report with a senior director in a one-on-one meeting or at a full board meeting. The latter method is an excellent way for the chair to signal openness and leadership to other board members.

Undertaking evaluations on an annual basis is important as it allows the board to assess the progress it is making in a range of areas over time. Some web-based systems offer multi-year reports which make comparisons over time very easy. Altering the evaluation process from consultant-based to web-based over time can reduce any risk of staleness in the evaluation.

Confidentiality is an important element in any director evaluation as it fosters trust, honesty and openness, which are essential elements of an effective evaluation. Without these factors, the free flow of information may be seriously curtailed. For this reason director evaluation information is usually aggregated and feedback given in summary form.

There can often be a progression over time in the type of evaluation process used. Many boards start with a simple paper-based whole-of-board evaluation, then move to a more comprehensive web-based board evaluation, and in subsequent years they use chair, CEO and individual director evaluations. Finally, they may use management evaluations of the board and the more probing and comprehensive consulting-based evaluations.

No matter what the process, it must be meaningful and useful, easy to use and be practical enough to produce specific improvements in governance.

Every board must strive for improvements and developments in its governance. Director evaluation is an effective tool to achieve this and benefits of evaluation clearly outweigh the costs and potential disadvantages.

Iain McCormick is the managing director of *www.directorevaluation.com*, a board evaluation consultancy that offers free paper-based evaluations, a comprehensive range of web-based evaluations and full consulting-based services.