OPINION

Informed Boards

– YEAH RIGHT!

Independent directors usually rely on the chief executive for most of their information. Yet the current global crisis tells us that such reliance can be deeply flawed, says Auckland-based governance consultant Iain McCormick.

PETER HAHN, WRITING in the *Wall St Journal* in a 2007 article entitled "Blame the Bank Boards" said: "Amnesia about past credit mistakes is common in the banking business ... This amnesia is taking its usual blame for the current slowdown. But this time is very different. The handwriting has been on the wall for some time, and bank boards have made little effort to read it." Can the comment also apply to our dead and dying finance companies?

What kinds of information should independent directors rely on to make astute business decisions, especially in highly unpredictable times? Should they develop sources of impartial information that are independent of possible management bias? Perhaps, if independent information had been acted upon, at least some of our current crisis may have been prevented?

Robert Thomas, executive director of the Boston-based Accenture Institute for High Performance Business, and some colleagues recently suggested in a provocative article in the *MIT Sloan Management Review*, that management always knows more about a company than shareholders or directors. Therefore, management may make business decisions that are not in shareholders' best interests.To overcome this, directors should obtain information that is independent of management and use it to test the utility of decisions from the shareholders' perspective.

The quality of the interaction between management and the board will be influenced by how much the two parties know about each other's interests, aspirations, fears and blind spots. Thomas and colleagues identified four types of interaction:

- Open discussions and debates where each side fully discloses the critical information.
- Discussion in which the board undertakes its advisory role and provides management with knowledge, experience and insights into the business.
- Disputes in which the board is unsure of important facts (eg, about critical but detailed business operations). In these circumstances the board may challenge management to disclose information so that astute decisions are possible.
- The danger zone where both management and the board are ignorant of the critical information, for example about competitor tactics.

Thomas and co believed that recent surveys reveal the degree to which dependent directors rely on management for critical information. In one 2005 survey, more than two-thirds of directors said they lacked access to independent information channels. In a second survey, the independent directors were less satisfied with the financial, operational and strategic information they received than were the non-independent directors.

The demand for greater disclosure of more relevant and critical information is growing in the United States. Activist investors want more pertinent information to try and reduce the frequency and severity of objectionable surprises. Consequently, boards are making more collaborative efforts to work with investor groups to develop investor-critical performance measures.

Other groups of sophisticated investors are cleverly combining publically available company information with known commercial trends to understand 'real' company performance and risk. Independent directors who are surprised by seemingly sudden changes in company performance may find it difficult to justify their positions if sophisticated outsiders know more critical information than they do.

Private equity companies are suggesting that they can provide benchmark governance and performance standards against which publically traded companies can be measured. Regulators are demanding more real time reporting and interpretation as digitally-based disclosure systems develop and proliferate. Some boards are even devising their own performance measures and presenting these to investors!

But there is resistance to these emerging trends. Directors and managers are concerned that outside information could disturb the quality and balance of their collaboration. They worry that too many peer comparisons or third party reports will overburden boards already struggling to deal with long and complex meeting agendas.

Finally, boardroom behaviour is shaped by the cultural norms of the participants and these tend to change slowly. And bringing in new more independent-thinking directors who demand more information from management may not work if their actions are constrained by well-established directors who see the new demands as unnecessary.

From my own discussions with a range of chairs and directors there is often a strong desire to look after shareholders and to use independent information to help in this. The question I'm frequently asked is: "At a practical level how do we get hold of and use independent information?"

A distinction needs to be drawn between internal information that is available from the company and information that is external to it. Information can also be developed or presented by the CEO so is CEO-dependent. Alternatively, it can be independent information from other sources. Internal, CEO-dependent information is the common feedstock for most boards and consists of board papers, board presentations and accounts.

Internal, independent information consists of company information that comes direct from third party or similar sources. It may consist of senior staff presentations and discussions that are undertaken without the CEO being present; staff opinion survey reports which are sent to the board directly from the survey company; customer, joint-venture partner and supplier meetings where the board can talk directly to the individuals concerned.

External, CEO-dependent information may consist of media releases, the annual report and so on.

External, independent information consists of media and industry sector information relevant to the company. Examples include the National Bank Quarterly Economic Forecasts, IBIS-World, a US based firm specialising in long range forecasting of specific industries and the business environment generally, The Economist Intelligence Unit which provides forecasts on more than 200 countries and six key industries and The Conference Board which disseminates a broad range of knowledge about management and the marketplace.

The aim of gathering and using independent information is not because directors distrust the CEO – if they do, they should be looking towards the succession plan for a solution. Rather, the aim is to use independent information to supplement and constructively challenge the CEO-dependent board information.

As one insightful and experienced director recently put it: the company board papers are useful but there needs to be a careful balance between the high-level strategic issues being drawn out and enough detail to really understand the business. It is critical to have strategic issues at the top of the board agenda followed by the business-as-usual issues.

Building trust and confidence in board information quality is critical. Three things can assist better: performance metrics; enabling board members to do 'what if' analyses with company information; and, systematic board evaluation.

Sound performance metrics should include a range of strategic and operational, financial and non-financial measures that are forward-looking indicators and assess progress toward a company's goals. The joint process of developing these measures builds trust between management and the board.

Thomas and co believe board metrics should match the metrics that management uses to assess company performance.

Modern dashboards which contain critical board information are linked to the company's accounting and management information systems and are deployed using the software-as-a-service model which means that directors can go online at any time and see their own company's dashboard updated with the latest information. Alerts can also be used so that directors get immediate notification of, for example, prices rising or dropping below a critical threshold.

According to Thomas, US directors like being able to do electronic 'what if' analyses with company data. It allows the board to undertake concrete assessments of underlying trends. Standardised, readily available digital data from external sources also allows directors to compare many aspects of company performance with peer organisations.

Critically important data can be generated from both inside and outside the boardroom. Online director evaluation systems allow directors to comment on the performance of the CEO and each other in a constructive but critical manner and so provide another important avenue for independent information in the board room.

The demands placed on boards by these trying economic times require greater use of independent information. If there is any hope of averting future corporate meltdowns it will partly lie in directors rapidly gaining and utilising both CEO-dependent and independent information to understand the reality of the company's current and future performance.

Go to www.management.co.nz/CorporateGovernance.asp to see this article in full.

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