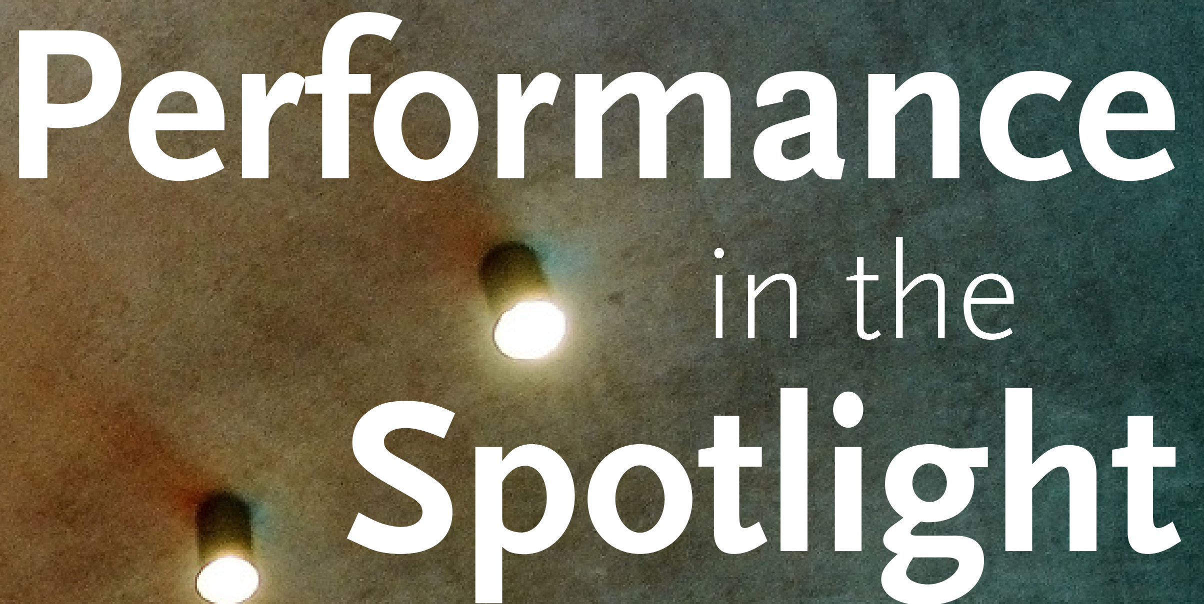


Performance in the Spotlight

Assessment and Board Effectiveness

POINT of VIEW

Investor focus on board performance has reached new levels of intensity. The chairman and CEO of Vanguard, one of the largest mutual fund companies in the world, recently sent letters to the independent directors of its biggest holdings in which he outlined six principles of governance. "In the past, some have mistakenly assumed that our predominantly passive management style suggests a passive attitude with respect to corporate governance," he wrote, "Nothing could be further from the truth."

We have come to expect that kind of perspective from activist investors, who have long been assertive about board governance and composition. Now, large institutional investors are joining the chorus. Firms such as State Street, BlackRock and Vanguard are calling for greater transparency about how candidly boards are addressing their own performance and the suitability of individual directors. As the Council of Institutional Investors sums up, disclosure about assessment "is an indication that a board is willing to think critically about its own performance on a regular basis and tackle any weaknesses ... and can be a catalyst for 'refreshing' the board as new needs arise."

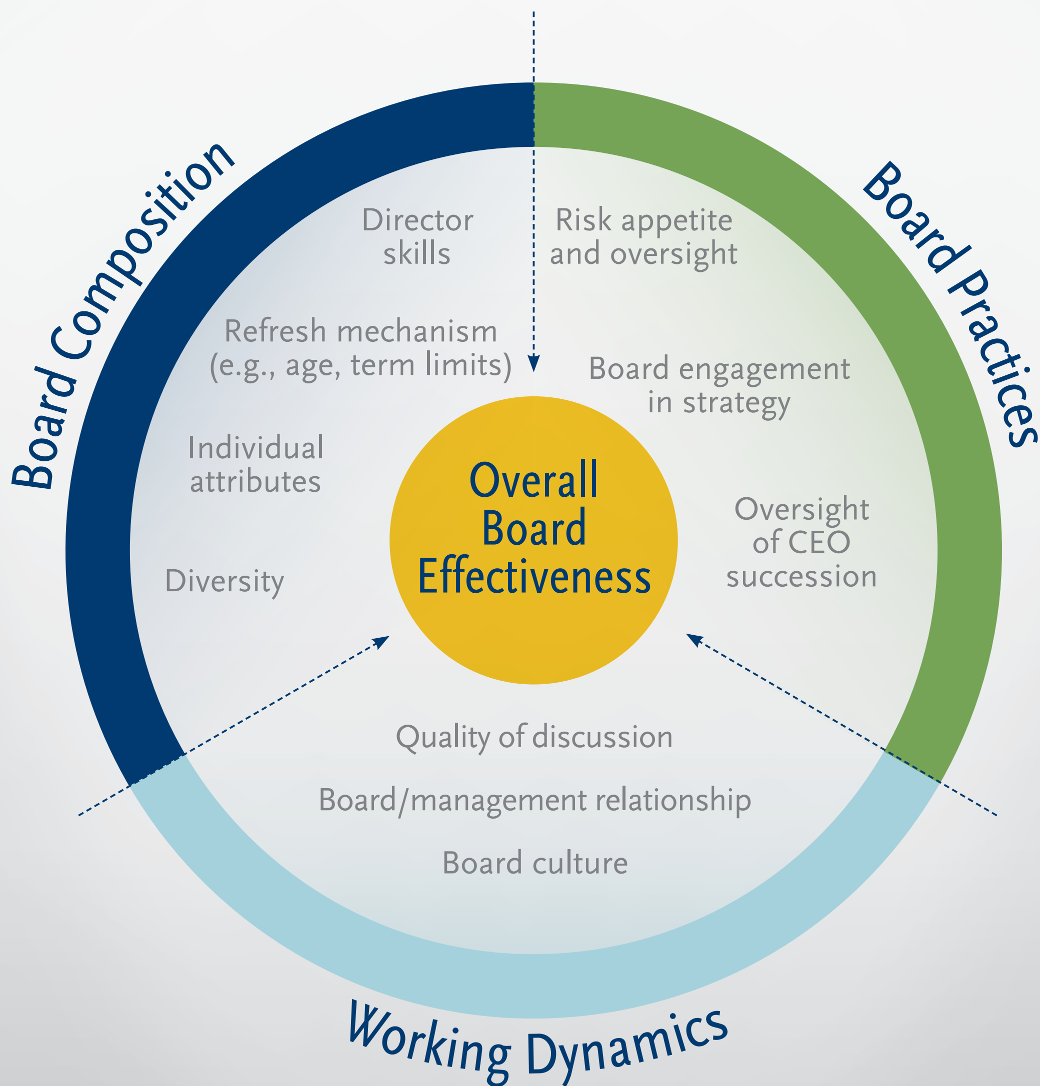
Annual board assessments have become ubiquitous, but are boards truly using them to ensure they are as effective as their shareholders expect them to be?

Some evidence suggests the answer to that question is no. For example, 39 percent of U.S. directors in the 2015 PricewaterhouseCoopers' Annual Corporate Directors Survey thought that someone on their board should be replaced. The primary impediments to replacing an underperforming director are board leadership's discomfort in addressing the issue and the lack of individual director assessments, previous research has found. The best boards are holding themselves to higher standards.

Boards that are committed to improving their effectiveness use the assessment process to get at six key questions:

- How effectively do we engage with management on the company's strategy?
- How healthy is the relationship between our CEO and board?
- What is our board succession plan?
- What is our mechanism for providing individual director feedback?
- What is our board culture and how well does it align with our strategy?
- What processes are in place for engaging with shareholders?

Board Effectiveness Assessment



Improving board effectiveness

When done effectively, board assessments provide the board with an opportunity to identify and remove obstacles to better performance and to highlight what works well. They give directors a forum to review and reinforce appropriate board and management roles, ensure that the board has the right perspectives around the table and bring to light issues brewing below the surface. A robust assessment can help ensure that the board is well-equipped to address the issues that drive shareholder value by focusing on the following questions.

How effectively do we engage with management on the company's strategy?

Oversight of the business strategy always has been a core responsibility of the board. But, today, the threats and opportunities facing companies are more dynamic. Digital transformation, business model shifts, the rise of new competitors and the impact of doing business globally require many businesses to change faster than in the past. So, regular strategic discussions have assumed greater urgency. The board should ensure that the management team is responding to emerging developments most effectively.

The CEO and his or her team "own" the strategy, but the board provides critical oversight. Directors should challenge assumptions and the soundness of the strategy, fine-tuning where needed, and measure performance against a set of agreed-upon objectives. The best boards ensure that the articulated strategy provides a forward-looking roadmap for the organization, including the specific levers to improve performance. A clear, sound strategy should serve as the foundation for all of the board's work, and high-performing boards are disciplined about making sure that it does.

The board conversation has increasingly drifted toward reviews of historical data — compliance reviews, financial reviews, safety reviews — that have less impact on business results, many directors report. This backward-looking review can come at the expense of forward-looking strategic matters where directors' expertise can be valuable in shaping future results. High-performing boards make time to focus on what matters, striking the right balance between important oversight responsibilities and forward-looking conversations.

How healthy is the "balance of power" between our CEO and board?

The relationship between the board and the CEO requires balance. The board is ultimately responsible for selecting the CEO, reviewing his or her performance, aligning CEO compensation with the performance of the business, and planning for the succession of the CEO. At the same time, the CEO is a close partner in many of these endeavors, sometimes taking the lead. For example, in succession planning, the CEO drives management succession at senior levels and serves as counsel to the board. The CEO's role diminishes as a transition nears, and the board moves toward selecting the next CEO. To minimize confusion about the respective roles of the board and CEO, it's helpful to have an open channel for communication. Effective use of executive sessions is part of the answer. Regularly meeting in executive session, both with and without the CEO, helps reduce the awkwardness that can arise when the board has executive sessions only on an as-needed basis. When the board meets without the CEO, it is best practice to debrief with the CEO immediately. The CEO evaluation also provides an opportunity for the board to assess aspects of the CEO's performance — including succession planning — that the board is ultimately accountable for overseeing.

What is our board succession plan?

In the words of F. William McNabb, Vanguard chairman and CEO, having the right directors on the board "is the single most important factor in good governance. ... Who they are, how they interact and the skills they bring to the table are critical from a long-term value standpoint." Boards should continually consider whether they have the optimum composition, given the company's strategic direction and the current business context. Boards should also establish mechanisms to identify the expertise that will be valuable as the context and strategy change. For example, in an industry that is rapidly consolidating, a board will want to consider whether it has the capability it needs to best oversee multiple acquisitions or the sale of the business in shareholders' best interests. The board of a company with a new first-time CEO may decide it needs someone to serve in a mentoring capacity to the CEO. Regularly reviewing the current composition and any gaps positions the board to take advantage of natural attrition from director departures and retirements. The best boards also forge agreement about the right degree of turnover and the mechanisms to promote board refreshment, including appropriate time frames.

What is our mechanism for evaluating the contributions of individual directors and providing director feedback?

On many boards, the elephant in the room is the performance (or lack thereof) of an individual director. Consensus is growing in support of conducting individual director assessments as part of the board effectiveness assessment — not to grade directors, but to provide constructive feedback that can improve performance. It can be difficult or uncomfortable to raise individual director performance issues, but high-performing boards expect directors to stay engaged and to contribute fully, and are willing to address under-performance. They establish a mechanism for surfacing and addressing issues and use director succession planning to encourage healthy turnover and accountability. They also create an environment that encourages individual directors to think critically about their contributions and the relevance of their skills to the company strategy.

The **8 Biggest** Contributors to Board Dysfunction

1. Too much time spent on compliance and other backward-looking reviews at the expense of strategy
2. Lack of trust between the board and CEO
3. Weak or non-existent CEO succession plan
4. Lack of board succession planning
5. Disruptive or disengaged directors
6. Poor decision-making processes
7. Lack of a direct channel to shareholders
8. Too much board information and material

What is our board culture and how does it contribute to our ability to advise management effectively?

A really good board understands its own culture and how it impacts its decision-making and relationship with management. Despite the growing appreciation for the importance of culture, few directors are able to describe their board culture beyond "collegial" or "engaged." A deeper understanding of the culture of the board — how directors make decisions, handle disagreements, share information and the spirit in which they do these things — can improve the board's ability to advise management and provide appropriate oversight. In a fast-moving, highly dynamic industry, for example, the board needs to learn fast, remain open to alternatives and needs at least some directors with a more agile orientation. Culture can be shaped by influential figures, such as the chair, the CEO, the founder or long-serving directors; structural elements such as the format and conduct of meetings; selection and onboarding of new directors; or external events and the board's response to them. High-performing boards are willing to examine their culture more closely and assess its alignment with the needs of the business.

What processes are in place for engaging with shareholders?

Management is responsible for communicating with investors about the business, but shareholders increasingly want to engage with the board on a range of governance issues, including succession, compensation, risk oversight and other concerns. Often, it's not until after a board has experienced a challenge from shareholders — losing a say-on-pay vote, for example — that it concludes it needs to improve communication with shareholders. The most effective boards stay abreast of how the company is perceived by investors. They identify in advance who should take the lead from the board (whether a committee or individual board leader) in dialogue with shareholders and in responding to investor inquiries. Robust relationships with investors can help the board understand how the company is viewed externally versus competitors and can reduce the chance that the company will be surprised by activists or proxy votes. And when challenges do arise, the board is more likely to have built up a reservoir of understanding and support among large long-term shareholders.

Conclusion

The bar continues to rise for boards, which not only face pressure from shareholders but also want to hold themselves to higher standards of performance. Boards can use robust board assessments to ensure that they measure up to the evolving standards of corporate governance and have the composition, practices and healthy dynamics to be effective stewards of the business.

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