

**HENLEY INTERNATIONAL CORPORATE GOVERNANCE  
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**TAKING BOARD EVALUATION BEYOND SIMPLE  
COMPLIANCE: DIRECTOR BEHAVIOUR AND BOARD  
PERFORMANCE**

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**Context**

**Compliance Complicity**

Much of the current activity which passes for “Board Evaluation” is little more than a simple check on compliance. Yet a moment’s thought shows that this must be nonsense because compliance is the professional role of the company secretary and legal counsel under the leadership of the Chairman. If a board is not compliant then it cannot be evaluated effectively. Compliance needs to be assured before board evaluation can start. Compliance is necessary but not sufficient. Sufficiency comes from the major evaluative focus being on board *performance* both around the boardroom table and on its subsequent effect on total business performance. Many boards find such an approach too difficult and tend to fall into a low level of internal complicity based on the notion that if they can show they are compliant then “a quick word or two with the chairman” should allow them to stand before their owners at the AGM and state that they have done their duty of annual evaluation.

**A Reminder**

Taking such an approach shows that they have hardly begun to take board evaluation seriously and are certainly not following either the letter nor the spirit of the 2003 Code of evaluating the board itself, each of the committees, and, especially, each director. So let me give a gentle reminder of what the Code and the new 2006 Companies Act demands.

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.*

From 1 October 2007 the UK's 2006 Companies Act demands changes in many board's mindsets through it stressing the concept of "enlightened shareholder value", the need for directors to ensure and state that their company is a going concern and has a future, and that the board fulfils its duties of Care, Skill and Diligence. This is a useful basis for board evaluation.

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

When the 2003 Combined Code was published and became effectively 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, from 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 simple, compliance-based 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.

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

Now, however, things are changing. With the arrival of the new 2006 Companies Act and its focus on “enlightened shareholder value” and the codification of the Seven Non-Exhaustive Duties of Directors the bar is being raised. 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. Many 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, combined with growing concern for the employment of their members, a more inquisitive media, fund managers being much more demanding of quantifiable director and board performance linked to added shareholder value, and others concerned with the corporate effects of globalisation, and the combining of NGOs like CORE to press for litigation, all mean that much greater interest is being given to the quality of the process board evaluation and its consequences. Whether the board likes it or not the game has more public and the corporate governance debate is moving towards the public side of the boardroom door.

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 facing 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 still see board evaluation as an impertinent 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 being accepted slowly. I argue that it is the key to adding sustained stakeholder value creation.

### **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 ultimate responsibility for its structure and processes. Yet many chairmen are uncomfortable with accepting this role as they are unschooled in it, especially the “soft” behavioural aspects of board dynamics. 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. There is no gap analysis.

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 outsourced 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 for listed companies 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 (now DBERR) in its *Building Better Board's* book, the Institute of Directors in their 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

To which is added a section on Board Dynamics.

Combined with the 2003 Code main principles 4 – 7 this can move the board evaluation forward from being just a tick box process because it is then possible to start gap analyses of each aspect of each task, and so set more accurately and cost-effectively priorities which highlight board development needs. In its more advanced form such an evaluation will also include detailed behavioural analyses for each director.

This brings us to a much more contentious issue – the evaluation of individual directors. Using the Four Tasks of the Board and the Board Dynamics questions a robust framework can be constructed for each director. My practical experience of implementing board evaluation often shows two issues which require starting with two specific actions. First, take only the two key specialist board roles as spelled out under the Companies Act – the Chairman and the Company Secretary – and agree to evaluate only them initially as part of the annual board evaluation process; using a gap analysis and factor analysis approach. In this way the other directors become used to the idea of individual evaluation and early issues can be dealt with quickly without unsettling all of the board. Second, only when board members are truly comfortable with this process handle the individual evaluations at the same time as that of the whole board and the committees. Otherwise ensure that they happen after a gap of three to four months. Many chairmen still find individual director evaluation, especially the 360 degree variety, a novel process and are more comfortable with just having a “quiet one-to-one” with each director. But a 360 degree is highly effective developmental tool if handled sensitively. This can be started very simply 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 subtlety “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, 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. 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 is a very public statement. However, as more pointed questions arise from the owners and stakeholders the need to go deeper and wider emerges. 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 oversee the evaluation and go beyond the board's self-assessment to comment comparatively on other companies and countries using the consultant's wider experience. Although not disclosed by the Chairman to the owners, except occasionally for any pro-board comments, these have proved invaluable in the boardroom.

But recently some issues have arisen with such independent reports and the board's self-evaluation. If there is any link to US investors, however small, then under their "Discovery" processes it may be possible for disgruntled litigants to get access to both the self-assessment scores and the consultant's report. This has not been tested in the courts. 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. As this area is contentious the UK could well do with guidance from the Financial Reporting Council on this aspect.

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

As many large listed companies are spending around £100,000 per year for their main boards companies, and up to £75,000 for each of their legal entity boards, this investment does need careful consideration by the chairman and board. Can a compliance-only approach be cost-effective when such sums are involved? This is why I advocate the board development approach as a better investment. 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 assurances of rigorous board evaluation increasingly. As the 2006 Companies Act goes live on 1 October 2007 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, and company, effectiveness in the future. It will no longer be a “nice to have” but a “need to prove” – especially that the board’s strategic thinking is adding to stakeholder value.

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Tourrettes-sur-Loup  
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