London Stock Exchange

Corporate Governance

FOR MAIN MARKET AND AIM COMPANIES

25. Board evaluation

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The requirement for boards of directors to evaluate their own effectiveness has developed within the UK regulatory framework over the last 20 years. Following the report in 1992 from Sir Adrian Cadbury's committee on the financial aspects of corporate governance, the concept of board effectiveness was developed further in 2003 by Sir Derek Higgs, who noted: "Performance evaluation of the board, its committees and its individual directors should be undertaken at least once a year. 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, appointing new members to the board or seeking the resignation of directors. The board should state in the annual report whether such performance evaluation is taking place and how it is conducted." ('Review of the Role and Effectiveness of Non-Executive Directors'.)

In 2009, Sir David Walker refined the guidance on evaluation in his review of corporate governance in UK banks and other financial institutions, stating: "The board should undertake a formal and rigorous evaluation of its performance, and that of committees of the board, with external facilitation of the process every second or third year." In the years since, these recommendations have been endorsed by the Financial Reporting Council, and the UK Corporate Governance Code now provides that FTSE 350 companies conduct externally facilitated board evaluations at least every three years.

In one sense, the purpose of an evaluation is very simple: to assess the board's contribution, individually and collectively, to the health and success of the company. However, there is no single template for an effective board, and likewise, there is no single template for an effective evaluation. There are a number of methodologies that can achieve this purpose, and the approach taken will partly depend on why the evaluation is taking place — whether on the grounds of compliance, to respond to external pressure or regulation, to benchmark the board's performance, to facilitate change, or to enhance the board's long-term efficacy. There are a number of variables to take into account: factors such as business complexity and life cycle, board size and contribution, the number of participants, the board's timetable and the available budget will all influence the design and impact of the evaluation.

Most evaluations are instigated annually by the chairman and/or the senior independent director, although an external evaluation, commissioned every three years, may involve the approval of the whole board. Information is gathered from the board directors (both executive and non-executive), which ensures that all the participants start with an holistic and comprehensive view of the work, dynamics and processes of the board. However, if there are very few executive directors — the chief executive and chief financial officer, for example — it can be helpful to include the company secretary and one or two key executives below the board, such as the chief risk officer, head of internal audit or human resources, and outside parties such as the external auditor, particularly if they know the directors well. Retiring, or newly appointed, directors can also offer useful perspectives. However, those who do not regularly attend board meetings, or do not have good communication channels to all the directors, will probably not be able to add an informed view.

What to review

The role of the plc director is changing. Board responsibilities have widened from meeting basic legal obligations to providing competences that advance a plethora of corporate objectives. Directors are expected to contribute to the development of strategy, the evaluation of performance, the oversight of risk and control, and the communication of corporate messages, standards and values. They are encouraged to contribute to a healthy boardroom dynamic, in which executive directors can talk candidly and without fear of retribution, and non-executive directors can respond with challenge and support in equal measure. It is assumed they will promote good governance and proper process, understand the intricacies of board composition and tenure, and take on dedicated, time-consuming roles such as chairman, committee chairman and senior independent director.

Given the breadth and depth of the board's role, the possibilities for an evaluation framework are endless (see the panel on the right). However, it is likely that the review will investigate aspects of the board's approach to its work, its culture and dynamics, and its structure and processes. There are a number of influences to take into account, and no right or wrong answers. For example, some companies operate in slow-moving and transparent industries, and can dedicate an annual board session to examining strategic options, while others operate in fast-moving and opaque industries, and have to address strategic options as they arise throughout the year. Several boards have delegated risk committees and chief risk officers; others divide the oversight of risk between the audit committee and the board. A number of companies have shareholders on the board or activists in the register, and will design their communication channels differently to those with unchanging registers and long-term, anonymous shareholders.

Likewise, there are many influences on the development of board culture and dynamics. Small boards will benefit from an intimate and familiar dialogue, but may suffer from a lack of challenge or breadth of view; boards with large numbers of directors may gain from the diversity of perspective, but lose from the lack of time within which those views can be aired. Strong chairmen will promote contribution and clarity, while weak chairmen will inhibit involvement or fail to orchestrate the board's dialogue. Equally, open and transparent chief executives will welcome challenge and interaction, whereas defensive chief executives will strive to limit the board's influence. Inappropriate composition, or uneven tenure, may result in the board's contribution lagging behind the business, or dramatic and untimely changes to important relationships.

Board processes and structure also adapt to the needs of the company over time. International companies may hold fewer board and committee meetings than their localised counterparts, but their meetings may extend over many days and locations. Some chairmen schedule a board dinner before every meeting, with careful alternation of attendees and agendas, while others prefer to hear the board's views in formal meetings. Meetings themselves can vary: a number of agendas focus on executive presentations and Q&A sessions, while others dedicate time to collaborative debate and conversation.

Internal evaluations

Internal evaluations are designed to incorporate written questionnaires (often with quantitative rankings) and/or internal interviews. Questionnaire responses are returned on a confidential basis, usually to the commissioner of the review or to the company secretary, and are collated to provide the basis of discussion for an individual interview or a collective board debate. If the intention is to track responses over time, a common set of questions (either quantitative or open-ended) can be used every year. There are some important considerations: questions require careful phrasing, so that respondents interpret them in a similar way; the number and order of the questions should be designed to encourage thoughtful responses (handwritten, emailed or

Factors to take into account in designing the board evaluation

Factors influencing the work of the board

- The company's history and stage in its life cycle (operational complexity and location)
- Rate of sector growth or decline
- Speed of corporate decision making and levels of bureaucracy
- Changes in the business model and access to internal and external resources, including finance
- Maturity of the strategic process, and involvement of the board
- Changing markets (the competitive landscape, customer profiles, supply chains, technology and regulation)
- Quality of risk management and internal control
- Oversight of performance and reward
- Maturity of executive succession planning and leadership development
- Shareholder structure and unity of objectives
- Visibility of stakeholders, and levels of engagement
- External interest and pressure, and relationships with advisers

Factors influencing the use of board time and process

- Structure of board and committee calendar and agendas
- Quality of executive and non-executive preparation
- Transparency, presentation and timeliness of corporate information
- Separation of strategic and operational issues
- Division of presentation and debate
- Balance of formal and informal time
- The level of board and committee support
- Availability of induction and development

Factors influencing the culture and dynamics of the board

- Corporate culture and context
- Clarity of board and committee roles, and levels of delegation
- Style of leadership (chairman, chief executive, committee chairmen)
- Quality of relationships between executives and non-executives
- Board size, composition and tenure
- Collective understanding and relevant experience
- Quality of contribution, debate and decision making
- Levels of trust and respect
- Openness and transparency of issues
- Degree of challenge and the management of conflicts

Adapted from 'This Year's Model: influences on board and director evaluation', Long, TE, 2006 through the internet); repetition should be avoided; and individual confidentiality should be protected and explained.

Internal evaluations offer an acceptable methodology for most companies two years out of three: they are quick and cheap to conduct; they provide a basic understanding of the board's strengths and weaknesses; they can involve a large number of people; and answers and/or rankings can be compared year on year. There are disadvantages: questionnaires are blunt research instruments (partly because the questions are linear and often repetitive, and partly because directors are reluctant to write down confidential and complex views and concerns); there are no independent perspectives or recommendations to consider; and the board cannot benchmark itself against others.

External evaluations

External evaluations vary from the use of an online questionnaire to an in-depth psycho-analytical assessment. Likewise, the evaluator is interpreted by some chairmen as providing a simple service, and by others as a valuable adviser and critical friend to the board. There are contrasting approaches: some evaluators work with a template, which predetermines the role of the board and best practice for directors; others design a bespoke evaluation for every company. Some attend to the historic and/or current effectiveness of the board; others are forward looking, testing the board's preparation for the future. Several methodologies are focused on tangible, visible outcomes such as board papers, processes and structures; others explore less tangible influences such as behaviour, relationships, culture and dynamics.

It is important, therefore, that chairmen have the right to choose, in consultation with colleagues, an appropriate methodology for the board and the company, including to what extent the focus of the evaluation is on the board's current performance and/or its future needs, whether individual contribution is assessed (peer review), whether the effectiveness of committees is included in the evaluation, and how the findings from previous evaluations are to be incorporated. There are no right or wrong methodologies, but there are different and decisive board requirements, levels of engagement, required skills and competences (from the evaluator), and necessary outcomes.

In many companies, it is the company secretary who is asked to prepare a shortlist of potential evaluators and make an initial recommendation to the chairman. Although this can be a helpful filter, it is imperative that the chairman, who is responsible for the effectiveness of the board, does not delegate the final decision. Experience, skill and chemistry are important, and the chairman has to be comfortable that an individual or firm will be able to maximise the long-term benefits of an evaluation for the board and the company, and be satisfied that the evaluator can conduct the work with sufficient objectivity and independence.

It is also important that all the directors are supportive of the process; good communication with the board on the approach and purpose, the process and the time commitment — with the necessary level of candour and feedback — will enhance the quality of input and level of engagement. Occasionally, potential evaluators are invited to address the board, or a smaller group including the senior independent director and committee chairmen, before the evaluation begins, which provides an opportunity to raise and address directors' questions and concerns. It is also advisable, if possible, to seek references on the quality and integrity of the evaluator's work from previous clients.

With regard to timing, partly due to a lack of planning, and partly due to reporting pressures,

evaluations are often commissioned at the end of a company's financial year, and at the beginning of the drafting session for the annual report. Inevitably this leaves inadequate time to engage directors in a meaningful evaluation, particularly one that involves extensive interviews, observation and debate. An external evaluation will take more time to organise and conduct than an internal evaluation, and the chairman will need to plan the process to suit the board's calendar; it is advisable to commission an external evaluation when there is adequate time to discuss its findings and recommendations, rather than to meet a disclosure deadline.

Given that most evaluations are a snapshot of the board's effectiveness, it is useful to conduct the interviews and observations within a limited and defined period; this enables directors to describe the same experiences and refer back to the same incidents, such as the last board meeting, remuneration committee or strategic away day. There are often logistical difficulties with directors' diaries, and therefore forward planning is vital; it is always helpful to schedule the evaluation several months in advance.

The use of interviews

The effectiveness of the board depends on intangible as well as tangible factors, and is difficult to measure quantitatively. Consequently, many evaluators will conduct qualitative research through the use of interviews and observation. Interviews can produce high-quality evidence and tend to work well on a semi-structured basis where the interviewer has a framework of topics to be covered (and therefore a basis for comparison between directors), but enough flexibility to vary the emphasis. This framework should be discussed with the chairman at the beginning of the review, and will be influenced by, inter alia:

- the company's stage in its life cycle, its size and its geographical reach
- the company's shareholding structure
- current and future issues facing the board, the company and the sector
- board size, composition changes, and the profile of individual directors
- the degree to which individual contribution will be assessed.

The quality of information provided and retained within an interview depends heavily on the interpersonal skills and experience of the interviewer. A properly contextualised interview requires substantial forethought; the interviewer should know enough about the company, the external environment within which it is operating (for example, the impact of changing regulation, a fast-moving competitive landscape or a sector in decline), and the director's background and role on the board, to be able to maximise the relevance of the questions, and understand the context of the answers. The interviewer may require a separate briefing from the chairman and chief executive, as well as a review of the company's documentation, such as the annual report and analysts' reports, before the evaluation begins.

An experienced interviewer will help directors feel at ease at the start of the interview, usually by explaining the context of the review, the framework for the discussion, and the parameters of confidentiality and anonymity. The skill of the interviewer lies in the ability to listen to what is said and what is not said, to distinguish certainty from uncertainty, and to understand the range of factors shaping nuance and interpersonal dynamics. These skills are vital if sensitive material and candid responses are to be handled correctly. In assessing the suitability of a potential individual or firm, the chairman may want to consider the following questions:

- Has the interviewer worked or studied in relevant fields, and been involved in information gathering, analysis and presentation? In a comprehensive review, a huge amount of evidence is gathered, demanding high-quality analysis, and skilled written and verbal presentation

- Has the interviewer spent a significant amount of time in board and committee meetings, either as a director, an attendee or an adviser? It is helpful for directors to know that the evaluator understands the context within which they are operating, is knowledgeable about the board environment, and can empathise with the issues that arise
- Can the interviewer communicate difficult messages in a constructive way? Most boards demonstrate areas of both strength and weakness, and the emergent themes need to be presented in a way that encourages the directors to discuss issues and agree resolutions
- Is the interviewer independent and objective? Ongoing business relationships with the company or ties with particular board members — most importantly with the chairman — may inhibit directors from candid discussion and influence the evaluator's interpretation of the findings.

Observation

A comprehensive evaluation will often include observation of the board and committee meetings, and/or a strategy day; this helps the evaluator to form a dispassionate view of the board (rather than relying solely on personal accounts), triangulate the evidence given during the interviews, review the relevant documentation, and prioritise the board's strengths and weaknesses.

Observation also facilitates important perspectives on, for example, the physical characteristics of the boardroom, the interplay between directors, and the relationship between the information provided to directors in advance of the meetings, and the related discussion. Current papers and standard documents, including those provided for board and committee meetings, and terms of reference, will also provide context and an opportunity to benchmark against the practices of others.

Occasionally, directors are concerned that colleagues will behave differently while being observed. This is rare, as external advisers and attendees are present at most board meetings, and directors are not usually self-conscious. More important is to have the confidence to trust the evaluator with highly sensitive information; confidentiality is paramount, and the chairman should have assurance that the information will be used only within the context of the evaluation.

Communication

At the conclusion of the evaluation, the chairman and the evaluator will need to consider how the findings should best be communicated to the board in the interests of improving its effectiveness. There are a number of options, including whether:

- the evidence should be presented to the directors as an unadulterated mirror image, or as a perspective to which the evaluator has contributed context, judgement and recommendations
- quotes should be used in specific contexts and maintain appropriate anonymity
- recommendations and/or action plans are to be offered
- concerns regarding individuals should be identified (not normally recommended).

Depending on the approach taken, the key themes emerging from an evaluation, and any associated recommendations and potential changes, can be communicated in a number of ways. Written documents, board presentations, individual meetings and collective discussions will promote

different levels of constructive criticism and debate. Although written documents are an important reference point for the board, a collective discussion provides a better catalyst for directors, allowing issues to be raised within a confidential forum. The success of this discussion often depends on the chairman; an effective chairman will engage directors in an open and honest debate, and facilitate the identification of priorities, agreed actions, responsibilities and timeframes.

The length of a collective discussion is often difficult to determine at the beginning of an evaluation. Occasionally, very few issues arise and the discussion can be quite short. In some cases, evaluations reveal two or three significant themes for debate and warrant several hours. The chairman can choose whether a short conversation at a board meeting, or a lengthy discussion over dinner, is the right forum to maximise the benefits of the evaluation. Confidential feedback to individual directors can also be helpful if issues arise relating to, for example, contribution and approach or the effectiveness of delegated committees.

Disclosure

The external evaluation process provides an inimitable opportunity for directors to debate the value and impact of their contribution on a confidential basis with an independent adviser. However, the disclosure of this debate to the outside world is problematic. Given the variety of evaluation methodologies available, shareholders and stakeholders rely on clarity and transparency of reporting. Although there is guidance relating to disclosure within the UK Corporate Governance Code, the most comprehensive guidance is in the Walker review of 2009:

"The evaluation statement should either be included as a dedicated section of the chairman's statement or as a separate section of the annual report, signed by the chairman. Where an external facilitator is used, this should be indicated in the statement, together with their name and a clear indication of any other business relationships with the company and that the board is satisfied that any potential conflict given such other business relationship has been appropriately managed …

"The evaluation statement on board performance and governance should confirm that a rigorous evaluation process has been undertaken and describe the process for identifying the skills and experience required to address and challenge adequately key risks and decisions that confront, or may confront, the board. The statement should provide such meaningful, high-level information as the board considers necessary to assist shareholders' understanding of the main features of the process, including an indication of the extent to which issues raised in the course of the evaluation have been addressed. It should also provide an indication of the nature and extent of communication with major shareholders and confirmation that the board were fully apprised of views indicated by shareholders in the course of such dialogue."

Part of this disclosure is easily communicated in writing, specifically the name of the individual and/or the firm conducting the review, any existing relationships between the firm or individual and the company and board (and potential conflicts of interests), and a description of the process undertaken; this is often disclosed in the chairman's statement and the corporate governance section in the annual report.

More difficult is the description of any confidential or sensitive themes that may have emerged, particularly if they relate to individual directors (including the chairman) and the culture and dynamics of the board. The chairman and the senior independent director may decide to give major shareholders and regulators a verbal update on these issues, and any agreed changes, when appropriate. Occasionally, the evaluator may also be asked to contribute to these meetings.

Conclusion

Although much progress has been made, these are early days; even the most experienced directors and external evaluators in the UK have been assessing board effectiveness for less than a decade, and best practice is still emerging.

However, there is growing evidence that evaluation can act as a catalyst for improving the board's effectiveness and its ability to prepare for future challenges. For chairmen, the ability to establish a confidential forum — where directors can speak frankly and without fear of inappropriate disclosure, and yet which provides an objective and contextualised view — is unique.

As this new discipline develops, directors, shareholders, stakeholders and regulators will become more knowledgeable and discerning about the range of options available, and appreciate the integrity and value of this essential process.

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Boardroom Review was founded in 2004 by Dr Tracy Long, and is a leader in the field of board evaluation: between 2004 and 2012, Dr Long conducted over 90 evaluations and 1,000 interviews with executive and non-executive directors, across plc, mutual, privately owned and public sector organisations.

Dr Long currently serves on the board of the UK government's Department for Culture, Media and Sport, where she is chairman of the audit and risk committee. She has served as an executive and a non-executive director on more than 20 UK listed and unlisted company boards, often as a shareholder or a shareholder representative, and is an Hon ARAM of the Royal Academy of Music.

Her doctoral research on the role of the non-executive director won the Keith MacMillan Prize for Research in 2005.

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