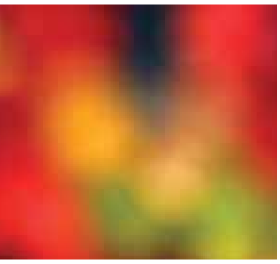


Board evaluations — we're doing them, so why do we still have non-effective directors?

By James Beck, Managing Director, and Erick Fibich, Principal Advisor (Victoria), Effective Governance

- While boards and the directors that comprise them have to be fit for purpose, the needs will vary from company to company
- Board evaluations are not standalone processes, but rather form part of an integrated, evolving cycle of governance accountability and improvement
- Effective evaluations are carefully structured and planned, with defined objectives, and outcomes implemented on an ongoing basis

A major trend in corporate governance over the past 20 years has been the shift from boards being seen as just a legal necessity to being seen to have responsibility for areas such as strategy and adding value to the organisations they govern. One outcome of this shift in thinking is the increased use of board evaluations as a method of performance improvement and pressure is now on to make evaluations more formalised and rigorous.

This is due to increasing regulatory prescriptions or recommendations[1], which have in turn resulted in the increasing use of board reviews as a way boards and directors can demonstrate their effectiveness.

That said, it is often the case that boards undertaking these reviews are not, in fact, improving. We have encountered many board members who despair of the non-effective directors who populate their boards from year to year in blissful ignorance of their failings! *Why is this so? Why aren't these board reviews having the desired effect?*

We would suggest that it is because the reviews they conduct are not getting to the heart of just how a board operates, what skills the board needs, and how different individuals and their behaviours can affect board effectiveness.

What all experienced directors know, and what is now attracting increased attention from governance experts, is that a board can have all the policies and procedures in place for good governance, but if the dynamics around the boardroom table are poisonous, the outcomes will be poor board performance, often contaminating organisational performance.[2] For example, a dominant personality on the board can inhibit contributions from other directors.

Further, many corporate failures share a common problem: boards with a culture where dissent was suppressed and loyalty was measured by agreement rather than disagreement. This was true in the case of both Enron in the US and HIH Insurance in Australia, where the directors had a tendency to reject warning signals that something was wrong with the company. Indeed, poor board behavioural dynamics is often what prompts boards to undertake a board evaluation in the first place.

Opinions vary as to how, by whom and when a board evaluation should be conducted. Further, one of the major challenges facing a board evaluation is choosing the appropriate level of analysis for the process. You cannot substitute company performance for board performance. Just because a company is performing well does not mean its board is effective. There may be a good management team in place, current performance may reflect the work of a past board, or it may be a matter of luck.

Boards, like most groups, require three different types of effectiveness if they are to maximise their potential. These types of effectiveness operate at three different levels — the organisational level, the group level and the individual level.

First, a review should consider board purpose, since it is only by fulfilling its purpose that the board can contribute at the organisational level. Next, evaluations should include both group and individual levels of analysis, where the attributes of a director affect their ability to contribute to a board in a variety of ways.

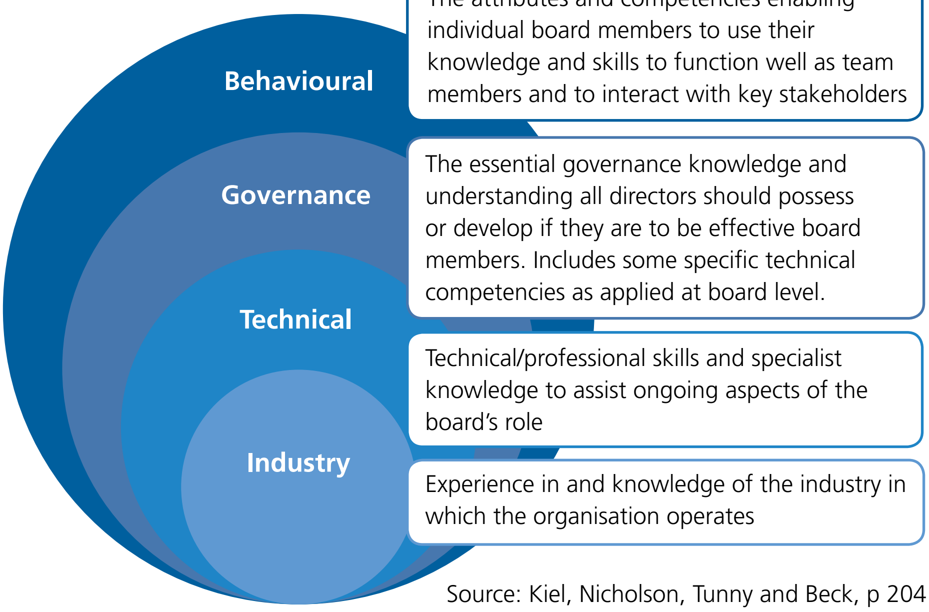
Fit for purpose

A board needs to be 'fit for purpose' to carry out the tasks the organisation requires of it. Further, it requires its directors to work together effectively. For example, analysis of board contributions to the global financial crisis highlighted how board 'effectiveness has been undermined by a failure to observe appropriate boardroom behaviours'[3], such as the willingness and ability to challenge management. Effective boards will share the attributes of an effective team including cohesion, cognitive conflict, shared commitment and values. While these attributes are no substitute for individual competence, they do allow the board to make the most of the people that they have serving on the board to execute the board's roles and responsibilities.

An effective board is also one where individual directors have the required competencies and are contributing appropriately. As a starting point, an individual director's knowledge, skills and abilities including specific company and industry knowledge are considered important to board performance. There is, however, no clear competency list. For example, in regulatory frameworks there is there is little consideration given to a director's competencies beyond 'independence' or 'financial literacy'.

Thus, most advice on director competence is insufficiently tailored to the multitude of organisational contexts that exist. Instead, competencies vary from company to company and board to board with the various fit-for-purpose requirements (for example, strategy formulation, risk and compliance oversight) differing between boards. By implication, so will required competencies and what often results in a complex list of highly desired competencies that are almost impossible to satisfy in the real world.

Figure 1: Board competencies



Source: Kiel, Nicholson, Tunny and Beck, p 204

The focus on individual competencies also needs to be broader than knowledge, skills and abilities. Emotional and social competencies are also important components of an effective director's competency set. While it is important to consider if the individual directors are contributing effectively, this does not mean that an effective board requires the same kind and level of performance from each director, but rather that each is contributing from their capabilities appropriately. Boards need to realise that in many cases, director competencies may need to be built over time — not every director will come to a board with a full complement of competencies. Further, the board's skills requirements will change over time as the company evolves and in accordance with its strategic direction.

Skills analysis

How do you know if your board has the skills it needs? We recommend a skills analysis. It should be noted that a board review and a board skills analysis are different activities with differing objectives. A skills analysis provides an inventory of what competencies a board has and where there are gaps; it is one way to reduce the risk to an organisation and to directors from poor decisions made because of inadequate knowledge of the company's industry, strategy, compliance, risk management or the financial aspects vital to the viability of any organisation.

Directors cannot perform to expected standards without competencies, but specific competencies such as accounting, legal or marketing qualifications, for example, cannot guarantee that they will perform adequately as directors. Sometimes extremely competent individuals may fail on a board due to personal and/environmental factors out of their control. Based on our experience in reviewing numerous boards, we believe an analysis of director competencies should consider the areas of competence shown in Figure 1.

Table 1: Examples of board competencies

Competence	Examples
Industry knowledge / experience	• Industry experience • Knowledge of sector • Knowledge of broad public policy direction • Understanding of legislation / legislative process
Technical skills / experience	• Accounting • Finance • Law • Marketing • Information technology • Experience in developing and implementing risk management systems • Human resource management • CEO / senior management experience • Strategy development and implementation
Governance competencies	• Director — medium organisation (10–99 employees) • Director — large organisation (100+ employees) • Financial literacy • Strategic thinking/planning from a governance perspective • CEO / executive performance management • Governance related risk management experience • Compliance focus • Profile — reputation
Behavioural competencies	• Team player/collaborative • Ability and willingness to challenge and probe • Common sense and sound judgment • Integrity and high ethical standards • Mentoring abilities • Interpersonal relations • Listening skills • Verbal communication skills • Understanding of effective decision-making processes • Willingness and ability to devote time and energy to the role

Each board or nomination committee will need to decide what competencies it wants in a director when developing such a list. Table 1 provides an example the type of competencies a board might want using the four areas of competence shown in Figure 1. This type of list can be used in a skills matrix to assess the board's capability requirements against the mix of current directors. It should be noted that, for each of the chosen competencies, there should be stages of development to describe performance in each skill (for example, none to expert) with a brief description of performance at each of the stages.

Possessing these skills will only lead to improved company performance if the directors are able to put them to good use, and it is through a board evaluation that the board can establish whether directors are doing so. Further, to provide constructive feedback for non-effective directors, we recommend a robust peer assessment.

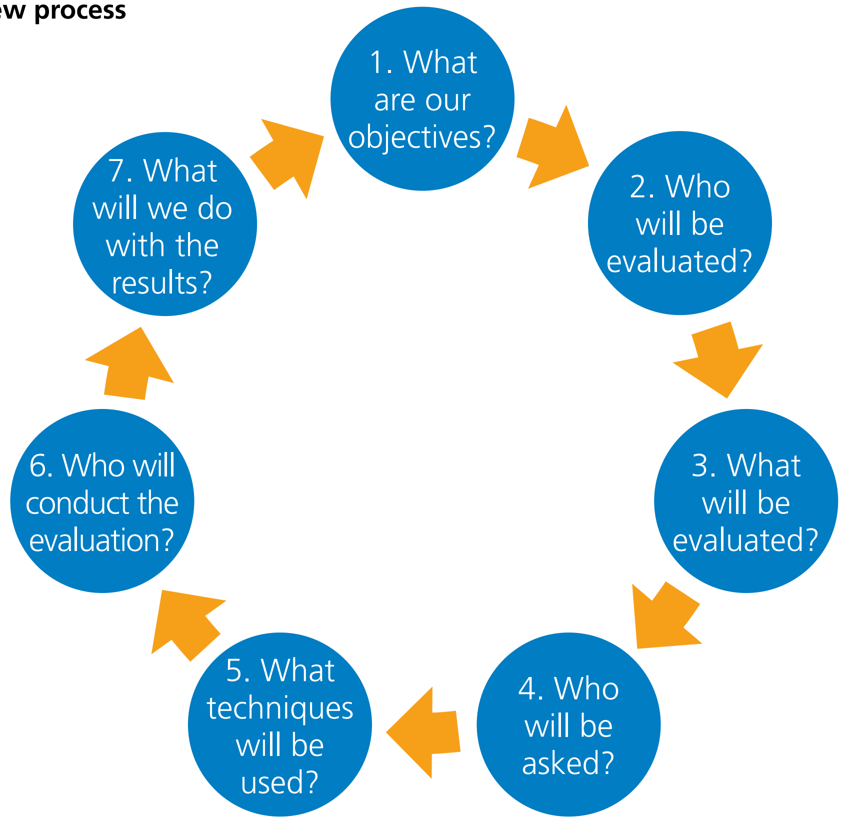
Getting practical — implementing a whole-of-board review

We now briefly outline how your board can use a board review as part of a system of continuous improvement by using a widely used model for designing an evaluation process (see Figure 2).[4]

What are our objectives?

Rather than focusing on the actual areas of governance for review, the first step is to be clear on the board's motivation

Figure 2: Board review process



Adapted from Kiel, Nicholson and Barclay, 2005

in undertaking a review. It is important that all directors understand the rationale for the review. Normally, this involves the delegated individual (for example. the chair) or group (for example, the nomination committee) documenting the objectives and obtaining board approval.

The most common reason for board evaluations is improvement at the group level. For example, an evaluation may clarify individual and collective responsibilities. From an organisational perspective, evaluations can play a symbolic role by setting the tone for a continuous improvement approach within the organisation.

Where board reviews are regulated, care should be taken so compliance does not become the sole objective of the process. A compliance focus quickly turns an evaluation into a 'checklist item' and boards can fail to spend the time and effort to conduct a process that enhances performance.

Who will be evaluated?

Comprehensive governance evaluations can entail reviewing the performance of a wide range of individuals and groups. Boards need to consider three groups:

- the board as whole (including committees)
- individual directors (including the chair's role) and
- key governance personnel — generally the chief executive (CEO) — and company secretary.

Considerations such as cost or time constraints, however, may preclude such a wide-ranging review.

A common issue in deciding who to evaluate is whether to concentrate on board-as-a-whole only or whether to include individual director assessment. Regular board-only evaluations may give only limited insight into any performance or governance problems, so we recommend that boards progress to the evaluation of board committees, individual directors and the chair to gain greater insight into board performance.

What will be evaluated?

Deciding what will be evaluated depends on the purpose and scope of the review. While evaluations will have a targeted objective (for example, addressing a specific, known problem in governance), the complexity of possible sources and solutions nearly always requires a broad selection of topics on which data will be collected. Most governance issues involve complex interactions between the board's composition, relationships (for example, between the board and management) and supporting policies, procedures and processes. Consequently, most evaluations do not involve a single issue, but rather a systematic review of the likely causes and consequences.

For these reasons, board evaluations generally use some form of governance 'good practice' framework as a guide for the evaluation. There are many such

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frameworks available; for example, Kiel, Nicholson, Tunny and Beck's Corporate Governance Practice Framework[5], and regulatory frameworks and advice such as the ASX Governance Council's Principles and Recommendations.

Who will be asked?

This decision involves understanding:

- who has the knowledge required to inform the questions formulated in the previous step
- whether the board is open to hearing the view of that person/group (even if anonymous)
- what the potential effect might be for the person or group who will be asked
- whether it is feasible to collect this information (having regard to issue such as resources and access).

Thus, there is no standard list of participants for a review; rather it requires a considered review of context, objectives and feasibility.

Most evaluations are self-evaluations based on director feedback alone. However, there are major weaknesses to overcome unless there are other inputs to the process — it is almost impossible to fully evaluate performance and self-evaluations are best used when the individual(s) involved have high levels of self-awareness.

This is where other internal and external sources of information become crucial. They allow the reviewer to corroborate insights and views from directors with others both within and outside the organisation. Internal participants could include senior managers (particularly the CEO and company secretary). Sometimes other employees can contribute, if the data sought is about general governance issues, but the lower the level of interaction between the board and the participant, the less useful it becomes.

A constraint of external sources is that they may have little exposure to the board and their responses are often more about organisational performance than board performance. As with non-board internal sources, the external source needs to be targeted and relevant, having some knowledge of the actual role the board is playing.

What techniques will be used?

Method selection is an underestimated aspect of board evaluations as practitioners often lack any grounding in research methodology and fail to consider the strengths and weaknesses of different approaches. Those developing the process may pay insufficient attention to the scope of the evaluation and will often rely on familiar tools or approaches. As the saying goes, 'if all you have is a hammer, everything looks like a nail'.[6]

The question here is whether to use quantitative, qualitative or mixed (that is, combined) methods. Quantitative methods are best used when the topic being assessed is well understood, the measurement tools are well used and verified and/or benchmarking or comparison is a key goal. Qualitative research is best used where you are not sure what the issues are. In practice, most rigorous evaluations involve mixed methods (both quantitative and qualitative data) — generally a combination of surveys, individual interviews and facilitated group sessions.

The different approaches used in board evaluations include the following tools.

- *Diagnostic surveys or questionnaires* are the most common form of evaluation. In addition to providing summated ratings of director perceptions, surveys can indicate gaps between current and desired performance or engagement to provide greater focus for change. Sometimes this can involve a comparison between board and management perceptions to highlight differences (positive or negative) and/or the similarities or differences between self and peer perceptions.
- *Interviews with directors* may be a formal process with an external adviser conducting the interview or it may take the form of an informal 'chat with the chair'. However, interviewing, particularly for evaluation purposes, is a complex skill that can be underestimated.
- *Observation* involves reviewing the board in action and is particularly useful when the board is interested in an external review of board dynamics. Rather than dealing with perceptions, the data is direct.
- *Document reviews* involve an analysis of board and committee agendas, board papers, meeting minutes, director attendance records and other documents. This can provide meaningful insights into the workings of the board. Gaps in documentation can provide insights into the sophistication of the board and its understanding of issues such as its legal responsibilities.
- *Psychometric testing* can also be helpful given that directors' personalities are often seen as a key factor in boardroom behaviours. As such, we have often wondered why standardised tests and instruments are not used more during board evaluations. While we have been involved in over 600 evaluations, it is only in very recent years that they have been begun to be employed to any extent.[7]

Who will conduct the review?

Board reviews require a level of expertise and objectivity. The major decision involves the choice of an internal or external facilitator. Internal reviews respect the board's authority, are more likely to provide directors confidence surrounding the confidentiality of the process and are likely to cost less.

There are, however, several limitations to an internally conducted review. For example, the internal reviewer may lack the skills required (for example, interviewing or survey design) and they are likely to have a bias (often unconscious).[8] Significantly, the review is likely to achieve little if the reviewer (for example, the chair) is the source of the problem(s) or it may not be appropriate given the objectives of the review.

A good external facilitator is more likely to have undertaken a significant number of reviews, so they can often provide important insights into techniques, comparison points and new ideas. An external party also provides transparency and objectivity, and can play a mediating role for boards facing sensitive issues — particularly those involving board dynamics.

As a middle ground, there are online diagnostic tools available that can provide confidentiality and objectivity to the process. If this method is chosen, the board must ensure it discusses the results and the implications of those results for the board.

What will we do with the results?

A board's response to the outcomes of a review should be based on how to satisfy the original objectives of the review. In most cases, the objectives involve the board reviewing the results and agreeing targeted actions for governance improvement, particularly when the focus of the review is on whole-of-board improvement.

In the case of individual director evaluations, what to do with the results should again reflect the objectives. Such evaluations will generally concentrate on providing the individual director with feedback, so the results are unlikely to be shared with the whole board. Instead, they will be discussed between the board chair (or process facilitator) and each individual director.

Disclosing evaluation outcomes more broadly is a topic of increasing importance. Often the board will communicate aspects of the review to different parties such as management. Interestingly, there are mixed views on the disclosure of even non-sensitive aspects of board evaluation, and it is dependent on the reviews objectives and stakeholder group to whom disclosure is made. Consequently, those boards that do disclose results more broadly tend to divest generic information with little insight for those interested in the board's work in this area.

Conclusion

Board evaluations are not standalone processes, but rather form part of an integrated, evolving cycle of governance accountability and improvement. For example, a skills analysis may be required to complement a board evaluation to ensure the board has the appropriate skills to meet the organisation's needs now and into the future.

Effective evaluations also require the board to set annual objectives, collect, disseminate information on progress toward the objectives, then judge performance, and implement improvements on an ongoing basis.

The key to success is to turn any recommendations from a board review into positive outcomes and improved performance. Along with the implementation of any recommendations for change, the results of any board evaluation process need to be integrated with other governance processes such as director selection or nomination processes, or orientation and education programs, since an evaluation can inform these areas.

This may seem burdensome, but if your board takes the time to think about the process — perhaps using the steps detailed here — it can be a worthwhile experience for all. This includes any current 'non-effective' directors, since a comprehensive board review will often provide them with the self-awareness to change their ways and contribute positively to the work of the board. This too requires effort, for example, through professional development, but again, it will be worth it for both the individuals involved and the board as a whole.

The Governance Instutute provides Members and subscribers with access to a Board Review Diagnostic developed by Effective Governance at governanceinstitute.com.au/knowledge-resources/board-and-ceo-diagnostic-tools/

James Beck can be contacted on 1300 295 515 or by email at James.Beck@effectivegovernance.com.au. Erick Fibich can be contacted on 1300 295 515 or by email at Erick.Fibich@effectivegovernance.com.au. ■

Notes

1 For example, the ASX Corporate Governance Council's *Corporate Governance Principles and Recommendations*, 2nd edition
2 For more on board behavioural dynamics, see Kiel G, Nicholson G, Tunny JA and Beck J, 2012, *Directors at Work: A Practical Guide for Boards, Thomson Reuters*, Sydney
3 Institute of Chartered Secretaries and Administrators (ICSA), 2009, *Boardroom behaviours: A report prepared for Sir David Walker by the Institute of Chartered Secretaries and Administrators*, London: Institute of Chartered Secretaries and Administrators, p 3
4 Kiel GC, Nicholson GJ and Barclay MA, 2005, *Board, Director and CEO Evaluation*, McGraw-Hill, Sydney
5 op cit
6 This is known as the 'law of the hammer' or 'Maslow's hammer' and relates to method-driven social science research. See, Maslow AH, 1966, *The Psychology of Science: A Reconnaissance*, Harper & Row, New York
7 See also Demasi A, 2013, 'Psychometric testing in the recruitment process', *Keeping good companies*, Vol 65 No 1, pp 50–53. While the article focuses on the use of psychometric testing in the context of recruiting employees, the principles can also be applied to board members
8 For an exploration of the types of biases which may manifest, see also Brennan N, 2013, 'Behavioral and psychological influences on boards', *Keeping good companies*, Vol 65 No 8, pp 457–461 ■