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BOARD EVALUATION

We hope that this article will give overview and guidance both to the boards who intend to do their first evaluation and to those who wish to develop their methods to make evaluation more productive.

It is an extract of a paper presented at the 8th International Conference on Corporate Governance and Board Leadership at Henley College on 12 October 2005. The title was "Evaluating the boards of the city of Stockholm"

The role of the board is instrumental in good corporate governance. The task is characterized by the pressure of responsibility, limited time and distance to the reality which the board is set to direct and control. Board evaluation can help the board to tune its contribution to the sustained success of the company. Board appraisals are prescribed by the Combined Code and other codes of governance, but many boards are still uneasy when facing assessment. It may in part be due to the absence of established practice. The literature describes methods based on questionnaires and interviews. Questionnaires usually have a simplistic design and therefore have limitations. Interviews require a thorough understanding of the conditions of board work and not all boards are prepared for them.

Evaluating the board

It is about performance

The role of the board is crucial in every corporate governance system. The board is the bridge between shareholders and management. If the company gets into trouble – the question is raised: Why didn't the board ...? The quality of the work of the board has great importance for the performance and prosperity of the company. Should it not be watched closely? This has not been the case in the past. The good news is that, at last, board evaluations are happening.

Why have boards not been evaluated previously? The opinion that it should be done was brought forth in the sixties. A guide for board appraisals was published in the late seventies. As a result of growing interest in corporate governance, boards in the US began to undertake assessments of their work. In the mid-nineties, already one quarter of the boards of Fortune 1000 companies were reported to have made board evaluations. In 2001, the NACD, the National Association of Corporate Directors, Washington, published a report about board assessment – focusing on the “right” things the board should do and observe. Codes of best practice recommend board evaluation in the UK and in Sweden. Recommendations of annual performance evaluation have been included in the listing requirements of the stock exchanges in New York, in London through the Combined Code and in Stockholm.

Over fifty per cent of the listed companies in the US undertake a formal board evaluation and half of them include individual appraisal of each director. In Sweden, board evaluation received scant interest in a survey in 2001. Since then, it has been accepted among the large listed companies. In the UK, the FTSE 100 companies have by and large adopted the formal requirements of the Combined Code and inform about board assessments in their annual reports of 2005. Of these, 25% were handled by external advisors and 55% reported that appraisals led to some sort of action.

Smaller listed companies in Sweden have been given a few years of grace. There are still no reports of compliance to the Combined code among listed companies up to and beyond the FTSE 350 and the AIM companies are exempted. There is anecdotal information that larger US non-profit organisations follow the example of the listed companies and perform board assessments. No reports of evaluation of boards in companies owned by municipalities have been found.

It is difficult to find rational reasons why boards should not be evaluated like any other function of the company. The hesitation is probably due to psychological factors. Many directors may not be used to having their performance put under the magnifying glass. Some might feel a certain uneasiness due to lack of experience of the process. The aim, as well as the methods, should therefore be clarified. Is the goal to improve the quality of board work? Are the results meant to give input to the nomination committee? The Swedish code of corporate governance states that the results shall be submitted to the nomination committee, which apart from the chair, consists of representatives of the shareholders.

It is not a beauty contest

Board evaluation is not about grading a board in relation to others. The ratings that business magazines perform may cause misunderstanding. The titles “The best .. “ and “The worst board” have little to do with reality. These ratings depend on public data about the composition and size of the board, on committees, the number of meetings etc. Although these input data are important, they have little bearing on the quality of the output. Enron had a good board rating - formal requirements were met – but we still witnessed one of the greatest failures of board work.

We will never see the perfect board because its mission is overwhelming. The board shall, with limited investment of time and removed from the reality (for non-executive directors), take all the major

decisions and control the company. The quality of board work depends on the interplay between directors and the respect they show each other. The dynamics of the boardroom depend on trust and candour, openness, willingness to challenge each other, time for reflection and much more. The chair is the single most important person to set the right conditions for productive board work. Board leadership is vital for the quality of the operations of the board.

Board evaluation should be part of a continuous process to improve and adjust the work. The scene changes and the board aims at a moving target. The business environment and competition alters, CEOs come and go, organisations are contracted or expanded and the composition of the board is changed. Problems occur where they are not expected. Does the board have the right information, is it on top of what is happening, does it challenge the strategies and discuss alternatives and does it understand the values that drive the organisation? Board evaluation is about the road and not about the goal.

Allow time for reflection

The benefit of board assessment lies in the follow-up. It is important that the board is attentive to the signals that evaluation gives. The board should set aside generous amounts of time to discuss the evaluation, give space to listen to opinions and take decisions. The quality of the signals the board receives from the evaluation does not lack importance.

Boardroom practice does not have the same characteristics in all countries. Fundamentals of good board practice do however have similarities, even if there are differences. In Sweden, the boards consist of non-executives. In 58% of the listed companies, the CEO is also a board member. In the US, the role of CEO and the chair are usually not separated. The influence of institutional investors and of the codes tend to make board work more and more similar.

Corporate governance is defined as the system by which companies are directed and controlled. It can be applied to companies irrespective of geographical origin or ownership structure. The art of board evaluation is still an emerging field and experience is accumulated within consulting firms rather than in the public arena.