BUILDING BETTER BOARDS

BY - Deb Nelms

The real challenge for directors isn't regulatory compliance—it's high performance. To achieve it, they need to systematically examine their purpose, tasks, talents, information, and agenda.

The key to better corporate governance lies in each director's performance within the working relationships between boards and executives, the social dynamics of board interaction, and the competence, integrity, and constructive involvement of individual directors. Boards seeking meaningful improvements cannot count on answers imposed from the outside. Instead, they should think aspirationally and act practically, deciding where they want to go and then equipping themselves for the venture.

That venture will probably be a multi-phased one, as many boards have a mindset characterized by ceremony and conformity. Today, boards are continuing to evolve into constructive seats of challenge and inquiry that add value without interfering and making CEOs more effective but not all-powerful. A board can reach that destination only if it functions as a team.

The high-performance board, like the high-performance team, is competent, coordinated, collegial, and focused on an unambiguous goal. Such entities do not simply evolve. They must be constructed and have an exacting framework. We at Corporate BoardLink call that act "board building."

The challenge of board building is multi-faceted. Generally, companies are in some phase of their board building development. To help them, we offer and collaborate with each board using a set of tools that are used to define and achieve their objectives. The following guidance derives from our recent work with the CEOs, directors, and external research of dozens of major companies on the topics of board effectiveness, governance reforms, and CEO performance appraisal and succession.

We also have relied on studies conducted by professional services firms which surveyed mostly independent directors representing the boards of more than 200 large public and private corporations. In general, the results of these surveys mirrored our firsthand observations. One point that emerged repeatedly was the importance of regular self-assessments when building a strong board.

The Right Mindset

Board building is an ongoing activity, a process of continuous improvement. Boards must keep coming back to the same questions about purpose, resources, and effectiveness. The best mechanisms for doing that are annual self-assessments. According to our survey, conducting and acting on such assessments are among the top activities most likely to improve board performance overall.

Of course, not everyone does what they know is best for them. Only 72% of respondents to our survey in addition to the overall research we've conducted said their board's performance is formally evaluated on a regular basis. And about two-thirds of those, or 48% of the entire sample, have a clear plan to address the concerns raised by their assessments. We have found that many boards lack data from which to draw conclusions about their success. In addition, they also lack the tools for using the data they do have that can be used for improvements. Without the right system and process, the ability to coach and monitor performance has limited results.

But to assess or not to assess isn't really the question. The New York Stock Exchange now requires annual board evaluations. Companies do retain great flexibility around what to assess as well as how to apply the results. Some boards continue to use paper-and-pencil surveys comprising recycled checklists cobbled together. That will keep them listed on the exchange, but it won't do much to improve their minimalist approach to governance and performance improvement.

Others treat self-assessment as a transformational exercise. The boards of Medtronic, Service Corporation International, Bank of Montreal, and Best Western, among others, have self-assessed themselves into high-performance teams, rethinking members' roles and working relationships. Such extensive reinvention requires time and energy, often scarce commodities for directors and CEOs. Therefore, a progressive and well-designed self-assessment built to uncover and discover is preferable to checking the survey boxes. A board's cursory glance in the mirror is not enough. But what does transform boards is a systematic culling of quantitative and qualitative data through surveys, confidential interviews, and facilitated group discussions.

The investment is worth it. By making routine the practice of rigorous introspection, boards ensure that they are fit to cope with existing circumstances and adapt to new ones.

The Right Role

Like most quests for change, board building begins with a vision. Specifically, boards must decide how engaged they want to be in influencing management's decisions and the company's direction. With this step, they move beyond the letter of reform and begin to focus on its spirit. Five board types have been identified that fall along a continuum from least to most involved. At the start of any board building program, the directors and the CEO should agree among themselves which of the following models best fits the company.

The Passive Board. This is the traditional model. The board's activity and participation are minimal and at the CEO's discretion. The board has limited accountability. Its main job is ratifying management's decisions.

The Certifying Board. This model emphasizes credibility to shareholders and the importance of outside directors. The board certifies that the business is managed properly and that the CEO meets the board's requirements. It also oversees an orderly succession process.

The Engaged Board. In this model, the board serves as the CEOs partner. It provides insight, advice, and support on key decisions. It recognizes its responsibility for overseeing the CEO and company performance. The board conducts substantive discussions of key issues and actively defines its role and boundaries.

The Intervening Board. This model is common in a crisis. The board becomes deeply involved in making key decisions about the company and holds frequent, intense meetings.

The Operating Board. This is the deepest level of ongoing board involvement. The board makes key decisions that management then implements. This model is common in early-stage start-ups whose top executives may have specialized expertise but lack broad management experience.

The point of this exercise isn't to pack boards into rigid boxes. These characterizations are essentially archetypes. Real-world boards move back and forth across the scale, their levels of engagement changing as issues and circumstances do. A passive or certifying board in crisis, for instance, may morph temporarily into an intervening board to remove the CEO, and then into an operating board until a new leader is in place.

Still, selecting a level of engagement provides the philosophical framework for everything that follows. Simply having that conversation is a significant first step toward improved board performance. The board may find that it disagrees sharply with the executive team about its role or that individual directors harbor divergent views, making it difficult to act in concert.

Having characterized itself to itself, to shareholders, and to management, the board can evaluate each subsequent decision for fidelity to the model.

The Right Work

Establishing an overarching level of engagement helps onboarding new directors and the established board directors set expectations and ground rules for their roles relative to senior managers' roles. But an engagement philosophy, like most expressions of general principle, does not apply equally to all spheres of activity. Boards, after all, potentially participate in dozens of distinct areas.

Many board tasks are familiar legal obligations: approving mergers and acquisitions; providing counsel to senior management; hiring, firing, and setting compensation; evaluating the CEO; ensuring effective audit procedures; monitoring investments; and so on. The latest governance requirements call upon boards to spell out those duties in written charters. At the end of each year, they go down the checklist and affirm, “Yes, we did that.” But that is a recipe for compliance, not necessarily for good governance and maximizing board performance. A better approach is to translate these mandates into categories of work, each composed of several activities.

Work Category Assessments are designed in a way that Directors can rate the existing and optimal levels of engagement for each activity on a sliding scale. Activities that are chiefly management’s responsibility receive a one; activities that fall exclusively within the purview of the board get a five. Senior managers should fill out the same form. The form includes activities such as : Strategy-strategic direction, strategic plans, strategic execution; Strategic transactions-major investments, portfolio changes, M&A; Operations-R&D, marketing and sales, IT; Risk management-enterprise risk, ethical performance and compliance, reputational risk, audit; External relations-brand positioning and integrity, shareholder relations, legal and regulatory, other constituencies; CEO effectiveness-CEO performance appraisals, compensation, succession; Others.

The results provide a foundation for two forms of gap analysis. First, by comparing actual and desirable levels of engagement for each activity, the board can plot in detail where to pump up or down its energies. Second, juxtaposing directors’ and managers’ views of the board’s role may bring to the surface disagreements that otherwise act like submerged mines. Sometimes, the reverse happens: The directors at one large media company, for example, were pleasantly surprised when managers rated the board’s optimal involvement in some areas higher than the board had rated itself.

This exercise has other applications as well. As the directors are considering all the scenarios that might require changes in involvement, they’re forced to contemplate the future. The board can also use this approach in fulfilling its self-defined mission and whether meetings devote the right amount of time to the right topics. Finally, it is a starting point to determine whether directors possess adequate skills, experience, and knowledge in the areas that matter most.

The Right People

A team is only as good as its members and high-quality board members can be scarce. 81% percent of our survey respondents said it has become more difficult to recruit qualified directors. Close to 40% said their boards lack an effective process for selecting new members.

In addition, reform efforts emphasize several narrow aspects of board composition. The Sarbanes - Oxley Act prescribes a heavy dose of independent directors. But the real issue goes beyond independence, it’s a matter of competence. We are not referring merely to the technical expertise of audit committee members but to all competencies related to the company, its environment, its culture, and its industry.

Composition Assessments look at both the collective capabilities of the board and the attributes of each director. Again, research is revealing. More than 90% of the respondents said their boards possess the collective capabilities to be effective. By comparison, directors' individual proficiencies inspired less confidence. Only:

- 73% of respondents said their colleagues have detailed knowledge of the company's industry;
- 69% said their colleagues have accounting and public-reporting expertise;
- 61% said their colleagues understand the company's key technologies and business practices;
- 60% said their colleagues possess expertise in global business issues;
- 58% said their colleagues contribute potentially valuable external contacts.

The Work Categories exercise described above is the cornerstone of a Composition Assessment. Boards take inventory of each director's strengths based on professional experience and technical knowledge and align them with activities that require maximum board involvement. The resulting Capabilities Profile illustrates the match and sometimes the alarming mismatch between what the board needs and what directors can do. Such knowledge is critical for developing director recruitment profiles, board director position descriptions, and the vetting process for new or next term directors.

> A major airline company, for example, was determined to enlist the best directors possible to help fight the battles engulfing its industry. The board thoroughly analyzed the company's business issues to determine what skills and experience it needed. Directors zeroed in on knowledge of the airline and travel industries, an understanding of marketing and consumer behavior, access to key business and political contacts, and experience with industry reconfiguration.
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> The board then defined the capabilities and qualities expected of all directors, such as independence, business credibility, financial expertise, industry expertise, confidence, and teamwork. To be as representative as possible, it considered each director's knowledge of geographic markets, particularly their knowledge of key hubs, CEO experience, leadership in the business sectors, and gender and ethnic diversity.
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> Next, the board assessed all its directors and mapped their skills, experience, and backgrounds against the new criteria. The gaps became the guide post for targeted recruitment profiles. In the end, several board members voluntarily stepped down to make way for new directors who had the capabilities needed to compete successfully.
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> Capabilities Profiles also provide a safe mechanism for directors and senior managers to broach sensitive subjects. "For about a year, I'd wanted to raise the issue of recruiting more directors with industry experience," said the CEO of a *Fortune* 500 company involved in a massive turnaround. "I felt sure this issue would make several board members defensive, so I held off." Then the board performed a Composition Assessment. "To my surprise, they raised this issue themselves," the CEO told us, "and tasked the nominating committee to develop a list of board candidates with

exactly the kind of experience I felt we needed all without my having to be the heavy." This framework should also be applied to Lead Directors, Committee Chairs, the Vice-Chair, and the Chair.

Evaluating personal performance, of course, requires precision and delicacy. It is not surprising that 66% of our survey respondents report that the boards on which they sit conduct no individual assessments. Under growing pressure to perform, however, boards must recognize which directors need help and which should not be nominated for another term. Consequently, more boards are adopting formal assessments of individual directors, including peer review.

The Peer Review comprises a series of questions rating individual member's demonstrated knowledge of key areas, their understanding of and preparation for their roles as directors, the quality of their input or advice, and their contributions to board interaction. All board members, including the member being evaluated, fill out the review. Reports are furnished to each board member and to the board's independent chairman, who uses them to guide discussion during each director's annual review. Peer feedback has influenced decisions about recruitment, retirement, committee leadership and selection, and education initiatives for directors.

The Right Agenda

Agenda management is often considered a mundane subject. However, agendas dictate what the board discusses and at what length. To control the agenda is to control the work of the board.

Historically, management has been in control of meeting agenda-setting (approximately 60%). As a result, many companies and directors routinely hear and see precise and scripted presentations, followed by perfunctory discussion, and the vote to ratify recommendations. CEOs, if so inclined, can overload the agenda with so many segments that they crowd out serious questions, troublesome concerns, or authentic debate.

"At many U.S. companies, the board meetings are shorter and there's much less discussion," says one retired CEO who has sat on the boards of both U.S. and European companies. "It's a nice presentation on interesting issues, but it's done in quick serve style."

But with the call to accountability, corporate boards are stepping up. To the extent that CEOs participate in the board building process (and CEOs *must* participate in the board building process), they comply with some level of power-sharing—a high level in the engaged, intervening, and operating models. The presiding director can collaborate with the CEO to devise an agenda agreeable to both. Alternatively, at the end of each board meeting, participants can collectively set the agenda for the next meeting. In any case, the rating of tasks (described above) is the touchstone. Directors and managers can review the agendas and minutes of past meetings to ascertain how much time they devote to each area. They can then compare those findings with the board's priorities to establish a correlation between interest bestowed and time spent.

The board at a major consumer retailer, a corporate governance leader, has gone further, transforming agenda management into something of an art. At the start of each year, the board sets three top priorities, for example, strategic direction, capital allocation, and succession planning. It then places each topic at the top of the agenda for at least one upcoming meeting. The board also devotes one meeting a year to setting the strategic direction for each major operating division, an acknowledgement of the company's growing complexity. Directors do not unduly limit questions and debate, requiring management to submit major items for board approval at least one meeting prior to the scheduled vote so they have the chance to discuss them. But they are mindful of their time and insist that presentations be short and to the point.

We encourage Boards to find ways to stay engaged with the company's issues outside of regular meetings as well. Even without executive diversions, board meetings are simply too packed with must-accomplish items to allow an in-depth examination of any one item. That is frustrating for directors who want to dig deeper into the meatiest subjects, most notably succession planning and strategy. Annual off-site meetings or retreats, one-on-one sessions involving CEOs and directors, and sit- downs between groups of directors and employees who have common interests all make the intervals between meetings fruitful.

The board's standing committees can also provide continuity. In response to the heightened focus on accounting and financial reporting, for example, many audit committees now meet in person or via teleconferencing more often than the board. Certainly, committees give directors the chance to concentrate on specific issues, developing deeper expertise in the process. In some cases, boards have come to rely less on committees, motivated in part by the concern that some will emerge with greater influence than others and impair each director's ability to work together.

The Right Information

The corporate secretary of a major company explained to us the "dark side" of communications between senior management and the board. "There are two equally effective ways of keeping a board in the dark," he said. "One is to provide them with too little information. The other, ironically, is to provide too much." The secretary went on to describe his own experience on the board of a public corporation: "We received reams of financial information in advance of each board meeting, which was way too much to absorb and could not be properly understood without considerable background information."

Thus, do boards fall prey to the confusion of data with information, which is no less real a problem. Too many board directors are overwhelmed by fat stacks of often insignificant numbers but lack the right information presented in the right way to produce informed action. We're been surprised to learn that, in some cases, directors who have served on boards for years confess that they don't really understand how their companies make money.

Certainly, boards face a huge information challenge. Directors are outsiders with limited time to learn about the company. If knowledge is power, then the balance lies with managers, who live and breathe operations. Indeed, only 34% of the directors in our research said they have independent channels for obtaining useful information about the company. The rest rely on what management chooses to share with them. Throughout our research, directors asked us repeatedly, "How can I tell what's really going on?"

In some cases, a little class time helps correct the imbalance. One company we worked with, for example, decided that its board lacked the background to intelligently review its strategy, business model, and performance. So, the CFO walked audit committee members through the company's balance sheet line by line and later did the same for the entire board in an intensive three-hour workshop. Directors, including some who had been on the board for years, came away with a much better understanding of important issues.

In that case, the board diagnosed its own problem. Other boards, however, suffer from a more general discomfort: the feeling that something is missing or preventing them from doing their jobs. Often, that something is a particular kind of information.

> The board of a private pharmaceutical company, for example, conducted a self-assessment that exposed concern about the chairman and CEO combined roles. Further conversations narrowed the focus: Directors, it turned out, worried less about the combination of roles than about a lack of information regarding acquisitions the CEO was pursuing. The solution was to change the information flow to the board rather than separate the two roles. Similarly, at a hospitality company, directors expressed dissatisfaction about the board's role in strategic direction. Their chief complaint? They weren't getting information on risks and returns before being asked to ratify major initiatives.

Such knowledge gaps are common. Boards often subsist on just two sources of information. The first is retrospective data on corporate performance and operations. In other words, trailing indicators. The second is presentations by management, particularly by the CEO, whose articulation of a vision and interpretation of financials significantly shape the board's views. Given those options, companies can get into trouble before their boards find out.

Not long ago, we worked with a board that was under sharp criticism for taking too long to remove a CEO following major performance shortfalls and significant valuation declines. But the directors shouldn't have been faulted for dragging their feet. As one explained, "Six months ago, we had a very articulate CEO who made an eloquent case about the company, and we had financial measures that indicated we were one of the most valuable market capitalization companies in the country. How were we to know what was going on below? In fact, once we saw the problems, we acted with blinding speed, although in many ways it was too late."
It is management's responsibility to ensure that boards get the right information at the right time and in the right format to perform their duties. The best boards design processes to deliver formal

information that combines both leading and lagging performance indicators, which will vary by industry and company. But boards should also be free to collect information on their own, informally and without management supervision. Directors at several firms we work with, for example, are required to periodically visit company facilities unaccompanied by senior executives.

The Right Culture

Culture is a system of informal, unwritten, yet powerful norms derived from shared values that influence behavior. We know that culture affects teams: Even those doing the same work with identical structures and similar composition perform differently depending on their social systems and beliefs. Thus, passive boards, governed as they are by formality and reserve, will perform differently from boards like the one described in the exhibit on page ten “Do We Have an Engaged Culture?” Engaged cultures are characterized by candor and a willingness to challenge and they reflect the social and work dynamics of a high-performance team.

Structures, composition, information flow - these things can be designed. Culture, by contrast, develops over time and tends to reward those who perpetuate it, making it difficult to change. At one financial institution during a self-assessment, some directors argued for a more open and participatory culture. But the majority clung to the status quo.

Boards cannot easily change their cultures. But as members engage more as a team, board cultures will change. The closer directors get to an engaged culture, the closer they are to being the best boards possible.

Yes, it is harder to clean house than to simply tidy up, but the rewards are proportionately greater. An ambitious board building process, devised and endorsed by directors and management, can turn a good board into a great one. But that transformation happens only when boards define their optimal roles and tasks and marshal the people, agendas, information, and culture to support them.

At its most effective, board building contributes not only to performance but also to member satisfaction. “I’ve served on this board for nearly ten years, and this is the first time I’ve really sat down and thought about how we have been working together,” said the director of a consumer products company engaged in such a project. “Our discussions always focus on how we are addressing everything on the overloaded agenda. Now that I’ve spent some time thinking about this, there are definitely some things we could do better. It also made me think about why I joined this board in the first place,” he said. “Somewhere between all the meetings and the calls, I seem to have lost sight of that.”

See Exhibit One below.

Does your board have an engaged culture?

Engaged cultures are characterized by candor and a willingness to challenge. In each of the following areas, engaged boards reflect the social and work dynamics of a high-performance team.

Agendas

- The agendas limit presentation time and maximize discussion time.
- There is lots of opportunity for informal interaction among directors.

Norms

- Board members are honest yet constructive.
- Board members are ready to ask questions and willing to challenge leadership.
- Board members actively seek out other directors' views and contributions.
- Board members spend appropriate time on important issues.

Values

- The board serves the business community by actively participating in governance.
- The board is responsible to the company's various stakeholders and constituencies.
- Board members are personally accountable for what goes on in the company.
- Board members respect one another.
- The board is responsible for maintaining the company's reputation in the industry.