

# The Boardroom Practice Limited

◆ Building Governance Best Practice ◆

## Practical Perspectives on Governance

### BOARD EVALUATIONS

Few of us like exams, or tests, and calling these exercises “evaluations” doesn’t help ease the discomfort. Unsurprisingly Boards tend to bristle too when called upon – not infrequently by persons other than their own shareholders – to undertake “A Board Evaluation.”

Board reaction can be defensive as the process is frequently perceived as being one of inferred criticism, which commences on the assumption that the Board is under performing and not necessarily doing the right things.

Equally unsurprising then that the exercise generates a certain amount of antagonism, is frequently not productive and is often seen as being a prescriptive waste of time.

The Boardroom Practice argues that this is highly understandable – and an unnecessary adverse reaction - that stems from the way we think about and design evaluation procedures – mainly by making them simplistic “cover versions” of assessment procedures designed far from the commercial world for quite different purposes, largely by people who are neither shareholders nor directors.

We think this needs to change and we can do better.

### What’s the Point

Reasons put forward to conduct Board Evaluations are in fact some extremely good reasons NOT to undertake Board Evaluations. These include “because the OECD says its “best practice” “, “because it’s an audit requirement”, because “the politicians who are voted in have to justify the tax investment in the business”, and because the “Harvard Business Review says they’re essential”.

The only real, relevant and sole point for Board Evaluations is to check out the performance of the Board **as the agent of shareholders**. Just why is explained below. For the moment though, consider that it should be shareholders – not observers driven by other agendas and collateral motives - who should be calling for and interested in the outcomes of “Board Evaluations”.

### Evaluations must have a framework

Board Evaluations should not take place in a vacuum even if that vacuum is called “best practice”. All participants need a clear framework which instructs them on what the purpose of the Board is and therefore what is being evaluated. This ought to be obvious, simple and explicit. Frequently it is not.

The framework is:

1. The Board’s object is maximising shareholders wealth for a given level of risk. Note that this is not the same as ever seeking reductions in risk. You can’t make money if you are perfectly hedged. The idea is to set an accepted level of risk for a given business and maximise wealth given that risk. A high tech new start will have, necessarily and fruitfully, a higher level of risk than a well established utility. The yardstick for this might then be successful comparably risky companies.
2. The relationship is a Principal – Agent one. The Board is the Agent. The shareholder is the Principal. Principal – Agent theory and problems are of central relevance. This relationship is the one that needs to be

monitored. It is from ill defined Principal-Agent issues that problems such as management empire building, money losing mergers, out of control HR practices, wonky diversifications, imprudent accounting decisions and the like emerge. The framework keeps pointing us back to the Principal - Agent relationship.

### **Evaluations as a Development Not Just Monitoring Tool**

We tend to get grumpy about assessments and evaluations. We are less antagonistic toward learning. Accordingly, The Boardroom Practice Limited designs and implements Board Evaluations as a Board Development tool. More than a semantic difference is involved. Boards who can see a gain in skills, competence, experience and ability to make better judgements are more likely to be receptive to raising their performance through such tools.

By necessity, evaluative processes need to form part of the process – otherwise monitoring is absent – but they should form a productive input to an individual Director and collective Board development and maturation process.

Development means we expect evaluations to generate improvement in processes, improvement in satisfaction for Directors and better service to shareholders.

### **Evaluations should not be mechanistic**

The lure of box ticking, IT driven box ticking and form filling is huge in the current practice of Board Evaluations. Generating questionnaires and writing programmes which automate them feels and looks like good productive work. For the most part its not. Its falsely authoritative and frequently irrelevant work.

For any evaluation to be useful it has to be customised in an idiosyncratic fashion to the business for which the Board develops and drives strategy on behalf of the shareholders. At the same time it has to allow comparisons with the rest of the commercial world so it cannot be simply a stream of consciousness based story. It provides a reality check.

This mix can be tough to achieve. There are however our thoughts on some of the key ingredients.

### **Evaluation should be contextual**

The touchstone for director decisions and Board policy development should be market not textbook and certainly not cost based. The markets for product, capital and management resources combined with directors and management response to those made are the prime determinants of shareholder wealth. Good judgements are always made within the real time context.

Board development should be designed, customised and implemented in the context of those markets - the real world the Board has to address. In high tech companies Board sensitivity to IP is critical. In export companies an appreciation of exchange rates and forward cover is critical. In State-Owned enterprises some understanding of government policy is important. Crown Research Company directors need to soak up the characteristics of labour markets for scientists and so on.

The development process needs to reflect these contexts and customise and internalise them into evaluative processes – there is no one size fits all in “Board Evaluations”.

### **A Little Extroversion Please**

Looking out as well as in is crucial. Orthodox Board Evaluations tend to look inward at Board performance not outward at shareholders situations and stakeholders expectations. Frequently it is a Board not just “in touch with itself” that we want but one in touch with consumer, creditor, government and community expectations.

Introverted excellence at self imposed procedures or self congratulatory compliance is not enough. Indeed it can be fatal introspection as the real world moves on. Translating external expectations into internal performance is the more relevant challenge – and the basis of real Board Performance.

### **First Risk Then Return**

It is difficult to find strong correlations between rising share prices, improving value growth and good governance. Almost impossible to measure and even more dangerous to attribute cause and effect them.

Less dangerous but potentially even more important is the principle that good governance is a risk management tool. Strong governance which eschews conflicts of interest, promotes accountability, enhances transparency and follows other strong governance principles is likely to enhance risk management.

It may not drive up shareholder's wealth immediately or in tangible ways. It does have the potential to prevent disaster. A truly effective Board needs to achieve the balance.

### **Compared with What?**

This a vital question. Evaluations are rarely if ever a comparative process. Marking off a dozen Likert scales proves nothing unless the results are compared with something meaningful. Comparators have to be developed for content issues (Board performance relative to markets and wealth creation and destruction processes) and process issues (such as capital budgeting and key personnel appointment processes).

Comparators need to meet the traditional psychometric criteria. Consequently they need to be reliable, i.e. capable of being repeated with consistent performance as indicators, and valid, i.e. provide indicators which benchmark what they purport to in real understandable terms.

### **Numbers Are Just Numbers Without Real Meaning.**

Comparative tools must not “abuse the data”. Stats 101 tells us that Likert style data is at very best nominal so we can't average it, calculate standard deviations or regress it, and graphs employing it are likely nonsense, impressive nonsense but meaningless – indeed what we can do with it is limited to a small family of non parametric statistics - and what on earth does that mean.

### **The Boardroom is not an Entity,**

The “Boardroom” is a composition of distinct elements creating a collective dynamic.

TBPL essentially differentiates the various components of the Boardroom. These are:

1. Chairs
2. Deputy Chairs
3. Directors
4. Boards

They each have different roles - simplistic and obvious - yet scrambling them together which many Board Evaluation processes tend to do, is unhelpful. Nor does a development tool for Chairs necessarily have any relevance for Directors. Collective performance is a different animal to individual performance – the benchmarks are different, expectations are different and the contribution to shareholder wealth is different. The development tool should reflect this.

## **Evaluation and Development should Address Tough Questions and Treat Directors as Adults**

Simplistic of questioning how often and how well directors read their Board papers is likely of no value at all. In general, tough evaluative and development questions do not concern procedure per se and they do not concern business as usual – the real environment and issues.

They do concern issues such as:

1. How does the Board operate under stress
2. How does the Board bring the CEO to account
3. How does the Board sanction the management
4. How does the Board understand the company's market
5. How does the Board monitor changes in shareholders expectations.

Evaluation processes which do not address these issues are living in a static, isolated vacuum unprepared for the “event” that will inevitably happen in our world of constant change.

### **A Sows Ear Out of a Silk Purse**

Jagger told us “you can't always get what you want”. So did Jeffrey Sonnenfeld, governance expert from Yale who points out that a clean bill of health would have resulted from a conventional Board Evaluation of Enron. There is a lot more going on in a truly effective Board than just sticking with text book practice.

In particular that much under emphasised intangible “Board dynamics” is critical. Factors such as functional teamwork, culture and behavioural interaction are frequently beyond the evaluator's ruler, let alone the fix it kit, but may be the difference between value added and the abyss.

Our conclusion is that the orthodoxy may well miss the target and the challenge is to move beyond to factors which at least have the potential to make a difference – a real difference.

### **Through a Looking Glass Darkly – The Future**

Clearly we at The Boardroom Practice believe that the current conventional approach to “Board Evaluations” their perceived role and purpose, is fundamentally flawed. They do not address the real components that create effective Board Performance and are most importantly not a generative tool for the benefit of Board's Chairs, Deputy Chairs, Directors and Shareholders.

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