# A FOCUS ON GOVERNANCE OUTCOMES

## ASSESSING BOARD PERFORMANCE

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In the early days of what has become an ongoing focus on good governance and board effectiveness, board evaluations were largely limited to compliance matters.

Today, assessments are about making good boards better by using greater rigor to identify opportunities to improve the board's value and contribution.

## Introduction to Board Evaluation Practices

Presently, there are no regulatory requirements for a board to evaluate its performance. Nor is there a general prescription on how assessments are to be conducted or how often. While not legislated, regular board evaluations are recognized as a best practice that is being readily adopted given their recognized value in improving organizational oversight. This is not to say that regulators and other stakeholders do not deem regular evaluations to be important.

The current focus on corporate governance began about 25 years ago with a preoccupation with boards adopting a range of governance inputs to foster more effective oversight. These inputs include the myriad guidelines, best practices and regulations that, together, form a governance regime that have common elements across sectors and across geopolitical boundaries.

This document encourages a new focus on governance outcomes as opposed to traditional inputs when assessing board performance and effectiveness. This premise recognizes that sustained efforts to adopt and refine governance inputs have failed to satisfactorily impact how organizations are governed.

Governance outcomes result from actually realizing the purported benefits that would result from the effective implementation of governance inputs. These inputs relate largely to the many component pieces that come under the banners of board structure, governance processes and boardroom dynamics and relationships.

### Board Assessment Process Review

This document reports on a review of processes typically used to assess board-related effectiveness and is structured as follows:

- An introduction to assessing board performance;
- An overview of research findings relative to current best practices for assessing board performance and effectiveness;
- Current evaluation processes typically employed at leading organizations;
- Consideration of a shift from assessing board effectiveness by focusing on governance outcomes as opposed to traditional governance inputs; and,
- An outline of revised and recommended process steps and corresponding tools to support a governance outcomes approach to assessing board effectiveness.

### A Brief Survey of Board Evaluation Practices

Regulators and other oversight bodies have included board and related evaluation processes as a part of good governance practices and guidelines for more than 25 years. These were precipitated by a focus on boards and their effectiveness in response to significant corporate failures, the lessons learned and an effort to clarify how good governance is achieved. Since then, there have been regular iterations of guidelines and practices in which board evaluation processes have been a consistent component. The following is a brief survey of current practices and standards in diverse jurisdictions.

### King IV Report on Governance for South Africa

The King IV Report recommends that an evaluation of the governing body be conducted every year. To provide for sufficient time to appropriately respond to the results of such performance evaluations, the King IV code recommends for a formal evaluation process to be conducted at least every two years. Every alternate year, the governing body should schedule an opportunity for consideration, reflection and discussion of its performance.

> *Principle 9: The governing body should ensure that the evaluation of its own performance and that of its committees, its chair and its individual members support continued improvement in its performance and effectiveness.*

Within this principle, there are practices cited in the King Report IV that are recommended for those boards that want to deliver on this principle. Selected practices include:

- The governing body should assume responsibility for the evaluation of its own performance and that of its committee, its chair, and its individual members by determining how it should be approached and conducted.
- The board should appoint an independent non-executive member to lead the evaluation of the Chair's performance if a lead independent is not in place.
- A formal process, facilitated either externally facilitated or not in accordance with the methodology approved by the governing body, should be followed for evaluating the performance of the governing body its committees, its chair and its individual members at least every two years.
- Every alternate year, the governing body should schedule in its yearly work plan an opportunity for consideration, reflection and discussion on its performance and that of its committees, its chair and its members as a whole.

While disclosure is not within the scope of this work, disclosure best practices included in the King Report include the following:

- Arrangements for the evaluation of the performance of the governing body, its structure, its Chair and its members, the CEO, the Company Secretary or governance professional;
- Whether such performance evaluations have been undertaken during the reporting period and the reason for any exceptions;
- Whether the performance evaluations were performed in-house or facilitated externally, with reasons if necessary;
- An overview of evaluation results and remedial actions; and,
- The governing body's views on whether the evaluation process is effective in improving performance.

This disclosure is expected to be a part of the reporting in an organization's annual report.

## Office of the Superintendent of Financial Institutions (Canada)

In Canada, the Office of the Superintendent of Financial Institutions (OSFI) highlighted the importance it places on these evaluations in its own governance guidelines published in 2013:

"The Board of a FRFI should regularly conduct a self-assessment of the effectiveness of Board and Board Committee practices, occasionally with the assistance of independent external advisors. The scope and frequency of such external input should be established by the Board."

Monitoring and evaluating the effectiveness of boards and individual directors will continue to be a major focus of international regulators, investors and other stakeholders going forward. They will be an important tool for determining the status of governance outcomes and steps required to achieve and sustain them.

Boards typically have total freedom to design evaluation processes to best meet their objectives or stakeholder expectations. This also means having the freedom to experiment with a view to keep the exercises fresh, engaging and productive. Arguably, this is exactly what this review is attempting to accomplish.

In considering how this freedom might be exercised, it is important to link, where possible, changes in approach and content, to practices in other jurisdictions that will lend credibility to new and innovative approaches. It is also good to understand trends outside of Canada if one believes those might be reflected in Canadian practices in the future. Staying ahead of the curve demonstrates the kind of leadership that has been a hallmark of how governance and other practices should be adopted by organizations committed to governing well.

## United Kingdom Corporate Governance Code

For example, in 2014, the updated United Kingdom Corporate Governance Code now states:

> *"FTSE 350 companies must use an external advisor to facilitate their board evaluation every three years; disclosure is required around the evaluator's independence."*

In addition, these guidelines also recommend that the appointment of a Lead Independent Director to conduct the annual evaluation of the Chair.

Relative to the OSFI governance guidelines, the U.K. Code adds rigour in terms of the objectivity and independence of the process.

## Current Assessment Practices

The standards for board evaluations contained in the guidelines cited in this report stand in marked contrast with disparity of practices as reflected in the results of an independent study conducted in 2014 on the topic of how board evaluations are conducted. Based on anecdotal evidence, it would appear the following practices have not evolved significantly in the intervening time and make a case for needed change.

- 20%: Completed entirely in-house, usually by corporate secretary
- 8%: Facilitated by a third party
- 36%: Facilitated by board chair or other director
- 25% Directors evaluate board performance in group discussion
- 11%: Company does not have an evaluation process

# Choices and Options for Optimizing Board Assessments

Boards can easily defend the status quo in terms of how they evaluate their performance as a team, as well their component pieces. That said, many organizations consistently demonstrate leadership in the area of board-related evaluations, as well as other governance practices.

The following represent themes identified during a broad review of board-related assessments and the process used to complete them. These themes reflect best practices and personal expert experience in conducting board assessments.

## Engaging Management

The success of board evaluations can be enhanced by soliciting input from as many individuals as possible who have first hand observation/experience of board performance. In addition to members of the board, it can be particularly beneficial to also include members of management or staff in the process as they bring unique and valid perspectives to the assessment process. While management may not be well positioned to respond to all related issues, they can add an important perspective to the broader evaluation process.

In doing so, it is recommended the evaluation process design include the following:

- Management participation should be limited to those who have regular interaction with the full board or one or more of its committees;
- The same confidentiality should be provided to management as that committed to board members;
- Reporting should not separate out conclusions reflecting Board and Management input. As there tends to be a high level of consistency of responses between the two groups, all responses (both survey and interviews) should be melded into a single assessment report. Where there is disparity of responses, these different perspectives should not be assigned to either the Board or Management, as this can have a negative impact on the candour Management will exercise in its assessment of the Board.

## Interviewing Evaluation Participants

There is real value to be derived from making one-on-one confidential interviews as central part of the assessment process. Relative to relying solely on survey results, interviews are highly effective in uncovering more meaningful, relevant and thoughtful feedback. In my professional experience, evaluation participants often view surveys simply as a task to be completed. As much as they serve as a useful starting point in a more rigorous evaluation process, they do not always uncover the most salient issues impacting good governance.

I acknowledge the use of interviews results in increased demands on Directors' time. However, the expected payback relative to the time investment by directors is significant and worthy of serious consideration.

## Less Reliance on Numerical Rankings

The recommendation that consideration be given to incorporating one-on-one interviews with all assessment purposes pre-supposes a different role for or reliance on survey results. Survey results tend to provide limited insight into board and director performance issues. As such, they provide a useful starting point for follow-up interviews by identifying a starting point or key themes for those interviews. Relying on surveys to identify performance issues is challenging, as numerical rankings, on their own, rarely provide sufficient depth of insight into where improvements might be made.

## Participation by New Directors

Many organizations defer participation by new directors in full board assessment processes until at least a full year or some other term has been served. The rationale for this policy is entirely understandable and can be easily supported. It reflects a belief that new directors need to have a certain exposure and service on the board to be able to meaningfully assess and provide an informed perspective on how well their colleagues deliver on their fiduciary duties.

At the same time, there is real value to be derived from all board members participating in the board assessment process, despite the limited tenure of newer directors. Newer directors can bring a fresh perspective and probe different issues that may not be top of mind of more veteran board members.

## Use of External Facilitators

The provisions of the 2014 UK Corporate Governance Code, which now require board evaluations of FTSE 350 companies to be externally facilitated every three years, are clearly the direction in which board evaluations are heading. About 19% of the largest public U.S. companies used an outsider for their board evaluations in 2013. Spencer Stuart, the international executive search firm, predicts that as many as 35% of major U.S. companies will follow suit in the next several years.

Most North American boards that use an external resource for their board evaluations also tend to follow the UK approach of "every three years" instead of annually. Board evaluations in the intervening years are generally conducted internally, often using a survey format or short phone calls from the board chair or chair of the nominating/governance committee to each director.

## Introduction to Governance Outcomes

The concept of governance outcomes, while not revolutionary, is far from mainstream. This approach is new, innovative, leading edge and, in most jurisdictions, largely untested. However, it is no longer without precedent. In the 2016 King Report on Corporate Governance (South Africa) addresses "governance outcomes" explicitly, representing what the authors cite as the "original intellectual thinking of the King Committee". These governance outcomes include:

- Establishing an ethical culture;
- Creating sustainable organizational performance and value creation;
- Protecting and building trust in the organization, its reputation and legitimacy;
- Adequate and effective control by the governing body; and,
- Setting an example by the Board's own ethical behaviour.

Arguably, some of these "governance outcomes" can be viewed as inputs. Is establishing an ethical culture an outcome in and of itself or does it, in turn, lead to something else – an outcome (or outcomes) that boards and organizations in general should pursue? An ethical culture should lead to trust and confidence in that organization, the work of the board and the leadership that reports to it.

Similarly, adequate and effective control by a board is, surely, a governance input that is fully intended to produce some greater, more impactful outcome. But to date in the recent history of focus on governing well, most boards have been measuring these and other inputs without undertaking the much harder work of identifying, understanding and defining metrics that will show proof of the degree to which the intended ends – the outcomes – are achieved.

As much as the work of the Institute of Corporate Directors in South Africa has helped launch and move the governance outcomes agenda forward, there may well be more work to determine exactly what constitutes genuine governance outcome.

The author believes governance outcomes relate to the benefits, payback or reward realized when the underlying principles of good governance are fully achieved.

Examples of these principles include:

- Leadership;
- Stewardship;
- Independence;
- Transparency;
- Owner rights; and,
- Accountability.

The author has been exploring the concept of governance outcomes for more than two years and has identified the following as being primary governance outcomes:

- Trust and confidence in the work of the board and management on the part of key stakeholders, particularly an organization's owners and customers;
- Deep reputational respect across a broader set of stakeholders;
- Mission and vision achievement; and,
- Increasing organizational value.

An outcomes-focused approach relies on a markedly different board evaluation model with an entirely new focus those forces a shift away from governance inputs to governance outcomes. This new focus reflects:

- The Board's <u>impact</u> on the organizations, as opposed to isolated practices;
- The Board's <u>value</u> as a strategic asset to the organizations they oversee; and,
- The Board's <u>contribution</u> to organizational success in tangible, relevant ways.

## Governance Outcomes Assessment Focus

### Introduction

Assessing governance outcomes is likely to achieve success in the following ways:

- Refreshing and re-energizing the more traditional approach to board assessments organizations have typically employed, with diminishing returns resulting from the repetitive process.

- Challenging process participants to think about how the board performs from different perspectives, frustrating some while energizing others.
- Identifying new opportunities the Board of Directors could leverage to continue on its good governance journey.

## Process Objective

A Governance Outcomes Assessment focuses on confirming the value, impact and contribution the Board of Directors makes to the success of the organization. To achieve this objective, the assessment is designed to determine how the organization is governed, identifying and affirming the Board's strengths, along with opportunities for improvement.

## Assessment Principles

It is proposed all board performance assessments abide by the following principles:

- The annual Board evaluation process should be conducted annually. All Directors and Senior Management (those regularly in attendance at Board of Directors meetings) should participate in the process.
- Full Director participation is critical to ensure the process produces accurate information and valuable results. Participation should be mandatory.
- The process should adopt as much rigour as possible to help ensure the best possible and most accurate outcome in assessing the Board's effectiveness. With this in mind, organizations should make interviews a standard and mandatory part of the overall assessment process.
- A formal action plan to address the issues/ opportunities should be developed and adopted by the Board in response to the results of the assessment.
- The annual Board evaluation process and associated action planning session should be facilitated by a resource determined by the Governance Committee.
- Management, presumably the Corporate Secretary's Office, will be responsible for working with the Governance Committee to facilitate the annual review/ action planning process.

## Proposed Board Assessment Process Steps

An effective annual board performance assessment process relies on key steps:

- **Step One:** The solicitation of board member and selected management views on questions relating to the impact of the current approach to corporate governance and the board's effectiveness in giving effective oversight. An online survey is accessed by all participants, requiring about an hour of each participant's time.

When answering the questions or offering input, participants are asked to do so with a view to identifying examples that will help qualify the organization's governance strengths and, where possible, enhance the board's contribution to its success.

- **Step Two:** Key themes from the survey process should form the basis of the mandatory interview phase. Interviewees are asked to elaborate on these themes or identify other relevant factors impacting board effectiveness.
- **Step Three:** Analysis of the collective input from Steps One and Two with a view to the formulation of a comprehensive report highlighting key themes and issues identified from the input phase.
- **Step Four:** Consideration by the full Board and Senior Management of the results of Step Three through a facilitated session from which a greater shared understanding of governance strengths and opportunities, with a view to identifying priorities and making commitments going forward will be identified and commitments for action are made.

  As part of Step Three, the Board and Senior Management should participate in an action-planning session to discuss the annual evaluation results and deal with issues/opportunities requiring attention as a result of the review.
- **Step Five:** Following the debrief session with the full Board on the conclusion of the assessment process and receipt of the results in report form, original input from the survey participants should be destroyed.
- **Step Six:** The action plan should be delegated to the Governance Committee for implementation, with regular updates reported back to the board to ensure appropriate accountability.

## Governance Outcomes Assessment Questions

The following are questions that could form the basis of the survey phase of the board performance assessment process. These questions are designed to move beyond the traditional focus on governance inputs and, instead, probe issues related to governance outcomes and the impact the board has on the success of the organization it oversees.

## Value of Corporate Governance

- How do you define corporate governance in the context of the Board's work at the organization?
- How do you measure the value the organization derives from its corporate governance function?
- How is the organization receiving good value relative to the time, resources and funds required to support the corporate governance function?
- From a theoretical perspective only, what would the organization lose if the Board ceased to exist?

## Governance Outcomes

- In considering the past year or so, please identify three or more tangible outcomes you can attribute to the work of the Board of Directors in leading the corporate governance function at the organization.
- What tangible contributions (please identify a minimum of three) has the work of the Board of Directors and/or Committees made to the organization in achieving strategic priorities?
- How does corporate governance contribute to the organization success in tangible ways?

## Governance Gaps / Future Opportunities

- What corporate governance accountability(ies) are not being addressed as rigorously by the Board of Directors as you believe is required or appropriate at the organization?
- From your perspective, what was the Board's most notable shortcoming during the past year in terms of its oversight obligations?
- Please describe the most significant contribution the Board can or should make to the success of the organization this coming year.
- Please consider how the following key corporate governance contributors might be changed or improved to ensure optimal corporate governance going forward:
  - Governance Structure (how the Board is organized)
    - What could be improved in terms of governance structures?
- Governance Processes (how the Board does its work)
  - What improvements could be made to current governance processes?
- Governance Culture: (how key governance players and contributors work together):
  - The Board team
  - The Board and CEO / Management
  - The Board and other key roles (e.g., internal audit, CFO, etc.)

  What could be improved in how the Board works together as a team?

  What could be improved in how the Board works with the CEO and Management?

  What could be improved in how the Board works with other key roles (e.g., internal audit, CFO, etc.)?

## Governance Principles

What gaps exist in how the Board adheres to the governance principles of:

- Accountability
- Transparency
- Leadership
- Stewardship
- Independence?

## Trust and Confidence

A key objective of corporate governance is to foster trust and confidence between stakeholders.

- What could be done to enhance the current level of trust and confidence the Board has in Management?
- What could be done to enhance the current level of trust and confidence in the Board of Directors on the part of Members?
- What could be done to enhance the current level of trust and confidence in the Board of Directors on the part of Management?
- What could be done to enhance the current level of trust and confidence Members have in the Board?
- What could be done to enhance the current level of trust and confidence the regulators have in the Board?

## Concluding Questions

- Please provide any additional comments or insights applicable to this year's governance review.
- If you were not able to answer these questions, please elaborate.

# Final Remarks

Over the past quarter century, many boards have responded positively to new ways of encouraging greater oversight effectiveness. One of the most significant developments has been the practice of regularly assessing board performance. Over time, however, the practice of assessing board effectiveness using the same process and metrics produces diminishing returns. Board performance assessment practices need to evolve as well so they are positioned to deliver new insights and serve as a catalyst for continuous board improvements. The purpose of this paper is to encourage boards to adopt this proactive posture in adopting new practices and applying greater rigour to its approach to assessing their effectiveness.

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*John T. Dinner Board Governance Services, www.boardgovernance.ca, has been helping clients across sectors and across Canada achieve their organizational objectives through excellence in board governance. Board members and organizational leaders value John's insights, practical approach and ability to facilitate needed governance change or transformation.*