Is Your Board Effective?

Directors and executive leaders want their boards to be effective—that's undeniable. But what makes a board not just competent, but a truly high-performing, value-enhancing board? That definition is much more elusive.

At too many companies, effectiveness is only evaluated in the past tense, and sometimes only after something has gone wrong. If the question is "why wasn't the board effective?," there can be real reputational or legal culpability.

Instead, boards should focus in the present and future tense: Is the board effective? Does it understand and execute its responsibilities, staying focused on truly strategic items and fostering an environment conducive to value creation? Does it have the right mix of backgrounds, skills, and experiences to thrive? And will it remain effective in the future, given anticipated challenges and opportunities?

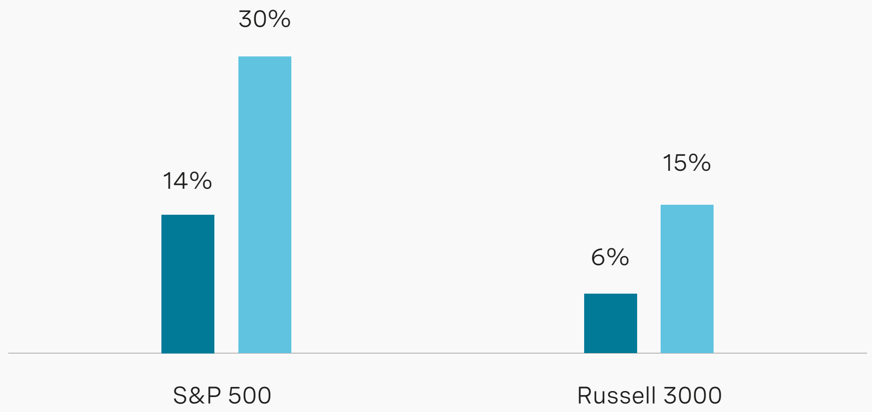
As companies face increasingly tricky terrain, answering these questions is critical. In addition to ever-present requirements to increase financial value for owners, other stakeholders are ratcheting up their own demands and are more likely than ever to hold the company and its directors responsible if those demands are not met.

All companies should regularly ask if their board is effective, and most do so through the board's annual self-evaluation. But when did your board last evaluate its evaluation process? This paper highlights the changing needs of evaluation stakeholders and offers suggestions on how to make your next board assessment fit for purpose.

The current board evaluation landscape

The annual board evaluation process is evolving at many companies, and the historical compliance-oriented "box-checking" exercise is no longer seen as sufficient. Now, board evaluations often go deeper; this past year, 52% of companies in the S&P 500 disclosed that they conducted a combination of full board, committee, and individual director evaluations, up from only 37% in 2018. Companies are also getting more help with their evaluations—use of outside facilitators more than doubled in both the S&P 500 and Russell 3000 over the last four years.[1]

Companies Utilizing Independent Board Evaluations (2018 vs 2021)



With growing pressure from an array of important stakeholders and influencers - shareholders, proxy advisors, executives, and board members themselves - expect these numbers to continue increasing.

Source: Board Refreshment & Evaluations, The Conference Board, 2022

Demand from shareholders and proxy advisors

Shareholders are increasingly vocal about board evaluation practices, with many explicitly declaring their expectations in annual proxy voting guidelines.[2] Many link evaluation practices with board refreshment, noting that evaluations may begin valuable dialogue about the backgrounds, skills, and experiences needed for the company's future success. These things are no longer seen as "nice to have" – investors recognize that these are essential ingredients to a value-enhancing board, and as a result are much more likely to hold companies and directors accountable through votes at the annual meeting as well.

Beware the universal proxy era

The universal proxy era is here and it will only increase the pressure on both board effectiveness and individual director re/nominations. While commentators rightly note that this will affect contested director elections, this will affect how companies prepare for uncontested elections as well. The risk that an activist – whether a hedge fund or an investor with an ESG-focused thesis – targets a company and individual directors has never been greater. Due to the current business climate, including rising interest rates and inflation, many companies will find themselves with an activist reviewing their business. To build a defense in this new era, companies should demonstrate their commitment to board effectiveness and enhancing performance. We suggest they do so by describing their evaluation processes, as well as their thoughtfulness about board composition, by enhancing director biographies, skills matrices, and related voluntary disclosures.

Demand from board members

Board members are also independently seeking more rigorous evaluations. In many cases, expectations for their own boards has risen. With directors averaging over 224 hours in service to public company boards in 2021,[3] who wouldn't want that time to be more productive and pleasant?

This applies both to cases where a director suspects that something that needs to be fixed on a board *and* when they are proactively seeking to make a good board even better. Occasionally this manifests as a concern about peers; this past year, 47% of directors think at least one fellow director should be replaced, and 19% would replace two or more.[4] But increasingly, directors are turning the lens on themselves, proactively asking: *How can I get better?*

Put simply, directors want to be effective. When presented in a fair, thoughtful, and forward-looking manner, peer feedback enables them to be.

Dealing with sensitive individual director feedback

A company ran its annual board assessment via a detailed electronic survey. The anonymous, unedited results were typically shared with the board. One year, the survey generated several critical and unhelpful comments. The internal leader felt uncomfortable sharing that feedback broadly with the board, but also felt uncomfortable ignoring it. We were hired to understand the root of these comments and to present them in a compelling way to relevant directors. Our interview-based process uncovered the source of friction between several directors and addressed it in a low-stress, forward-focused manner, enabling the board to enhance culture, collegiality, and effectiveness.

Demand from executives

Executives are also strong advocates for robust evaluations. Effective boards provide invaluable strategic counsel and oversight to management teams, unlocking substantial organizational value. Conversely, ineffective boards can actively impede executive leadership teams, distracting them from value creation.

Outside facilitators can anonymously share information with the board about how its work is perceived by senior leadership. Such information is often incredibly compelling, bringing vague concepts about corporate governance to life, and helping boards make changes that lead to a real positive impact on the company's performance.

Uncovering management's view of the board

In one evaluation, interviews with select members of the executive leadership team uncovered a significant level of distrust and dissatisfaction with the board. In a series of well-intentioned attempts to demand excellence, the board had sometimes overstepped from governance into management, and from strategic to tactical matters. As a result, the management team felt untrusted, disempowered, and demotivated. If left unaddressed, this posed a significant morale and retention risk; if addressed indelicately, it could ignite a powder keg in both the boardroom and C-suite. After carefully and quietly investigating the issues were we able to frame the topic in a productive, forward-looking manner, accompanied by concrete, achievable recommendations that helped bridge the gap between the board and leadership team.

How can your board make its evaluations more effective?

When it comes to board evaluations, one size does not fit all. Each process should be customized to deliver the greatest return on investment. As part of that customization process, boards should consider five key design questions:

- **What (and who) are you evaluating?**
- **What is the focus of your evaluation?**
- **On what sources will you rely?**
- **Who will lead?**
- **How will you turn insight into action?**

What (and who) are you evaluating?

While many annual evaluations focus solely on full board performance, ignoring committee and director performance constitutes a missed opportunity.

Investors agree. In its seven key indicators of board evaluation strength, the Council of Institutional Investors stated that “effective board evaluation processes assess performance at three levels: the board, the committees and individual directors.”[5] Integrated evaluations that capture feedback at all three levels are most likely to determine the biggest opportunities to enhance board performance. While the subject of the evaluation may change from year to year, boards should be deliberate when scoping, balancing the pros and cons of different approaches.

Leaving Lake Wobegone

Individual directors often grade themselves more generously than the average shareholder. As a result, skills matrices and other disclosure intended to demonstrate the board’s breadth of skills may inadvertently *decrease* a reader’s confidence in the board. In addition, relying on self-identified skills may give a board false confidence in its composition, obscuring a critical skills gap that it could otherwise address.

We are frequently asked to review board skills disclosure critically but constructively. Doing so in a way that leads to productive change often requires a careful review of a company’s disclosure against that of its peers alongside an interview process that generates trust and buy-in from all participants. Such processes can create a roadmap for board refreshment that many companies tell us they would have be unable to create on their own.

What is the focus of your evaluation?

Oversimplified, board effectiveness combines winning structures, processes, and people. The best evaluations are holistic, reviewing how a board is designed, how it operates and spends its scarce time, and how it handles important and contentious discussions. Many boards use the evaluation process to refresh benchmarking data on how the board compares against peers, important reference companies, and evolving investor priorities as well, all of which can uncover gaps before they become problems.

Many existing evaluations are designed to only examine one of these key elements. For example, many law firms offer evaluation services that assess corporate governance from a very (if not purely) technical lens, often focusing on shareholder activist defense mechanisms. While accomplished in their areas of expertise, many of these advisors have difficulty assessing, remediating, and reporting on the interpersonal and cultural issues that are most likely to inhibit board effectiveness. Only holistic evaluations that examine structures, processes, and people can confidently assess whether the board is an asset in creating real shareholder and stakeholder value.

On what sources will you rely?

While analytical surveys have their place, when they are the entirety of an evaluation they are more likely to generate heat than light. Evaluations that simply point out differences in average scores won't provide meaningful insights or actionable ways to improve, as the sample sizes simply can't provide statistically significant data. Comparing average scores on given questions across in a multi-company database isn't much better, and does not offer any diagnosis or - more importantly - solutions.

We believe that interviews are the essential foundation of any rigorous and effective evaluation. Candid, unattributable discussions with every board member - and key members of the leadership team - provide the necessary nuance for an evaluation to generate actionable insight.

Going beyond the numbers

Nine months after its last survey-based evaluation, a board chair reached out and shared her frustration. "We received data that showed where we were doing well but it didn't tell us why, and data for what we weren't doing well but with no instructions on how to fix things." Having previously eschewed an interview-based process, the board agreed it was now necessary. Interviews with the board and executive team revealed the fundamental sources of frustration and ineffectiveness, including key disagreements about elements of the board's oversight of CEO succession and about the appropriate boundaries between the work of the board and its committees. Creating a productive path forward required careful attention to company and board cultural issues and personalities, but both the board and CEO left with a shared path to address critical topics that had been previously seen as unmentionable.

Who will lead?

Evaluations must consider both internal and external leadership. Internally, most processes are overseen by the board's chair, lead independent director, and/or chair of the committee responsible for corporate governance. The best processes also carefully solicit and consider executive input, particularly that of the CEO.

Conducting an externally-supported evaluation at least every two or three years can be extremely valuable. Not only do external advisors bring a broader perspective informed by working across numerous boards, their outsider status allows them to provide a safe space for interviewees to share sensitive information they might not be comfortable sharing internally.

How will you turn insight into action?

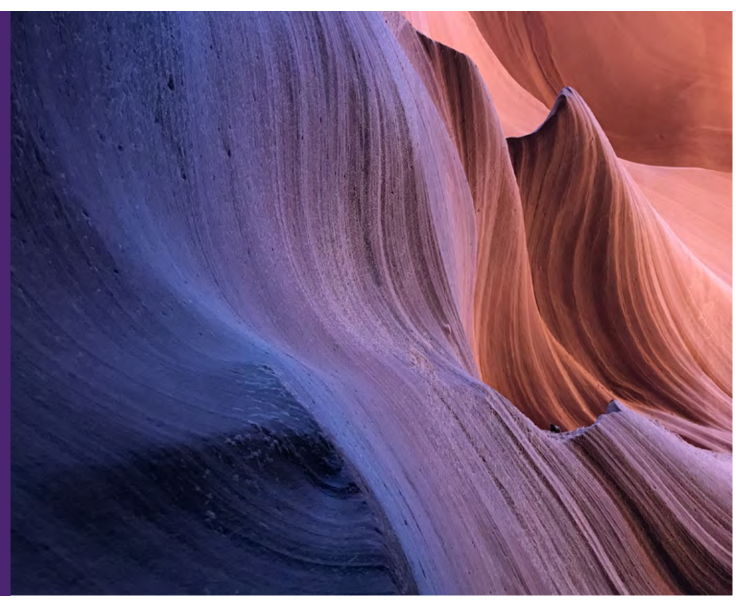
Identifying opportunities is not enough. The most powerful evaluations uncover a handful of critical opportunities and a pathway to address them.

We are often called to remediate a prior "failed" evaluation. Sometimes, a company has been given a laundry list of minor suggestions without any prioritization or scale. Other times, feedback is presented poorly, corroding collegiality and injecting distrust. To address this, working with experts who focus on critical issues in a positive, future-oriented way is essential.

Any board assessment should be viewed as a part of a broader journey toward effectiveness and high performance, rather than a one-time outcome. We previously wrote[6] about the importance of a multi-year evaluation cycle, and continue to believe that tracking board progress in subsequent years is one of the best ways to effect change. Most of our clients undergo an externally-facilitated deep dive every two or three years, focusing on defined priorities during off-years.

Conclusion

More stakeholders than ever are asking: "Is your board effective?" Too many directors and executives confide in us that they are not able to answer that question with conviction. Establishing a thoughtful board evaluation process equips you with the information necessary to be confident in your answer and helps your board on its journey to an unequivocal "yes."



Appendix

ISS	"Board refreshment is best implemented through an ongoing program of individual director evaluations, conducted annually, to ensure the evolving needs of the board are met and to bring in fresh perspectives, skills, and diversity as needed."[7]
Glass Lewis	"Glass Lewis strongly supports routine director evaluation, including independent external reviews, and periodic board refreshment to foster the sharing of diverse perspectives in the boardroom and the generation of new ideas and business strategies. Further, we believe the board should evaluate the need for changes to board composition based on an analysis of skills and experience necessary for the company, as well as the results of the director evaluations, as opposed to relying solely on age or tenure limits."[8]
Vanguard	Vanguard believes that "regular and meaningful evaluations enable boards to analyze their current composition and identify opportunity areas."[9]
BlackRock	"Board composition, effectiveness, diversity, and accountability remain top priorities."[10] Supports robust evaluation practices and disclosure.
State Street Global Advisors	SSGA views "board quality as a measure of director independence, director succession planning, board diversity, evaluations and refreshment, and company governance practices."[11]
Northern Trust	"Boards should, on at least an annual basis, formally evaluate the CEO, the board as a whole, and individual directors. Evaluation of the board as a whole should consider the balance of skills, experience, independence, and knowledge of the company on the board relative to the company's long-term strategic plan. Evaluation of the board should also consider the board's diversity, including gender, how the board works together as a unit, and other factors relevant to its effectiveness. Individual evaluation should aim to show whether each director continues to contribute effectively and to demonstrate commitment to the role."[12]
Legal General Investment Management	LGIM believes "the evaluation of directors is an essential way of improving board effectiveness and ultimately its performance. It is also a way for investors to determine the quality of debate and interaction between board members... LGIM expects an internal board evaluation to take place annually... External reviewers can also bring different perspectives on the functioning of the board, as well as experience of how other boards operate."[13]
Columbia Threadneedle Investments	"All boards should implement an evaluation process that considers the effectiveness of the entire board, its committees, the contributions made by each member, including its systems for interaction between the board and company management, areas for improvement, and behaviors and overall board culture. The nominating or governance committee may oversee the evaluation process and should report general findings and areas for improvement publicly to shareholders. Large or systemically important companies should leverage professional, independent assistance to facilitate evaluations on a periodic basis (typically every three years)."[14]

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About Russell Reynolds Associates

Russell Reynolds Associates is a global leadership advisory firm. Our 600+ consultants in 47 offices work with public, private and nonprofit organizations across all industries and regions. We help our clients build teams of transformational leaders who can meet today's challenges and anticipate the digital, economic and political trends that are reshaping the global business environment. From helping boards with their structure, culture and effectiveness to identifying, assessing and defining the best leadership for organizations, our teams bring their decades of expertise to help clients address their most complex leadership issues. We exist to improve the way the world is led.

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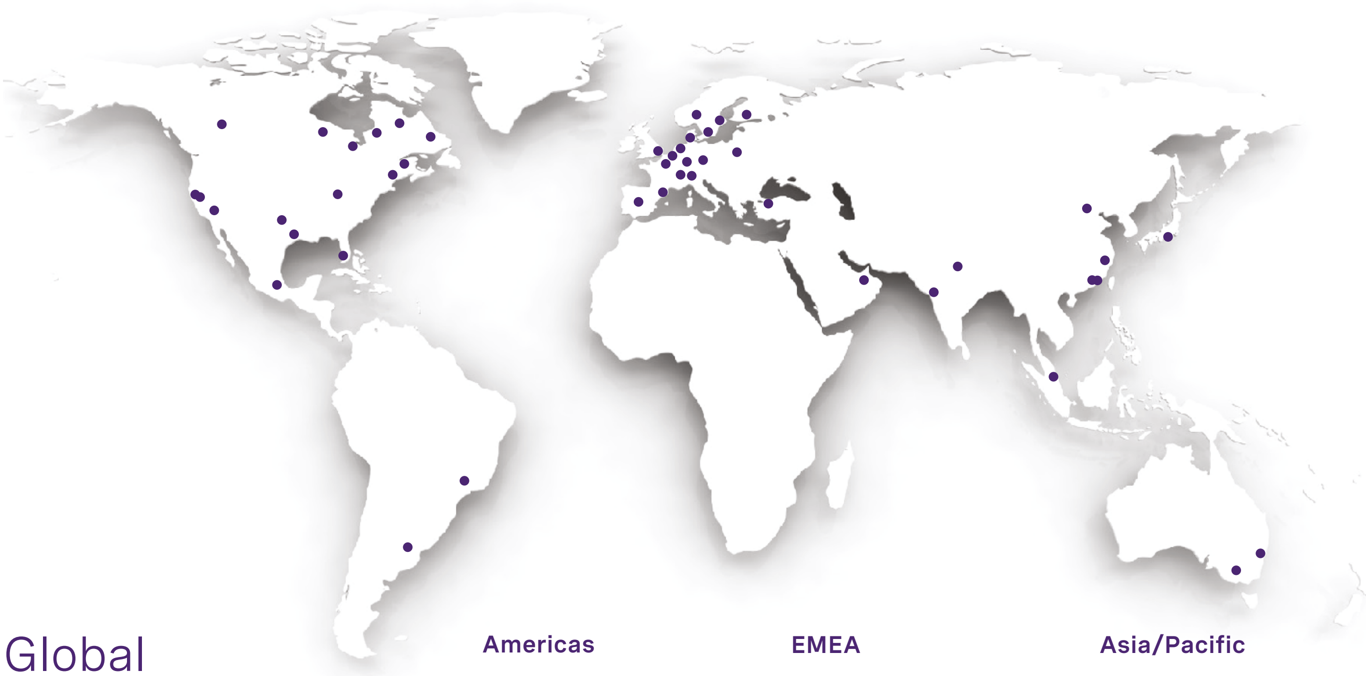

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