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Holding the Board Accountable through Evaluations

Don't let this opportunity for improvement pass by

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I find it interesting that while there is no shortage of oversight scrutiny on management's activities, the same cannot be said of the board's activities. Perhaps this is due to the board being at the top of the oversight pyramid or the secrecy cloak often surrounding board communications. Regardless of the rationalizations for not formalizing an evaluation process, boards need to lead by example and demonstrate that they are holding themselves accountable, just like any other part of the organization. Sure, boards are accountable to shareholders, regulators, creditors, courts and other stakeholder groups, but this article is about self-imposing an evaluation process in the spirit of continuous improvement.

Board evaluations are not just for big-public companies, but rather an important process consideration for all boards and committees regardless of size or industry. The board of directors and its committees serve as the foundation of corporate governance in providing oversight of management as led by the CEO. Governance is a process led by people and enabled by technology. Like any other process, it should periodically be evaluated relative to board and committee objectives. This means taking an objective and candid look at the process, the people, the technology, and ultimately the results. Oftentimes, the boardroom evaluation process is one of the more divergent areas of governance practices as companies struggle to define the why, who, when, what and how these evaluations should be conducted.

Why should an evaluation be considered?

The ultimate obligation of effective boards and committees is to serve shareholders to the best of their abilities, or their organizational purpose in the case of non-profits. While there are several tools available for evaluating boardroom activities, many of them simply evaluate whether the organization is complying with basic fiduciary and regulatory requirements. While compliance is a must, boards desiring to make a real difference should set the bar much higher. Benefits of a more robust evaluation process include:

- 🕒 promoting accountability among directors and stakeholders;
- 🕒 confirming an understanding of duties;
- 🕒 ensuring an ethical control environment;
- 🕒 confirming independence between non-management directors, management and key third-parties (e.g., outside legal counsel, internal audit, external audit, agents, etc.);
- 🕒 identifying the need for additional skills or expertise;

- 🕒 assessing director composition in terms of diversity (e.g., backgrounds, age, ethnicity, gender, personalities, beliefs, etc.);
- 🕒 helping to prioritize responsibilities;
- 🕒 providing candid assessment of what is working and what is not;
- 🕒 creating awareness for anticipated risks and opportunities;
- 🕒 enhancing the ability to attract qualified leaders, both executive management positions and directors;
- 🕒 challenging the committee structure in light of rapid changes;
- 🕒 promoting comfort levels with investors and creditors thus reducing cost of capital; and
- 🕒 sending a message to shareholders that the board takes its duties seriously.

Boards risk falling into the abyss of a 'status quo' environment by simply going through the motions without implementing a robust evaluation process. The board's journey must keep up with changing environments.

Who is best positioned to conduct the evaluation?

This is a difficult question that requires careful consideration. Using internal resources may be the most cost-effective option, but it poses a greater risk for potential bias to creep into the process as the lack of actual or perceived independence can quickly become a real threat. Hence, many companies engage a third-party to facilitate the evaluation process. This helps to mitigate the risks of tainted results since the directors themselves are not processing the surveys, questionnaires or any other evaluation documents. They simply complete what is asked of them, generally through a cloud-based application, and have an independent party process the results. This is the easy part, but who is left to do the analysis and report the conclusions involve significant risk considerations.

Viable options for on-site analysis and reporting back to the board and its committees include general counsel, outside counsel, the chairman of the board or a third-party vendor. All of these have their pros and cons. One important consideration is confidentiality. Whoever has the responsibility to conduct the evaluation will be privy to sensitive information. Very tight non-disclosure agreements will need to be in place when using outside resources. Even when utilizing in-house resources, risks exist, as everyone associated with the process needs to be reminded of the highly sensitive nature to the evaluation process.

An even more important consideration is objectivity. It is paramount that an unbiased mental attitude exists in performing the evaluations. This means not compromising conclusions in the spirit of obtaining and communicating the absolute truth. Objectivity requires that those gathering and interpreting the performance evaluation results do not subordinate their judgments for any reason. In reality, this is often difficult to accomplish when strictly using internal resources. While there is no absolutely correct answer for all organizations, one thing is certain, without "objectivity" the evaluation process can be critically weakened.

Another important consideration is discoverability through legal processes. Organizations generally do not want to leave a long audit trail of the strengths and weaknesses of their boards and committees in light of discoverability. To mitigate this risk, the attorney-client privilege can come in handy. This is an evidentiary rule that protects both attorneys and their clients from being compelled to disclose

confidential communications made between them for purposes of furnishing or obtaining legal advice or assistance. The attorney-client privilege is designed to foster frank, open and uninhibited communications between the attorney and client. No other profession has this strong of a protection veil, not even CPAs. Therefore, many companies have either general counsel or outside legal counsel involved in the evaluation process. A potential downside is that these individuals may lack expertise in structuring boardroom evaluations, thus limiting the benefits of the process. In these cases, the attorney can work with a qualified third-party to ensure an attorney is involved for those areas that will keep the attorney-client privilege in order.

When should evaluations be performed?

The answer depends on the organizational needs, risks and operating characteristics of the board and its committees. That said, companies should adopt a periodic performance evaluation timeframe, such as annual or biannual, and follow it. Otherwise, it is too easy to postpone the evaluation process in lieu of other priorities.

Special circumstances, such as a merger, acquisition, divestiture or aggressive expansion into new markets, should also trigger consideration of a non-periodic evaluation to assess readiness for the new activity. These evaluations can be tailored and streamlined to meet specific needs of what lies ahead. A successful evaluation can help the organization identify needs and resources that might otherwise not be considered.

What should be evaluated?

Companies have a lot of latitude on what to evaluate, but it should reconcile to what is required of the board and its committees as formalized in their applicable bylaws and charters. Of course, this assumes that board bylaws and committee charters are comprehensive in adequately defining expectations and requirements to investors and other stakeholder groups. For example, audit committees need to be deeply aware of applicable legal requirements through credit agreements, stock exchange listing requirements, regulatory regulations and governmental filings.

While evaluation areas will differ from company to company based on their operating environments and needs, the following areas should be considered for evaluation purposes:

- 📍 governance structure
- 📍 code of conduct
- 📍 culture
- 📍 expertise of directors
- 📍 independence of the board, its committees and its auditors
- 📍 access to information and dissemination
- 📍 management oversight
- 📍 management relationship
- 📍 orientation and training of directors
- 📍 overall performance in terms of reaching objectives and fiduciary duties



- 📍 risk awareness, including cyber risks
- 📍 shareholder and stakeholder relations

How should the evaluation be performed?

It is too easy to have good governance practices on paper, yet poor practices in motion. Thanks largely to Sarbanes-Oxley, Dodd-Frank and other federal legislation; some companies have gravitated into a checklist mentality rather than focusing-in on behavioral matters that lie at the core of strong boardroom activities. Do not get caught up in a frenzy of preparing checklists and generating documentation in the name of 'getting-it-done,' but rather utilize a robust evaluation tool to evaluate the more substantive aspects of performance. This will involve assessing culture, independence, data sources and relationships; as opposed to simply assessing meeting frequency, attendance and charter compliance through meeting minutes.

There is a great deal of scalability and flexibility regarding specific boardroom evaluation tools. A popular avenue is to utilize an anonymous, web-based survey of all audit committee members, followed by analysis culminating in a final written report. The anonymous component helps to protect the identities of respondents, which can also facilitate more open responses.

Conclusions

Many tools for evaluating boards are designed with a mentality of simply evaluating basic regulatory, board and committee requirements. Indeed, compliance with regulatory and charter requirements is a must, but boards wishing to make a real difference need to set the bar higher. This will involve an information collection process that includes open-ended questions, along with expert facilitation to realize a deeper analysis. Without addressing root causes of the more difficult cultural aspects of the board and its committees, evaluation benefits will be muted. Remember that maximizing value from the evaluation process will require a robust collection instrument and a heavy dose of objectivity.

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