Up to the job?

THE UK CORPORATE GOVERNANCE CODE RECOMMENDS THAT THE PERFORMANCE OF THE BOARDS OF FTSE 350 COMPANIES SHOULD BE EVALUATED BY EXTERNAL ASSESSORS EVERY THREE YEARS. **LOUISE REDMOND** LOOKS AT CURRENT PRACTICE AND WHAT NEEDS TO CHANGE.

For many public listed companies, external boardroom performance evaluations are a new undertaking. Most often chairmen have carried out their own review of the board's performance through individual discussions with other directors or by asking them to complete a questionnaire which is then collated by the company secretary. It feels quite different to commission an external adviser to carry out the evaluation, so just how widespread is the practice, and what do we know about those companies that complete one?

NEW REQUIREMENTS The Higgs Review of the role of non-executive directors was published in 2003 and has guided UK corporate governance since. Higgs was the UK response to a series of corporate scandals primarily involving fraudulent or misleading accounting practices at companies such as Enron, Nortel and WorldCom.

Although few at the time thought there would be a British Enron, the Higgs Review was set up to make sure one didn't emerge, by looking at the role of non-executive directors to see how they could more effectively counteract executive "misdemeanour".

In his report, Derek Higgs recommended that the company chairman conduct at least an annual review of the performance of the board and that "the use of an external third party to conduct the evaluation will bring objectivity to the board". Since then some chairmen have taken that gentle advice and have from time to time engaged an external adviser to support their own board evaluation. One FTSE 100 chairman has developed his own internal evaluation process and has it reviewed by a business school professor.

In 2007 the financial crisis hit UK banks and building societies directly as the wholesale funding markets dried up and revealed weaknesses in the balance sheets of large and small banks – from RBS to Dunfermline Building Society. Many felt the boards of the banks had failed their shareholders and the public, and that boards should be strengthened to counteract dominant executives.

Sir David Walker was commissioned to review the governance of the banks and produced his report in November 2009. He came down more firmly in favour of external board performance reviews for financial institutions: "The board should undertake a formal and rigorous evaluation of its own performance and that of committees of the board with external facilitation of the process every second or third year."

Walker's view prevailed in the Financial Reporting Council's revisions to the Combined Code in 2010, widening the principle to all sectors of the economy. The new UK Corporate Governance Code, for company financial years starting after 29 June 2010, incorporates the principle that evaluation of FTSE 350 boards should be externally facilitated at least once every three years. The code maintains the "comply or explain" principle, so companies can choose not to follow the code but need to explain why; it is then up to shareholders to decide whether or how to take action.

The EU green paper asks whether this principle should be applied across all EU member states – potentially also to companies above a set market capitalisation. This would ensure that company boards could be thoroughly reviewed and improvements made.

WHAT HAVE COMPANIES BEEN DOING? Law Debenture research from May 2011 shows that many FTSE 350 companies are not used to external board evaluations. The research findings reflect what companies have been doing in financial years before the impact of the new 2010 code, so we will need to wait until mid-2012 to look for any initial changes due to the code and it will take three years to get a complete picture.

The research gives details of whether companies carried out their

own internal board evaluation or used an external facilitator. FTSE 100 companies were more likely than FTSE 250 companies to have their evaluation carried out by an external facilitator: 34% as against 17% (see Figure 1). If we assume that companies will in future hold an external evaluation every three years, this finding shows that on average FTSE 100 companies are on track but that FTSE 250 companies have some catching up to do.

However, if FTSE 100 banks and insurance companies are separated from all other FTSE 100 companies, a sharp difference is apparent: 62% of the former had an externally led board evaluation compared with only 23% of the latter (see Figure 2). So external board evaluations are clearly not common in many FTSE 100 companies either and a higher rate of external evaluations can be expected in the next few years as they comply with the new code.

THE RESULTS OF BOARD PERFORMANCE EVALUATIONS Companies are not required to make any specific report on their plans as a result of an evaluation; they simply need to report how the evaluation has been done. It might be expected that some recommendations would be sensitive and left unreported. Some shareholder groups also say they fear that evaluations will fail to deal with the most important issues.

Yet quite a few companies do publish action plans. Our research reviewed the quality of these and classified the actions. We found that 39% of FTSE 100 companies completing an evaluation, whether internal or external, gave some sort of report on their actions. The equivalent percentage for the FTSE 250 companies was 11%. Clearly, the bigger companies are prepared to be more transparent about what they will do as a result of their evaluations.

In assessing the quality of the plans we classified any containing clear and specific actions as "high quality", and those that were vague or general as "low quality"; we tended to the generous side when in doubt. A high-quality plan might include a specific action for identifying or developing key talent in the business; a low-quality plan might just state that executive succession was agreed as a topic but without listing what was to be achieved the following year. For FTSE 100 companies, we found that 70% were of high quality compared with only 30% for FTSE 250 companies (see Figure 3).

Our research also included a review of what the actions covered. The most frequently mentioned actions are improvements to board-level strategy development, director skills and training, and executive succession planning. These are not quite the same as the original aims of the Higgs or Walker Reports. Of course, sensitive actions, such as being more effective at challenging dominant chief executives, may be left unreported as long as they are identified and acted on.

CHANGES FOR FUTURE YEARS Clearly, we expect that externally facilitated performance evaluations will become more common in UK boardrooms. One experienced non-executive director told us that he had been through 12 board evaluations but couldn't say what had happened as a result. Perhaps he was just unlucky. We will need to see some high-quality external evaluations to get the real benefits that the creators of the code expect.

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Figure 1: FTSE 350 evaluations

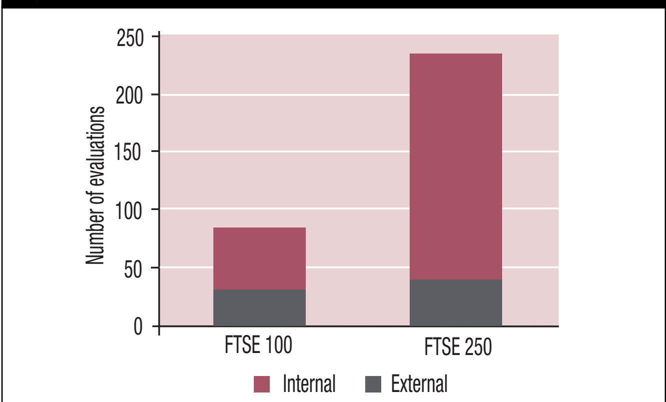

Figure 2: Financial sector v corporate sector evaluations

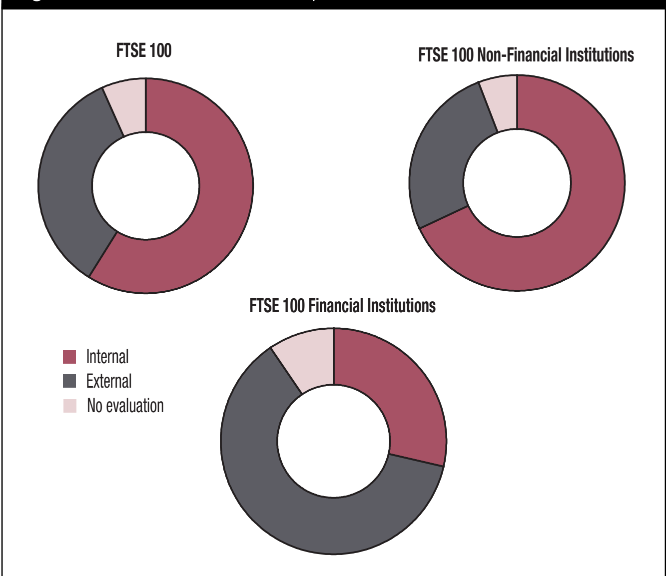

Figure 3: FTSE 350 action plans