Do We Have the Right Tools to Deliver Value?

A New Look at Board Evaluations

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UPTURN

EVERYONE HAS TO ADD VALUE – INCLUDING THE BOARD

How can the board say it added value if the organization is not worth more today than it was last year?

Over the past decade shareholders are turning to rating agencies such as Institutional Shareholder Services for performance assessments of individual directors. The assessments go beyond attendance records and listing committee memberships and are getting to the heart of the question – did this director add value?

Shareholders of public companies can now assess whether individual directors performed well. But what if your stock is not publicly traded? How can the board convince you they worked in your best interest?

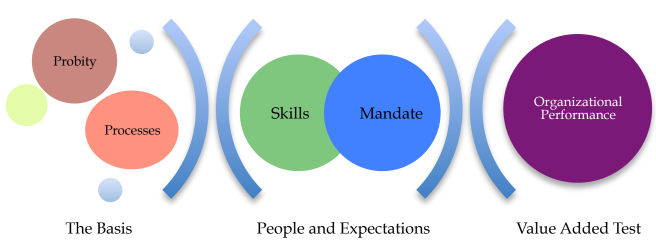
A Board Value Added Test may be just what you need.

Assessing board performance must go beyond asking – did we get the basics right.

Tone setting, independence, a functioning committee system etc. once played a major role in assessing board performance. Now they're table stakes!

If we don't have the right mix of people, including those who have already been where we intend to go, and we don't make effective use of their knowledge, then performance will almost certainly be sub-optimal. Even the most talented CEO can't carry an ineffective board.

Once the inputs to good governance are in place, then it's a question of "how exactly did we add value"?



Shareholders and other stakeholders always have the right to ask – has the board delivered? The best way to respond is to show how the board added value.

Corporate governance is improving notwithstanding what the "naysayers" would have us believe.

Corporate failures such as Lehman, Nortel and others are broadly publicized. Criticism is rightfully leveled when environmental damage is done or business practices were found to be inadequate. These exceptions unfairly undermine confidence in our corporate sector.

Less sensational are the vast majority of organizations that have invested significant time and energy and taken great care to improve oversight and standards. It has been a long journey that started with examining governance practices and putting standards and processes in place.

Next, attention turned to ensuring individual directors with requisite skills and needed expertise were recruited.

The effect has been much improved governance across an increased number of organizations.

Now the challenge is to assess whether governance reforms are leading to improved organizational performance.

THE BOARD EVALUATION PROCESS REVISITED

Each year the board must complete an evaluation of its performance. The evaluation of individual board members, and the board as a whole is critical to good governance practice. So too is the design of the assessment process. Critical questions must be answered – did the board organize and conduct itself to meet contemporary governance standards – was its conduct effective – and most critically – did the board add value?

In order to make that assessment value must be defined. For commercial entities, market capitalization and/or breakup value are good places to begin. The degree to which the organization eclipsed competitors is also worth considering. Not for profits and those in government sectors may need to consider measures more directly associated with their specific mandates.

The following sections set out a process that boards can use to determine if they have added value.

Overview

* Source – Abridged from Upturn Consulting Board Value Added Evaluation

The first order of business is to assess the degree to which governance standards have been met. Most boards are familiar with this type of assessment, but less so with the next two phases. The next step is to ascertain if the board actually met its responsibilities – did the board do and decide those issues only it can. The final phase of the evaluation focuses on determining if the board, and the decisions it reached helped to make the organization more valuable.

BOARD EVALUATION IN THREE STAGES

Stage 1 – Assess Whether Basic Standards Have Been Met

In order to determine if the organization is meeting contemporary governance standards it is important to raise questions about the structure of the board, the way it is organized and the processes it has put in place.

*The following are examples of the types of questions the evaluation should consider:

1. Is the board properly structured, inclusive of its committees, and does each have effective terms of reference?
2. Are board and committee meetings, including in camera meetings held frequently enough to ensure the board's mandate is met and is the nature of the issues discussed aligned with the needs of the organization?
3. Does the board identify those decisions it must approve and does it take adequate care in its decision making process?
4. Are board members independent and independently minded such that in making critical decisions they are free of bias and provably not conflicted?
5. Has the board established a code of conduct and defined the ethical standards it expects the organization to operate within?
6. Are policies suitably framed, periodically reviewed and tested for compliance?

The importance of an effective foundation of core governance principles cannot be overstated. The absence of or deficiencies in governance standards has gotten a number of organizations into trouble.

These should be viewed as basic requirements for contemporary boards. They are inputs to good governance – absolutely necessary, but not sufficient.

The board must be guided by recognized governance standards but in and of themselves, governance standards can only set the stage for effective performance. Having the right mix of skills and experience and a clear understanding on what must be accomplished must also be in effect.

Stage 2 assesses whether these requirements have been met.

*** Source – Abridged from Upturn Consulting's Board Assessment Program – Stage 1**

Governance and Management

Two Specialized Roles

With the Same Objectives

The roles and responsibilities of the board and the CEO are both essential to the success of the organization, but they are different from each other.

Each fulfills a specialized function. Each must have a plan to ensure responsibilities will be met. Each must ensure an adequate level of capability, and that they are effectively organized. Each must be accountable, and each must add value.

If the organization is worth more today than it was a year ago, if it is sustainably outperforming competitors, gaining market share, leveraging innovation, and brand value has increased – the CEO and board can be encouraged that value has been added.

What if this is not the case?

Rationalizing sub-optimal performance - "we'll do better next year", or simply blaming the CEO are dangerous conclusions. Moreover, they deny the opportunity for the board to assess how it might have been more effective.

The board can't run the company but they can ensure they are asking the right questions and gauging the situation effectively. By testing the board's performance against that of the organization a much clearer picture emerges as to whether the board was truly effective.

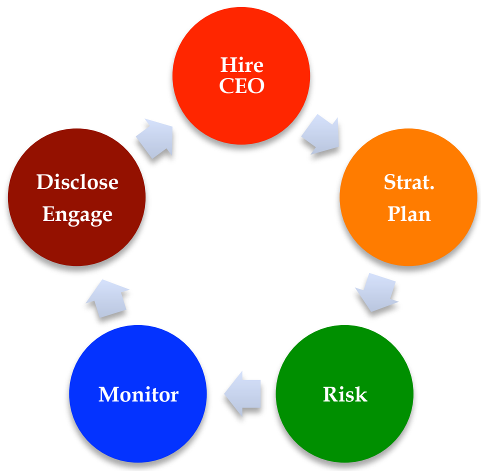
Stage 2 – Assess Capability and Effective Execution of the Mandate

Organizations must constantly change and adapt to capture new opportunities.

The board must ensure that it is equal to the challenge and in order for that to occur, it must have among its members, credible people who:

1. have a firm understanding or the organization's business model, understand its challenges and how it adds value to shareholders and customers;
2. have some relevant experience in those areas where the organization is headed – in other words, to the greatest degree possible have been there and done that!
3. are independent.

The board has 5 critical jobs it must do to meet its responsibilities:



It makes sense to ask penetrating questions to determine if the board can meet its mandate. Here are some examples.

Hire, evaluate, mentor, replace the CEO	**Contribute, assess approve strategy**	**Identify and ensure the effective management of risk**	**Monitor and provide oversight**	**Ensure disclosure and engage shareholders**
How does a board with less than complete knowledge of the business hire the right CEO and monitor them effectively?	How does a board without having at least some of its members with experience in the sector and areas of new endeavour reasonably adjudicate and challenge proposals?	Does it not seem reasonable that directors with relevant experience will have better insight into the opportunities and pitfalls the organization will face?	Can boards without knowledge of major business lines raise the right questions at the right time?	Do shareholders feel better informed and protected when there are independent directors with expert knowledge who are members of the board?

*Source – Adapted from Upturn Consulting's Board Assessment Program – Stage 2

Step 3 – Determine if the Board Added Value

Governance is not about running the business. That is not the board's role. To the degree that the board intervenes, then the accountability of the CEO is lessened.

Shareholders elect the board to provide direction, input and oversight, and to work with the CEO to ensure he or she is successful. It is a balance the board must get right. Although it can delegate authority to the CEO, the buck still stops with the board.

How then does the board have any impact beyond simply hiring the CEO and hoping they made the right decision? More specifically, how does the board ensure it has made a positive contribution without interfering with the CEO?

It is important to recognize that when it comes to adding value, the objectives of both the board and CEO are identical. Each of the parties plays a different role in achieving them.

*Value is added when:

1. The overall value of share capitalization and break-up value are increased.
2. Brand growth is evident, net promoter scores are increasing.
3. Leadership is strong, succession risk is managed and engagement surveys are positive. Challenges are embraced. Innovation is encouraged and supported.
4. Earnings growth is sustainable with targeted proportions of recurring high quality revenues. Efficiency ratios are at target. The organization is making a competitive rate of return when compared to the sector and is being paid for its risk.
5. Financing is available if, as and when required at a reasonable cost.
6. The organization can adaptable and can seize new opportunities as they arise.

The CEO adds value by delivering on each of the foregoing. The board adds value when:

- the focus is on accomplishment – substance over form while meeting established values
- there is a mutual understanding of the outcomes required that can be measured objectively
- key performance indicators emphasize the most important requirements
- remuneration is based on sustainable performance, smoothed as required
- risk taking is encouraged where returns suggest ongoing opportunity
- stress testing is ongoing and independently corroborated.

***Source – Adapted from Upturn Consulting's Board Assessment Program – Stage 3**

A logical measure of whether value has been added is to determine if the organization is worth more today than in was a year ago. It's important to consider the degree to which value may have been influenced by external factors such as bubble conditions, overbought markets, high PE multiples etc.

An effective assessment of the sustainability of value has to take into account a number of factors which may not be easily measured – track record of the senior management group, inherent honesty, the level of capability are examples of criteria which may not be easily measureable in the short term.

The most important way in which a board adds value is in having the capacity, strength and confidence to assess performance adequately.

Our Approach to Board Assessments

We've set out how we think governance assessments should be approached in this document.

The assessment process requires that we work with the board and CEO to ensure our findings are on target and conclusive.

Our experience indicates that boards can meet baseline standards with relative ease if they are not doing so already.

The assessment of the capabilities of the board can be a touchy subject and it is in these cases that an external advisor can add value.

Once our report has been presented, we can be of further assistance. The emphasis on measureable value emphasizes the need for valuation modeling, economic profit calculations, risk adjusted return rates, targeted KPI's and stress testing – all areas where we can assist.

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