


INDEPENDENT EXTERNAL BOARD REVIEWS

Board evaluations build board effectiveness, but it is time to raise the level across all companies

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discretion and control. Best practice has been led by the FTSE 100 companies and influenced by the governance compliance indexes, which inform the investor communities of the 'governance footprint' of a company.

The emerging code and evaluation

Under the FRC (Financial Reporting Council) Governance Code, the use of independent external board evaluation has staggered into existence in the form it has today. Emerging from the Higgs Report in 2003 the combined code suggested good practice to be 'an annual evaluation of board performance' with the suggestion that 'use of an external third party will bring objectivity to the process'. The 2006 code retained the annual performance evaluation, but the reference to external facilitation disappeared!

It wasn't until 2010 that an externally facilitated review at least every three years became part of the code for the FTSE 350, this included a statement of the facilitator's connection to the company. The following year the FRC produced a 'Guidance on Board Effectiveness', which set out a detailed approach to the 'independent externally facilitated board evaluation'. This started a process of creating a board evaluation standard, but which was still voluntary under the 'comply or explain' doctrine.

Since 2011 the 'independent external board evaluation' process has meandered

on, with various failed attempts at a code of practice, including our own code of Advanced Boardroom Excellence published in 2014, which sought to advance the discussion. All these endeavours called for greater formalisation of what would be covered by a board review. Consequently, the interpretation of what should be covered in an independent and externally facilitated review was, and still is, at the discretion of the board and covers a wide range of standards applied to supporting the effectiveness of the board.

The 2018 drop kick

In 2018, after an extensive period of consultation, the FRC launched a revised 'Code and Board Effectiveness Guidance', under the watchful eye of the Government. The revised code takes a much more strident and prescriptive view of what the structure of an externally facilitated board performance review, conducted at least every three years, should look like: no questionnaires only, observations of boards and committees, review of board papers, meeting executives, shareholders, advisors and workforce. The new guidance is also more assertive on the independence issue, stating that a board should be 'mindful of existing commercial relationships and other conflicts of interest and select an evaluator who is able to exercise independent judgement' but still subject to comply or explain. However, following various parliamentary inquiries and reports, the Government has clearly lost patience with and confidence in the FRC

Independent external board evaluations emerged in parallel with the general development of the governance code for companies. The question now arises whether their current shape is fit for purpose in the modern corporate environment, where society/CSR and employee engagement are playing an increasing part in the context of a company's right to operate and accumulate numerous benefits and advantages from society?

As the code of governance became more formal, so the question arose of how the effectiveness of the board would be monitored. While the legal aspects of operating a company has a built-in 'monitor' through the courts and regulatory agencies, governance monitoring has emerged as a voluntary process, over which the company and board have significant

PROGRESSING EFFECTIVENESS

Independent, external evaluations can help a company's development

as an effective regulator and is in the process of a major reform of its duties, responsibilities and accountabilities.

While a further revision of the code is unlikely in the near future after such an extensive consultation process, the bite applied to the provisions is likely to become fiercer, much in the style of the Financial Service Regulator, which has limited tolerance for non-compliance with its guidance and principles.

In an additional drive to rejuvenate the quality of board governance and effectiveness reviews, the Government has also invited the governance institute ICSA (Institute of Chartered Secretaries and Administrators) – to convene a group of investors and companies to develop a 'code of practice for external board evaluations'. This best practice code is long overdue and is attempting to bring some semblance of standardisation and increased professionalism to the arena of board evaluation.

The current mandate for independent external board reviews

However, while the investors, companies and board evaluation practitioners consult with ICSA and await the publication of the code of practice, there is a pressing need to support boards in their performance evaluations in response to the revised Corporate Governance Code, which become active from the start of this year. The revisions to the Governance Code are significant and take many boards into territory that they will be unfamiliar with. Some of the key changes, for example, include:

- An expanded board remit to promote 'contributing to wider society'
- Workforce policies and practices, consistent with the company's values and supportive of its long-term sustainability
- An expanded focus on purpose, culture and values, monitoring and reporting on culture throughout the company
- The engagement with the views of the company's key stakeholders beyond the shareholders, with the consideration of their interests in board discussions and decision-making
- A workforce engagement process (workforce includes beyond just those with formal employment contracts)
- A greater focus on the issue of overboarding for board appointments
- An intensification of effort in promoting and creating diversity and building diversity throughout the workforce and executive pipeline
- Emphasis on the remuneration committee's independent judgement and discretion in reviewing the executive and workforce remuneration, incentives and rewards, ensuring alignment with the culture and long-term success of the company
- The remuneration committee's expanded remit to include determining senior management remuneration and pension alignment of executive directors to the wider workforce

These are significant changes, which are likely to be assertively monitored and questioned by a revamped FRC, with a more active control of the standards and monitoring of board of directors.

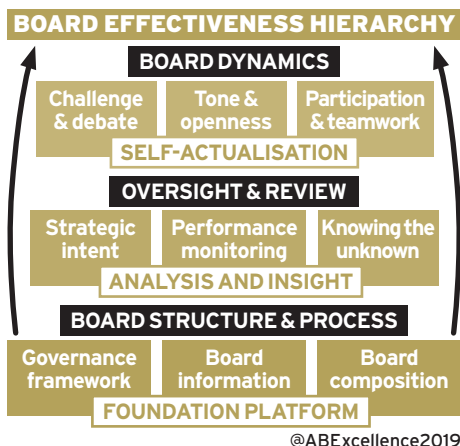
Consequently, the role of the independent external boards evaluation becomes not only to review the current performance of the board but also to provide a development roadmap and recommendations to progress the effectiveness of the board. This is in keeping with a developing trend for a new generation of NEDs, who perceive their personal reputations to be exposed and at risk, to see an effective independent external board evaluation as a quality benchmark.

The process of independent external board reviews

Board reviews have in the past placed too much emphasis on the procedural building blocks of the board and often failed to emphasise the board dynamics aspects of an effective board. Understanding and effectively assessing board dynamics through observations, direct discussions, procedural and written information, requires experience, professional insight and a depth of understanding of group and organisational dynamics. The benchmark of a good board is the effective contribution from the whole board and in an open manner, which accesses and leverages the knowledge, skills and experience of the entire board of non-executive directors and executive directors. »

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» As we look at a board’s landscape, the hierarchical nature of effectiveness shines through, as we gain insight and understanding of the dynamics of a well-functioning board.



Principles of independent external board reviews

The structure of what goes into an effective independent external board evaluation, has no common framework. The 2018 report from The All Party Parliamentary Corporate Governance Group (*APPCGG 15 Years of Reviewing the Performance of Boards, Lessons from the FTSE All Share and Beyond*), indicated an improving value but with a wide range of attitudes and reasons for carrying out a board review, of which the top four are:

- Recalibrating focus & agreeing priorities
- Raising issues & prompting open discussion
- Improving board dynamics & engagement
- Providing an external view & best practice

The future of independent external board evaluations will be measured by their usefulness to the board in providing a mirror to their own performance and in a manner that is honest, productive and future-focussed. There is no doubt that the inner world of boards and the executive team is more exposed than it has ever been, unfortunately, this has, by and large, not been a confidence-boosting process. Boards will increasingly need to show their metal and steer a delicate path between greater oversight, guidance and leadership of a company’s landscape, while still facilitating the executive to fulfil its purpose and goals. While there is no intention to usurp executive decision-making and leadership, the board NEDs are required to be familiar and cognisant with the broader society pressures, strategic landscape and future horizons of the company to fulfil their role.

What does the future hold?

The independent external board evaluation will continue to emerge and be refined, supported by the development of a code of practice for external board evaluations. The key elements of this code of practice are likely

to emerge around a framework, which ensures a greater standardisation and professionalism of the process. While the flexibility should still exist for the company to shape the board review process, this should be to enhance the board review and not to minimise its scope.

The key to the success of independent external board evaluation will be effective independent oversight of the code of practice – definitely a case of practicing what you preach. This should provide a strong impetus for an independent, objective and reflective view of the board, unhindered by perceived weakness of the current approach, which is seen as too focussed on not upsetting the client and downplaying hard news, according to the APPCGG report.

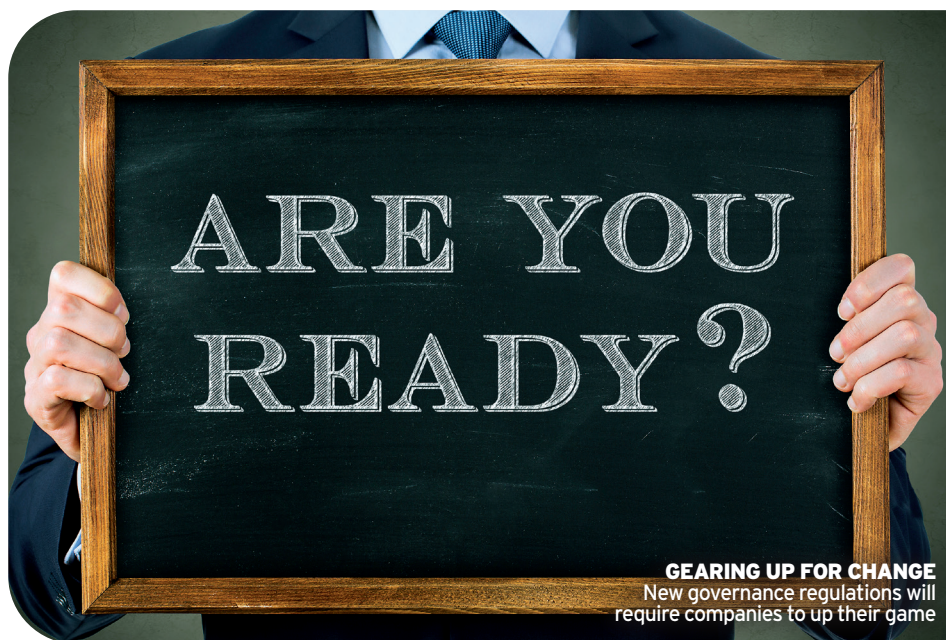
One of the longer term issues will also be how the private sector is brought into the independent external board evaluation world. Under the current, recently published Private Company Governance Code (Wates Principles), there is no requirement to undertake an independent external board evaluation. It will be interesting to see where the new FRC leads on this.

unlike the audit committee guidance under the code which has an implied threat from the FRC as ‘the competent authority for audit in the UK’ and ‘regulatory authority of the accountancy and actuarial professional bodies’.

This contrasts starkly with the introductory wording of the board effectiveness guidance, which seems to bend over backwards to ‘lighten’ the guidance: “The primary purpose of the guidance on board effectiveness is to stimulate boards’ thinking and the guidance is not mandatory and is not prescriptive.”

The mood of Parliament, in response to public pressure and disbelief in the corporate values on display, reinforced by interest group lobbying, has swung decisively towards bringing companies into a full participant in society and to eradicate the almost daily scandals, which are currently defining the corporate sector.

Resetting the guidance on board effectiveness with a presumption of excellence and compliance to the clear standards it contains, would only take a few tweaks, without the need for any wholesale



As Simon Osborne, Chief Executive of ICSA said in taking on the Government’s challenge to create an external independent board evaluation code of practice: “We firmly believe that a high-quality independent board evaluation or board effectiveness review is valuable for companies, indeed organisations, of all sizes and in all sectors.”

Conclusions

The exciting world of board evaluation is at a crossroads. History shows us that the best aspire to the best standards while the rest will seek to minimise and marginalise the board effectiveness provisions of the code and the guidance. Up to this point, there has been no real sanction for any dereliction,

revision. The new FRC governance regulator is also likely to be give an oversight on the standards and disqualification of boards directors, as part of a revised brief, bringing a consequent level of leverage that has been hitherto been missing.

While some will cry over governance and cost, the reality is that these are the standards our best boards are achieving and it is time to raise the level across all companies. The voluntary nature of governance has had a good run for its money and there is a mounting pressure from government, society, employees and the massive pension investor funds, for companies to get in step with the changes in today’s society and growing expectations of the corporate sector. 📌