Board effectiveness – continuing the journey

April 2015

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THE INVESTMENT ASSOCIATION

INVESTMENT MATTERS

Executive summary

This thought leadership report is based on a series of individual meetings and roundtables held jointly by EY and The Investment Association, bringing together leading chairmen, board directors and senior investors to debate the issue of board effectiveness. The majority of the chairmen and directors we spoke to are on the boards of large, multi-national, UK-listed companies. We have written this report by drawing on the collective wisdom expressed during those discussions, supplemented by insights and perspectives from EY and The Investment Association.

In producing this report, our shared goal is to pinpoint leading practice and new ideas for improving and demonstrating board effectiveness. Our roundtables and individual discussions confirmed that there is no 'silver bullet' in this crucial area: all boards are different — indeed unique — and there is no one-size-fits-all template for an effective board. However, a number of fresh perspectives and practical ideas emerged that can support boards on their journey towards excellence, and which we want to use to provoke new thinking, discussion and better outcomes, with individual existing (and future) board members, entire boards, executive management and investors.

Two imperatives that arose consistently in our conversations were the importance of boards as a whole keeping up to speed with evolving leading practices, and of individual board members sharing their ideas and experiences. Therefore, even if you are fulfilling all of the aspects that we highlight in this report that contribute to improved board effectiveness, are you also helping others — especially newer board members — to do the same?

We addressed the topic of board effectiveness across seven themes:

- The role of the chairman
- The role of non-executive directors (NEDs)
- Progress on diversity
- Board succession and the work of the nomination committee
- The purpose and impact of board evaluations
- Information flows to the board
- The role of investors

While there is not enough room in this executive summary to capture all the recommendations and discussion points that we highlight in the remainder of the report, a number do leap off the page. These include the importance of having a robust board evaluation strategy; the need to create a strong pipeline of future boardroom talent by getting talent further down the organisation 'board-ready'; and the requirement for both chairmen and NEDs to balance their portfolio of roles, bearing in mind the possibility that a time-consuming corporate event could occur at one of their companies at any time.

Other key points include; the benefits of regularly discussing the CEO's tenure or setting the expectation at the time of appointment that the CEO's tenure is for a particular phase of the company's development or duration; the need to structure the board's information flows so they are relevant and useful, prioritising quality over quantity; and the value of involving investors in defining the board's focus areas and the attributes to be sought in new board appointments.

We want this report to stimulate and further the discussion between management, NEDs and investors so that each has a better understanding of the others' position such that over time their objectives become and remain aligned. All three need to work together to deliver effective boards and positive outcomes. We recognise that this can sometimes be challenging for boards as shareholders are not homogeneous, and may have differing views.

To provoke this discussion and positive outcomes, we have posed key questions under each theme. These are summarised below to provide you with a handy checklist.

See inside

1 The role of the chairman

- What approaches have you brought to the role from previous experiences?
- In what ways do you think the experience and approach required for the chairman's role are changing, and how are you manifesting those changes in your own chairmanship?
- What steps do you take to ensure that you extract all the potential value that exists around the table?
- What do you do in your role as chairman to ensure that all board members are properly supported and engaged?
- How do you help spread best practice to other companies and directors?

2 The role of non-executive directors (NEDs)

- As a NED, what do you do to ensure you will be able to balance your portfolio under circumstances where one company needs a large increase of your time?
- What factors does your board take into account when assessing prospective NEDs – do you focus on length of relevant experience, or also look at personal attributes?
- How do you balance maintaining your independence with acquiring and maintaining a sound knowledge of the business?
- What development and learning opportunities have you had both before and after joining the board?

3 Progress on board diversity

- How do you consciously encourage and foster diversity of thought and personality on your board, and consider the impact of these differences on overall board dynamics and effectiveness?
- As a board, how open are you when discussing new board appointments with investors?
- Does your nomination committee ensure that candidates for NED roles are not ruled out solely due to a lack of board experience?
- As an existing member of the board, what do you do to help make new directors more effective?
- What are you doing as a 'home'[1] company in preparing existing talented employees to successfully secure external board positions?

4 Board succession and the work of the nomination committee

- Have you discussed tenure with your CEO? Would you consider doing this from the outset with a future CEO?
- Have you got a clear idea of the mix of skills, experience and 'social style' your board needs? How regularly is this reviewed?
- Have you identified a talent pipeline several levels below the board? What is your approach for developing it over the next few years?
- How actively and extensively do you engage with investors around your succession planning? What information do you share?
- How can you improve your nomination committee reporting to provide investors with comfort that succession plans are in hand?

[1] 'home' company refers to the company at which someone is a full time employee

5 The purpose and impact of board evaluations

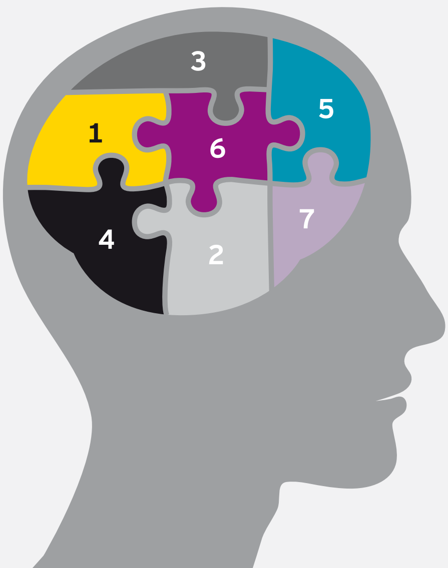
- Do you have a well-considered strategy for the board evaluation process within a 3-year cycle, incorporating an external evaluation?
- Does the board's evaluation strategy allow individual directors to provide full and frank feedback?
- What was the scope of your last external board evaluation? Did it tell you something you were not aware of? Was the scope appropriate?
- Do employees below board level (but with visibility of/access to the board) provide input into your board evaluation?
- How extensive and detailed are the disclosures on board evaluation in your annual report, both on the process followed and also on substance of the evaluation – including scope, focus areas, findings and actions?

6 Information flows to the board

- How do you ensure that as a NED you have all the information you need, presented in an appropriate manner to enable you to carry out your role?
- Does the board decide on the information it needs from management to make informed long-term decisions for the company?
- How have you influenced the content/length/structure of board papers over the last few years? What could be done to improve them further?
- Are your board information and agendas structured so as to reflect the interests and objectives of the board?
- How do you demonstrate the quality of board information and decision-making to shareholders?
- What information sources (outside of board papers) do you have access to and make use of to get a holistic view of the market and industry? Are these resources provided by the company?

7 The role of investors in board effectiveness

- What do you see your role as being with regard to board effectiveness?
- Do you think you have the right level of engagement with the Board on its effectiveness? How productive is that engagement?
- Do you use conversations about succession planning to support boards in introducing new talent that will bring differing perspectives?
- Do you see it as your role to support boards as well as hold them to account?
- To what extent is the information provided to investors tailored to your needs?
- How do you follow up on the outcomes of board evaluations?



Introduction:
the context of this report

The future is unpredictable — and businesses are more complex than ever before. In such an environment, an effective board is pivotal to a company's long-term success and sustainability.

The importance of board effectiveness is rising at a time when boards are under considerable pressure, both in terms of the time and resources available internally and also from external stakeholders including governments, regulators and shareholders. However, there remains considerable debate over the factors that contribute to board effectiveness, and how boards can evaluate and direct their progress towards better decision-making and business outcomes.

Against this background, board effectiveness is a topic that has been much discussed and reported on by bodies including by the ABI. In publishing this report, EY and The Investment Association have come together to take stock of the progress made to date and help develop the conversation on board effectiveness – with a clear focus on promoting leading practice and new ideas that may contribute to further progress in the future.

We have designed this report so that each of the seven themed chapters can be read either on a standalone basis or as part of the overall report, depending on the reader's specific role and interests.

The core role of the chairman is to lead and create the conditions for the board and its committees to be effective. As boards are changing over time, so is the role of the chairman.

This evolution is underlined by the chairman's position as the lynchpin of many of the areas examined in this report – not least diversity, succession planning and information flows. The chairman also plays an important part in engaging with investors on corporate governance issues.

Inclusive leadership

Increased diversity may bring benefits to the board by counteracting 'groupthink' but it also means that chairmen have to work harder to bring differing viewpoints together and achieve consensus. An inclusive leader is vital to harness the benefits of diversity. There is also a greater need, at least in the short term, for the chairman to support and develop new and less experienced board members, by helping to ensure they are both aware of their responsibilities and able to contribute to discussions.

On any board, the relationship between the CEO and chairman is vital. Chairmen run the board, not the company: they are not executives and should not encroach on the role of the CEO. However, many NEDs recognise that the role of CEO can be a lonely one. So it is important for the chairman to build a good relationship with the CEO as a sounding board, adviser and confidant. It is equally vital that the chairman is both visible and accessible to the CEO, NEDs, executives and any others in the business who may need to speak to him or her. For this reason, many chairmen like to have an office at the business to facilitate this.

Contributing to the selection of board members

Using their personal and professional experience and insights, chairmen play a key role in searching for and appointing new board members. For example, talking candidates through real-life situations and 'what-if' scenarios can be more valuable in determining if someone is right for a role on the board than simply 'playing the CV tape'. When appropriate, the chairman should also involve investors in the process to ensure a smooth appointment. This can be handled by allowing investors to suggest skills or personality types for the selection matrix (see theme 4 on succession planning) or even individual directors for the role. It is increasingly common practice for the company's largest shareholders to see the shortlist of candidates prior to a decision and announcement being made, especially when a new CEO or chairman is being appointed.

Structuring and leading discussions

The chairman should lead in making a company more transparent by setting the tone and culture of the boardroom. The board delivers the greatest value through open and frank debate – so the chairman should both manage and encourage this, and ensure there is the right degree of challenge and questioning from the board. We continue to hear that boards need to be taken through the journey of key decisions, and this may mean that many decisions or projects are taken to the board numerous times, in order to ensure that the NEDs' opinions are sought throughout the process. Boards will no longer rubber-stamp executive proposals, so the chairman has to do a lot to make sure that the board members are fully engaged before being asked to make a decision. He or she also plays a vital role in setting the agenda for board meetings and making sure this agenda is aligned to the strategic objectives.

Managing time and 'bandwidth' across multiple roles

Particularly when they have multiple roles and other commitments, chairmen need to continually assess their own availability in light of the likely needs of the companies they serve. For example, they may have a portfolio of chairman and NED roles that appears perfectly manageable in 'normal' times. But is the same workload still feasible if, say, a CEO departs unexpectedly?

The role of the chairman: some key questions to ask

- What approaches have you brought to the role from previous experiences?
- In what ways do you think the experience and approach required for the chairman's role are changing, and how are you manifesting those changes in your own chairmanship?
- What steps do you take to ensure that you extract all the potential value that exists around the table?
- What do you do in your role as chairman to ensure that all board members are properly supported and engaged?
- How do you help spread best practice to other companies and directors?

The UK Corporate Governance Code (the Code) states that the role of NEDs is to constructively challenge and help develop proposals on strategy.[1]

This means NEDs play a crucial role in sustaining and improving board effectiveness, both by challenging executives and holding them to account, and also by using their own skills and experience to set the strategy. Some CEOs also use NEDs as a sounding board to test ideas, either in their area of expertise or of a general business nature.

Over the past decade the role, responsibilities and accountability of NEDs have all expanded significantly. This trend has led both to an increased time commitment on the part of NEDs and also a greater professionalisation of those taking on NED roles. In recent years, we have seen some directors move from executive positions at an earlier age to take up a portfolio of NED positions, resulting in a new style of NEDs who are younger and more tech-savvy than their predecessors. These NEDs' facility with technology means they may need less support from the company. At the same time, advancing technology also means it is easier for NEDs to communicate directly with each other, and discuss issues or concerns away from board meetings. This is helping to increase NEDs' overall understanding of the issues, in turn leading to improved board effectiveness. However, this could also have the counter-effect which needs to be managed – the cohesiveness of the board could be undermined by a lot of side conversations.

The growing pressures on NEDs

The pressure on NEDs is increasing, a development that is prompting questions about how much they can take on and what support and training they need to fulfil the role effectively. NED roles have become more time-consuming as the complexity of companies and the expectations of stakeholders have increased. In some industries e.g. financial services, major regulatory changes and greater media scrutiny have had a particular impact. Committee work, especially on the remuneration committee, has also become much more time-consuming.

In some cases, corporate failures have shone a spotlight on individual NEDs, and they are increasingly taking on more personal reputational risk. At the same time, events such as re-election processes and votes on remuneration are offering investors new ways to show dissatisfaction with boards.

Are NEDs taking on too much?

Time is clearly an issue: a NED role that may be notionally a 40-day commitment may take 80 or 85 days to fulfil at certain times. One NED we spoke to said she doubles the stated time commitment for the first year, because getting up to speed can be so time-consuming. While we do not advocate a formal cap on the number of NED roles an individual can hold at any one time, it is clear that their effectiveness can be impaired if an individual takes on too much.

Organisations require different commitments at different times. As with the role of the chairman, a portfolio of NED roles that is manageable on a business-as-usual basis may become too much if a major transaction or sudden corporate event occurs in one or more of the companies. It is essential that NEDs consider how they will fulfil their commitments if one or more of the companies require a greater time commitment.

Due to the complexity and importance of their role, NEDs need to be given appropriate training. Some NEDs feel alone when it comes to this. It is essential that companies provide appropriate training for their NEDs in order to help them be effective, whether sector-specific training or training on independence of thought. NEDs should also be able to ask for training if they feel they need more.

> "I double the stated time commitment for a new NED role; it takes significantly longer in the first year."

[1] A.4 of the UK Corporate Governance Code

"Being a NED is very different from being an executive. You gain respect through being thoughtful, listening and building interventions over time – which can be almost the opposite from being an executive."

"We have people who are desperate to help with our new financial system: we have to tell them they've got to retain their governance role."

What makes a good NED?

To a large extent, the factors that differentiate a 'good' NED depend on what each individual NED brings to the business. However, to maximise the contribution from each NED, it is vital to have a balanced board that is diverse in many dimensions. NEDs with direct industry or sector experience tend to be highly valued, but there is also a need for people with experience in different sectors to ask the 'stupid' questions and suggest different approaches. Even where NEDs share a sector background, careful attention must be paid to the skills of those who make it to the board: are enough people with an operational background coming through, for example?

During our discussions we heard that it is beneficial for NEDs to take on different roles on a board. This seems to be happening organically, with – for example – those with IT skills tending to gravitate towards overseeing IT projects. Some may spend more time in the business while others remain at arm's length. While detailed knowledge of the business is valuable, it is important that NEDs do not lose sight of their governance role and effectively become executives. It is also important that NEDs who have come from functional backgrounds such as HR or finance are able to contribute to board discussions across all areas, and not just within their area of expertise. These issues are becoming more acute as the pressure for more diverse boards results in less experienced NEDs taking on board roles for the first time. It is vital that NEDs are not only objective and independent, but also that they understand enough about the business and its context to make good decisions. Traditional concepts need to be challenged – it is important that NEDs spend the time they need to understand an issue or decision. Investors we have spoken to understand the growing time commitment required by NEDs and consider that an increased time commitment does not necessarily impact on independence.

Creating effective NEDs

While inexperienced NEDs can become effective very quickly under a good chairman, the board can be a strange and intimidating place for a novice. NEDs need a combination of training, mentoring and exposure to the board, and this is a process that should take place over years rather than months.

Particularly important is the need for first-time NEDs to adapt when they transition from an executive role. As an executive it is important to be authoritative and to lead the company and debate on particular issues. As a NED the focus shifts from authority to influencing i.e. shaping the debate, being thoughtful, listening and progressively building their contribution to the discussion with a number of interventions. Informal exposure to board meetings and mentoring from board members can help this transition from authority to influence.

It is very important for NEDs to get 'out and about' in the organisation, primarily to gain a better understanding of the business and how it works. This in turn enables them to make more informed decisions around the boardroom table. Another useful activity is for NEDs to debate and discuss issues with managers outside the senior team: this helps them both to 'set the tone' for how business is conducted, and also to gauge whether the tone the board has set has become embedded throughout the business. They may also want to conduct site visits and 'mystery shopper' exercises to understand a customer's experience of interacting with the business.

Maintaining independence

All NEDs need to strike a fine balance between independence, knowledge, experience and objectivity. The Code states that the board should determine whether a director is independent in character and judgement and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the director's judgement[2]. Having served on the board for nine years from their first election is one of those circumstances. With this in mind, it can be beneficial to train board members in scepticism – a staple in the audit profession – as well as objectivity. This training should occur alongside testing for diversity of thought and 'social style'. All of these activities raise a number of questions: what criteria are boards using when they recruit NEDs? Are they taking into account personal qualities such as judgment, or simply looking at the number of years of relevant experience? Are they taking into account how the 'social styles' of board members – to-be will align with the approaches of existing board members as well as the impact on the overall group dynamic?

While NEDs play an important role in challenging management, taken too far this can lead to a split between NEDs and executives. These dynamics raise a conundrum concerning NED remuneration: if NEDs are financially dependent on the income from their role, this may lead to them being unwilling to resign in protest. However, if only financially independent people become NEDs, this will once again reduce board diversity. Similar considerations apply to personal risk – if the reputational downside of a NED role is too great and the ability to mitigate that risk too limited, the very people you want on a board may rule themselves out of contention. Given the increase in time commitment and responsibilities, shareholders want to ensure that NEDs are fairly remunerated.

As noted above, a nine year tenure is one circumstance which requires the board to consider the independence of the director. Therefore, nine years has been the accepted term for a NED. Throughout our conversations, some NEDs felt there was a new consensus emerging for terms of six years. This is the point at which some NEDs believe they need to consider if they are still effective in the role. This would enable the board to be refreshed more regularly. However, a NED in a particularly complex company may feel that nine years is a more suitable term, due to the length of time required to understand the business.

The board working as a team

Despite the diversity of perspective, it is very important that the directors work as a team – this is the responsibility of the entire board. Team spirit and cohesiveness will only emerge if people spend time together developing personal relationships in informal settings such as board dinners. If directors adopt too many roles or are too geographically spread it can limit the ability to build that spirit as individual directors have to rush off to other commitments or fly in and out specifically for board meetings.

The role of NEDs: some key questions to ask

- As a NED, what do you do to ensure you will be able to balance your portfolio under circumstances where one company needs a large increase of your time?
- What factors does your board take into account when assessing prospective NEDs – do you focus on length of relevant experience, or also look at personal attributes?
- How do you balance maintaining your independence with acquiring and maintaining a sound knowledge of the business?
- What development and learning opportunities have you had both before and after joining the board?

[2] B.1.1 of the UK Corporate Governance Code

The pressure on boards to be more diverse

Boards are under increasing political and shareholder pressure to increase their diversity so as to more accurately reflect their organisation, customer base and wider society.

In 2009 Lord Davies set a target for FTSE 350 boards to aim for 25% female board membership by 2015. There have also been investor and corporate initiatives to improve gender diversity such as the 30% Club. Solid progress has been made towards this target, especially by FTSE 100 companies.

In our view, board diversity in its broadest sense is an essential driver of board effectiveness. The most important objective for any effort to increase diversity should be to have a diversity of perspectives on the board – and broadening the representation in terms of gender and ethnicity are two clear ways of achieving this. A board that is diverse in its composition is more likely to make better decisions and avoid the tendency to engage in 'groupthink'. Not only do board members with different perspectives challenge the status quo, but they can also introduce multiple views on the risks, consequences and possible implications of any board decision.

Given the complexity of today's businesses, it is important that the board is able to draw on a wide range of experiences to understand opportunities and anticipate challenges. In addition, a diverse board enables the company to anticipate events more accurately and holistically, and take better account of the views of key stakeholders, including employees and shareholders. In short, board diversity is integral to building a successful long-term business.

While boards have by and large responded positively to the target of 25% female representation, three questions arise:

- How does diversity contribute positively to board effectiveness, and how can this be measured?
- Is the quest for more diverse membership undermining board effectiveness by forcing companies to recruit less experienced candidates?
- What responsibility does the 'home' company – the business at which someone is a full-time employee – have to get potential candidates 'board-ready'?

We'll now look at each of these questions in turn.

"We did a Myers Briggs [psychometric profiling exercise] – and, my God, we were all the same."

The benefits of boardroom diversity

Now that gender diversity is more common, board members with experience of it assert that it brings positive influences, especially in terms of its impact on the atmosphere in the boardroom. Many chairmen have told us that they initially appointed female NEDs to the board in order to comply with the Davies Review, but that the appointments have brought significant benefits. They point particularly to an improvement in the quality of discussions on specific issues, an enhanced ability to consider issues from different perspectives, and more openness to asking probing or searching questions to get to the heart of an issue. Experience shows that women on a board often take a more inquisitive approach, which in turn can empower the male members of the board to do the same – thus increasing the board's overall effectiveness.

The number of women on a board can have a big impact on the overall dynamics. While one woman on a board will make a difference, the presence of two or three women seems to disproportionately multiply the effect. We would encourage companies to target 30% female representation – a level of representation that could help to change the culture and dynamic of the board, and that enables some female NEDs to feel more comfortable.

As we highlighted above, the greatest benefit of diversity is the avoidance of 'groupthink' – the unconscious and often unquestioned sharing of common assumptions among a group of people who have similar backgrounds, upbringing and values.

A board with members from diverse backgrounds is more likely to reflect the concerns of an increasingly global customer base: it will also reduce the risk of boards losing their connection with society as a whole when discussing issues like remuneration and ethical concerns.

That said, boards should not assume that simply hitting diversity targets 'on paper' will ensure they achieve the diversity of thought and perspective that lead to better business outcomes. They should be taking steps to measure their diversity of thought and 'social style' as well. Also, there are limits as to how diverse a board can become: some boards of multinational companies are already larger than optimal because of the need for wide geographical representation. More generally, there are legitimate questions about how a board can make itself more diverse beyond gender – but it is important that requirements around this do not become too prescriptive to the detriment of board effectiveness.

> "The atmosphere round the boardroom table [once women joined] was completely different… from that moment we started having proper debates. It changed the dynamic and the willingness of the executives to listen to the non-executives."

Perceived risks of diversity

Directors have told us that they found the 'first wave' of gender diversity relatively easy: it was not hard to find strong female candidates who had appropriate experience and skills, and who were happy to be recruited. However, some commentators are concerned that the pipeline of 'board-ready' female talent is not strong enough, especially as the number of female executive directors is still relatively low. Therefore the second and third waves of recruitment may be harder and the result could be that smaller boards are left with too high a proportion of inexperienced directors.

The risks around inexperience can be overstated – and some relatively inexperienced directors have become effective quickly, particularly under the guidance of a good chairman. Also, as boards become more diverse, the role of the chairman becomes more important – inclusive leadership is key to harnessing the benefits of diversity.

Being a new director on a board can be an intimidating experience, and there is a danger that new directors appointed from functional roles – such as IT and HR – may find themselves 'pigeonholed' and struggling to contribute to more general commercial discussions. To manage these risks, chairmen need to be ever more adept in being inclusive and extracting the most value from individual members, and in bringing the board together as a group.

Recruitment consultants – or 'headhunters' – have supported progress towards greater board diversity by recommending more diverse candidates to chairmen. However, it is unusual for them to push a chairman towards greater diversity if this is not their desired direction. Headhunters could still do more to understand new talent, for example by looking for more personal qualities beyond board experience, but this requires both investors and chairmen to be more open-minded. There are some chairmen who believe that they have a role in developing directors, with one chairman suggesting that one seat on the board should be a 'development seat' in which they seek to appoint an inexperienced director, who over time they will seek to mentor and develop.

Overall, it was clear from our discussions with directors and investors that boards' priority must remain recruiting the right candidate – and that the weighting ascribed to board-level experience is one factor in assessing the diversity of perspective on the board. Some chairmen are personally committed to, and indeed passionate about, increasing diversity, and have invested significant time in developing and promoting women.

> "People talk about the numbers and the recruitment process changing, but not about what the benefits are in the outcomes of decisions: there's not enough analysis of whether the business decision is better."

> "How do you learn to operate in a plc environment, whether you're a man or a woman? If you can't get your point across in the boardroom, you're no good at all."

Getting inexperienced candidates 'board-ready'

The participants in our discussions felt that the 'home'[3] company has a responsibility to prepare potential candidates for board roles. From their experience, participants said that newly appointed NEDs are more likely to stay in their executive role if they have a stretching NED role to challenge them alongside it. Being a NED elsewhere can provide development opportunities for the individual, which can benefit both the 'home' company and the individual. For the board on which the individual serves as a NED, having serving executives among its members brings a current business perspective to the discussions. Conversely, the individual can also take lessons from their NED role back to their 'home' company.

Attending some board or board committee meetings will help with the transition from executive to NED, and build a better understanding of how a board works in practice. Leading companies already provide these opportunities for their executive committee. Companies can also help prepare those in the pipeline below executive level by supporting them in taking up board positions on charities and NHS trusts, for example. In the listed sector, it has been suggested that investment trusts are a way to gain exposure to boards. There are also a host of external events and mentoring programmes that individuals can use to smooth the path to the boardroom.

Diversity: some key questions to ask

- Does your nomination committee ensure that candidates for NED roles are not ruled out solely due to a lack of board experience?
- As an existing member of the board, what do you do to help make new directors more effective?
- As a board, how open are you when discussing new board appointments with investors? Do you use these conversations to help introduce new talent and bring new viewpoints that can benefit the board?
- What are you doing as a 'home' company in preparing existing talented employees to successfully secure external board positions?
- How do you consciously encourage and foster diversity of thought and personality on your board, and consider the impact of these differences on the group dynamics and overall board effectiveness?

[3] As noted earlier, the 'home' company refers to the company at which someone is a full time employee.

Board composition is fundamental to board effectiveness. Having the right skills and balance on the board is essential to asking the right questions and making good decisions.

To gain these qualities, boards need to take a long-term view, both in terms of developing internal candidates and also maintaining awareness of external candidates. Succession planning remains difficult, especially when it comes to the post of CEO.

Moving towards the ideal board

The succession planning process benefits greatly if the board has a clear understanding of what an 'ideal board' might look like. This enables potential candidates to be assessed on the basis of whether they would move the board closer to that ideal.

> "Succession planning is part skill and part luck."

Some boards have developed a 'matrix approach' that breaks down the board's composition by factors such as gender, skills, and geography, mapped against the time when current board members will rotate off. This matrix is then used to inform a search for potential candidates up to three years prior to their appointment. It is important that boards keep themselves refreshed with at least one new appointment every few years.

The make-up of the 'ideal board' may also change over time as the needs of the business change. For example, if a company expands into a new region, it may want to bring someone onto the board who has familiarity with working in that geography. Alternatively, if a company is acquisitive, it may want someone who has experience in acquiring and integrating businesses.

> "We have a matrix for rolling people on and rolling people off the board, based on the composition of different kinds of skills, geography and gender. We start to eye people up for three years before they join."

Aside succession planning in the normal course of events, there may be situations where there is a need for a more radical refreshment of the board, particularly where there are concerns with board effectiveness or dynamic. This is often characterised by a significant number of directors changing simultaneously.

Creating the future talent pipeline

In recent years, demands on boards and the increased focus on diversity has led to a greater emphasis on developing internal candidates. This should not simply be a matter of picking people whose next move might be a board post. Instead the development of these individuals to be 'board-ready' should begin much earlier in their careers – possibly even at 'board minus 3 level' – something that the best companies are already doing to a large extent.

Investors are increasingly interested in what talent exists several levels below board level. As we highlighted in the discussion on 'home' companies in the chapter on diversity, companies can play a role in developing this talent by supporting these individuals in taking NED roles on charities and NHS trusts. Companies should also consider preparing talent to take up NED roles within other companies as well as an executive committee role internally.

These preparations will generally involve a mixture of rotating prospective candidates around the business combined with direct mentoring from – and exposure to – the board, such as attending board or board committee meetings. As well as informing the board's discussions, this also gives the board a better sense of what talent exists below management level and there is benefit to be gained by the board from the perspectives of younger employees.

Internal candidates are often preferable for CEO and CFO positions, as they may be better able to maintain the momentum of the business and the handover can be smoother. While the creation of an internal leadership 'pipeline' is important, there can be challenges in keeping everyone content. It is also hard to predict whether the board's need in, say, five years' time, will be for an internal candidate or someone with an external perspective.

> "I sat the CEO down at the first meeting and asked him to think about himself in 10 years' time: it's not a difficult conversation to have on the first day."

Setting expectations over tenure

As mentioned earlier, the succession of the CEO role is the most difficult to plan for. This is partly because there are different situations for which boards need to prepare. One is a crisis; it is good practice to have identified a few internal candidates who would be able to assume the role in an emergency. Many boards also track external candidates, so they are prepared in the eventuality that the CEO retires or resigns. However, the most difficult situation to plan for is when the board believe that it is time for the CEO to leave.

It is important that conversations about the CEO's tenure are held in advance in order for companies to prepare appropriately. There is a danger that longer-serving CEOs and chairmen can become 'untouchable' – with the result that they remain in post as long as the company continues to perform as expected and investors think they are doing reasonably well. This length of tenure may not be in the best interests of the company.

Given this risk, the best time to have the conversation about succession and to set expectations for length of tenure is at the outset: this is a much easier conversation to have on 'day one', as it is potentially less emotive.

This conversation can then be used as a reference point when discussing the topic in the future. An alternative is to set the expectation at the time of appointment that the CEO's tenure is aligned with achieving a particular milestone within a phase of the company's development or lifecycle. Ideally, the discussion on succession should occur on an annual basis to ensure that both the CEO and board are considering the issue on a regular basis. A CEO could also be tasked with the responsibility for finding and developing their successor.

Involving the whole board and investors in succession planning

Although the nomination committee is ultimately responsible for succession planning, the chairman and the rest of the board must also be involved in assessing potential candidates. Interaction between candidates and the board enables the board members to see how the future boardroom dynamic might work. NEDs are often very busy, but it is very worthwhile for them to spend time meeting new board appointees ahead of them joining the board.

It is best practice that a company's largest investors are involved in succession planning, but it is not their role to manage it. A good chairman will consult investors in advance of a recruitment search, so they can contribute to the skills matrix by highlighting the qualities they would want in a new appointee. Some companies consult their largest shareholders on the final shortlist before the appointment is made. However, some chairmen's ability to do this may be constrained by the size of their share register: it is clearly easier to involve investors when the share register is more concentrated.

A further item on investors' wish-list is better disclosures about succession planning. Historically, investors have learnt more from companies in private discussions on succession planning than from the annual report. Investors believe that companies should provide meaningful disclosures on their succession plans, including reporting on the initiatives they have in place to develop the next cadre of senior management.

> "If the chairman starts a discussion about succession planning, by talking about their own succession it is easier to encourage others to do the same."

Board succession and the work of the nomination committee: some key questions to ask

- Have you discussed tenure with your CEO? Would you consider doing this from the outset with a future CEO?
- Have you got a clear idea of the mix of skills, experience and 'social style' your board needs? How regularly is this reviewed?
- Have you identified a talent pipeline several levels below the board? What is your approach for developing it over the next few years?
- How actively and extensively do you engage with investors around your succession planning? What information do you share?
- How can you improve your nomination committee reporting to provide investors with comfort that succession plans are in hand?

The ultimate measure of board effectiveness is business outcomes. However, board evaluations are a proven and valuable way to help the chairman and board assess their effectiveness, and provide a mechanism for future focus and actions to improve it.

The Code[4] requires boards to undertake a formal and rigorous annual evaluation of their own performance and that of their committees and individual directors. Under the provisions of the Code, FTSE 350 boards are obliged to undertake an externally-facilitated board evaluation at least once every three years.

What impact have board evaluations had?

A message that emerged consistently from our roundtables and individual discussions was that boards have found externally facilitated evaluations helpful. While they do not always uncover new issues, directors told us that they can help them to address difficult issues, and also that people tend to be more forthcoming with an external evaluator – especially where there is a problem. Directors are more likely to elaborate fully on issues if they feel that their views will be kept anonymous. We heard that this is much harder to achieve through an internally facilitated survey.

Well-facilitated external evaluations can add real value. They present a mechanism through which a chairman may broach a difficult conversation about the relationship between the executives and NEDs, or the effectiveness of one particular NED. They can be a barometer for culture, particularly when the feedback is about the CEO or CFO. Subject to an appropriate scope, it can also be useful for boards to hear how they are perceived by those below board level. Some board evaluators also involve shareholders in their board effectiveness review to get an 'outside-in' perspective on the board.

While we believe board evaluations have contributed positively to effectiveness overall, one issue is that they have the potential to be retrospective. A backwards-looking evaluation may be valuable as a reaffirmation of what is already known, but it may not shed enough light on how well the board is equipped for future challenges, or indeed on what it needs to do to navigate them successfully. It is also helpful for companies to link board evaluations to succession planning, as board evaluations often identify gaps that need to be resolved, whether in terms of skills, experience or personality type.

The importance of a robust evaluation strategy

It is important for a board to have a strategy in place for the evaluation process covering the three-year evaluation cycle, to allow monitoring of progress and follow-up on action points. Some companies have disclosures to this effect in their annual report; the first year of the cycle is an externally facilitated evaluation; the second year focuses on the actions taken and changes made in response to the issues raised in the external evaluation, and the final year is an internal evaluation often consisting of a series of interviews. Throughout, the end-to-end evaluation process needs to be appropriate for the individual business, and also to the needs of the business at that point in the company's development. The follow-up activity undertaken in the years after an evaluation is important for the evaluation to be effective. It is therefore vital that companies budget for this as well as the evaluation itself.

Most boards take evaluations very seriously – and while our discussions yielded some good examples of leading practice at companies, we can only report so much as we are limited to publicly disclosed information and anecdotes.

[4] B.6 of the UK Corporate Governance Code

However, the Code requires companies to report on evaluations in their annual report, and when this is done well it gives investors some valuable insights into the workings of that particular board, as well as comfort on its effectiveness. Some companies choose to undergo an external board evaluation every year; while this might appear to go 'beyond compliance', we heard that it can mean the evaluation is approached as more of a compliance exercise, which could have the effect of reducing its value.

Given the involvement of an independent third party, externally facilitated evaluations do provide some assurance to investors. However, the shareholders we engaged said that – due to sensitivities over confidentiality or potential litigation – they often receive less insight than they would like into the findings from an evaluation and the resulting actions. So investors would like to see clearer disclosures relating to this issue. Admittedly, companies are generally more open and honest on these matters in meetings and roadshows. However, more generally, investors feel that companies should explain the performance evaluation process, and disclose any significant recommendations, actions taken and changes or improvements that the board has committed to following a review. This is especially important since the outcomes of these evaluations tend to vary year-on-year, and many take more than a year to implement fully.

The purpose and impact of board evaluations: some key questions to ask

- Do you have a well-considered strategy for the board evaluation process within a 3-year cycle, incorporating an external evaluation?
- Does the board's evaluation strategy allow individual directors to provide full and frank feedback?
- What was the scope of your last external board evaluation? Did it tell you something you were not aware of? Was the scope appropriate?
- Do employees below board level (but with visibility of/ access to the board) provide input into your board evaluation?
- How extensive and detailed are the disclosures on board evaluation in your annual report, both on the process followed and also on substance of the evaluation – including scope, focus areas, findings and actions?

Timely, accurate and relevant information is the cornerstone of good decision-making. Indeed, a board can never be effective if its members are not supplied with the right information.

We have spoken to some chairmen who see providing the board with the right information as a fundamental part of their role. At the same time, some directors have told us that much of the information and data currently supplied to them is accurate but backward-looking, meaning it is of little help in strategic and forward-looking decision-making. The core role of a board is to set the strategy for the future, and having access only to information about the past may prevent it from doing this effectively.

Boards must structure their information flows

Boards need to know what information they need, and request it in a form that is useful to them. To enable this to happen, NEDs should spend enough time in the business to understand their own information needs. At the same time, the chairman and company secretary play a vital role in ensuring the information sent to the board is fit for purpose and facilitates effective discussions.

A further consideration around information is that structure is vital: boards need to understand how the information they receive maps against their strategic objectives, and supports their decision-making and purpose as a board. Some directors have told us that it is often unclear to them whether a report is intended to support decision-making or just for information: the information needed to ratify a decision is different from the information needed to put it into action. It is important that NEDs understand the purpose of each item in the information pack, and what is expected of them. Having board papers clearly marked as being for information, discussion or decision enables directors to prioritise appropriately. Another leading practice is for information to be mapped against key strategic priorities.

Aiming for quality of information – not quantity

We live in a data-rich world where modern information systems supply copious amounts of information. However, they also offer the ability to 'drill down' and interrogate data to an unprecedented degree of detail.

While this level of detail is important for management, there is an important balance to strike for the board. While the information provided must offer enough insight to allow it to correctly frame further questioning, it is important that the board members are not overwhelmed with detail. Some directors are reluctant to commission additional reports or analysis, with the result that the information they receive and use tends to resemble that used by management for operational purposes in running the business. This may lead to directors taking an operational rather than strategic view.

There should also be constant refinement of the type of information boards are given. Since in many cases, management are busy and lack the time and resource to think about what information the board needs, it is good practice for the chairman to check with NEDs after board meetings if they want to discuss anything or whether they wish to receive more or different information.

Time is of the essence

Good company secretaries are vital in facilitating the flow of information to the board. Distributing papers as early as possible gives members more time to analyse and challenge information ahead of decisions. There is a tendency for the younger NEDs to view, read, annotate and store their board papers electronically. This enables them to refer back through board packs from previous board meetings – a practice that can aid effectiveness. Another advantage of using information in electronic form is that it potentially frees up some of the company secretary's time, enabling him or her to focus more on value-add strategic activities.

The truth is out there

As well as being proactive in requesting the information they need, board members should actively seek out information from outside the boardroom rather than being dependent on what is supplied to them. This can include informal discussions around the business, formal 'stakeholder days,' or even mystery shopper exercises to gain a better understanding of the customer experience.

As well as company-specific information e.g. on business performance, NEDs ought to have contextual information on the general market and competitive dynamics. This will ensure that they can make informed long-term strategic decisions.

Finally, it is important not only that the board members are fully informed, but also that they can demonstrate to others that they are. Shareholders need to have comfort that the board has explored the full spectrum of risks the organisation has faced, and that the right information has been supplied and the right questions asked.

Focusing on information flows: some key questions to ask

- Do you and the other board members have all the information you need, presented in an appropriate way to carry out your role?
- How have you influenced the content/length/structure of board papers over the last few years? What could be done to improve them further?
- Are your board information and agendas structured so as to reflect the interests and objectives of the board?
- How do you demonstrate the quality of board information and decision-making to outsiders?
- Does your company offer to provide resources and other information sources outside the board papers on the general market and industry competitive dynamics to ensure you can make the most informed long term strategic decisions?

Investors have a direct interest in ensuring that boards are effective and hence focused on protecting shareholders' interests and the long-term sustainability of the business.

Without being drawn into the minutiae of board decision-making, investors can still be very influential – not just in helping boards focus on the right issues, but also by empowering them and giving them the confidence to make the right decisions. An example includes supporting moves to meet diversity targets.

Investors face similar challenges to board members in terms of information flows and deficits, as well as often being over-stretched with their portfolios. Like boards, investors do not want to be immersed in detail: but they do need to understand why actions have been taken, and feel reassured that key activities are being done well. Much of this assurance comes through annual reports as well as investor roadshows and meetings with board members.

Time permitting, exposure to board members and discussions with committee chairmen is to be welcomed. Investors have told us that they are increasingly being offered meetings with the chairman – a trend that has increased in recent years, especially among the larger listed companies. These interactions can help investors gain a sense of how inclusive and open a chairman is with the rest of the board, as well as presenting an opportunity for investors to probe some of the themes covered in this report. These meetings, general disclosures, and the board's response to poor performance or specific issues are investors' only real means of gauging the board's effectiveness.

> "As an investor, dealing with an ineffective board is like going into battle."

Criticisms are sometimes levelled at investors over the difference in views between the corporate governance function and the fund manager. While this remains an issue, NEDs acknowledge that the situation has improved, and that investors' input has helped some companies clarify their thinking prior to writing to investors to consult on issues such as executive pay. However, it is imperative that investors continue to demonstrate the joined-up nature of governance within the investment process. Similarly, it is important that companies do not play fund managers and governance specialists off against each other. It is also essential that the conversation moves away from remuneration, and focuses on fundamental governance issues such as strategy and the work of the nomination committee.

The role of investors in board effectiveness: some key questions to ask

- What do you see your role as being with regard to board effectiveness?
- Do you think you have the right level of engagement with the Board on its effectiveness? How productive is that engagement?
- Do you use conversations about succession planning to support boards in introducing new talent that will bring differing perspectives?
- Do you see it as your role to support boards as well as hold them to account?
- To what extent is the information provided to investors tailored to your needs?
- How do you follow up on the outcomes of board evaluations?

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The Investment Association is the trade body that represents UK investment managers, who collectively manage over £5 trillion on behalf of clients

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