

BRIDGING EFFECTIVENESS GAPS

**A Candid Look
at Board Practices**





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National Association of Corporate Directors
2001 Pennsylvania Ave. NW
Suite 500
Washington DC 20006
202-775-0509
www.NACDonline.org

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Managing Director, Peter R. Gleason
Chief Knowledge Officer, Dr. Alexandra R. Lajoux
Senior Manager, Research, Kurt L. Groeninger, Esq.
Research Manager, Katherine Iannelli
Research Analyst, Adam Lee
Publications Editor, Carolyn Fischer
Design by LetterSpace Creative

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Introduction

Effective board oversight demands information that is as current and relevant as possible. There are, however, natural gaps between what management communicates and what the board needs to know. The information flow between management and the board may not always be perfect, and board committees may have similar troubles bringing the full board “up to speed” on certain issues. The purpose of this report is to address these issues, which we call the “effectiveness gap.”

In the most general sense, the role of the board is to oversee a company and its management. This oversight role is largely dependent on the quality and scope of information the board receives, exclusively in some cases, from management. The sole reliance on one avenue of information may limit or skew needed dialogue on the most important issues facing the company. Information on risk management, for example, may be accurate but incomplete. Data from the *2012–2013 NACD Public Company Governance Survey* shows that responding directors are more satisfied with the information they receive on corporate performance versus information on risk management.¹ However, presenting the right information is not the only challenge facing corporations.

Public company boards are composed primarily of independent directors, but the independence of the information they receive is often questionable. This is not to say that information is inaccurate, incomplete, unfair, and/or biased—it may be just the opposite. It is undisputable, however, that management controls the message and there is potential for a lack of candor. If the board’s oversight relies on the information it receives, then a board may be limited by management’s ability to present data in a manner consistent with its own views and artfully direct the board’s decision process.

Many times the information provided to the board is fair, accurate, and without bias, but in some cases, an inherent conflict can exist between the board and management. This conflict should not be ignored. As the corporation’s oversight body, boards have the ability to hire, compensate, and fire the CEO. The chief executive, on the other hand, has an interest in retaining his/her position and receiving fair compensation. CEOs are leaders, and as such they have very definitive views of strategy and direction and exert a significant influence on those around them. These positive attributes are found in some of the most effective leaders, but they are not always compatible with the board’s information needs. Boards need to see information exactly as it is, transparently, without varnish or bias, but management having a vested interest in the matters at hand, may lack the independence to meet this objective.

The goal of this report is to offer some tips and strategies to improve communications between the full board, C-suite, and committees. In particular, we focus on four areas of concern: strategy and risk, executive compensation, CEO succession planning, and board evaluations. These four areas are traditionally of high importance to board members yet have also presented challenges.

To help bridge the gaps in effectiveness, it was necessary to speak directly with individuals from both management and the board. While the National Association of Corporate Directors (NACD) is able to assess the director perspective, we needed the C-suite perspective as well. We partnered with McGladrey to host four small gatherings of executives and directors in an effort to find ways of improving communications and relationships. The conversations that occurred during these gatherings provided the material for this document.

While the executives and directors focused predominantly on the effectiveness gaps, other topics arose that addressed general board difficulties. It is important to also highlight these areas of concern. The candid, and often surprising, comments are captured in this document.

Strategy and Risk

Overseeing a company's strategy is perhaps a board's most important duty. For many years, respondent directors of the annual *NACD Public Company Governance Survey* identified "strategic planning and oversight" as their top priority. Recently, the survey participants also ranked "risk and crisis oversight" in the top three. The importance of these issues is unmistakable. A director's primary duty is to ensure the long-term sustainability and profitability of the company while increasing shareholder returns.² The existence of a good corporate strategy is crucial to seeing it through. Subsequently, a significant portion of a board's time should be spent reflecting on corporate strategy and the potential risks involved. This, however, is not always the case.

Board meeting agendas are stocked with issues requiring board attention, especially compliance matters. Many directors find that not enough time is given to the critical business issues needing director input, such as corporate strategy and performance. Many directors indicate that there is a limited amount of time to understand the risks facing a company and that it is difficult for some directors to add significant value to discussions. Given the fact that boards average 5.5 meetings per year and dedicate only 6.5 hours per meeting,³ it is not surprising that directors find it difficult to address all the most important issues facing the board.

The lack of time is only one gap between board and management. While the C-suite gets a daily dose of strategy and risk, the board gets only glimpses of the problems facing the company. The C-suite's ability to transfer their knowledge of strategic risks is paramount to the board's oversight and understanding. Unfortunately, some CEOs may be unwilling to unveil the full scope of risk facing a company because it may be seen or felt as an admission of weakness. On the other hand, boards want to focus on risks to adjust strategy and explore contingencies.

This gap presents a challenge to boards and C-suites, but other issues also exist. The following are some areas that require the collaboration of company leadership to achieve better results.

Financial vs. Non-Financial Risk

Financial data is often the dominant consideration when making business decisions. This “hard” financial data is very useful in identifying and accounting for risks to the company. However, financial data may not reflect all of the risks that threaten an organization’s ability to execute a business strategy.

Companies operate through multiple key business processes, such as customer relations, research and development, logistics, shipping, and information technology, as well as core internal controls for accounting and legal matters. All of these processes are prone to problems, and if severe enough, this can do drastic harm to an enterprise. Many of these processes cannot solely be measured in financial terms. As a result, companies rely on other non-financial measurements. Unfortunately, these metrics often use “soft” data and are more difficult for corporate leaders to assess. Subsequently, in an effort to detect risks, directors may spend much more time looking at financial data and miss issues that may be even more foundational to a company’s success or failure.

Many directors are concerned that they are missing pieces of information critical to a holistic understanding of the business and its risks. The non-financial information may fill the gap in director understanding. But, this information is often only available to the senior management team and may not make its way to the board level. Directors should make it clear that risk assessments must reflect the thinking of those “on the front lines.” This perspective should also be part of board presentations.

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The Audit Committee

For many years the audit committee has been the main body for risk oversight. Currently, 44.9 percent of boards assign the majority of tasks directly related to the oversight of risk to the audit committee; another 39.8 percent place it with the full board.⁴ There is a perception among some boards that the audit committee does the “real risk oversight work.” This observation is not without merit; according to NYSE rules, the audit committee is charged with “discussing policies with respect to risk assessment and risk management.”⁵ The rule also instructs boards that the audit committee is “not the sole body responsible for risk.”⁶ Despite recommendations from NACD, boards still place risk oversight with the audit committee.

This placement presents some issues. On some boards, the individuals on the committee are considered “experts” in risk by other non-audit committee members.

Therefore, the non-audit members leave the “heavy lifting” to audit members. As the audit members become more experienced with management’s risk processes and practices, the more entrenched the risk oversight duty becomes. Subsequently, a majority of directors on the board do not know the “DNA” of the company and find it more difficult to contribute to the discussion around risk.

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Of course, the role of the audit committee, as it relates to risk, is to bring key concerns to the full board for discussion. Transferring that information, however, is not without its flaws. When the information does reach the full board, it is often edited by management and the audit committee so that it becomes of little value. In other words, the risk information gets compartmentalized in the audit committee and does not adequately make its way to the full board. Unfortunately, some directors argue that the knowledge of risk practices and systems, like that of the audit committee members, is what every director needs but lacks.

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While there are multiple solutions to improve the full board’s knowledge of risks, committee member rotation may be an effective solution. Currently, committee membership rotates relatively infrequently; 23 percent of boards rotate every three years, 28.4 percent rotate at a frequency greater than every four years, and 22.2 percent do not intentionally rotate committee membership.⁷ Some directors at our roundtables suggested that rotation on a yearly or every other year basis would allow for wider director participation on the audit committee and provide real, working knowledge of risk systems of the company. Executives, on the other hand, felt that rotation would diminish the expertise necessary at the audit committee. This begs the question, what expertise is required?

There is some disagreement between directors and boards as to whether the standard to serve on an audit committee is high enough. Some specialized knowledge of finance and accounting is required to sit on the audit committee. Both NYSE and NASDAQ require audit committee members to be financially literate. For NYSE, audit committee members must be “financially literate, as determined by the board, or must become financially literate within a reasonable period of time following their appointment.”⁸ For NASDAQ, directors must be financially literate at the time of appointment, defined as the ability “to read and understand financial statements.”⁹ In addition, each audit committee must have one individual considered to be an “audit committee financial expert.” Many directors believe they should have time to be “trained up” on the issues and accounting procedures, as stated by NYSE guidelines, while some executives believe with NASDAQ that financial literacy should be required from all audit committee members from the start of their service.

Executive Compensation

Executive compensation is always a headline-grabbing subject, generally with negative overtones. Yet in recent years, the news about compensation has been good. In the 2012 proxy season, the second-year-mandatory say-on-pay votes occurred, shareholders supported all but 53 of the Russell 3000 companies' pay packages; this amounts to about 3 percent of the total reported vote results.¹⁰ Most directors believe that the compensation they award is appropriate for their executive and company; 77.8 percent of respondents to the NACD governance survey found that CEO pay is commensurate with his/her performance. Fewer than 8 percent believe pay for their CEO exceeds performance. In addition, "CEO compensation" ranked 9th (out of 21) in a list of top governance priorities for 2012.¹¹

Despite the agreement by both shareholders and directors that compensation is being handled well overall, directors still have concerns about crafting an equitable and motivational pay package. Primarily, the complexity of compensation presents a balancing act for boards. Directors must consider long- and short-term goals, financial and non-financial metrics, peer groups, and a host of other issues. It is unsurprising then, that compensation committees are more likely than other committees to hire outside consultants.¹²

Long- vs. Short-Term Incentives

The area of long- vs. short-term incentives is perhaps one of the most difficult to balance. A common view is that executives should be rewarded for long-term performance. In fact, NACD recommends "compensation committees should design pay packages that encourage long-term commitment to the organization's well-being."¹³ This long-term focus does not always match up with the investment world's expectations. Quite often, investors buy and sell based on quarterly results. Directors are therefore forced to incentivize some level of short-term performance.

Directors should not be hesitant to use some short-term targets. Executives do need to meet these short-term goals and should be rewarded for doing so; however, these should not amount to a large percentage of total compensation.¹⁴

Checks and Balances

Just as the audit committee is often the “holder” of risk issues, so too is the compensation committee the holder of executive pay. Because of the complex issues involved, many full boards do not have the time or understanding to get buried “in the weeds.” Often, the full board will concur with the committee’s opinion and only scratch the surface with questioning of the pay package.

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This approach may be flawed as some directors believe that compensation packages are not thoroughly vetted and deserve greater attention from the full board. This communication gap between the committee and full board may create less robust metrics and pay plans. These concerns should be allayed with greater involvement by the full board. According to roundtable attendees, directors not sitting on the committee should have a “checks and balances mindset.” The full board should bring a fresh perspective to the compensation plan and “strive for pay packages that will be perceived as fair, both internally and externally.”¹⁵

Include More Non-Financial Measures

The use of financial targets is the predominant method for compensating executives, but many directors are concerned that the over-reliance on financial metrics can draw the CEOs attention away from other critical areas. Executive talent management, for example, is an extremely important aspect of succession planning that may not always receive attention in a compensation plan.

Deciding which non-financial measures to use can present a challenge. Boards should consider the unique features driving corporate success and growth, and incentivize management to nurture these areas. A balanced pay package would include financial metrics as well as a substantial portion of non-financial goals.

CEO Succession Planning

The “gap” between management and the board is perhaps no greater than in CEO succession. Succession planning has gained in visibility and importance in recent years. The need to build strong “bench strength” cannot be understated; but all too often, directors are too removed from the executive candidates. Directors should have frequent contact and accessibility to create an informed opinion about possible successors. Given the realities of director service, obtaining this type of contact is difficult.

Transparency and Accessibility

Selecting executive successors is all about getting to know the candidates. Board members need time with junior executives to understand the way they operate and think. Unfortunately, the distance between a board member and non-senior executive is difficult to surmount; it is especially challenging if a CEO restricts access to his/her staff.

Discussing the topic of succession on an annual basis may not suffice. Directors require an opportunity to meet with all the candidates and see them “in action.” While listening to presentations given by candidates and seeing how they operate under board scrutiny is important, directors should also incorporate “unscripted contact” into their opinions. In some cases, this contact can be done through multi-day strategy sessions or informal social events. These opportunities allow directors and potential successors to form a better understanding of one another. As one director at the sessions pointed out, “a person’s personality has nowhere to hide during a 4-hour golf outing.”

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On the other hand, some CEOs rebuff the idea of directors becoming better acquainted with less experienced executives. For various reasons, some chief executives restrict access to employees. This can make it more difficult to familiarize oneself with a future CEO candidate. Directors should explain to the CEO the

necessity for contacting company staff. If the CEO is still reluctant to the idea, the board may consider including accessibility as a metric for future executive compensation plans.

Looking for External Candidates

There is a perception among many directors that the need to look externally for a new CEO means the board failed at succession planning. This belief is not without reason: studies have shown that companies fare better with internal CEOs than external hires.¹⁶ Additionally, internal CEOs are typically less expensive and last longer in the position.¹⁷

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The opinion that boards should only hire from within may be an extreme view. However, most directors agree that the intent to hire internally should be the default. There are some advantages to hiring internally: these candidates know the company, its strategy, and its people. But if it is determined that those three factors are hindering corporate growth, then an external hire may be the better choice. Boards looking to “reboot” a company may also find external candidates to be most helpful.

While boards should first look internally for acceptable candidates, they should not close the door completely on external candidates. In fact, a comprehensive pool of candidates will include a handful of individuals from outside the company. Directors can “keep tabs” on external executives and track them from afar. Updating the board periodically on an external individual’s career developments would be appropriate in a yearly succession plan review.

Board Evaluations

Board evaluations are common features of every public company board. Due to listing exchange requirements, an evaluation of some sort occurs at almost every board. Full board evaluations are conducted by 91.8 percent of companies.¹⁸ Committee and individual evaluations are slightly less common, used by 82.9 percent and 47.6 percent of boards respectively.¹⁹

Despite widespread use, evaluations have been a topic of great interest and debate in the past few years. Some directors tout the benefits of evaluations, while others question the value it brings. Doubt in effectiveness can stem from a communication challenge among board members. Directors often point out that they do not want to “rock the boat” with peer criticism.

“Is There Such a Thing as ‘Too Collegial’?”

The objective of board evaluations is to judge the extent to which the directors are meeting the goals they sets for themselves, collectively and/or individually.²⁰ While the purpose is laudable enough, holding fellow directors accountable for any deficiencies identified by an evaluation presents a challenge. Some directors believe that a board may be “worse off” by criticizing a director and board dynamics will be harmed; subsequently, the company may also suffer. In other words, it may be simply easier to have a harmonious board than possibly damaging the company; as one director put it, “the incentives just aren’t there.” In response, directors have often “pulled their punches” and not been as critical of others in the group. This collegiality without constructive criticism can lead to evaluations that do little good for the board.

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There are no easy answers to this problem, but there are some practices that may help. First, the use of outside advisors to implement the evaluation process can provide a major advantage. Directors tend to be more candid with external evaluators, resulting in more robust feedback. The pressure of collegiality is also lessened if a third party presents any “bad news” to the board. Second, directors must understand that negative

feedback on an evaluation does not mean termination from a board. Rather, these are opportunities for additional board education and the creation of a performance improvement plan. If, however, these plans fail to achieve a desired result, it may be necessary for the board to take action.²¹

Using 360-Degree Evaluations for the Board and Committees

While not widely used (11.7 percent of public boards),²² 360-degree evaluations can be extremely useful in understanding gaps in board performance. Directors have cited this practice—in which management gives its opinions of the board and its committees—as a means to provide added detail and an outsider’s perspective on the workings of the board. Typically, these types of evaluations are performed for the full board, but the use of this tool at the committee level can bring a new level of feedback to small working groups.

Board committees could consider asking external parties to gauge their performance. For example, external auditors could provide honest feedback on the fulfillment of audit committee duties; compensation advisors could also opine on compensation committee effectiveness. While this practice may seem foreign, it is one more piece of outside information boards may rely on to improve their own performance. Of course, as in all evaluations, results should be treated as confidential and, if possible, privileged.

Conclusion

The board members and C-suite executives who were invited to our sessions gave frank and sometimes surprising accounts of their boardrooms. While each individual acknowledged difficulties they have experienced with other members of their organizations, they followed with an explanation of how things were improving. Though communication was often the problem, it was also always the solution.

A board, like any other organization, will have its share of difficulties. These usually derive from some level of communication breakdown. Often information is not transferred wholly or accurately. In other cases, the classic problem of “stove-piping” in the committees is the culprit. Regardless, boards have an opportunity to solve these issues by opening a dialogue.

Members of NACD and McGladrey were honored that the board members and executives took the time to speak with us and help in the creation of this report. We hope corporate leaders can use this report to identify issues they too may be having and begin to solve them.

Endnotes

- 1 National Association of Corporate Directors (NACD), *2012–2013 NACD Public Company Governance Survey* (Washington DC: NACD, 2012) [hereinafter *2012–2013 NACD Public Company Governance Survey*].
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- 4 Id.
- 5 NYSE, Inc., Listed Company Manual Rule 303A (2012) [hereinafter NYSE, Inc., Listed Company Manual Rule 303A].
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- 14 *Executive Compensation and the Role of the Compensation Committee* at 6.

- 15 Id.
- 16 Kelley School of Business & A.T. Kearney, *Homegrown CEO: The Key to Superior Long-Term Financial Performance Is Leadership Succession* (Bloomington IN: Indiana University, 2011).
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2001 Pennsylvania Ave. NW
Suite 500
Washington DC 20006
Phone: 202.775.0509
Fax: 202.775.4857
www.NACDonline.org

