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Board Evaluation: A Key to Strategic Planning

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Are your board evaluations tied to your company's future outlook?

Evaluations of boards and individual directors are unusual, and tend to be linked to past results. In a recent study of four boards, we found that self-evaluation can help boards meet the future—if evaluations are tied to outlook.

Background

A company's board of directors can have an important influence on a company's success or failure.* It logically follows that someone must evaluate the board's performance. Since shareholders are not organized to do it, the duty rests with the directors themselves. Yet the idea that a board of directors should evaluate its own performance is relatively new.

The *Report of the NACD Blue Ribbon Commission on Performance Evaluation of Chief Executive Officers, Boards, and Directors* introduced this concept to many companies when it was published in 1994. After this report was published, a few mentions of board evaluations appeared in corporate governance publications, and two subsequent NACD Blue Ribbon Commissions reiterated the importance of evaluating both the board as a whole and individual directors (*Director Compensation*, 1995, and *Director Professionalism*, 1996). Shareholders, in their search for better returns, naturally applauded the idea.

* Authors' Note: For example, see Ira M. Millstein and Paul W. MacAvoy, "The Active Board of Directors and Performance of the Large Publicly Traded Corporation," *Columbia Law Review*, June 1998, pp. 1283-1321.

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These developments have encouraged some boards to begin evaluations. These pioneers tended to start at the easiest place—the evaluation of the board as a whole—and then at times proceed to evaluating individual directors. Yet most companies still do nothing on board evaluation. Larger firms have been much more active than smaller firms in conducting evaluations, but even among large firms only a minority evaluate individual directors.

For example, 58 percent of the large firms (sales over $10 billion) were evaluating the board as a whole compared with only 15 percent of small firms (sales less than $200 million). In contrast, only 19 percent of the large firms and 8 percent of the small firms were evaluating individual directors. (See *Current Board Practices*, Second Study, American Society of Corporate Sectaries, 1998. See also the *1997 Corporate Governance Study* of the NACD.)

Parallel with these developments has been an increased emphasis on board participation in strategic planning. (See the NACD Blue Ribbon Commission reports on *Performance Evaluation*, 1994, *Compensation*, 1995, *Professionalism*, 1996, and *CEO Succession*, 1998.)

The tie-in between corporate strategy and board evaluation, however, has been largely overlooked. Indeed, we began our study without focusing on this tie-in. But we quickly realized the major impact that corporate strategy should have on the evaluation of the board and individual directors. While this is important to all firms, it is especially so for smaller firms because of the rapid changes in outlook they often experience.

Our Study

We studied the performance of the boards of directors in four firms. The firms operated in different industries and ranged widely in size—from a firm with minimal sales up to a firm with more than $400 million in sales. Three were publicly traded and the fourth hoped to go public within a few years.

Although our evaluations began by focusing on the board as a whole, they quickly turned to the contributions of individual directors. Our evaluations also evolved from a focus on the past to a focus on the future.

We began our research by employing the very useful board evaluation questionnaire presented in the *Report of the NACD Blue Ribbon Commission on Performance Evaluation of Chief Executive Officers, Boards, and Directors.* We then interviewed the CEO and each of the other directors.

When we focused on the current picture, some boards seemed to be functioning quite well. First, all had a majority of independent directors, and all had directors with knowledge and contacts that had been useful to the company. And the boards by and large had scored high on most questionnaire measures.

We found that merely evaluating the results of the performance questionnaire without asking the directors about the outlook for the firm could cause us to dwell on past accomplishments and neglect future needs. It was necessary to consider the company's long-range outlook in order to make changes in the board that were essential to help move the companies through their next stages of growth. As with many small firms, our firms' outlooks were not necessarily incorporated into formal strategic plans. This made it all the more imperative to bring outlook into the evaluation process.

Firm No. 1

This company seemed to have an especially well-balanced and properly functioning board. A merger of two companies had created the firm and the directors chosen for the merged firm had jelled as a cohesive board. One member told us, "I'm involved in a number of boards, and I think this one handles its affairs in a most professional way." And the CEO exclaimed, "The board members are very good; I have worked for several companies and this board has been the best I have worked with."

Indeed, a straightforward board evaluation yielded no significant weaknesses in the board. The board was provided with proper and timely information and the CEO had adequate room to manage. The company had achieved important success in U.S. markets. But when interviews with the directors indicated a long-term need to expand overseas, it became important to consider changes at the board level.

▸ This board needed to go global. No one on the board had international experience or knew much about overseas markets. Thus, the obvious answer was to add board members with international experience.

▸ Another needed action was to begin educating the existing directors about overseas markets. A retreat for directors to consider in depth the overseas markets was to be followed by the routine inclusion of information about overseas conditions in the information packets regularly provided to directors.

Firm No. 2

The company had operated in a stable, regulated environment. Deregulation had begun and was expected to proceed at a fast pace—"everything is changing," noted one director. Specifically, deregulation would mean expanding markets and more competitors, with increased emphasis on supply management, controlling costs, and improving response time for customers.

▸ The board needed to change its focus from a primary concentration on internal activities to a more balanced review that included external activities—particularly external matters such as possible actions by legislative and regulatory bodies, new opportunities in the marketplace, and activities of potential competitors.

▸ This change in board focus meant that the package of information provided by management for board meetings needed major changes to reflect the new environment—as one director exclaimed, "more information, and in layman's terms!"

▸ The new environment also called for new expertise on the board, necessitating the replacement of some existing directors. Also, a different director selection process was needed. A director described the existing process: "The board is selected basically on friendship, pretty much by the CEO. He brings in a friend and presents his credentials. There should be a statement by the board about the kind of expertise and what kind of mix we're looking for." The CEO recognized the need for change, saying "I plan to have a nominating committee in the future."

▸ The new situation called for changes in the relationship between the current CEO and the non-employee chairman of the board, who had previously served as CEO. The chairman tended to dominate management, especially because of his experience as the previous CEO and his extensive knowledge of how to operate successfully in a regulated industry. The current CEO would require more freedom to make quicker decisions to meet the more rapid changes that he would encounter in an unregulated environment.

▸ The future changes were of such magnitude that the board needed a retreat of one or two days to learn about the future environment and how to cope with it.

Firm No. 3

This was a biotech firm engaged in developing new technology. It had spent over $50 million on research and development and was just entering a phase when it would begin commercializing its first product. This development indicated the following changes would be needed on the board.

▸ Wholesale changes were needed in board membership. Other than the CEO, who was a professional manager, and one venture capitalist, all of the directors were renowned scientists, principally university professors. Although such a board makeup seemed appropriate when the company's activity was principally research and development, the prospect of attempting to commercialize a product called for different board expertise.

While linking evaluation to strategy is important to all firms, it is especially so for smaller firms because of the rapid changes in outlook they often experience.

▸ When the board evaluation was tied into the future plans of the company, it became obvious that the board needed expertise in general management, in product marketing and sales, and in the pharmaceutical industry. The CEO was quite young and had only a modest amount of general management experience, and the venture capitalist had none. No one had experience in marketing and sales, and none had experience in the pharmaceutical industry—even though firms in this industry were to be the main marketing target. As one director noted, "Adding a director with pharmaceutical company experience would be helpful both in understanding the perspective of the large pharmaceutical company and in providing contacts with such companies."

▸ Some existing directors needed to be retired in order to make room for new directors, but as one director observed, "the problem is that people always like to be associated with success, so it's tough to retire someone." His solution: "The obvious thing to do is to transition some of our scientists to a scientific advisory board." This would make departure from the board more acceptable to the

DIRECTOR SUMMARY

Relatively few boards evaluate themselves and their members, and those that do tend to concentrate on the past. This new study of four companies provides compelling evidence that boards can benefit from self-evaluation that is linked to their company's strategic needs. ▸

Just as "too many cooks spoil the broth," too many venture capitalists can spoil a board.

scientists while keeping their expertise and contacts available to the company.

▶ The informal method of board communication would no longer be adequate. The board consisted mainly of scientists from the same general scientific community. As long as the activity of the company was principally research and development, it was easy for communication to take place via informal contacts—face to face as well as via e-mail and telephone—not only among board members but also between board members and the scientific employees. But the prospect of the firm entering the commercial marketplace with new board members from different backgrounds required a different communication pattern. In the future, the information provided would need to meet the needs of the reformulated board and would need to be gathered and disseminated to board members on a formal basis.

▶ The information prepared for the board would include benefit/cost profiles of potentially competitive products.

Firm No. 4

The board of this company seemed to be performing less satisfactorily even for current conditions than did the other three boards. This company was somewhat similar to Firm No. 3 in that it had not yet reached a stage in its development that it earned a profit. But it was different in two important ways: 1) It was selling products on a commercial basis but just not on the scale needed to operate profitably and 2) three of the seven outside directors were venture capitalists.

These two factors combined to result in a board that attempted to micro-manage the company on an ad hoc basis. The venture capitalists, eager for the firm to begin earning a profit, felt justified in delving into many details and making frequent recommendations ordinarily in the province of management. One director described the board meetings, "We get bogged down in details that are management issues and not board issues. I don't think it has been a particularly fruitful interaction." And according to the CEO, "The venture capitalists have a tendency to 'micro-ask.' Some of their questions are worthwhile, but 90 percent are clutter. There are twice as many opinions as there are directors at the meeting. I'd be insane to take action based on them." The views of the venture capitalists were different; one whom the CEO described as "talking for hours on end" opined, "I'd say the board meetings are effective." This situation—plus the need to expand into new markets in order to reach a profitable level of operation—called for board changes to cope with the future.

▶ The board needed new directors who were knowledgeable about and had contacts in the prospective markets.

▶ Just as "too many cooks spoil the broth," too many venture capitalists can spoil a board. As one director explained, "I don't think it's healthy to have three venture capitalists on the board five years after the startup, especially when there's product to be sold. Venture capitalists should step off the board after a time."

The obvious decision was to replace two venture capitalists with two new directors with the needed industry backgrounds. This had the advantage of retaining the financial discipline imposed by venture capitalists while adding needed expertise.

▶ The board needed to overhaul its board materials to incorporate new types of information—including competitors' activities—on the new markets. This would not be easy, but it could be done. As one director explained, "There aren't a whole lot of companies you could compare us to, but there's certainly a product. I feel it should be done." Another added, "We ought to be able to isolate some cases relatively similar to this and look at the adoption curve time."

▶ This new competition-oriented material would not only inform the directors, but also make it easier to restructure the relationship between the CEO and the board to give the CEO the freedom to make decisions needed in entering new markets.

One director suggested an "away day" that focused on material that would give them the chance to fully understand the strategy. More time spent on strategy was obviously needed, since one venture capitalist said, "Our strategy is to achieve cash-flow breakeven"—certainly an inadequate strategy statement!

Conclusion

Conducting board evaluation in the context of the firm's long-range outlook can reveal important changes needed for the board to add value for the future. Furthermore, a board evaluation can begin with a focus on the board as a whole, but once the company's long-range outlook is brought into the picture, the evaluation must turn to the contribution of individual directors.

In all four of our cases, the boards needed new kinds of members and new types of information. These two changes would make it easier to accomplish another important change needed in three of the four cases: a restructuring of the CEO-board relationship in order to give the CEO room to manage the firm while keeping the directors informed and being held accountable by them. ▶

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