ANNUAL CONFERENCE TOPIC

Cover Story

How Does Your Board Rate?

NOW YOU CAN USE A BALANCED SCORECARD TO MEASURE AND IMPROVE CORPORATE BOARD PERFORMANCE.

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Though in recent years more attention has focused on improving corporate performance measurement by using strategic management systems such as the balanced scorecard, little has changed at the top of major companies. Neither corporate boards nor individual board members have faced the rigor of performance measurement or management systems. They often haven't set the goals, objectives, and targets that are expected throughout organizations, and they haven't been held accountable for their performance. Why? Boards don't have the information or the metrics they need to do so. But that's all beginning to change, and it's essential that financial professionals become involved in this process to ensure corporate accountability.

Drawing on prior research about performance measurement and board governance and on our examination of corporate board governance practices, we've concluded that the lack of measurement of board performance is a significant barrier to improving internal governance and external accountability. In a recently released report, we carefully examined the key success factors for improving corporate governance and developed measures for evaluating the performance of corporate boards, individual board members, and CEOs. In the report, we introduced two new applications of the balanced scorecard: a CEO balanced scorecard and a board balanced scorecard. (For the complete report, see "Measuring and Improving the Performance of Corporate Boards," the Society of Management Accountants of Canada, Hamilton, Ontario, Canada, 2002; http://www.cma-canada.org.)

Here we present the main elements of the board scorecard and show how strategic management systems can provide a process for better defining and articulating board strategy, implementing the strategy, and measuring and improving both board and corporate performance. We also provide a carefully developed set of performance metrics for board self-evaluation. Though set in a balanced scorecard framework, the metrics and analysis of linkages can be used in any strategic management or performance measurement system.

DEVELOPING A BOARD BALANCED SCORECARD

Over time, the definition of the roles and responsibilities of corporate boards has changed. But there's general agreement that a board has a fiduciary duty to represent a corporation's interests in protecting and creating shareholder value and must determine whether the company is managed to realize long-term success. As such, high-performance boards must achieve three core objectives:

1. Provide superior strategic guidance to ensure the company's growth and prosperity;
2. Ensure accountability of the company to its stakeholders, including shareholders, employees, customers, suppliers, regulators, and the community;
3. Ensure that a highly qualified executive team is managing the company.

To fulfill these responsibilities effectively, boards must be provided with relevant and comprehensive information that they aren't receiving now, such as information on alternative strategies; major risk factors; the amount of resource and investment required; requirements for additional technology and the implications—best, worst, and most likely case scenarios; succession planning; and current and evolving customer demands. By using a balanced scorecard developed specifically for evaluating and improving their performance, boards should be able to identify and understand the cause-and-effect relationships of their actions on shareholder value, thus focusing attention on the drivers of corporate success and the levers they can pull to improve their performance and the company's performance. The balanced scorecard will clearly indicate how boards can specifically impact shareholder value through the same causes and effects of learning and growth ➔ internal processes ➔ stakeholders' satisfaction ➔ financial performance.

These four dimensions connect in a chain of cause-and-effect relationships where one dimension of drivers impacts performance in the next. They should be mutually reinforcing, and all should contribute to improving the implementation of the board's strategy. For example, as shown in Figure 1, the impact of improving the quality of information provided to board members could be illustrated like this:

Strategic information availability ➔ system for reviewing strategic plans ➔ stakeholders' satisfaction ➔ project profitability.

To develop a board balanced scorecard, directors and top management must first discuss and explicitly define four basic elements: (1) objectives, (2) performance drivers, (3) measures, and (4) targets. For each dimension, *objectives* should provide additional clarification of the board's roles and responsibilities. They should specify what the board must accomplish to be successful in all four dimensions of the balanced scorecard, with each dimension capturing a distinct and essential aspect that leads to financial performance. Identifying strategic objectives requires that board members and management articulate a shared understanding of their specific duties. The objectives should reflect both the board's responsibilities and the areas of the corporation in which it might intervene since it isn't the board's responsibility to micromanage the company.

Next, *performance drivers* should be identified. These are actions that boards of directors could take to implement strategy that will improve both board and corporate performance. They are the key inputs and processes that must be monitored closely because failure to successfully complete the actions will likely hinder performance.

We'll discuss *measures* and *targets* later.

THE SCORECARD DIMENSIONS

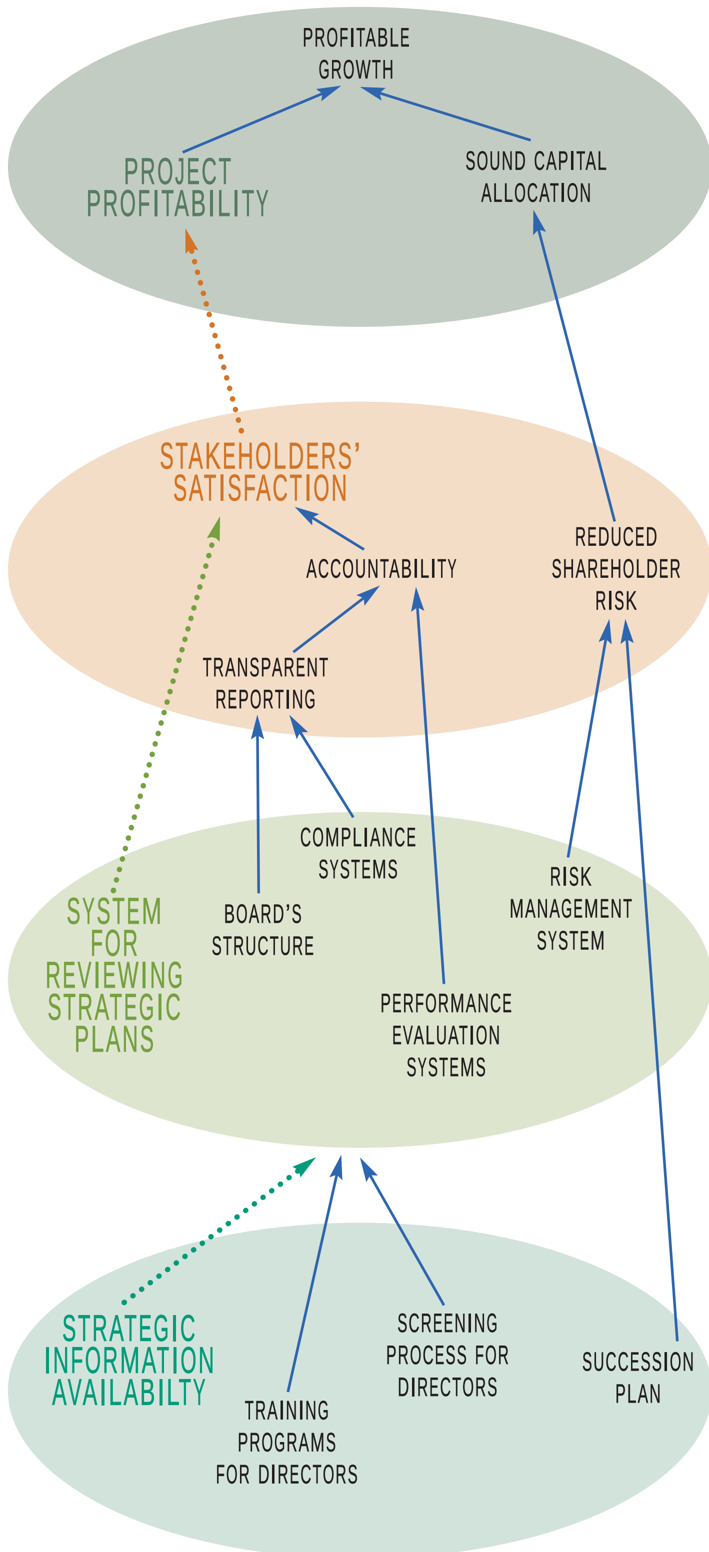
In the **learning and growth** dimension, the board must

Figure 1: The Causal Relationships in the Board's Balanced Scorecard

BOARD'S STRATEGIC OBJECTIVES

FINANCIAL	Long-term financial success
	Short-term financial success
	Long-term success of major organizational changes
STAKEHOLDERS	High level of ethical behavior and legal compliance
	High level of corporate governance and accountability
	Successful identification and management of various stakeholders' needs
INTERNAL PROCESSES	Effective risk and crisis management (internal controls/compliance system)
	Effective performance evaluation systems
	Effective review of strategic plans, structures, and major investments
	Effective functioning of the board
LEARNING AND GROWTH	Strong succession for CEO and senior management
	Improving board's information system
	Improving board's skills and knowledge

PERFORMANCE DRIVERS



Source: Adapted from Robert S. Kaplan and David P. Norton, The Balanced Scorecard, *Harvard Business School Press, Cambridge, Mass., 1996.*

Table 1: Examples of Metrics for the Board Balanced Scorecard

OBJECTIVES	MEASURES
FINANCIAL	
Long-term financial success	◆ EVA ◆ ROI
Short-term financial success	◆ Stock price ◆ Earnings (overall and per business units) ◆ Cash flow
Long-term success of approved major organizational changes	◆ Success of change (profit in excess of plan)
STAKEHOLDERS	
High level of ethical behavior and legal compliance	◆ # of ethical/legal violations ◆ Level of compliance with governance guidelines (CalPERS—California Public Employees Retirement System, NACD—National Association of Corporate Directors, etc.)
High level of corporate governance and accountability	◆ # of voluntary disclosures ◆ Evaluation of quality of external disclosures by stakeholders (survey) or by experts
Successful identification and management of various stakeholders' needs	◆ # of meetings with stakeholders ◆ # of complaints (employees, community, customers) ◆ Existence of communication channels with board ◆ Stakeholders' satisfaction survey

identify the key activities it needs to complete to develop, learn, and improve relevant skills and knowledge for the future. As you can see in Figure 1, in order to be successful in the learning and growth dimension, boards should pursue objectives such as "ensuring a strong succession for the CEO and senior management" or "improving the board's skills and knowledge." We have identified several key performance drivers that must be monitored to achieve board objectives. For example, to ensure a continually strong CEO and senior management, an effective succession plan must be in place. Also, through a screening process that involves stringent criteria, boards must ensure that directors are qualified and independent. The board must define the critical qualifications for independent directors, identifying its own current set of skills and expertise and comparing them with actual needs to ensure an optimal coverage of general, functional, industry-specific, and company-specific knowledge that

OBJECTIVES	MEASURES
INTERNAL PROCESSES	
Successful risk and crisis identification and management	◆ # of risk audits performed and results ◆ # of crises and evaluation of response
Effective performance evaluation systems (CEO, board, directors, corporate)	◆ % of performance linked to nonfinancial performance (social, environmental) ◆ # of board members owning stock ◆ Goals and objectives clearly defined for CEO, board, etc. ◆ # of actions taken based on performance evaluation
Effective review of corporate strategic plans, structures, and major investments	◆ # of visits to company sites by individual directors ◆ % of projects accepted by board that met or exceeded projected ROI ◆ Evaluation of list of information provided to board to assess projects (financial and nonfinancial) ◆ # of hours spent on long-term strategic issues
Effective functioning of the board	◆ Overall attendance at meetings ◆ % of meetings without CEO (executive sessions) ◆ % of meeting time allocated to opposing points of view ◆ # of days in advance that material is sent ◆ Average duration of meetings ◆ Nomination of lead directors
LEARNING AND GROWTH	
Strong succession for CEO and senior management	◆ Existence of a position description for CEO ◆ Interim CEO identified
Improving composition of board	◆ % of directors "financially literate" ◆ Diversity of board—race and gender (% represented) ◆ % of independent members
Improving skills and knowledge	◆ Existence of training programs ◆ Quality of programs as evaluated by new directors

will provide for a high level of corporate governance. Personal attributes such as diligence and strong ethics must also be evaluated and integrated into the screening process.

Also, the board must ensure that strategic, comprehensive information is available to board members. The quality of available information will directly impact the internal processes such as performance evaluation systems and the strategic plan review process.

The board should also identify key **internal processes** to be implemented so it can satisfy company customers and other stakeholders. Effective internal processes will enable boards to achieve their core objectives, such as ensuring a reliable financial reporting system or a sound process of reviewing strategic plans. Internal processes that ensure optimal board functioning must also be in place. Decisions about the number and composition of committees required to support the board's activities, the number and length of meetings, the appointment of a lead director, and the way the agenda is set will impact the board's ability to function effectively. For example, if the CEO controls the agenda, the board hears, discusses, and votes on the issues of the CEO or management. This may reduce the opportunity to learn about controversial issues, hear both supporting and dissenting positions on major strategic decisions, and fully explore difficult topics. Board meetings should be more than merely a ratification of CEO actions.

When performance evaluation systems or systems for reviewing strategic plans are implemented effectively, they can be powerful drivers of both stakeholder satisfaction and long-term financial performance. For example, systems for reviewing and approving strategic plans and major investments must enable the board to effectively assess the projects under review, evaluate whether proposed projects meet the needs of the various stakeholder groups, and assess the long-term impact of the investments on company success.

Regarding the **customer and other stakeholders** dimension, boards should try to achieve a high level of ethical and legal compliance and accountability. They should also ensure the successful identification and management of the various stakeholders' needs. The company's reporting strategy is a powerful driver of stakeholder satisfaction, so accountable companies should provide transparent reporting to their internal and external stakeholders, understanding their informational needs and concerns related to broad company issues. Disclosures should be in formats and language that are clear and accessible for high-quality communication to the various stakeholders.

Finally, in their scorecard, boards should demonstrate how they are contributing to success in the **financial** dimension. As they frequently approve major organizational changes, capital allocation decisions, financial plans, mergers and acquisitions, and other significant material transactions, boards share responsibility for these decisions with the CEO and other top management. The key drivers of success here may be profitable growth, sound capital allocation decisions, and the profitability of approved projects.

SUPPORTING METRICS

Each performance driver should be associated with specific measures and targets. Targets should reflect both industry best practices and the company's commitment to superior corporate governance.

Table 1 describes the inputs, processes, outputs, and outcomes of board activities. Corporations make important choices regarding board composition (inputs) that have a significant impact on board performance. The board structure and systems (processes) also significantly affect board decisions and performance. The manner in which the board prepares, deliberates, and makes important decisions is affected by the board's composition and affects the board's success at fulfilling its roles and responsibilities, improving its performance (outputs), and, ultimately, improving corporate performance (outcomes). Further, continuous feed provides the basis for improvement for directors, the board, and the corporation. Given their specific challenges and areas of concern, boards should develop a list of metrics that are most appropriate to fit the strategy and objectives of the company and the board.

A specific target—such as 90% of the directors should be independent, 100% of directors should be financially literate, there should be an average 90% attendance at board meetings, four meetings of directors should be held annually without CEO present—should be identified for each metric, and results should be compared against these targets and shared widely among directors and top managers. In a well-governed company, it's in the managers' best interests to have a well-qualified, competent, diligent board providing critical guidance and support. The balanced scorecard will have little impact if results aren't fully discussed. Results should be monitored regularly and used to identify areas of weakness, challenge the plans and systems in place, and establish new initiatives to improve deficiencies.

EVALUATING THE PERFORMANCE OF INDIVIDUAL DIRECTORS

The balanced scorecard can also be used to evaluate the performance of individual board members via metrics that are particularly important for them, such as how well each director contributes to the achievement of the board's strategy for improved performance. It's important to evaluate the performance of the board and the individual board members separately. Though overall board performance may be satisfactory, evaluating the performance of individual members provides an opportunity to determine whether there are board needs that aren't being met and whether certain directors should be replaced.

For example, an analysis of overall attendance at board meetings can be disaggregated into specific results for each director and provide additional information for board actions. When monitored individually, an overall attendance level of 90% may reveal a poor attendance record for only one particular director. These metrics are necessary to ensure that each board member is making a significant contribution to the board and improving corporate performance. They also provide a gap analysis that allows the board to determine what other contributions are necessary to meet overall board requirements.

Other individual metrics might include the number of hours of preparation for meetings, the number of visits to company sites, the quality and quantity of individual contributions in board meetings, and the level of individual skills and capabilities. It's useful for individual board members to have a small set of measures to better assess and highlight their individual contributions. Evaluations should contain full 360-degree performance reviews including self-assessments plus assessments from subordinates, board members, and various outside stakeholders. Self-assessments alone have significant weaknesses, so, unless they are supplemented with other input and metrics, a complete performance evaluation isn't possible.

EMPOWER YOUR BOARD

Improving board performance isn't just about complying with new regulations. The value is in taking the voluntary actions necessary to improve long-term corporate profitability and recognizing the critical role of the board in corporate oversight. Financial professionals provide the crucial information for management decision making as they are involved in providing corporate accountability for internal corporate governance and controls and for external transparency. Since the balanced scorecard is often managed through the office of the CFO, both financial and nonfinancial information typically flows through that office and from financial professionals. This is information that includes the amount of cash flow and rate of returns from projects approved by the board, percentage of projects that are successful, and measures like customer satisfaction and employee retention, which should be leading indicators of future financial performance.

Better information and measurements are necessary to improve organizations' strategic management systems overall. But these haven't been implemented at the board of directors' level. Maybe better information and measurement of board performance would have reduced the number of recent governance scandals. In some of these scandals, the problem was partially that the board didn't have the information to provide the proper strategic oversight or the accountability—this included not receiving the full information to evaluate executive compensation, and, in some cases, the board didn't even approve the compensation. Also, in some cases they didn't have enough information about the transactions or structure of the finance that was being used. And it's common that the audit committee receives financial information so late that they can't possibly review it in enough depth to provide adequate review or guidance.

In addition, boards haven't been evaluated, and the performance of individual board members hasn't been measured, nor have the directors been held accountable for their performance. Implementing a board evaluation system is critical to improving a board's performance as well as the market's perception of better performance.

With the balanced scorecard, companies can empower their boards by providing them information that's necessary for improved and more independent decisions on critical corporate issues. The balanced scorecard can also provide the techniques to more effectively develop and communicate board strategy, articulate key success factors and key performance indicators, and develop the systems that will improve performance. ■

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