



## Board effectiveness

'What is clear to me, both from the report and working with boards, is that the framework for how a board challenges and makes their decisions is rarely agreed and designed; it is often left to chance, individual preferences and quirks, which has the potential for a dysfunctional chaotic approach.'

*Helen Pitcher, Chairman, IDDAS*

## Succession planning

'There are intensely personal relationships behind the decision for chairmen, CEOs or other board directors to join or leave a board. A well-managed succession process will leave directors feeling valued and the organisation feeling confident and well led. Alternatively it has the potential to be the reverse.'

*Alison Gill, Bvalco*

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## News

# Combatting clutter in annual reports

'Clutter undermines the usefulness of annual reports and accounts by obscuring important information and inhibiting a clear understanding of the business and the issues that it faces.' These are the words of Bill Knight, Chairman, Financial Reporting Review Panel and Roger Marshall, Chairman, Accounting Standards Board in the Foreword to a new report from the FRC, *Cutting Clutter*.

In the report, clutter is defined as comprising of two problem areas: immaterial disclosures that inhibit the ability to identify and understand relevant information; and explanatory information that remains unchanged from year to year.

The FRC has developed a behavioural aid that can be used at suitable times during the annual report process to help overcome some of the barriers to cutting clutter. In addition, three disclosure aids – for governance, accounting policies and share-based payments – have been developed to demonstrate what these key areas of the annual report could look like without clutter.

The FRC understands that significant changes to disclosures need to be carefully planned for. They suggest that a project sponsor is identified to lead the annual report process and that at the start of the process the following issues should be discussed with the annual report project team:

- What are the overall objectives for the annual report?
- What is the overall tone of the annual report?
- What are the learning points from the prior year and areas of focus for this year?
- What is the agreed approach to materiality in financial statement disclosures?
- Who will be the single author empowered to take a high-level view of the annual report and edit it based both on the significance of individual disclosures to the report as a whole, and consistency with the overall objectives?
- What plans are in place to 'cut clutter'?
- What plans are there to communicate more effectively, for example, highlighting key information and changes for users?

The chairman should report personally in the governance overview including key challenges and the steps taken to operate effectively including: the balance of the board (skills, experience, diversity, etc); succession planning; board evaluation and director development; engagement with shareholders; and any other significant decisions reached by the board, for example, new remuneration policies or structures.

There should be personal reports in the form of short letters from the non-executive chairman of each of the board committees. The focus of these should be on activities, not policies and clear signposting needs to be given as to where these letters for each individual committee can be found within the report.

Relevant skills and experience of the board should be clearly stated to make it as easy as possible for the reader of the report.

Relevant information should be provided to demonstrate that the board evaluation process was robust and that its recommendations are being acted on.

Rather than repeating the provisions of the Code, separate out longstanding process information and clearly signpost where the information can be found (on a website or in an appendix). Any significant changes to governance processes made during the year and any impact they may have had should be highlighted.

The FRC is interested in receiving good examples of where clutter has been reduced to a minimum or eliminated completely.

### Next steps

The FRC intends to follow through on this initiative in a number of ways:

- Continue to work with those preparing annual reports, standard setters and regulators to push for change in response to the issues that have been identified.
- Work with the Government on its proposals to simplify narrative reporting to make it clearer and more focused.
- Plan to hold a meeting with interested parties later in 2011 so that views can be shared, progress discussed and developing good practice can be showcased. Anyone interested in attending this meeting should contact the FRC on the e-mail address below.
- If there is support for the 'financial reporting lab' proposal set out in the FRC's *Effective Company Stewardship* consultation, the FRC will ensure that cutting clutter is a key agenda item for that group.

See [www.frc.org.uk/about/cuttingclutter.cfm](http://www.frc.org.uk/about/cuttingclutter.cfm) for the full report. The FRC is particularly interested in views on the challenges and ideas presented in 'Cutting Clutter' report and views should be sent to: [clutter@frc.org.uk](mailto:clutter@frc.org.uk) by 30 September 2011.

## International

# Renewed focus on performance

In anticipation of the effect of new rules introduced as part of the 2010 Dodd-Frank financial reforms giving shareholders greater voting power on remuneration structures, US companies have started cutting pay and benefits for top executives.

Pay consultancy ClearBridge has examined the first 100 Fortune 500 companies to file details of proxy statements and there is clear evidence of a shift in pay practices.

The Dodd-Frank Act requires companies to hold non-binding shareholder votes on:

- executive pay packages (say-on-pay) – required for all publicly-traded companies with annual shareholder meetings held after 21 January 2011;
- frequency of future say-on-pay votes (say-on-frequency) – required for all publicly-traded companies with annual shareholder meetings held after 21 January 2011; and
- golden parachute payments in the event of a transaction (say-on-golden parachutes) – effective for proxies filed on or after 25 April 2011.

As say-on-pay vote results filter in it is clear that companies that perform, and successfully demonstrate that their pay packages support and drive performance, are more likely to win shareholders' votes.

In 2010, companies focused on minimising non-performance-based pay and enhancing shareholder alignment:

- Nearly 40 companies, including companies such as AT&T and OfficeMax, eliminated excise tax gross-ups (either from existing or future arrangements).
- Three companies reduced severance multiples for the CEO from three times cash compensation to two times cash compensation.
- Thirty-four out of 79 companies disclosing clawback provisions for their named executive officers adopted or enhanced these provisions recently.
- A growing number of companies are increasing their CEO stock ownership guidelines beyond five times: in 2010, a total of 24 companies had guidelines greater than five times.

The first 100 companies focused their disclosure on pay-for-performance. Many companies took a 'layered' approach and, early in their disclosure, highlighted key features and the alignment between pay and performance, using graphical representations; a few companies, including General Electric, included a summary of the compensation package and why shareholders should vote for it.

Several companies, including Kimberly Clark and Lockheed Martin, added a comparison of Total Shareholder Return (TSR) vs CEO pay.

Some companies re-introduced the proxy performance graph, comparing the company's TSR to TSR of an index and peers over a multi-year period.

Some companies, including Eli Lilly, provided graphical analysis of pay-and-performance based on measures such as revenue and earnings per share growth.

### Vote results

Eighty-nine per cent of shareholders, on average, voted in support of executive pay packages (compared with the broader market average of 93 per cent).

Companies with stronger TSR on a one- and three-year basis were more likely to get 'for' votes from shareholders on their executive compensation packages.

Two companies in the first 100 (Jacobs Engineering and Hewlett Packard) and three non-Fortune 500 companies (Ameron International, Shuffle Master and Beazer Homes) did not receive majority shareholder support of their executive compensation package. Another company stated that shareholders voted in favour of say-on-pay; however, based on the company's voting guidelines, abstentions count as 'Against' votes, in which case the company would not have received majority support.

Some companies, such as Disney and Hewlett Packard, have proactively engaged with shareholders, filing supplemental materials following recommendations from proxy advisory firms, such as ISS and Glass Lewis: one of the key issues for Disney was its excise tax gross-ups, which Disney chose to eliminate after engaging with key shareholders; the primary issue for Hewlett Packard was on the new CEO's employment arrangements, but they chose to focus on criticism of their director election process, possibly a more pressing issue given that they have a majority vote standard for director elections. Disney was successful in obtaining shareholder support for the executive compensation programme, while Hewlett Packard was not.

Although supplemental filings did not work in every case, the success for some companies provides evidence that pay-for-performance disclosure can influence the shareholder vote.

Whilst a significant number of companies who filed early recommended biennial or triennial votes, shareholders' show a clear preference for annual say-on-pay (26 out of 30 companies). This has also influenced the later filers among the first 100 to recommended annual votes.

### Conclusion

For the first 100 Fortune 500 companies, it is ultimately about renewed focus on performance and aligning pay with performance, which not only translates to shareholder approval but also supports the creation of sustainable, long-term shareholder value.

To see the full report go to [www.clearbridgecomp.com/our-point-of-view/clear-thinking](http://www.clearbridgecomp.com/our-point-of-view/clear-thinking)

# Global News

## Malaysian Corporate Governance Blueprint 2011

The Malaysian Securities Commission has published its *Corporate Governance Blueprint 2011* which sets out the Commission's proposals for improving the governance framework over the next five years and makes clear that regulation alone is not enough.

The Blueprint covers the following:

- Shareholder Rights – advocating the empowerment of shareholders through a fair, efficient and transparent voting process.
- Role of Institutional Investors – setting out proposals for a new code and encouraging institutional investors to take a leadership role in governance by exercising responsible ownership.
- The Board's Role in Governance – recommending that boards adopt a charter setting out, amongst other things: the board's functions and responsibilities as well as the key values, principles and ethos of the company; information about the company's governance arrangements, including the committees formed and the division of powers between the board, committees, chairman and CEO.
- Disclosure and Transparency – emphasising the enhancement of disclosure standards and practices to

promote informed decision-making by shareholders; setting out five pillars of disclosure and transparency; and making recommendations about the content of the Commission's Code.

- Role of Gatekeepers and Influencers – giving recognition to their critical role in encouraging self and market discipline; making wide-ranging recommendations, including greater clarity regarding the role of company secretaries; and widening the obligations regarding mandatory whistle-blowing.
- Public and Private Enforcement – reinforcing the critical and complementary roles of public and private enforcement in maintaining market confidence.

There are a total of 35 recommendations and the section on Implementation puts forward the means through which the recommendations will be implemented over a five-year period, through a new Corporate Governance Code and changes to the Listing Requirements to be effected in early 2012. An assessment of progress will be undertaken in 2013 and a full post implementation review will be carried out at the end of the five-year period.

*For further information go to [www.sc.com.my](http://www.sc.com.my)*

## New Corporate Governance Guidance for Unlisted Companies in the Baltics

The Baltic Institute of Corporate Governance (BICG) has launched the first ever Corporate Governance Guidance and Principles for Unlisted Companies in the Baltics. The Guidance is based on the Corporate Governance Guidance and Principles for Unlisted Companies in Europe prepared by the European Confederation of Directors' Associations (ecoDa).

The specific corporate governance needs of unlisted companies have, to date, been relatively neglected by governance experts as well as by policy-makers. In particular, the Lithuanian, Latvian and Estonian Corporate Governance Codes are primarily aimed at listed rather than unlisted enterprises. 'This sector comprises up 70% of our economy and improving corporate governance in this area will have a positive impact on the economy and growth in employment', said Kristian Kaas Mortensen, President of the BICG.

Fourteen principles of good governance are presented on the basis of a dynamic phased approach which takes into account the specific nature of a company in terms of size, complexity and level of maturity of individual enterprises and the degree of openness. The principles provide a governance roadmap

for family owners or founder-entrepreneurs as they plan the development of their companies over the corporate life cycle and may also be relevant for subsidiary companies and joint ventures.

After a statement of each of the principles, a number of key points are listed, the application of which underpins the implementation of each governance principle. This is followed by a discussion of the practical issues that are likely to be of interest to unlisted companies of differing sizes and levels of complexity in addressing each of the BICG principles.

The objective of the BICG principles is to provide insight for unlisted companies in the design of a governance framework; they are not intended to be a straitjacket. Unlisted companies are encouraged to exercise common sense in their implementation and ensure that their response is both proportionate and tailored to the specific needs of their organisation.

*To see the full Guidance and Principles go to [www.corporategovernance.lt](http://www.corporategovernance.lt)*

## Feature

# Integrated Reporting

**David Matthews** examines the needs of investors and other stakeholders and considers the potential benefits for companies of starting to rethink their reporting model and move towards Integrated Reporting (IR).

Even before the financial crisis, it was clear that all was not well with corporate reporting: no one involved – be it preparers, regulators, investors or wider stakeholders – seemed wholly satisfied with the current approach. The model, which focuses on the evaluation of historical financial performance rather than providing insights into business strategies and performance prospects, did not identify the shortcomings that existed and led to the financial crisis. The overall framework has been static for many years, with ‘change’ represented by bolt on requirements resulting in a patchwork of disparate reports. In this respect, the existing framework has failed to keep pace with technological developments, increasing demands for information on environmental and social aspects, and market needs to facilitate effective decision-making.

In an ideal world investors need to be able to make a meaningful and holistic assessment of a business’ strategy and ability to create and sustain value over the short, medium and longer term.

In the UK, the future of narrative reporting is being examined by government and regulators, and similar initiatives are underway in other countries to examine how corporate reporting could be improved. One particular initiative, notable because of its ambition and international representation, is the work of the International Integrated Reporting Committee (IIRC) to develop an internationally accepted IR Framework to combine both financial and non-financial information in a meaningful and holistic way.

### Needs of investors and other stakeholders

In an ideal world investors need to be able to make a meaningful and holistic assessment of a business’ strategy and ability to create and sustain value over the short, medium and longer term. And, given the ever increasing understanding and scrutiny by investors and other stakeholders of the environmental, social and ethical aspects of business, the connections between an organisation’s strategy, financial performance and its approach to these matters needs to be

clearly articulated. Clearly, today’s corporate reporting fails to meet these needs, tending to consist of complex and lengthy annual reports which try to satisfy both financial reporting requirements and the increasing regulatory and user demands for broader non-financial information. These are supplemented by additional reporting such as analysts’ presentations and sustainability reports, all of which absorb valuable management time and investment. Integrated Reporting seeks to address these issues by presenting more comprehensive and comprehensible information about an organisation’s total performance, prospective as well as retrospective, to meet the needs of the emerging, more sustainable, global economic model.

### Work of the IIRC

The IIRC is significant because it has the potential to carry influence, bringing together an international cross-section of representatives from the corporate, accounting, securities, regulatory, and standard-setting sectors, including the chairmen of each of the Big 4 accounting firms. The aim of the IIRC is to publish a draft IR Framework early in Q3 of 2011 for consultation and to have a final version available in 2013. This framework will bring together financial, environmental, social and governance information in a clear, concise, consistent and comparable format. The mandate of the IIRC evolves from a sustainability agenda, but its aims and articulation clearly go beyond environmental and social issues.

### Benefits of IR

Given the current challenges of meeting complex regulatory requirements for reporting and the inertia in changing the status quo, there needs to be clear commercial benefits for IR before companies will respond and change their approach to reporting.

From my perspective, there are a number of potential benefits to moving towards IR for both stakeholders and companies. Stakeholders, and in particular investors, would benefit from clearer reporting about the issues they are interested in, that meets their needs to understand the business as a whole and its potential to create value. Increased transparency and clearer reporting should also help to build trust with stakeholders. Analysing what information is important to different stakeholders, and what is material to the business, should lead to better stakeholder engagement.

At the same time companies will benefit from a clearer view of the issues which will influence value creation (or destruction) in the longer term, through the process of having to analyse and explain the issues that affect the company in a more integrated way. In particular, it could improve their ability to understand and act on external market drivers (competitive, economic, technological, environmental and social) key to managing business risks and opportunities and driving value. Considering the linkages and interrelations between different aspects of the business will equally improve risk management, and reviewing both the financial and non-financial information needed to present a holistic view of company performance, should also lead to better and more relevant information being made available for management for decision-making. All of these have the potential to improve business performance and hence value.

A welcome feature of IR should be a shorter and more focused report which would satisfy many stakeholders. In the short term, particularly given regulatory constraints, it is unlikely that this will replace existing reports. Consequently the integrated report will likely be supplemented, where needed, by other forms of reporting such as an on-line sustainability report where required to meet specific stakeholder needs. Admittedly this will be challenging, and will undoubtedly require bringing together initiatives such as IR and the UK's FRC's 'Cutting Clutter' initiative, but shorter more focused reports will be welcomed by both preparers and users alike.

### The future?

Corporate reporting has evolved to its current position over a long period of time and there are a number of not inconsiderable barriers to future change. These range from the need to comply with complex and differing local and global regulatory reporting requirements, difficulty in analysing and presenting non-financial information from disparate information sources across the business, to the difficulty in dedicating management effort and resources to consider change.

Companies now have a unique opportunity to shape the future through the forthcoming IR consultation. Those that believe that corporate reporting can be improved – for example whether it be through reducing length/complexity, increasing transparency or providing a more complete picture of corporate performance – should not miss this opportunity to influence the debate.

Company boards should take a fresh look at the company's corporate reporting and ask whether it truly provides a holistic view of their business strategy, value drivers, key performance indicators, risks and performance prospects.

The challenges of producing an Integrated Report should not be underestimated, but equally this should not act as a deterrent to progress. Moving from the status quo to IR does not have to be a single step, and small initiatives – such as simplifying and reducing current reporting, and bringing together information which currently sits in different reports – are useful first steps.

And so, companies that want to prepare for future initiatives need to be on the front foot. Company boards should take a fresh look at the company's corporate reporting and ask whether it truly provides a holistic view of their business strategy, value drivers, key performance indicators, risks and performance prospects. Does it meet stakeholder needs to understand the relationship of the business with the social and environmental context in which it operates? Is it focused on the issues material to key stakeholders, especially investors? And is the market value of the company what you think it should be? Given the likely effort and management time currently going into corporate reporting, it's worth considering the potential benefits from moving towards a more integrated approach. Are you ready to start the journey ....

*David Matthews, represents KPMG on the IIRC's Working Group. This article first appeared in the Audit Committee Institute publication Quarterly 33. The IIRC is expecting to release a Discussion Paper on Integrated Reporting early in Q3 of 2011, and the consultation will remain open for 90 days. At the same time, the IIRC is looking for companies to participate in its pilot programme over the period 2011–2013. If you would like to understand more about the work of the IIRC and the pilot programme, Integrated Reporting in general, please contact: David Matthews at david.matthews@kpmg.co.uk*

## Feature

# Board effectiveness

## Helen Pitcher looks at the taxonomy of challenge and asks how can non-executive directors get it right?

Challenge is the word of the moment, in the wake of the banking crisis, both the Walker Review and the Financial Services Authority emphasised the importance of challenging boardroom debate. Without it, they said, non-executives are not doing their job. When the FSA examines boardroom minutes or attends a bank's board meeting, robust challenge is one of the things it explicitly looks for.

So what does this look like in practice? Is it the scouring of the board minutes by the FSA looking for the word 'challenge' from NEDs, or a process of 'friendly advisers to the executive, who act to check and test their thinking'?

The recent *IDDAS Report on the NEDs Perspective*, as part of the Board Dynamics Series, provided a fascinating perspective of the issue of challenge and the NED. As the quotes below, taken from the report, show.

The role of 'challenge' for the NED is clear, even if it is interpreted in many different ways.

This ranges from the view of conflict as being inherent in the process: 'Challenge is critically important. In fact, one of the most important things an NED can do is to provide challenge and critique of the executive management's activities. You have to understand that it will be inherently confrontational, but this can be handled by people working professionally. You must not be fobbed off: if something appears wrong, then it probably is.'

To the strident: 'It is not acceptable to sit on a board when you don't understand the risks being faced by the company.'

To the downright sceptical: 'In reality, NEDs do not get into real strategic discussions early enough to really impact the strategy. We pitch up for a set piece, and the executive members are not soliciting real input.'

To the roundly sophisticated: 'You could see challenge as part of a mentoring, coaching or detached advisory process. This has a richer, more nuanced feel than challenge. There is something confrontational in challenge; it may be part of what you are doing, but only a small part.'

In the report, the context of the challenge framework was seen as particularly important, together with a real understanding of the business pressures and added value expertise that an NED can bring. The participants in the report raised an interesting question for the board and the regulators, with their counter intuitive view, that the 'Board Meeting, was not the place for effective challenge' and this was most effectively done outside the boardroom context. Also, that if there was a lot of conflict based challenge at the board, this was

a failure of the process. Clearly, this has implications for the broader role of the NED outside the boardroom, and presents an interesting 'test' for the regulators to seek out this effective challenge:

'The worst thing is to rely on doing the challenging at the board meetings. You have to invest time with the chairman, NEDs and EDs before the meeting. You raise issues, clarify perspectives in advance.'

'The board is more effective if the executives have an answer – not when they haven't. It is not a matter of trying to catch them out.'

'Ultimately, the board does one thing: choose or fire the CEO. Any board which does more than this is in danger of crossing the line between executive and non-executive. You are trying to do everything for the good of the company, and the challenge is intelligent questioning, rather than overt challenge. If an executive comes to the board and gets his proposal rejected, then it is almost a vote of no confidence.'

However, there is also the clear view that NEDs need to be vigilant to keep the 'company' on track:

'There is a danger if you don't understand, and don't challenge, of a box-ticking corporate governance route, instead of a fact-based assessment.'

'It is trying to see if they have thought it through rather than adopting a fashionable view.'

What is clear to me, both from the report and working with boards, is that the framework for how a board challenges and makes their decisions is rarely agreed and designed; it is often left to chance, individual preferences and quirks, which has the potential for a dysfunctional chaotic approach. This is fairly benign when the going is easy, but can descend into chaos where faced with a problem or pressure, just at the very time you need a well-structured and well-developed decision-making process.

As also we found from the report, even the way you approach a challenge, and the language you use needs to be carefully developed.

### The business context is important

'It takes time to learn what is seen as a challenge in an industry that is new to you, because you want to ask about KPIs, and issues and details. One chairman pointed out that this can be seen as threatening. So questions for knowledge can be seen as aggressive.'

'We have one-to-one meetings between individual NEDs and the CEO. That's where you can be at your most challenging in a relatively safe environment.'

**Timing and finesse is everything**

'The art is in knowing the right questions to ask. As an executive, you are aware of the two or three questions you would prefer not to be asked – good NEDs ask them.'

**Trust and the right to challenge should be carefully deployed**

'Unless you have the understanding and the trust, your challenge will be destructive rather than positive.'

'You do have to earn the right to challenge. I have watched some NEDs being downright unpleasant; this is not the role, and there is no need for this behaviour. You are a critical friend.'

'It is important to challenge in a supportive way (which is a challenge in itself), not always criticising, not being a pain.'

**Added value and earning the respect is needed**

'I tend to stick to what I know. I will challenge big time if I am uncomfortable in the areas I know – if I challenge on health and safety, or operations, everyone listens.'

'You must be clear on the focus, you mustn't get on your hobbyhorse. Above all, you must be respected.'

**The language you use is also important**

'You contribute to the discussions, but it is about style. You do not usurp the executive ground. When you speak, you flavour your comments with such expressions as: "I wonder ...".'

'It is all about the way you phrase the question. You don't say: "In my experience ...", or "Where I worked before ...". You ask: "Have you considered ...?" or "What do you think about ...?"'

**And above all it should be artful**

'You need to pick a few issues and be consistent. It is not helpful to nit-pick.'

'I had a situation on one board where, as chairman of the RemCo, I looked at the CEO's objectives and thought they were rubbish. So I spoke to the chairman who agreed to talk with him, and I suggested to the CEO that he might want to talk through his ideas with the chairman. When the item came up at the board, the CEO was able to say that he had decided he would like the opportunity of discussing it with the chairman before making a recommendation. This was a constructive intervention, with much more effect.'

This area of challenge and decision-making much exercised the participants and is also an area that the FRC considered important in their recently issued *Guidance on Board Effectiveness*. The concept of group-think where a board quietly and passively slips into a haze of acceptance and routine, is a dangerous, but unfortunately all too common scenario.

Unearthing the outcomes of these unseen and often unrealised forces can be dramatic; some of the described downsides of group-think in the context of a board are:

- Lack of rigorous analysis of ideas and strategy
- Making uninformed decisions
- Not hearing or acknowledging contrary views
- Limited group discussion
- Assumption of agreement
- Failure to re-visit and review the reality of a situation
- Selection of individuals who conform to the 'group'
- An internal focus.

While boards need not to be a unreconstructed war zone of challenge, conflict and venal cynicism, the dangers of a too cosy and complacent boardroom have been well documented.

'You are there to safeguard the company assets, not to agree with everything they are doing – ensuring what they are proposing is consistent with the strategy.'

It is my view, that only through a recognition of the behavioural nature of the board, and the discussion and agreement on the context for challenge and decision-making, that we will create open and effective boards, and in turn meet the criteria of high performing teams, where there is a common vision, values and strategy; with constructive, creative, challenge and debate, which surely is a prime function and description of an effective board?

*Helen Pitcher is Chairman of IDDAS and a main board director of the Savile Group plc. Her career spans 30 years in both the business world and the consulting sector. She held a variety of senior roles in blue chip companies. In her subsequent consulting career, she became CEO of CEDAR, which she built into one of the best-regarded consultancies in the human capital world. Helen is recognised as a leading organisational performance coach and mentor, who works at the most senior level in FTSE 100 and international companies and in the public sector. She has a worldwide network of alumni whom she has coached over the years. Helen is a panel member of the Employment Appeal Tribunal, a member of the Selection Panel for Queen's Counsel and Chairman of its Ethics and Integrity sub-committee, Chairman of KidsOut, and a trustee and fundraiser for several other charities. She was recently appointed to a Special Appeals Panel for returning Armed Forces veterans.*

[www.iddas.com](http://www.iddas.com)

## Feature

# Succession planning

**Bvalco** runs a regular series of debates for chairmen, board directors and company secretaries. This article is an extract from a recent debate concentrating on succession planning.

All firms must eventually experience the potential disruption of replacing the CEO, chairman and other board directors. The extent to which the succession process disrupts firm performance and share price both in the short and medium terms seems, to a great degree, to depend on how well planned and executed the process is. The statistics of smoothly run succession processes indicate that there is room for improvement. A recent study of 2,500 publically listed firms found that 89 per cent required an interim CEO for a period of more than 45 days, with interim CEOs described as being 'a last resort'.

We started our discussion considering, why is succession so difficult to do well? Succession planning implies letting go: of people, past strategy and practices. The ending can be planned, for example the end of an agreed tenure, or unplanned such as sudden illness or death. But more typically, succession happens when an ending creeps up. The awareness of the need for a change in strategic direction starts to dawn, the performance of the business becomes troubling, or there is a gradual change in personal circumstance of a board director which necessitates a change. Whichever way you look at it, succession (planned or unplanned), is a highly emotive topic which no one approaches neutrally. Considering succession raises a number of questions such as, 'am I replaceable? If I need to be replaced does that mean I am now not good enough?' As a result the natural human tendency is to avoid tabling the discussion. Even if discussion is tabled, there is often avoidance of driving the thinking through from options to firm conclusions. This dynamic of letting go is one which needs to be actively managed and worked through. Without proactive management decision taking may be delayed and may detract from the business of the board.

### Is succession a transaction or a continuous process?

The UK Corporate Governance Code presents board appointments alongside questions of director commitment and development, highlighting that these are connected issues. The question arose, to what extent are the terms and language that boards use to consider succession potentially misleading and misaligned with these goals?

The term 'Nomination Committee' is potentially misleading; nomination implies a transaction whereas in reality effective succession requires a balance between the need for continuity and the need for change and improvement. The implication is that to be truly effective, succession requires that boards think about changing a person, the skills or roles before a change

is required. A continuous, forward-thinking process is more effective than a responsive one. Succession planning done well, is most effective when it is a cyclical process, in which boards are engaged in a continuous process of succession. A 'talent mindset' is required for this to be effective. The phrase 'talent mindset', coined by McKinsey & Co (1997) is more typically associated with ensuring proactive development and management of young stars. Whilst youth might not be naturally associated with succession planning for boards, the philosophy that every board member is responsible for developing, renewing and proactively sourcing people based on capability, motivation and the strategic needs of the business holds true. Likewise, the view that having the right people, with the right knowledge and behaviour on the board can be as much a value driver for the board as other types of talent are in other layers of the organisation. Of course, the board cannot look solely for talent inside an organisation but must seek the right balance between those who know the organisation inside out and those who can bring fresh perspectives and independent challenges. Included within an effective succession process therefore will be a view of developable skills, not just possible replacement people.

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### When might succession planning be inadvertently triggered?

It was discussed that a strategic change of direction necessitates a review of skills on the board, although accessing the real thoughts that people hold at this time can be difficult. Reviewing whether the board needs to change because of a shift in strategy is difficult for board directors to face – in a sense turkeys voting for Christmas. It is likely that every board member will hold a view of what skills are absent from and needed by the board, but accessing those views can be difficult. People are naturally reticent to propose that their own skills or those of their colleagues might not be needed. External facilitation can be a useful tool to surface the views that directors hold, but cannot easily be expressed in open

forum. It is not so much that directors don't want to express their views, but that finding the space to articulate them free of concerns can be difficult. One-to-one discussion with a skilled facilitator enables individuals to surface and process thinking without the pressure of having to formulate a complete solution.

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As well as external triggers such as a change in strategy, the more difficult to deal with are internal triggers. In the situation where the dynamic of a board appears not to be working sufficiently well, a discussion of succession might be triggered. Locating inefficiencies in the board in terms of insufficient skills or lack of knowledge in one or more individuals is tangible and straightforward. Earlier address of what is not right with current board dynamics might be more effective than simply replacing people as a result of a crisis. Looking for new people often feels like an easier solution but looking at what is not right can often be a more sustainable solution. Locating problems in individuals is often seen as easier to deal with even when it is obvious that the problems might not lie in the individual but with the dynamic of the group. Changing one individual may shift the focus in the short term toward new relationships and give a sense of invigoration but may not necessarily solve the underlying issue.

#### **In what way might an orderly process become an overly cosy one?**

The chairman's role in maintaining an orderly process was stressed. There are intensely personal relationships behind the decision for chairmen, CEOs or other board directors to join or leave a board. A well-managed succession process will leave directors feeling valued and the organisation feeling confident and well led. Alternatively it has the potential to be the reverse. The role of the chairman is crucial in consulting with and keeping shareholders, executive and non-executive directors informed and involved. The better this is managed, the more likely the process will be perceived as an orderly one. Too orderly, however, might equal a cosy process and signify a conformist culture; a problem which has plagued boards over time and one to which 'outside elbows' is often required to wake up and disrupt the tendency to stick together.

Self-selection breeds a tendency toward group-think and closes the group to influential factors outside of themselves. In the succession process there may be hostility toward the concept of new skills at the risk of compromising renewal, regeneration and innovation. In this situation an apparently smooth process might not lead to a good outcome. Succession planning can become about massaging egos or gifting what has been earned rather than what is needed. A good process is not the same as a good outcome.

The topic of cosiness and self-perpetuation is one at the forefront of a history of financial crises. 'Crony Capitalism', was the description applied to the way in which Japan and Korea suffered in the 1980s and 1990s and is a term easily applicable to the most recent issues in the UK and Ireland. Boards chosen for their connections and the ability to smooth their way through business might be perceived to be an asset. However, we only need consider cases like the Guinness share-trading fraud in which executives with brilliant strategies and ideas ended up in prison whilst the 'cosy board', who schmoozed but failed to act, went unpunished.

The UK's Corporate Governance Code and the FSA have proposed and are serious about the value of external review as a mechanism to bring attention to the issue of self-perpetuation. Boards may not yet be serious about external review but the FSA and the FRC are, because the problem in self-assessment, is the self. With evidence that an outside lens is vital in breaking up cosiness, board members are wise to look for congeniality where appearance over substance matter.

#### **Choosing the 'right' board members**

The question of the complexities of selecting the right person was tabled. Even though NEDs are appointed by the board on the recommendation of the Nominations Committee, and subject to approval of the shareholders at the AGM, is that sufficient to free the NED from the power and influence of the chairman to be his own person? When replacing NEDs, the reasons for asking for a resignation may be about the balance of diversity on the board, or that certain knowledge or skill gaps need addressing. However, there will also be intensely personal and relational reasons behind the decision. This highlights the need for transparency and honesty in the process. The selection and assessment of board directors is a topic that has received much attention, particularly since the recent financial crisis. Those in Significant Influence Functions (not just board members) are subject to review by the FSA, but one has to ask, what are they looking for and are they going about it in the right way? Research indicates that the most valid practices for assessment for competence and truly understanding a person's strengths and weaknesses, involve multiple methods, multiple raters and multiple measures



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of a person over time. There are substantial differences in sophistication of how corporate businesses and partnerships measure individual capability and how effectively they do or don't relate those measures to development or performance.

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*This is an extract from a meeting of the Bvalco 'Food and Thought Forum'. To read the whole article as well as others in the series please go to <http://www.bvalco.com/white-papers.htm>. Alison Gill is a member of the Bvalco team and is a board behaviour and dynamics consultant. She co-authored Annex 4 of The Walker Report: 'Psychological and Behavioural Elements in Board Performance' and the FT Non-Executive Director Qualification Module on boardroom behaviour and dynamics. Alison has consulted for chairmen, non-executive and executive directors across public and private sectors for more than 15 years. She facilitates creativity and delivers insight to help boards strengthen relationships, enhance decision-making and improve productivity. She can be contacted on [alison.gill@bvalco.com](mailto:alison.gill@bvalco.com)*

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