

Excellence Not Mediocrity Needed in Governance

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Introduction

New Zealand's governance model is weak and damaging for the economy and community. It accepts mediocrity and mediocre results instead of requiring excellence. It accepts directorships as a right, a hobby, a lifestyle choice or the product of patronage, rather than as a highly skilled and demanding profession.

There is little informed debate on improvement and compelling lessons (Solid Energy, Fonterra, non-bank finance companies, etc., etc.) are largely ignored.

The Institute of Directors (IOD) adoption of the Chartered Director concept may be useful to the broad base of its aspiring membership, but it doesn't address the critical issues affecting board and director performance.

The position in Australia is broadly similar, for similar reasons.

Major changes are needed, particularly given the shrinking supply of potential directors with the requisite capability and experience. Professor Peter Swan's recent Australian study is valuable as a "big picture" measure of current governance failings. This paper focuses on crucial weaknesses in the current governance model.

The Swan Study

A recent Australian study by Professor Peter Swan (Professor of Finance, University of NSW, The Australian, 28 August, 2013) shows that company performance declined significantly as independent directors replaced non independent directors, following the ASX's rule change in 2003 encouraging ("if not why not") a majority of independent directors (without links to management or major shareholders) on boards. His study of 969 companies between 2003 and 2011 included 561 that changed their board composition after the 2003 ASX guidance. The share of independent directors on Top 200 company boards increased from 10% to 60% in this period.

The 561 companies lost an estimated \$70billion in value in the period compared with those that didn't change, based on both accounting and market based performance measures. "The relative ignorance of independent directors, combined with their lack of incentive to monitor has been a fatal combination for performance" said Swan. "If you owe your position to the CEO would you be hard on him"?

The Critical Issues with the Governance Model

Most organisations are hierarchical. The more senior roles do more difficult/complex work than less senior roles. Consequently people in more senior roles must have a higher level of capability, including cognitive capability, relevant experience and wisdom, to succeed. “More complex” typically means making decisions with less “hard” data and more uncertainty and risk; and which relate to longer time periods. For example, should we invest in a new technology, country or plant when the payback period is at least 10 years; or invest \$10million to invent a new technology; or adopt a particular strategy with a 20 year horizon. Less complex work might be: meet this week’s target; or build this warehouse by 30 June this year, following this plan and budget.

Typically the CEO is the highest level of management - the highest “executive” level in the organisation with, typically, another 4 lower levels down to “the factory floor”, each with a correspondingly lower level of work complexity.

Critically, in organisational terms, directors work at a level above the CEO and two levels above his/her direct reports; and the board chair is 2 levels above the CEO. That is the reality, in terms of the work of the role, and it means very tough criteria for director and chair capability and selection.

Focussing on the accountability and actual work of the board reinforces the critical importance of this hierarchical perspective. The board has the accountability and authority to govern the business. It may delegate parts to the CEO role, who may further delegate some to lower level roles but the board remains ultimately accountable. It must lead on performance and adding value, typically helps to develop and then approves the strategy and makes the other major decisions in the business, including what to delegate.

Considering how a board makes its decisions is also insightful. With major issues the CEO presents their analysis and recommendations to the board, typically incorporating the work of their executive team, other executives, experts/outside consultants, and so on; and the Board finally decides. In this process the directors must thoroughly test and challenge the CEO’s presented views and recommendations, if necessary ask for more information and then make a good decision. The presentations and board discussions should include the CEO and other senior executives and experts - and all should engage a free and frank debate.

There is a further, equally challenging, high level dimension to a director’s work. The board defines the CEO’s role, recruits and appoints the CEO, sets their work priorities, evaluates their performance and holds them to account, sets their rewards, assesses their personal development needs and may remove them from role for poor performance.

How can the board and its director members do this high level, complex work credibly and effectively if they lack the capability to deal with this genuinely high level of complexity- at a level that is above the CEOs! And, that is the essence of a director's role, working at a level above the CEO.

It's not about just about IQ, it's about the ability, including experience and judgement, to deal effectively and astutely with high level complexity, typically in front of their peers and management, and to make good decisions in the best interests of the organisation. A director does not have to be competent in all aspects of the role but must be in some that are important for the business and, overall, add value to the team.

Unfortunately, many less competent directors are appointed, including in the State Sector, without regard to this fundamental requirement, people who are not capable of doing the complex, high level work. The serious risk with less than competent directors is that the full complexity of the decision is not adequately dealt with; they simplify their assessment to within parameters that they are personally comfortable with and able to deal with, so they are not addressing the real question but a simplified version of it - which is not the same thing!

This is a recipe for mediocrity - or outright failure - and it undermines the credibility of directors, boards and the governance model. The examples of this weakness are numerous!

The Capability Problem

Given the "work of the role" of a director it is a real challenge to find genuinely capable directors, to build an excellent team. Many aspiring directors will not develop the capability to become effective directors. They will not have the opportunity to develop the requisite experience and judgement. "Continuing Professional Development" cannot fill the gap! Learning on the job is only viable where there is already a good foundation of "requisite capability", which is increasingly difficult to find.

An important ingredient is often experience as a chief executive/senior executive in good organisations, which operate in challenging environments, have good systems and processes and work hard on culture, people development, risk and continuous improvement. Public Sector organisations are less likely to provide the quality of relevant experience, but there are also weaknesses in the private Sector, particularly with the retreat of multi-nationals.

There will also be people with valuable specialist knowledge or capability, who are capable of working well in a good team. However, particular care must be taken with “professionals”, accountants, lawyers and the like. Their profile and seniority in their profession may give them more credibility that is justified in governance, because of the narrowness of their expertise and experience - though there are excellent exceptions. And, “a safe pair of hands” is code for “they are not up to it”.

A good board must be a good team, comprising directors with the requisite mix and level of competencies, experience and cognitive capability. It will understand that compliance is important but not enough and that adding value, particularly through continuous improvement, and astute risk assessment, mitigation and appetite design are vital. It will continually learn and improve.

Appointing a director to a board is like a jigsaw puzzle. An excellent appointee for one board may not be the best for another board. Labelling someone as a “good” director is an abstract generalisation. The critical question is will they be a good director for this board at this time, which rather undermines the value of the “chartered director” appellation.

Diversity, widely defined is important, but not at the expense of excellence.

Another weakness: in spite of poor performance few directors are removed from role/ not re-elected. Many boards lack an effective process to remove poor performers. From the outside boards are often opaque and directors difficult to evaluate, but shareholders elect directors, and high profile, well regarded directors can be part of the problem. Honest and frank conversations amongst directors are an important part of the process, but all too rare.

Conclusions

- The role of a director is typically considered only superficially when making appointments. The critical hierarchical context of organisations is not understood and largely ignored.
- This leads to poor director appointments, people lacking the requisite cognitive and other capabilities; and poorly performing boards - delivering mediocrity, not excellence.
- Reflecting this, the current governance model is weak and needs fundamental reform. The shrinking pool of genuinely capable directors adds urgency.
- Capability is the critical criterion for director appointments. This may mean smaller boards, 5 not 7 or 9, only 2 or 3 non executive directors and more executive directors.
- Director/board performance must be more effectively assessed and poor performers removed, promptly.

A Better Approach to Governance

I don't envisage a uniquely better new model, but some important changes are needed, particularly for listed companies:

- Greater emphasis on forming the best board team. The objective should be excellence. A majority of NEDs is preferable but Executive Directors (EDs) should be selected if they are clearly better, even a majority of EDs.
- The basis for director selection should be clearly stated.
- The chair should be a NED
- More explicit annual reporting on the capability and performance of the board, as a team, including the chair, and the performance management processes undertaken with the board. This should be a board report, signed by all directors.
- Similar information should support the election /re-election of any director. There should be an anonymous poll amongst directors, results disclosed, showing how many support or oppose an appointment.
- Stock exchanges must be much more effective in setting higher governance standards.
- The IOD needs take a more effective leadership role in lifting governance standards, focussing beyond the lucrative but less productive market of aspiring directors.

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