Photo by Tom Cwiok

Richard Lewis, partner in the Eversheds Corporate Practice Group, came from London to present *Eversheds Board Report: The Effective Board* in Warsaw

The trickle-down effect

How do corporate boards create shareholder value?

In June, law firm Wierzbowski Eversheds and the Polish Institute of Directors, a foundation that promotes excellence in corporate governance, co-hosted a presentation of the *Eversheds Board Report: The Effective Board*—a global study by the international law firm which uses a statistical analysis to trace the connections between a number of factors related to board composition, such as the number of board members, age, tenure and compensation, and the performance of the company's shares. The report was based on an analysis of over 500 public companies worldwide that are top performers in terms of their share price.

While the statistical part of the report illustrates the dominant trends in board composition between 2007, when the research for the first edition was done, and 2011–2012, when the second edition was compiled, the report includes a strong qualitative component, which was put together based on interviews with 85 board members who shared their views on the challenges that board members of top public companies face today.

The reason a law firm would undertake such a complex, multifaceted study was explained by Krzysztof Wierzbowski, managing partner of Wierzbowski Eversheds in Warsaw, who said, "Intuitively, we always thought there is a correlation between the composition of the board of directors and the company's market performance, so the firm decided to go beyond the intuitive approach and did an intensive study."

Richard Lewis, a partner in the Eversheds Corporate Practice Group, who came from London to present the report in Warsaw, described the report's background. He said that many different measures may be used to try to correlate things like board composition with the company's performance. "We used share-price performance because it was relatively easy for us to make those kinds of judgment to undertake a quantitative analysis in order to understand what the effect is," Lewis explained. "It proved successful in the sense of coming up with a number of correlations between various different factors that correlate well or less well with particular factors related to board composition and board conduct."

Lewis noted that in countries such as Poland where companies have a two-tier board structure, the research was conducted in relation to the top level, the supervisory board.

Board size

One of the strongest trends in board composition captured by the report is that the best-performing public companies downsized their boards to an average of 17 members in 2012, an 8% drop since 2007. The trend was especially strong in 2009–2012. "A smaller board is a large cost-saving measure when you are talking about board members' remuneration," Lewis noted. "But it is also about having a manageable board size. We looked to see if there is a consistent relation between a smaller board and share-price performance. In our interviews, the feeling was that there is a correlation, and that a board of 11–12 is the ideal size. So if a company is to be managed effectively, a relatively small board is what suits it best."

Lewis noted, however, that shrinkage itself does not correlate directly with improved price performance: "It is about corporate governance, operational issues, and, at the same time, fostering a good, healthy debate on the board level in terms of the direction of the company."

Age

There is also statistical evidence linking share-price performance with the age of the board members. "Better-performing companies tended to have slightly younger directors on their boards," Lewis said. "The average age was 58.8 years in better-performing companies, as compared to the average age overall, which was 59.5."

Lewis explained that the underlying factor of this trend is the experience of board members. "It is important especially from IT and new business perspectives," he said. "You have new technologies coming into the market, pushing down the age for people who really understand the business. When you look at something like age and technology experience in a number of banks and other financial institutions, such as insurance companies, their boards are very homogeneous: middle-aged directors who don't necessarily understand how to sell over the Internet. And they are looking actively at how they can bring someone with that particular experience to the board."

But to bring a tech-savvy individual onto the board is a challenge in itself. "You want to bring someone new and young into the business," Lewis said. "But at the same time, from the regulatory perspective, that director needs to understand how a financial services company operates in a very difficult regulatory environment. So finding that individual is pretty much like looking for a needle in a haystack."

Tenure

Along with the issue of board members' age comes the question of how long board members tend to stay in one place. According to the Eversheds report, the average length of service was 6.7 years in 2012, an increase of 13% since 2007.

"Directors tend to stay in one place longer than five years ago," Lewis said. "It may be that companies are working through difficult issues in terms of the economic environment, the regulatory environment, and all the changes that have been going on in the last five years. So there may be a benefit for companies to actually have directors on the board for a longer time to give that continuity and to push changes through."

Diversity

There has been an important debate recently over gender diversity. However, what boards perceive as the most important elements in terms of diversity are diversity of experience, with 49% of the sample indicating this factor as the most important, followed by international experience (25%) and age (16%), with gender diversity ranking 4th in importance at 10%. "More women on boards and more diversity are certainly an issue which we have seen change a lot over the last five years," Lewis said. He noted that in 2007–2012 there was a significant rise in female board members in all regions: "In Continental Europe, the increase was over 109%. In Hong Kong, women on boards are up 128%."

He noted, however, that this growth came from very low base—"zero or 1% in many cases." And the percentage of female board members is still low among the top 50 companies by share-price performance, where they make up only 17% of non-executive directors, 5% of executive directors, 4% of CEOs, and 2% of chairpersons. Lewis pointed out that most companies are against quotas (a regulatory requirement in some countries). "People want to go on the basis of skill set, but not on the basis of gender," he explained. "The diversity debate which has been heavily centered around the gender diversity issue is irrelevant."

Thus while it can be difficult to balance all the experience that the board needs, Lewis took the view that the skill set of the board is absolutely critical.

The view from the chair

The issue of leadership was analyzed from the point of view of the role a company's chairperson should play to have a positive impact on the company's share-price performance. In the interviews with board members, it proved that this role is crucial. "It is especially crucial from the unitary board perspective," Lewis said. "Then, the role of the chairman is fairly fundamental, driving the debate at the board level and making sure you have the right atmosphere at the board level—setting the atmosphere, setting the tone, setting the expectations among the directors, making sure you get an open culture and healthy debate, fostering the right attitude, making sure the non-executive directors are focused and at the right level of experience, and making sure that there are various reviews in place and that the board is actually functioning properly."

As the interviews revealed, it is also the role of the chair to ensure that the recruitment of non-executive directors goes through an adequate process, so that the right people are coming onto the board.

In general, the interviews showed that the ideal chairperson is someone who can effectively foster team spirit and commitment to the organization for which the board members work. "What you don't want to have is a group of people who know each other all terribly well and are good friends, and give up the challenge aspect that they need to have among each other at the board level," Lewis explained. "That aspect is the chairman's role to get right and be able to foster that relationship at the board level."

The interviews also revealed another issue: the independence of the chairperson. "There are strong regional variations," Lewis said. "Some of the feedback we got, particularly from places like Hong Kong and Japan, is that trying to get independence in those regions is actually very difficult, because there are many more family connections there. It is much more about who you know. The idea of having an independent director is probably treated with a degree of suspicion. There certainly was some suspicion with the people with spoke to. But having independent directors correlates well with share-price performance, which we see in the US and the UK."

Outside CEOs on the board
Another connection established between board composition and the company's share-price performance is how CEOs of other companies in the same industry as the company on whose board they serve influence the company's stock price. The report found that the more such CEOs on the board, the better the company's share-price performance.

However, the report revealed that although a positive correlation exists, in reality the trend is in the opposite direction: The number of CEOs serving as non-executive board members of other companies declined over the last five years. According to Lewis, the decline may be correlated with the issue of the increasing burden on CEOs. "In the difficult economic time we have had for the last five years, you want your CEO very firmly focused on the company in which he or she is the CEO," Lewis explained. "Being engaged as a non-executive director in another company would be perceived very badly by the shareholders of the company in which he or she is the CEO."

Shareholder engagement
How well a company performs when it has a greater number of major shareholders was another area analyzed in *Eversheds Board Report: The Effective Board*. It transpired that the greater the number of major shareholders, the better the company's share-price performance.

But there are tipping points. "When you have one large shareholder, it did not correlate very well at all," Lewis said. "The optimal number of shareholding is 3%. This may mean that the divergence or pressure from different sources is a good thing, because it fosters a more dynamic board culture and leads to better share-price performance."

Another issue that Lewis underlined was that companies with more engaged shareholders tended to have better share-price performance: "The way we measured that was to look at to what extent the shareholders were actually turning up and voting at general meetings and to what extent they were taking their entitlements and rights to exercise them. The more that we saw companies with shareholders that were actively engaged through that particular part of the process, the better we saw their share-price performance."

However, he said that a number of companies polled expressed disillusionment with their investors. "Particularly companies with institutional investors were complaining about the lack of coherence in the shareholders' point of view," Lewis said. "For instance, the investment arm of an institution would be happy with the board while the compliance arm of the same institution may be saying that the board does not comply in terms of a number of issues."

Attitudes to risk
Managing risk is another area in which boards were examined. "When we asked board members what the top three challenges were, risk strategy was very high on their agenda," Lewis said. "It came in third overall, closely following growth strategy and economic climate. This deals with risk and how you can change the culture within your organization in terms of its appetite for risk."

When dealing with the risk issue, companies face some conflicting problems. "Companies' approach to risk has changed in the last two years, and it has gone high up on the agenda," he explained. "The trend was for risk to be dealt with through the audit committee, but it is very much dependent upon the organization you are in. Financial institutions, especially in the UK, would generally have a risk committee, so risk may be treated separately from the board. But at the same time you need to bring it back to the board anyway, because the board is the body that is ultimately responsible for everything. So there is getting that balance right."

The report also revealed that the majority of directors were in favor of having a separate risk committee, because if boards were to deal with risk analysis exclusively it would be a task cumbersome enough to distract the board from their other responsibilities.

> **"In nearly all industries, board members complained they do not have enough time to properly exercise their board duties.**

Risk assessment
Yet boards have to deal with risk analysis to some extent. This involves some paperwork and documentation which is supposed to help board members get the right information so they can make the right judgments. "Here we found that better information is needed," Lewis said. "The quality of information was not necessarily sufficient, many board members told us, for them to be able to make the right judgment. There is obviously now a big use of iPads and other tools that people would use in terms of presenting facts to the board. But in light of some comments we got, quite often a lot of information that comes out of that is not what board members can necessarily process in good time before board meetings so they can have constructive board meetings."

Lewis noted that while there is a lot of thinking going on around that issue, it seems that many boards do not know how to get the right level of information to make the right decisions.

More burdens on board members
Along with the quality information conundrum is another complaint voiced by board members surveyed for the Eversheds report. In nearly all industries, board members complained they do not have enough time to properly exercise their board duties. This finding is in line with the trend to downsize boards, also registered in the report. "If the board is to be kept to the level of 11–12 individuals, the time required for them to properly deliver their responsibilities is greater than it used to be," Lewis said. "Non-executive directors may complain that while they were formally engaged to spend a few days a month, now they spend 10 days a month or more working on the board."

Compensation
This leads to the compensation debate, where the pressure is clearly downwards in terms of what directors should get paid. "You have to ask whether the non-executive directors in particular are adequately remunerated," Lewis said. "One of the interesting comments we had in that respect was that in order to maintain independence, you should not be looking at the remuneration at all, because non-executive directors should be effectively able to walk away from the company. In other words, it is almost their social responsibility to do the job."

Lewis noted that owing to the economic crisis, there has been a lot of pressure, particularly driven by the press, to cut directors' compensation. In this environment, a number of boards ran into some difficulty enacting new compensation packages. "It is part of a debate going on around Europe about what is the right level of remuneration for board members," Lewis explained. "But there is a much wider problem with shareholders being deeply dissatisfied with companies' performance, the ethics of companies, and whether they pay the right level of taxes."

However, the report revealed that as a result of these pressures, there is much more dialogue going on between companies and their shareholders now. "When it comes to approval of remuneration packages," Lewis said, "you are less likely now to have a problem with shareholders, because there had been adequate discussions going on. Now the idea of having a package pushed through without adequate consultations is probably a no-go."