BoardroomDirect

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Issue in focus

Board renewal: Taking a fresh look at board composition

Many boards today are trying to figure out if they have the proper skills and experience to guide their companies now and in the future. Each board needs to consider whether the backgrounds and experience of its existing directors are appropriate or if new skills are needed. Recently, some critics have been outspoken about their perception of deficiencies in the current state of board renewal.

Some board members themselves are questioning the competency of their fellow directors. While a majority of directors at companies with annual elections are elected with at least 90% of the vote, there are still plenty of directors dissatisfied with their current board's composition. Early results from PwC's *2013 Annual Corporate Directors Survey* (the "PwC Survey") show that 35% of the 934 directors responding say someone on their board should be replaced; up from 31% a year ago. The top three reasons cited are diminished performance because of aging, lack of expertise, and lack of preparation for meetings.

"In our survey, we asked those who believe a change should be made about impediments to replacing a director," said Don Keller, a partner in PwC's Center for Board Governance. "Most indicate the biggest obstacle is that board leadership is uncomfortable addressing the issue." He added, "While it can be an unpleasant conversation, directors obviously believe the chair or lead director should take on director underperformance." This reason was cited nearly twice as much as the second and third explanations – lack of individual director assessments and ineffective assessment processes.

On average, directors are getting older and fewer are leaving boards to make way for the next generation. *The 2012 Spencer Stuart US Board Index* reports that the number of new directors has slowed to 291 of 5,184 total director seats in 2012, a 27% decrease from 2002. At the same time, the average age of directors (68), average board tenure (8.7 years), and mandatory retirement age (72-75) have all risen. Currently, 73% of S&P 500 companies have existing mandatory retirement age policies, but sometimes they are waived. Only 4% of S&P 500 boards specify director term limits, with the majority setting the limits between 10 and 15 years.

Many proponents of board renewal suggest that a director should be replaced after a lengthy tenure since they may not have "fresh" perspectives and because they may not be entirely independent. Additionally, a few US boards are getting questions from shareholders about term limits and mandatory retirement age. In some situations changing priorities or business strategies may move boards to seek out new skills.

Those who argue against term and age limits point out that board members possess significant and often irreplaceable cumulative knowledge from long-term board service. They suggest that one of the reasons for low board turnover is that companies are trying to retain their talented directors; fearing that the pool of potential new directors may not have the necessary skill sets.

Board diversity is another factor to consider when addressing board composition. In the PwC Survey, 72% of directors consider racial diversity in director candidates at least “somewhat important,” while 74% considered gender diversity to be at least “somewhat important.” Meanwhile, the 2012 Spencer Stuart US Board Index showed that 17% of S&P 500 directors are women, 91% of S&P 500 boards have one female director and 61% have two or more women on the board. **[Read Board Composition, Diversity and Refreshment, *Practical Law Journal*, Holly Gregory, Weil, Gotshal & Manges.]**

Internationally, regulators and lawmakers in some countries are going as far as requiring board diversity quotas to get more women on boards. The United Kingdom and Sweden have implemented voluntary quotas for women directors. In 2011, Australia required publicly traded companies to disclose the number of women serving on boards and the number of women executives. Recently, the European Commission approved a 40 percent quota for non-executive directors of listed companies that will be phased in by 2020.

Director skills set

According to the PwC Survey, the most sought after new director attribute is industry experience (48%), followed by financial expertise (41%) and operational expertise (38%). Additionally, the demand for familiarity with “new age” business skills (information technology, business globalization, and the influence of social media) has increased as boards look to add new directors, according to *BusinessWeek*.

“It’s a much more challenging task today,” Don Livingstone, audit committee and compensation committee member at Red Hat Inc. said about finding new directors. “There are two reasons: there’s a higher level of skills that are needed and then there are all the changes in governance. The idea is to make sure the candidates have some experience in several areas so that they are not one-dimensional.”

In the face of a focus on board composition worldwide, US boards are reminded of the importance of the nominating and governance committees and how vital a role they play in ensuring the regular evaluation of the board’s makeup in light of evolving trends and needs.

“A board’s effectiveness depends greatly on its members,” Keller said. “But directors are as different as the companies they serve. When it comes to composition, the most important thing for directors is to conscientiously and periodically evaluate whether the existing membership is best serving the interests of stakeholders.”

Self-evaluations

One of the most effective tools boards can have to measure and ensure the competency and overall diversity of their board is self-evaluation. No matter how it is carried out – through one-on-one interviews or by filling out questionnaires – a robust process is needed for building and maintaining an effective board.

The PwC Survey results show that during the past year, more than half of the boards took action on issues identified in their self-evaluation process. The most common changes were seeking additional expertise to join the board and changing board committee composition.

While some of the stock exchanges require annual board performance evaluations, the best boards go beyond a compliance requirement. They embrace the chance to refine the processes and optimize their effectiveness**. [For more on the self-evaluation process, read the executive summary on Board Dynamics in PwC's *Board Effectiveness – What Works Best*™ *2nd Edition*.]**

On his board, Livingstone said directors look at four key areas when conducting a self-evaluation. "We evaluate our technical skills since we are a technology company, the broadband level of business background, experience serving on boards, as well as equality issues," he said.

Recommendations for board members

1. Discuss whether the board has the right skills and experience it needs, both in light of current operations and in anticipation of future challenges. Consider analyzing the current composition to identify any gaps.

2. Focus on director succession planning.

3. Review your bylaws to evaluate whether term limits or mandatory retirement age policies need to be instituted or updated.

4. Consider the views of shareholders and other stakeholders when evaluating board composition to determine whether there are any concerns with existing board policies or board membership.

5. Take a fresh look at the board's self-evaluation process to ensure it is robust and has a clear and accepted objective to improve director and board performance. Consider whether director self-evaluations or peer evaluations would be beneficial or should be improved.