

Opinion

Board Responsibilities and CEO Succession Planning

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The **BoardProcessValue**® methodology promotes the active, business-oriented role of the board of directors of listed companies towards their shareholders on one hand, and towards the CEO and his executive management team on the other hand. Companies and their shareholders benefit from the value of board process that is active in these two respects. Our clients invest considerable resource and time in maximising the opportunity to shape those relationships. They do so by Chairmen refreshing the board's understanding of shareholders views on long-term issues affecting value. They also achieve it by; i) crafting very carefully the division and balance of authority and tasks between the board and the CEO; ii) by the mode of board delegation to CEOs; and iii) by ensuring monitoring is at the centre of board process.

This second **BPV**® **Opinion** raises issues of concern to all those who participate in making board process valuable and unique to the companies they serve. It is the first of two **BPV**® **Opinions** to address the issue of CEO succession. This first opinion looks at the practical implications of changing recruitment market conditions for CEO appointments. The second opinion analyses the empirical evidence for different models of succession process and the implications for Chairmen and Company Secretaries.

Whilst there is widespread agreement concerning board's responsibilities for succession planning, disagreement exists as to the form succession processes should take, and how boards should take account of changed market conditions for appointing CEOs. This **BPV**® **Opinion** considers what changed market and company expectations surrounding CEO appointments imply for how boards discharge their responsibilities.

Alongside discharging their fiduciary duties on behalf of shareholders by monitoring operating and financial performance, CEO succession is regarded as the most important board responsibility. From a legal and regulatory perspective, board's ownership of succession planning is uncontentious. However, this is not to say that external audiences, notably shareholders, stakeholders and competitors, are disinterested in this aspect of the board's work. Management of the transition period between CEOs has come to be regarded as a proxy for the effectiveness of board process in general, and the board's contribution to generating shareholder value in particular. It is viewed as a window into the collective thinking of the board about the talents, experience and managerial expertise that directors consider will best serve the long-term interests of a company.

Unlike routine monitoring and assurance gaining activities performed by boards, succession planning processes are not fed by reporting lines from management operating to established standards. More than any other aspect of board work, succession planning is the product of close collaboration between directors under the leadership of the Chairman - often organised via a sub-committee. Relative to other committees, e.g. audit and remuneration, the relationship between a succession planning sub-committee and its external advisors is also less structured and more ad-hoc. For these reasons, the appointment of a CEO is seen by many as the most accurate indication of a board's judgment and correspondingly their assessment of the future prospects of the business.



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What then are the external factors shaping the way in which boards develop succession planning processes and respond to the expectations described above? Three trends are relevant. Firstly, the rate at which large-cap public listed companies have replaced CEOs over the past decade has risen markedly. Secondly, rather than CEOs leaving their posts to retire, CEOs in 2006 are as likely to leave prematurely – a trend reinforced by the rising number of ‘serial CEOs’ who move directly from role to another. Thirdly, the proportion of ‘outside’ relative to ‘inside’ candidates selected for CEO positions has increased considerably over the same period. The net result of these macro changes is that current assumptions surrounding the availability of incumbent CEOs to participate in structured succession planning now requires re-thinking.

Companies need effective board processes that can respond to these changed market conditions and ensure that the boards’ most important contribution, the assessment of the future needs of the business and the evaluation of candidates, is not diminished. Regardless of the form that succession processes take - some key principles can be applied to ensure that the board’s contribution is maximised.¹

Treat CEO succession as an ongoing strategic risk – supported by appropriate information flows to board

Boards can obtain visibility of succession issues, like any other enduring risk for a business, through effective management of forward board agendas by the Company Secretary’s and Chairman’s Offices. It should be apparent from the forward agenda that were a succession process initiated at any point in the next 24 months how well the board would be placed to initiate succession planning. Would the most recent information received by the board be sufficient to discuss the future needs of the business and the criteria for

¹ Different models of succession process will be the focus of a *BPV® Opinion* later in 2006.

candidate selection? Does the information received by the board extend to levels immediately below internal candidates for the post? Can the board form an opinion as to the likely ‘knock-on’ consequences in relation to unsuccessful candidates following a CEO appointment?

Develop board’s familiarity with evaluations and performance reviews

Much has been written about director qualification in relation to audit committee membership. If technical expertise is deemed to be beneficial to the discharging of these duties, the same argument also applies to CEO succession. The skill-set in question here is the ability to understand how different criteria interrelate in making complex quantitative and qualitative decisions about candidate performance. The prime focus of the board should be on setting the most appropriate criteria for selecting the candidate most likely to deliver out-performance against those criteria. Familiarity with balanced scorecards and performance reviews will positively contribute toward an efficient outcome in the design and management of a succession process. It is also likely to result in more rigorous and disciplined comparison of ‘internal’ versus ‘external’ candidates and in assessing information from external executive search firms.²

Leverage existing board work when thinking about the future challenges, risks and opportunities facing the business

Boards have a central role to play in developing a view of the future business environment in which they expect a CEO to operate, and to deliver value to

² This excludes director experience of evaluating balanced scorecards. Professor Michael Jensen argues that balanced scorecard theory itself is flawed since it does not provide a single measure of performance, and therefore no information on the trade-offs between different decisions. See ‘Value Maximisation, Stakeholder Theory’, and the Corporate Objective Function, October 2001, *Unfolding Stakeholder Thinking*, eds J Andriof et al, (Greenleaf Publishing, 2002).

shareholders. Company Secretaries and Chairmen have an opportunity to leverage strategy away-days and other discussions to ensure that, on an ongoing basis, the board's shared understanding is refreshed and further developed. Definition of the future business environment is an area where retained resource to a succession sub-committee or working group (e.g. an executive search firm) is unlikely to add any significant value. It is also not an area where the board can easily look to management for guidance, especially if

internal executives are themselves candidates for appointment.

In treating CEO succession as a strategic risk, and in comparing different candidate's views on the future state of the business, the board must first be clear in its own mind as to how the company is most likely to create value in the future.

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