Board Smart

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OVERSEE EXECUTION

"Why do overlook and oversee mean opposite things?"

- GEORGE CARLIN

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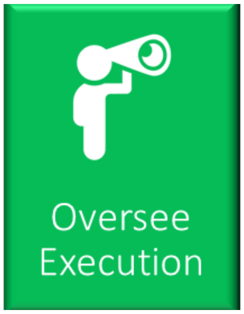
Effective governance is essential to organizational adaptation, survival, and success. This is the fifth in a series of six articles. Here we describe four leading practices to improve governance and board effectiveness through the exercise of the oversight power reserved exclusively for the board of a public retirement system.



1. **Oversee vital signs for vital functions**
2. **Require exception reporting**
3. **Oversee performance to see if it remains within risk tolerances**
4. **Ensure there are effective escalation mechanisms for exceptions**

The board can and should delegate the execution of board-approved direction and policy. Even if trustees are "experts," they are part-time volunteers. The board's responsibility to watch over does not mean the board has a responsibility to closely manage performance and related risks. That is management's job.

Trustees simply do not have the time to devote to execution. This is why the board is responsible for hiring a capable chief executive officer and holding that person accountable for the organization's performance.

Certainly, the relationship with management is not static and board involvement in operational details will vary depending on the circumstances (especially when there are major issues of concern that arise unexpectedly or where the board has lost confidence in management). Nonetheless, under "normal circumstances," a board's efforts to closely manage or supervise day-to-day management activities undermine both the executive and the board. Conflicting directions from the board can result in confusion and loss of direction.

What's important?
What's changing?
What does it mean?

The board cannot, however, delegate its responsibility to effectively oversee that the execution of the approved direction is occurring within policy nor to verify the reliability of the information it receives and the reports it issues. But what does it mean to oversee?

The Meaning of Oversight

Ironically, oversight has two meanings:

1. To watch over all but not closely supervise or manage
2. An unintentional failure to notice or do something

How does a board exercise proper oversight to ensure that the system is performing as expected? How does the board ensure that important issues are promptly brought to its attention so they can be addressed?

"Boards today, in exercising their oversight function, need to pay much more attention to a far broader range of issues than they ever have before. Boards need to identify which issues are relevant and material to their companies and to put in place oversight mechanisms that will allow the board to monitor the issues, receive inputs, and track company progress."[1]

Know what's vital.

Insight for Oversight

How does the board remain situationally aware? The rapid growth in the range of issues a board is now expected to oversee reflects, in part, the growing diversity and power of stakeholders (anyone who is affected or who can affect the organization). The velocity of change has accelerated as seemingly "small" issues can develop momentum overnight. Social media acts as an amplifier. The volume of data and differences of opinion can be overwhelming, create noise and distort key signals.

When things go wrong, one of the first questions often asked is: Where was the board? Were there red flags that were ignored? Could the problems have been detected earlier and preventive or corrective action taken?

These concerns have prompted many trustees to ask for ever-increasing amounts of detail. While this is certainly their prerogative, they often find themselves drowning in data rather than swimming in solutions. Is there a better way?

When a board gets too focused on the details, it is more likely to miss the big picture (i.e., the proverbial trees for the forest). While details are often easier to understand and address, a key role of the board is to understand and take the more difficult, long-term, big picture view. First, this is a role that the board is collectively singularly qualified for because it is the entity charged with the long-term sustainability of the organization. More practically, a focus on the big picture inevitably proves more impactful than micro-management.

Common Oversight Challenges[2]

How are trustees to avoid missing something if they don't dive into the details?

How then can boards more quickly detect important signals despite noise? Why do boards miss things? What are the challenges that need to be overcome? Many factors make situational awareness for boards difficult. Here are a few:

- The volume of data presented to boards for their approval, for direction setting, or just as information to facilitate oversight is overwhelming. Too often, boards can be overloaded with data. We call this the DRIP problem: Data rich, information poor.
- Directors differ in their appetite for detail and their level of preparation for board or committee meetings.
- The way the information is presented can be problematic.

Key Roles of the Board and Committees in Oversight

As discussed in the third article in this series "Set Direction," a key role of the board is first to set the direction and define the policies needed to guide execution. Such direction and policy need to be unified and consistent. The board needs to then prudently delegate execution to the chief executive officer together with the appropriate resources and authority.

Once approved, the board needs to oversee that the enterprise's strategy, operations, reporting, and compliance (legal, policy, and contractual) are carried out within policy. To effectively oversee enterprise performance and risk, the board needs to know what's important, what's changed (or changing), and what those changes mean. This is why it is so important for the board to approve key performance indicators and tolerance bands for comparing actual performance to expected performance.

Committees can play an important role in helping a board fulfill its oversight responsibilities and remain situationally aware. Committees act as the eyes and ears of the board. They should review the vital signs for each vital function within their mandate and then drill down into performance and risk information specific to their charter as needed to satisfy themselves that the information or intelligence is reliable.

Quickly detect signals.

Directors need to understand the direction of the key performance indicators (KPIs) over time and the policy implications of that improvement or deterioration. They also need to develop and maintain awareness of the bench strength of staff and advisors. Armed with this information, committees are positioned to make more insightful recommendations for the board as a whole.

One common gap is the oversight of cross-functional issues as they often don't fall within the natural purview of any particular committee. The chair, or the board itself, ought to assign these cross-functional issues to a committee (even if not an exact fit) or make an explicit decision that a particular area is "owned" by the board overall in terms of oversight and create space on the agenda for it.

FOUR WAYS TO IMPROVE BOARD OVERSIGHT

1. Oversee vital signs for vital functions

As discussed in "Set," a crucial element of that process is to determine what J.M. Juran called the "vital few" performance indicators to avoid information overload from the "trivial many." The vital few are the performance measures that are critical to the board's effective oversight.

When KPIs are selected correctly, there are often policy implications when the KPIs show unwanted or unexpected variations from the expected performance. If, for instance, a KPI drops below a board-approved tolerance that should prompt executive management to escalate and report the exception and the possible causes to the board. Management should describe its actions to resolve the issue. At the highest level, the idea is to understand if the variation indicates a strategic or tactical change that requires the board to reset direction or policy.

Actual results rarely match expectations exactly, which is why the setting of appropriate tolerances by the board around expected results is critical.

Variances may be over or under the performance target. Additionally, boards need to be aware that, in rare but high-impact situations, results that are "too good to be true" can be just that.

Can overperformance be replicated? Yes, but it can also identify more extreme situations such as fraud as with Bernie Madoff, Health South, Parmalat, Volkswagen Diesel, Wells Fargo, and Theranos, just to name a few.

Vital signs are the "vital few" key indicators of the state of health of vital enterprise functions. Human examples of vital signs include heart rate, blood pressure, temperature, pulse, respirations per minute, and oxygenation.

The identification of vital signs for each vital function is a strategic decision. Management is responsible for managing performance within established tolerances and providing reasonable assurance to the board that its reports are reliable and controls are effective unless otherwise notified.

2. Require exception reporting

Proper oversight, which leads to insight, can help a board maintain situational awareness. Exception reporting helps a board do that, by focusing on the exceptions rather than "normal" performance, as determined by the vital few key performance indicators.

What is an exception report?

An exception report is a document that describes where actual performance deviates significantly from expectations (not just in a negative direction). The purpose of exception reports is to focus board and management attention on those areas requiring further action. Exception reporting is a widely recognized and long-used management tool and is gaining acceptance in board rooms for business intelligence.

Exception reporting takes a mass of data and converts it into information, effectively saying "look here" to the board. One popular method is the "stoplight" report, where KPIs within the tolerance are green, those at the margins are yellow, and those not performing as expected are red.

Another option would be to highlight exceptionally good performance as blue. Any measurable function can be reported using exception reports. Indeed, these metrics and the reports can often be, and preferably should be, automated.

Successful exception reporting requires board consensus around the KPIs, expectations, and tolerances; escalation procedures for results out of tolerance, competent analysis of root causes of the unwanted or unexpected variance, clear management responsibility for further mitigation, and consistent, reliable monitoring and reporting of the metric.

> Require exception- based reporting.

3. Oversee performance remains within established risk tolerances

Ensure an effective system of checks and balances

Compliance reports are a nearly universal part of board oversight. Indeed, some types of compliance monitoring are required legally by virtually all jurisdictions, such as audit responsibilities or mandates to have fraud hotlines or to report cybersecurity incidents.

Regulated industries often require the board to guarantee there is an effective control environment, and board members can be liable if a regulator finds otherwise. Tone at the top is important and a necessary but not sufficient condition.

The board needs to ensure there is an effective system of checks and balances that includes clear roles, responsibilities, accountabilities, and lines of relationships regarding governance, control, and oversight.

Because compliance is so central, many boards or audit committees have standing compliance reports at each meeting. Violations are probed to see if an exception was a “one-off” or indicative of a need to improve the compliance program in some way.

Boards or audit committees often use sessions with external and internal auditors and with compliance and legal executives to explore not only the policies themselves but such issues as training, resourcing, upcoming regulatory changes, etc. These sessions can also be used to better understand if there are any incentives or KPIs that might encourage employees to breach the compliance rules. Such situations can result in major damage to the enterprise, as did the push for cross-selling at Wells Fargo.

4. Ensure there are effective escalation mechanisms for exceptions with policy implications

Exceptions to acceptable performance should trigger an escalation mechanism. Escalation mechanisms improve situational awareness by reducing the potential of losing sight of an unwanted performance. While many exceptions can and should be dealt with by management without requiring escalation to the board, some situations should be non-discretionary.

Some of these are mandated by regulation, such as the need for external auditors to report material irregularities to the audit committee. Most, however, are the exceptions noted in the exception reporting mechanism. At that point, the board needs to understand why the exception occurred, what has changed, and what it means in terms of the response needed.

Is the cause a failure of governance, people, processes, system, or external factors?

The role of exception-reporting is to consistently and reliably identify: What’s important, what’s changed, and what does it mean? The main concern for a board should be whether the enterprise is operating within the policies “Set” by the board. What are the implications if the exception continues or worsens?

Bad news must travel fast.

A board can require the use of tools such as root cause analysis to help determine the reasons for the exception. If the analysis does suggest that there should be a policy response/change, the board might want to consider the response hierarchy noted in "Set." The response hierarchy considers what the potential responses could be, ordered from the least that could be done to the most. Ideally, management should present the pros and cons of each option. The board can also consider independent expert advice if that would be helpful.

Summary

In this article, we described some of the oversight challenges facing boards and four leading practices to help boards improve the exercise of their responsibility and power to oversee the execution of approved strategy and policy.

However, one of the greatest risks of using exception-based reporting is whether reports of "normal" performance are reliable. Is green really green? Are critical controls working as expected? Management is responsible for proving reasonable but not absolute assurance that performance is as expected and controls are reliable unless otherwise notified. The board should obtain independent verification on the reliability of reports received by the board and those issued by the board. How can it do that reliably? "Verify Then Trust" is the subject of the next and final article in this series.

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[1] https://corpgov.law.harvard.edu/2021/05/10/directors-oversight-role-today-increased-expectations-responsibility-and-accountability-a-macro-view/

[2] https://corpgov.law.harvard.edu/2021/05/10/directors-oversight-role-today-increased-expectations-responsibility-and-accountability-a-macro-view/

[3] J.M. Juran, Frank M. Gryna Jr. and R.S. Bigham Jr. "Quality Control Handbook" McGraw Hill, 3rd edition 1951 p.2-16-17

