BUILDING A BETTER BOARD BOOK

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INTRODUCTION

Board members rely on information provided by management to inform their decisions on strategy, capital allocation, performance measurement, and risk management.[1] Unfortunately, some research calls into question the adequacy of the information board members receive and, by extension, the quality of decisions they are able to make. For example, a two-part study by Deloitte finds that the vast majority of boards do not receive information on the critical metrics (key performance indicators, or KPIs) that have a demonstrated link to the future performance of the business. The report finds that board presentations overemphasize standard financial metrics (such as revenue growth, margins, and cash flow) and underemphasize the detailed financial and nonfinancial metrics that provide deeper insight into the fundamental health of the business.[2] As a result, it is time to reconsider the construction and composition of board books.

BOARD BOOKS TODAY

The materials provided by management to the board in advance of board meetings ("board books") today suffer from three overarching problems. First, they prioritize the director's duty to oversee financial reporting above the need to truly understand the economic drivers of business performance. Because a company's public financial statements are reviewed by the board prior to their release, the data in board books generally tend to be hung on the framework of external reporting.[3] However, it is not clear that data presented solely under this framework are what managers and board members actually need to make optimal strategic decisions for new and ongoing activities.

Second, board books tend to have an abundance of information but a dearth of metrics that lead to true insight. A typical board book can run up to 200 or 300 pages. It often contains detailed results by product, division, etc., but these results are commonly not presented with sufficient detail to explain trends or put directors in a position to properly assess the situation and make decisions.

Third, the structure of board presentations becomes formulaic over time. Once a general template is established, it is very hard to make substantive changes. Board presentations tend to include an updated version of the same slides that were presented in previous meetings. If a board member asks a specific question requiring a new slide, that information is added in subsequent meetings and many times remains in future meetings even when it is no longer relevant. As a result, board books do not change with the marketplace, preventing directors from understanding how the industry—and therefore their corporation's strategy and investments—needs to evolve.

HOW TO MAKE BOARD BOOKS BETTER

ValueAct Capital has identified six common and serious pitfalls that plague corporate board books and provides recommendations for remedying them.[4] These pitfalls include the following:

Data lacks important context. Board books spend an inordinate amount of time bridging performance to plan. However, in doing so, they leave out important contextual information, such as absolute performance, historical trends, and performance relative to market. Sales growth above budget is less impressive if it coincides with a loss of market share or a reduction in the company's long-term rate of growth. A company's reported results should be reviewed alongside relevant financial metrics from competitors or customers to facilitate discussion and decision making. Too often strategic planning is reserved for dedicated, one-off planning days when it should instead be an ongoing part of the regular business review (see Exhibit 1).

Data focuses on results (outputs) rather than drivers (inputs). For example, a company might report historical and projected trends for customer subscription counts without providing a breakdown of how the product mix has changed across its customer base over time. Breaking down the installed base to show how many customers are subscribed to older versus newer products helps directors understand the size of the company's future opportunity. It also allows the board to reorient the discussion around a review of the drivers of success rather than a rearview-mirror discussion of recent historical trends. Board books should regularly include metrics that have a clearly related impact to the long-term performance of the company, and the linkages to performance should be well understood and reviewed often (see Exhibit 2).

Data does not inform organic (P&L) investment decisions. Boards review an exhaustive amount of information before making an external acquisition, but spend significantly less attention reviewing large ongoing expenditures that drive organic growth. For example, a board might review the relation between product sales and promotional expenditures, but they do not receive the detailed information to understand how current expenditures drive future cash flow. Including return metrics provides a more complete view of product economics and allows for more informed decision making about organic investment. The same lesson applies to all expenditures that drive profitability, such as research and development, advertising budgets, and salesforce headcount. These expenditures should be explicitly tied to future changes in revenue and profit so that the board understands what level of organic investment is required to achieve long-term goals (see Exhibit 3).[5]

Accounting allocations obscure true economics. When analyzing the profitability of various product lines, management must make judgments, such as the allocation of shared overhead. In many cases, these allocations are driven by external reporting requirements, which may or may not reflect the true economics of the business. Incorrect or incomplete allocation of corporate overhead costs can severely distort the underlying profitability of a business line. "True" (or more appropriate) allocation of expenses often reveals that a business is significantly more or less profitable than perceived based on GAAP allocations. The establishment and tracking of accurate profit and loss statements at product, business, or geographic level can help boards understand how their companies derive cash and improve strategic decision making (see Exhibit 4).

Data does not match a manager's sphere of responsibility. For example, a company might report sales figures by product line when accountability for that product line is shared among multiple managers across geographies. To improve accountability, results should be presented to coincide with the sphere of responsibility of individual managers. Supplementing revenue information with cost data (cost of goods sold; sales, general, and administrative; and other relevant costs), further increases accountability by providing a profit and loss statement associated with each manager and allows for better performance measurement in computing managerial bonuses (see Exhibit 5).

Unexplained outperformance is insufficiently investigated. Boards spend insufficient time exploring the factors that led to significant outperformance in a given period—in particular, questioning whether those factors are sustainable or will instead create a headwind in future years. Revenue or volume outperformance driven by one-time price promotions, product end-of-life, or competitor disruptions are not sustainable forms of growth and, if not acknowledged and understood, will lead to future disappointment and loss of credibility with external investors. A driver-based view of performance will expose the true causes of outperformance, either positive or negative (see Exhibit 6).

Substantive changes to the structure and content of a company's board book not only impact the board's and management's strategic decision making and execution but can also be relevant to the design of executive compensation. For example, one company that reconstructed its board book gained new insights into the profitability of its businesses. This led to the formulation of a new driver-based long-range plan, with key metrics tracked at the board level. To encourage management performance, the board devised an executive compensation plan that tied a significant portion of long-term stock awards to these same key metrics. Previously, the company had relied predominantly on time-vested stock awards with no performance features.

As a first step in thinking about board books, it is important to ensure that:

- Analyses reflect true economic realities and are not unduly constrained by accounting conventions.
- Metrics presented to the board match the way management actually runs the business.
- Performance measures are distilled to drivers rather than just results or outcomes.
- Data are presented with appropriate context, such as historical trends, customer behavior, and external benchmarking.
- Analyses focus on emphasizing long-term plans rather than annual budget allocations.
- Performance statements align with spheres of responsibility so that individual managers can be held accountable for results.

Finally, it is also important to recognize that improvements made to board books should be an ongoing process, and not done periodically every five to ten years.

WHY THIS MATTERS

1. Having access to appropriate data is critical to making sound decisions on strategy, compensation, and capital allocation. However, evidence suggests some directors do not receive the information they need on important drivers of the business. In general, what is the quality of information that public company directors receive? Is it sufficient to make optimal decisions? If not, how widespread is this problem? In situations where the quality of data is lacking, what discussions should the board use with management to improve information quality and presentation?
2. This Closer Look identifies many benefits to improving the content and structure of board books, including better understanding of unit or segment economics, better allocation of organic investment, better understanding of the effectiveness or ineffectiveness of the current strategy, and stricter accountability for performance. What are the institutional impediments that stand in the way of boards asking for and receiving this information?
3. One of the shortcomings identified in this Closer Look is that the information included in board books is overly reliant on accounting-based standards for external reporting. However, accounting standards do not always accurately reflect underlying profitability of products, divisions, customer types, etc. How accurate is this assertion? How should boards adjust information used for external reporting to reflect economic reality? To what extent should these adjustments be the same as those made to shareholders in quarterly earnings releases? ■

[1] Under the business judgment rule, courts have ruled that in the absence of "red flags" outside directors are permitted to rely exclusively on information provided by management, and if they do so, courts will assume a hands-off posture even if the board decision is clearly wrong.

[2] Deloitte, "In the Dark: What Boards and Executives Don't Know About the Health of Their Businesses. A Survey by Deloitte in Cooperation with the Economist Intelligence Unit" (2004); and "In the Dark II: What Many Boards and Executives Still Don't Know About the Health of Their Businesses. Executive Survey Results from Deloitte and the Economist Intelligence Unit" (2007).

[3] For example, business segmentation data and the allocation of expenses between divisions or product lines are typically presented in accordance with external reporting standards.

[4] ValueAct Capital manages more than $15 billion on behalf of some of the world's largest institutional investors, including U.S. universities, medical research institutes, charitable foundations, sovereign wealth funds and state pension plans. Founded in 2000, ValueAct Capital focuses on building a long-term, concentrated, and constructive value investment portfolio. During the last 17 years, ValueAct Capital has made more than 90 core investments, and its partners have collectively served on approximately 40 public company boards. Through its board service, ValueAct Capital has observed a positive correlation between corporate governance behavior and the ability to create sustainable long-term shareholder value. Based on its collective experience, ValueAct Capital has developed a view for how the enhancement of board books, as described in this Closer Look, can lead to better financial planning and analysis at the board level. ValueAct Capital's experience has been that an informed perspective of the financial and non-financial drivers of performance can in turn lead to better decision making and long term value creation.

[5] See Christopher D. Ittner and David F. Larcker, "Coming Up Short on Nonfinancial Performance Measurement," *Harvard Business Review* (2003). They find that companies that develop a causal business model based on KPIs exhibit significantly higher returns on assets and returns on equity during five-year periods than those that do not. The authors identify three benefits from developing causal business models based on KPIs: enhanced internal communication on strategic assumptions, better identification and measurement of strategic value drivers, and improved resource allocation and target setting.

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EXHIBIT 1 — COMMON BOARD BOOK PITFALLS

Data lacks important context

Device Sales: Before

	Target	Result	% of Target
Number of Procedures	450,000	477,000	106%
Average Sales Price	$120,000	$119,980	99%

Boards see positive results vs. plan and assume business is performing well

Device Sales: After

	Target	Result	% of Target	Y/Y Growth	Market Growth
Number of Procedures	450,000	477,000	106%	(11%)	6%
Average Sales Price	$120,000	$119,980	99%	20%	3%

Real insight comes from seeing share loss

Description

In the "before" snapshot, strong performance vs. plan appeared to show a healthy business. When market context was introduced, however, we saw a business that was losing volume share, but had been able to maintain growth through pricing. The pricing growth was also ultimately only due to a temporary foreign exchange benefit.

EXHIBIT 2 — COMMON BOARD BOOK PITFALLS

Data focuses on results (outputs) rather than drivers (inputs)

Subscriber Count: Before

	FY12	FY13	FY14	FY15
End of Period Subscribers (M)	90	97	105	112
% Growth (Y/Y)	*8%*	*8%*	*8%*	*7%*

Only looking at results appears to show a healthy subscriber base

Subscriber Count: After

	FY12	FY13	FY14	FY15
Subscribers Added	11	14	16	19
Subscribers Lost	(4)	(6)	(8)	(12)
End of Period Subscribers (M)	90	97	105	112
% Growth (Y/Y)	*8%*	*8%*	*8%*	*7%*
% Retention Rate	***95%***	***93%***	***92%***	***89%***

Drivers show a growing problem that can be addressed prior to impacting results

Description

A subscription business that appeared to be growing steadily. Once drivers were illuminated, though, we could see that declining retention rates left a larger and larger hole to fill every year. Declining retention rates were ultimately the result of underinvestment in service quality, which could be relatively easily addressed.

EXHIBIT 3 — COMMON BOARD BOOK PITFALLS

Data does not inform organic investment decisions

Investment Analysis: Before

Inorganic

Acquisition	Return on Invested Capital: Upside	Base	Downside	Earnings per Share Accretion: Upside	Base	Downside
$50M	35%	25%	15%	7%	4%	1%

Organic

R&D	Y/Y Growth
$1,200M	10%

No return analysis is offered for significant increase in organic spend

Investment Analysis: After

Inorganic

Acquisition	Return on Invested Capital: Upside	Base	Downside	Earnings per Share Accretion: Upside	Base	Downside
$50M	35%	25%	15%	7%	4%	1%

Organic

Addtl. R&D	Return on Invested Capital: Upside	Base	Downside	Earnings per Share Accretion: Upside	Base	Downside
$120M	27%	12%	5%	7%	2%	-1%

Scenario analysis shows organic investment does not look as attractive as the inorganic opportunity

Description

A small external acquisition received more analysis than a significant increase in ongoing R&D spend. R&D spend should be attached to specific revenue and profit expectations. When these profit expectations were analyzed under the same framework as the external acquisition, the organic investment did not compare favorably.

EXHIBIT 4 — COMMON BOARD BOOK PITFALLS

Accounting allocations obscure true economics

Segment P&L: Before

	Software	Hardware
Gross Profit	2,000	500
Operating Expense:		
Sales & Marketing	400	200
Research & Development	600	150
General & Administrative	100	50
Contribution Margin	**900**	**100**
% Margin	*45%*	*20%*

External reporting and org structure often dictate board reporting

Segment P&L: After

	Software	Hardware
Gross Profit	2,000	500
Operating Expense:		
Sales & Marketing	400	200
Research & Development	600	150
General & Administrative	100	50
Accounting Contribution Margin	**900**	**100**
Less: Cross Segment R&D	(200)	200
"True" Contribution Margin	**1100**	**(100)**
% Margin	*55%*	*(20%)*

But a time-activity based view yields different results

Description

The hardware segment appeared to be a positive profit contributor under accounting-focused reporting. The software segment, however, was carrying an additional R&D burden to create a custom version of the company's software to run on the company's internal systems. A more appropriate allocation of these costs revealed a more accurate understanding of the true economic profit of each segment and changed the calculus of whether continuing in the money-losing hardware business was justified.

EXHIBIT 5 — COMMON BOARD BOOK PITFALLS

Data does not match a manager's sphere of responsibility

Product Sales: Before

		Q1 2007	Q1 2008
Product #1	*Superfluous info that board can't draw conclusions from because not connected to management responsibility or spending decisions*	1,200	1330
Product #2		800	760
Product #3		100	120
Product #4		1150	1150
Product #5		600	510
Total Sales		**3850**	**3870**

Product Sales: After

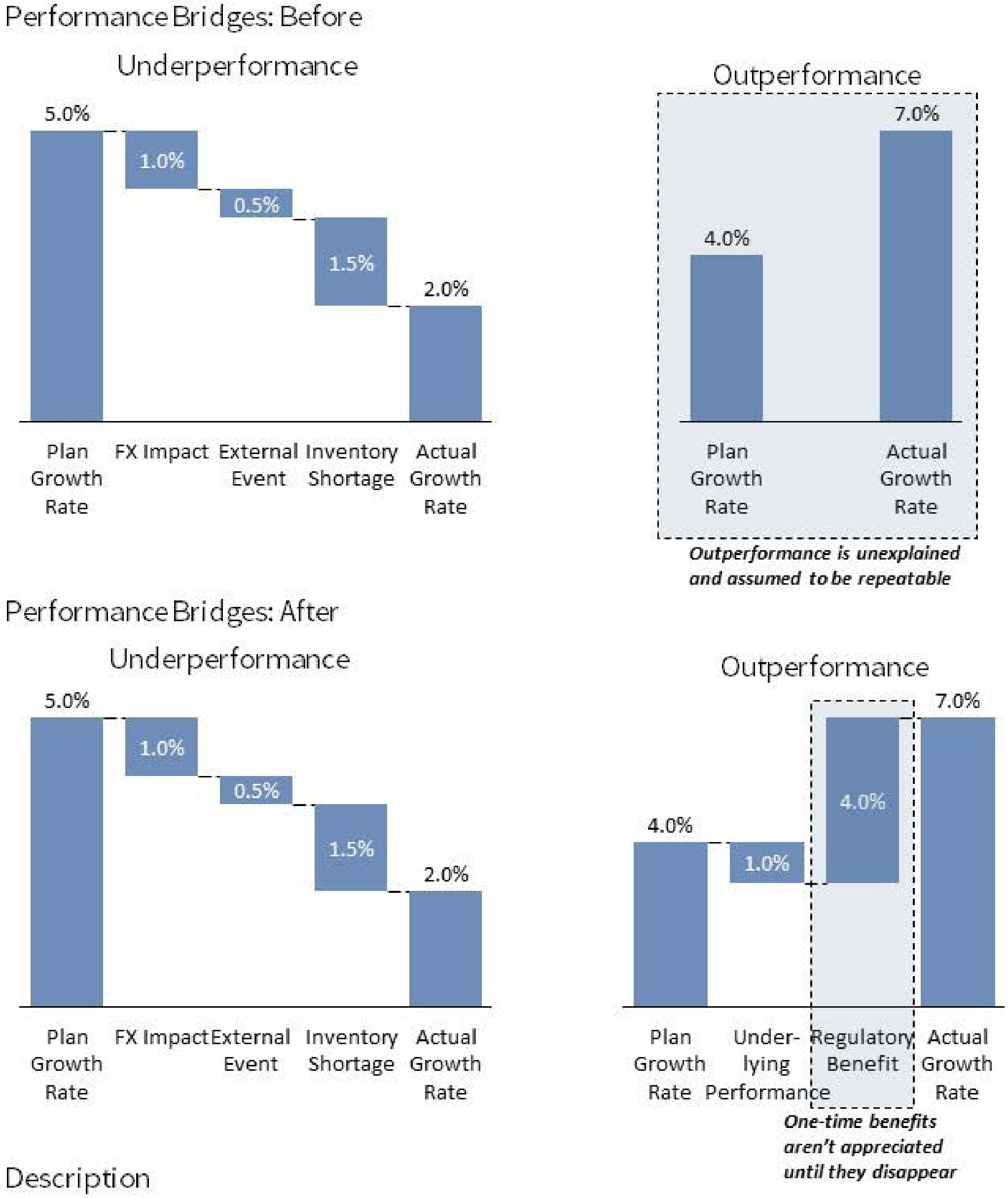
	USA Management		International Management	
	Q1 2007	Q1 2008	Q1 2007	Q1 2008
Sales	2400	2600	1450	1270
COGS	480	520	290	250
SG&A	700	750	500	550
Operating Income	**1220**	**1330**	**660**	**470**

Description

The board was provided with detailed information on product sales, which appeared informative, but was not easy to act on or interrogate as it did not align with any manager's sphere of responsibility and did not provide visibility into product economics with associated costs. The business was actually run by geography. Reporting aligned with individual manager accountability led to the reallocation of organic investment.

EXHIBIT 6 — COMMON BOARD BOOK PITFALLS

Unexplained outperformance is insufficiently investigated



Description

A segment that underperformed vs. management expectations was deeply dissected, while a segment that outperformed vs. management expectations was not investigated in detail and assumed to be repeatable. Budgets and guidance were constructed from the inflated growth number, and it was not until targets were missed the following year that the factors leading to unsustainable outperformance in the prior year were quantified.