Building board expertise through key supporting processes

Marie-Josée Roy

Marie-Josée Roy is based in the Faculty of Administrative Sciences, University Laval, Québec, Canada.

Summary

Purpose – *Although board expertise has been identified as an important determinant of board performance, some surveys are still reporting that the overall level of board expertise is insufficient to carry out current and emerging roles. Consequently, companies must ensure that board members have the required skills and knowledge. This study aims to examine three board processes aimed at developing and improving board expertise.*

Design/methodology/approach – *Based on disclosures in the corporate governance guidelines of 100 leading US companies, the study focuses on three board processes, i.e. director nominations, orientation and education programs, and board performance evaluations.*

Findings – *Based on the initial findings, it is found that most companies in the sample were in compliance with stock exchange requirements and provided information on director nominations, orientation and education programs and board performance evaluations. All too often, however, the companies disclosed generic, non-specific information; this provides little reassurance that the proper processes are in place to promote companies' long-term interests.*

Research limitations/implications – *By examining these key board processes, the paper contributes to the governance literature by providing empirical evidence on this important topic and offering guidance to companies examining board processes aimed at improving directors' overall expertise.*

Originality/value – *By focusing on disclosures in corporate governance guidelines, the authors also gain insight into decisions made by companies under increased pressure from securities regulators and other stakeholders to provide increased transparency on governance issues.*

Keywords *Directors, Boards of directors, Performance appraisal, Education*

Paper type *Research paper*

1. Introduction

Demands for increased board vigilance have been mounting over the last ten years. In response, numerous organizations and securities markets worldwide have recommended that boards include a majority of independent directors. Because independent directors are said to have greater detachment and objectivity and are reportedly more likely to question management decisions, many observers have argued that independent directors make superior monitors (Fama and Jensen, 1983). However, findings on the impact of board independence on board performance and corporate performance have been mixed; little or no correlation has been found, raising questions about the merits of board independence and about the true drivers of board performance (Bhagat and Black, 2002; Dalton *et al.*, 1998; Deutsch, 2005).

Some have explained the inconsistency of these findings by emphasizing the potential trade-offs associated with boards that are primarily made up of independent directors who may lack the necessary knowledge and skills to carry out their duties, particularly those associated with strategy involvement (Lawler and Finegold, 2006; Roberts *et al.*, 2005). Over the years, there have been a number of changes in how the role of corporate boards is defined (Anderson *et al.*, 2007). Whereas boards used to focus primarily on monitoring management, they are now increasingly expected to assume an advisory role and to participate actively in the strategic process (Adams and Ferreira, 2007; Lees, 2004; Sundaramurthy and Lewis, 2003). Empirical results suggest that board expertise is positively associated with increased involvement in strategic issues (Pugliese and Wenstøp, 2007; Ruigrok *et al.*, 2006; Zahra and Pearce, 1990; Zona and Zattoni, 2007). These studies underline the value of resources, experience and knowledge that both inside and outside directors may have (Hillman *et al.*, 2000). Although insiders contribute firm-specific knowledge and experience that may yield valuable insight, outsiders have access to important stakeholders and resources and may possess both functional knowledge (e.g. accounting, financial, legal or marketing) and general industry knowledge that is relevant to the board's functions (Forbes and Milliken, 1999; Hillman *et al.*, 2000; Ravasi and Zattoni, 2006). In addition, Rindova (1999) has recommended that when directors' expertise is being considered, skills associated with problem solving, communication and teamwork should not be overlooked.

Although these studies have identified board expertise as an important determinant of board performance, some surveys have indicated that the overall level of board expertise is insufficient to carry out current and emerging roles and responsibilities (Felton and Fritz, 2005; *McKinsey Quarterly*, 2008). Consequently, various stakeholders are now emphasizing board processes aimed at developing and improving board expertise. They argue that to ensure strong oversight and relevant input into strategic decisions, companies must ensure that board members have the required skills and knowledge. In particular, three processes have been targeted as essential to building board expertise:

1. education programs;
2. director nominations; and
3. board performance evaluations (Brown, 2007; Dulewicz and Herbert, 2008).

Brown (2007) has found that these processes are positively linked to board capability and that increases in board capability lead to improved board performance. Furthermore, some governance activists and governance rating services have identified specific evaluation criteria for these processes. In addition, many stock exchanges require listed companies to disclose information about these three areas of concern. For example, the New York Stock Exchange (NYSE) requires that its listed companies disclose this information in a mandatory company document called ''corporate governance guidelines'' (New York Stock Exchange, 2004). These corporate governance guidelines must be publicly available and should describe the board's responsibilities, qualifications, rules, and procedures.

There is an abundance of literature describing the best practices that companies and boards should adopt in order to improve directors' skills and knowledge. However, we still know little about how companies are reacting to these recommendations; further studies are needed to examine the processes implemented by boards to improve board performance. Based on disclosures in the corporate governance guidelines of 100 leading US companies, our study will investigate the following three board processes:

1. director nominations;
2. orientation and education programs; and
3. board performance evaluations.

Our aim is to contribute to the governance literature by providing empirical evidence on this important topic and to offer guidance to companies examining board processes aimed at improving directors' overall expertise.

By focusing on disclosures in corporate governance guidelines, we also hope to gain insight into decisions made by companies under increased pressure from securities regulators and other stakeholders to provide increased transparency on governance issues (Bujaki and McConomy, 2002; Long, 2006). In recent years, there have been significant increases in both the quality and quantity of corporate governance disclosures (Markarian *et al.*, 2007).

Based on these disclosures, stakeholders are able to evaluate the quality of board practices and obtain assurance that mechanisms promoting the corporation's long-term interests are in place. Furthermore, these company guidelines can help meet increased obligations and expectations with respect to enhancing the quality and quantity of communications targeted at a broader range of stakeholders. In addition, the evidence suggests that financial markets are responding positively to company governance guideline disclosures (Collett and Hrasky, 2005; Picou and Rubach, 2006). For example, Picou and Rubach (2006) found that the stock price of firms that issued governance guidelines increased following the announcement.

2. Methodology

To examine the processes associated with board skills and knowledge, our study was based on a sample of 100 companies taken from the *Fortune* 500 list. This list includes large companies from 75 different industries. While the original list includes both private and public US incorporated companies filing financial statements with a government agency, our sample focused on the first 100 public companies.

The governance guidelines were downloaded from the companies' websites in April 2008.

The companies' governance guidelines were reviewed and information on three specific board processes was compiled:

1. director nominations;
2. orientation and education programs; and
3. board performance evaluations

The company governance guidelines were initially analyzed and an exhaustive list for each of the above processes was drawn up; governance elements and terms used in the guidelines were also compiled. Based on this list, we developed three evaluation grids that reflected company decisions about governance issues; information in the company guidelines was then checked against these grids. During our review of the relevant sections of the guidelines, we determined whether the processes were mentioned; if so, the nature of the information was recorded.

3. Main findings

3.1 Nominating process

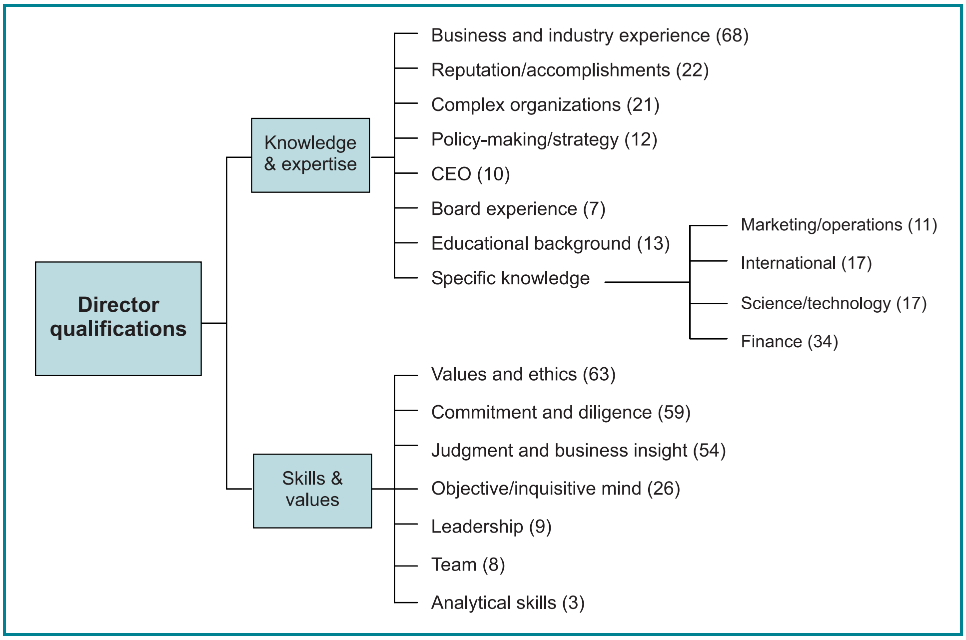
The first process examined was that of director nominations. In the past, many board members were selected by CEOs based on their personal relationships, affiliations or friendships, and were expected to vote with the CEO (O'Neal and Thomas, 1995). However, in the current environment, the competence, values and independence of board members are all significant areas of concern; the nomination of directors has become an important board task. For listed companies, responsibility for this process lies with an independent corporate governance/nominating committee. The NYSE has determined that it is the responsibility of this committee ''to identify individuals qualified to become board members, consistent with criteria approved by the board, and to select, or to recommend that the board select, the director nominees for the next annual meeting of shareholders'' (New York Stock Exchange, 2004, p. 8).

Although there has been a good deal of focus on independence as a requirement for board membership, criteria associated with directors' expertise and values are now being examined closely by corporate boards (Dulewicz and Herbert, 2008). Our study will focus on these specific criteria.

In Figure 1, we examine directors' qualifications in terms of:

1. knowledge and expertise; and
2. skills and values.

Figure 1 Directors' qualifications: survey findings



As regards knowledge and expertise, Conger and Lawler (2001) have emphasized the importance of adopting criteria tailored to a company's specific needs. They have also suggested that issues such as company size or degree of internationalization should have a bearing on expectations concerning directors' expertise. We found evidence of this in the company guidelines we reviewed; our findings show that most of the companies (68) stated in their guidelines that relevant business and industry experience are requirements for board membership. Some guidelines provided more specific information on the type of experience and knowledge required. Indeed, 22 companies mentioned that potential candidates would be selected on the basis of outstanding accomplishments or reputation, while 21 companies mentioned that directors must have experience dealing with complex organizations.

In some cases, the guidelines mentioned that candidates should have CEO experience (ten cases) or prior board experience (seven cases). Other more specific criteria included experience with policy-making or strategy (12 cases) and particular educational achievements (13 cases). Some companies included specific criteria concerning directors' functional knowledge of traditional areas of business: marketing/operations (11 cases), international management (17 cases), law (two cases) and finance (34 cases). As regards financial criteria, eight companies referred specifically to ''financial expertise'' while six mentioned ''financial literacy''. There is ongoing discussion about the required level of financial literacy for board members; based on our findings, it is evident that board members are increasingly expected to have sufficient financial knowledge to understand, evaluate and contribute to discussions of corporate financial and accounting issues. Similarly, board members are expected to have sufficient general knowledge to participate in all topics of discussion and are expected to ask questions of specialists until they feel comfortable casting a vote.

As regards directors' personal qualities and skills, our findings indicate that many companies have included such criteria in their guidelines. As seen in Figure 1, the criteria of strong values and ethics were mentioned most often (63 cases), while diligence and commitment were mentioned by 59 companies. Since board members are being asked to take on a far more active and time-consuming role than they did in the past, these findings are not surprising. In light of directors' more active roles, board membership today should be viewed as a highly significant time commitment. Board members must have a solid grasp of their company and industry and must perform the required due diligence if they are to be fully engaged in the process of addressing challenges and identifying potential solutions to company problems. Other frequently mentioned criteria included judgment and business insight (54 cases) and objective and inquisitive mind (26 cases). Finally, analytical skills were mentioned by three companies, while leadership and teamwork were mentioned by nine and eight companies, respectively.

Another important issue associated with director nominations is that of balancing new and existing directors' skills and knowledge to create board diversity. If the board as a whole encompasses a broad range of knowledge, expertise and viewpoints, diversity is fostered and the quality of board decisions is improved (Forbes and Milliken, 1999; Van der Walt *et al.*, 2006). Consequently, boards have been increasingly seeking to enhance board member diversity by appointing minorities and primary stakeholders. Bilimoria and Piderit (1994) have underlined the potential trade-offs associated with homogeneous boards: while they may bring cohesiveness, they can also lead to behavior such as groupthink. According to these authors, companies and boards must balance the need for cohesiveness and diversity through the nominating process. Our findings support this conclusion: 60 companies stated in their guidelines that they aim to achieve diversity in terms of background through their nominating process, while 49 stated that their process was aimed at achieving diversity in terms of factors such as gender or ethnicity.

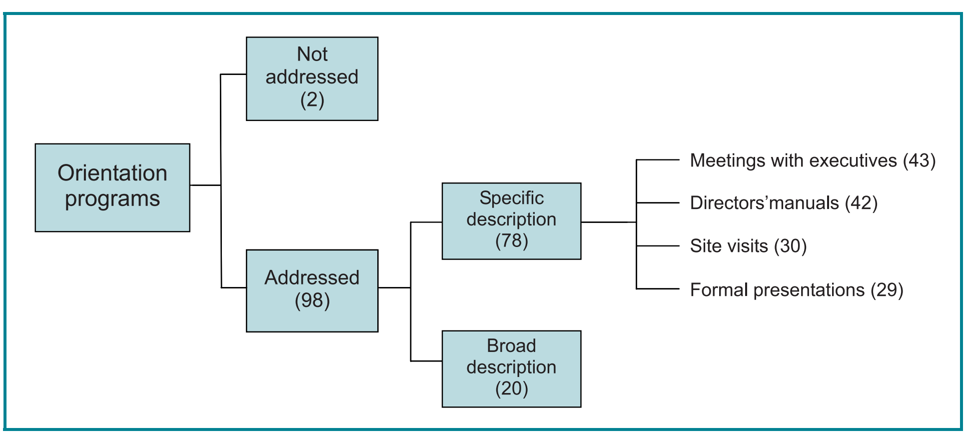
To help ensure that boards have the right mix of personal talents and qualities, tools such as the skill matrix have been developed in which current expertise is weighed against needed competencies; the skill matrix is typically developed through a three-step process. The first step is to identify skills and competencies that reflect specific organizational contexts and strategic corporate objectives. The second step entails checking the matrix of board members' current skills against the list of desirable skills and competencies. The third step involves carrying out a ''gap analysis'' to identify which skills and competencies are needed to complement those of the existing board members. This type of process should be a component of a comprehensive board performance evaluation system which should include a skill and knowledge assessment based on boards' specific needs.

3.2 Orientation and education programs

The second process we examined involves orientation and education programs for board members. Usually, the objective of orientation programs is to familiarize new directors with the company's operations and industry and to provide them with a clear understanding of their role (Long, 2008). Orientation programs typically include site visits, meetings with CEOs and senior management, formal presentations and directors' manuals.

As seen in Figure 2, a total of 98 companies addressed orientation issues in the guidelines we reviewed. While 20 companies addressed orientation issues without specifying the program elements, 78 companies provided specific examples. The most frequently

Figure 2 Orientation programs: survey findings



mentioned program elements were meetings with CEOs and senior management (43 cases) and directors' manuals (42 cases). Directors' manuals usually contain company information, strategic plans, board information, industry information and contact lists (Shultz, 2001). Other program elements included site visits (30 cases) and formal presentations (29 cases).

While orientation programs are primarily designed for newly appointed directors, education programs focus on building and maintaining both new and existing directors' competencies in a variety of relevant areas. Some companies believe that a rigorous nominating process will ensure that boards are made up of highly qualified individuals. However, in light of increasingly complex regulations, ever-changing business environments and higher expectations concerning the oversight role of corporate boards, directors' skills and competencies must now be actively developed and maintained.

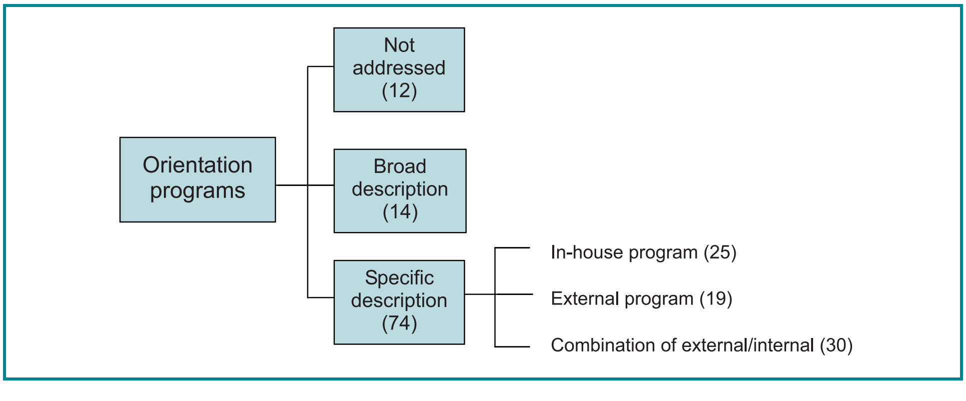
When considering educational programs, companies and boards have three options:

1. in-house programs;
2. external programs; or
3. a combination of both.

Based on our findings, 88 companies disclosed information about educational issues (see Figure 3). While 14 of them addressed these issues in broad terms, 74 provided more specific information. Of the latter group, 25 companies had in-house programs, 19 had external programs and 30 had combinations of both. The large number of companies relying on external programs (49 cases) (either partially or exclusively) is not surprising since there has been a dramatic increase in the number of programs offered by universities, leading authorities and other organizations. These programs, some of which are accredited, focus on specific board-related responsibilities and on how to improve board performance. They are typically divided into modules that address specific topics. A common objective of these programs is to ensure a minimum level of financial literacy, with most including a module on financial statements. In addition, most programs include modules focusing on specific committee responsibilities such as auditing, compensation and governance.

External programs may be a good alternative for some companies; developing specific in-house programs to address topics such as compensation, Sarbanes-Oxley compliance and directors' roles and responsibilities is often not necessary since these issues are typically covered in external programs (Epstein and Roy, 2007). External seminars may also provide board members with opportunities to meet directors from other companies and to share experiences and best practices. In addition, program/director accreditation sends a clear message to investors, shareholders and other stakeholders that companies are committed to sound governance practices and ensures that board members have the required skills and competencies. However, in-house programs that take into account industry-specific and company-specific challenges can also be valuable and highly relevant

Figure 3 Education programs: survey findings



tools. When evaluating educational programs, companies and boards should consider a mix of in-house and external programs, depending on the subject matter to be addressed.

Of the 49 companies relying on external programs, seven stipulated that the programs must be accredited by a relevant organization (in two cases, the guidelines specifically mentioned Institutional Shareholder Services). In 33 cases, budgetary issues regarding external programs were specifically mentioned; in these cases, the guidelines stated that expenses would be reimbursed by the company. Finally, as regards directors' participation in educational programs (either external or in-house), we found that these programs were mandatory in 22 cases. In most cases, however, the guidelines indicated that participation was ''desirable'' or ''encouraged''.

Implementing the proper mechanisms to identify educational needs is essential. The needs of the directors themselves must also be determined. Board members should communicate their degree of satisfaction with the training programs (either external or in-house) in which they participate. Boards should be attuned to changing informational needs as well as to the training needed to enhance skills, competencies and knowledge. A comprehensive board performance evaluation system would prove valuable when developing or selecting education programs aimed at improving the skills and competencies of existing and new directors.

3.3 Board performance evaluations

Annual board performance evaluations are required by many securities regulators worldwide (Long, 2006). However, the implementation of this requirement varies greatly from one company to another. Board performance evaluations provide a valuable opportunity to carefully assess both strengths and weaknesses, to consider the board's role and its contribution to improving corporate performance and to identify specific areas for improvement.

Minichilli *et al.* (2007) have concluded that an effective board evaluation system should address four important questions:

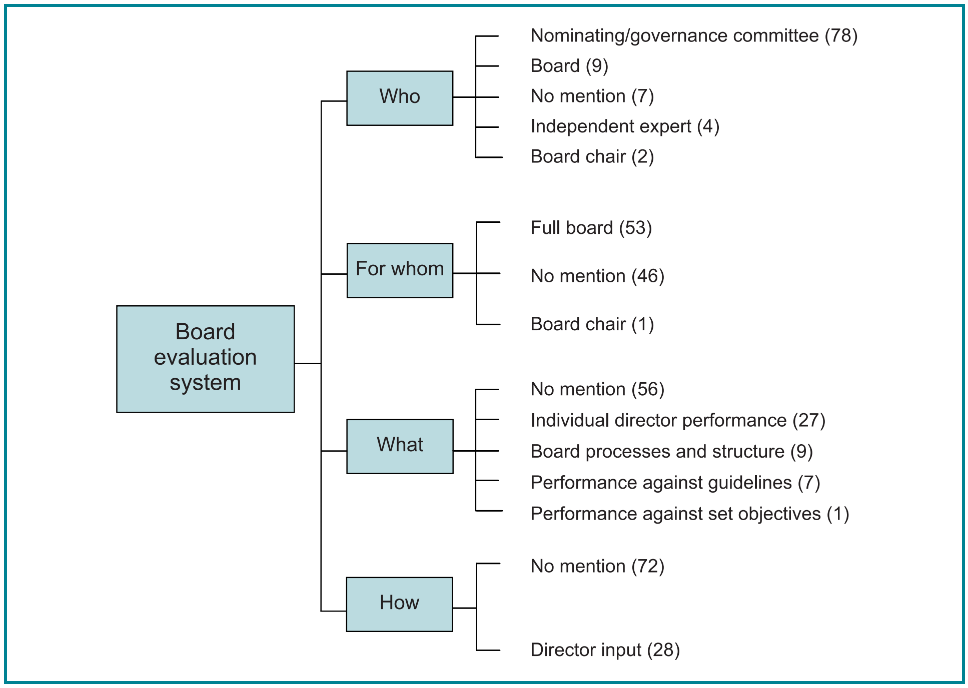
1. Who should evaluate the board (e.g. consultants or board committees)?
2. What aspects of board performance should be evaluated (e.g. board processes, individual directors, or specific criteria)?
3. For whom is the evaluation intended (e.g. the board or shareholders)?
4. How will the evaluation process be carried out in specific terms (e.g. via questionnaires or open discussions)?

The framework developed by Minichilli *et al.* (2007) was used to examine the types of information disclosed in the company guidelines. As seen in Figure 4, company guidelines mainly provide information on who is responsible for the evaluation process (78 companies stated that the nominating/governance committee was responsible) and for whom the results are intended (53 companies stated that the evaluations would be submitted to the full board for discussion).

As regards the aspects of board performance that are subject to evaluation, the company guidelines were of little help since most companies (56 cases) did not disclose any information on this particular topic. Consistent with other surveys (Spencer, 2007), our findings revealed that only a minority of companies (27 cases) conducted formal individual evaluations. Nevertheless, because directors are encouraged to focus on individual responsibilities and accomplishments relating to board performance improvements, individual evaluations should be part of the board evaluation process. Resistance to individual evaluations is often rooted in concerns that they might deter qualified candidates or offend and embarrass existing directors (Collier, 2004; Long, 2008).

Consistent with the study conducted by Dulewicz and Herbert (2008) concerning Financial Times Stock Exchange (FTSE) boards, we found that only a small number of companies established specific criteria or targets as part of their performance evaluation process.

Figure 4 Board performance evaluations: survey findings



Based on our findings, nine companies specifically mentioned that board processes/structure would be considered in the performance evaluation process, while seven mentioned that board performance would be evaluated against practices set out in their governance guidelines. These findings raise concerns about these companies' ability to identify and focus on the inputs, processes, outputs and outcomes required to significantly improve company/board performance.

In recent years, companies have placed greater emphasis on developing performance metrics aimed at measuring and managing corporate performance more effectively. Information systems have been developed to provide a broader set of metrics for use within new strategic management systems (Lees, 2004). Although some emphasis has been placed on developing improved performance metrics, they have generally not been applied to corporate boards. The reluctance to measure board performance has been identified as a significant barrier to improving internal governance and external accountability (Collier, 2004; Minichilli *et al.* 2007). Implementing measures in support of a comprehensive board performance evaluation system is critical. Such measures are essential for monitoring key performance drivers and for determining whether corporate boards are achieving their stated objectives (Epstein and Roy, 2004). Nevertheless, we found little evidence of these measures during our analysis of the company guidelines.

The companies provided scant information on how the evaluation process was carried out (72 of them did not provide any such information). However, our findings seem consistent with survey data indicating that evaluations are mostly self-evaluations based on director input (Dulewicz and Herbert, 2008; Spencer, 2007), and that they are insufficiently rigorous to contribute to significant improvements in board performance. Although tools such as self-assessments are important, they are only a first step. They should be viewed as one element of a broader system encompassing self-assessments, external assessments and other data sources, including both objective and subjective evaluations. Self-assessments alone have significant weaknesses; unless they are supplemented by other inputs and metrics, performance cannot be fully evaluated (Epstein and Roy, 2004).

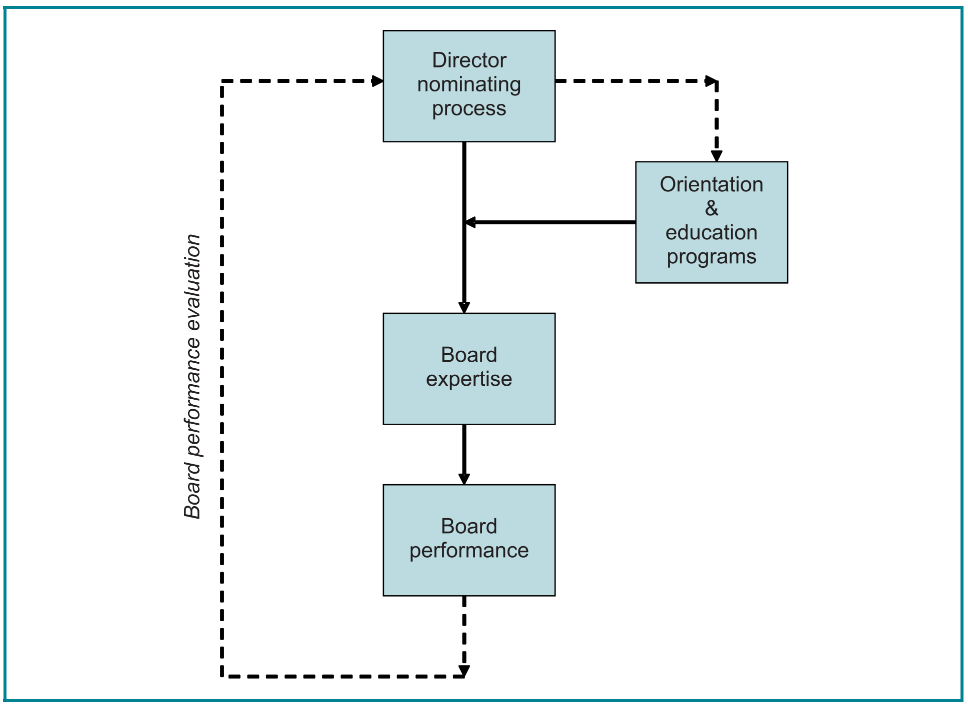
Because companies provided so little information about the metrics used in the evaluation process, our findings cast doubt on how well the three board processes are integrated. For example, most companies identified desirable types of skills and knowledge for directors. However, most company guidelines did not state that these criteria would be considered in the performance evaluation process. Ideally, the three processes should be well integrated since each process provides valuable information for improved decision-making, as seen in Figure 5. The performance evaluation of board should highlight boards' needs and point to specific board member skills and knowledge that must be obtained through either new members or additional board member training. These efforts should improve the overall level of board expertise and lead to superior board performance.

Reluctance to establish more rigorous evaluation procedures stems from three main concerns. First, evaluation procedures are often viewed as overly burdensome and time-consuming (Long, 2008). Second, companies fear that evaluation results could contain evidence of improper conduct and could be subsequently used in civil or criminal proceedings (Stybel and Peabody, 2005). Third, if boards fail to respond appropriately when problems are discovered, key stakeholders may be dissatisfied. As boards implement more rigorous performance evaluation systems, they will need to take on new responsibilities and make very difficult decisions. Indeed, performance measurement systems may reveal information that requires immediate action and decisions. For example, insufficient attendance by a director should be dealt with decisively; the performance measurement system will be of little use if the results are not used to improve and challenge current practices and performance. By carefully analyzing and articulating the drivers of board performance and measuring the inputs, processes and outcomes, companies could dramatically improve board as well as corporate performance.

4. Conclusion

Recent regulatory changes and pressure from investors and governance activists have led to significant changes in the way corporate boards carry out their responsibilities. Demands for increased involvement in strategic decisions have forced companies and boards to evaluate whether directors have the necessary skills and knowledge to participate fully in this process. As a result, processes aimed at enhancing board expertise are being

Figure 5 Integration of board processes



examined closely; efforts to gain a better understanding of these issues will be valuable for academics and practitioners alike.

Based on our initial findings, most companies in our sample were in compliance with stock exchange requirements and provided information on director nominations, orientation and education programs and board performance evaluations. All too often, however, the companies disclosed generic, non-specific information; this provides little reassurance that the proper processes are in place to promote companies' long-term interests. In particular, information on education programs and performance evaluations often consisted of ''boilerplate'' disclosures ostensibly provided to demonstrate corporate compliance with regulatory requirements.

Boilerplate disclosures could raise suspicions that board processes were implemented solely to gain and maintain legitimacy in the eyes of various stakeholders, not to increase board performance. Investors are often wary of companies that are unwilling to provide a rigorous accounting of their corporate governance practices. Therefore, for companies that are truly committed to improving board performance, enhanced disclosure is advisable. Companies that refine their governance practices and increase their transparency to stakeholders are able to provide better information to the financial markets while reducing investor risk and improving their stock price. In contrast, companies that adopt practices primarily in response to external pressure and that are fundamentally disinclined to improve their governance practices should be aware of the related risks; they are sure to miss out on significant opportunities for improved board performance.

Our examination of governance guidelines also raises concerns about the effective integration of the three board processes. However, it is important to note that although some activities may not be mentioned in the guidelines, they may still be carried out by corporate boards. Therefore, non-disclosure should be interpreted with caution; indeed, this represents a limitation of this study. Conversely, we were unable to substantiate whether company boards were in compliance with their own guidelines.

Although we have provided some insight into these important board processes and corporate decisions regarding governance disclosures, many aspects of this subject warrant further research. As mentioned previously, the actual integration of these processes could be examined by means of more detailed surveys or case studies. Such studies could investigate possible links between these processes and determine whether they reinforce each other or otherwise can act as substitutes: When there is a rigorous nominating process in place, do companies also require formal educational programs? In addition, more studies will be needed to evaluate the impact of these processes on board expertise, board performance and corporate performance. These studies can help to determine what specific processes are most strongly associated with increases in board expertise, board performance and corporate performance. Other studies could also focus on disclosure decisions and examine whether there is any correlation between the quality/quantity of disclosures across these three processes. Studies could also investigate possible correlations between company disclosures and corporate performance.

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About the author

Marie-Josée Roy is an Associate Professor on the Faculty of Administrative Sciences at University Laval in Québec Canada. Dr. Roy teaches strategic management and her research focuses on corporate social responsibility and corporate governance. Marie-Josée Roy can be contacted at: marie-josee.roy@mng.ulaval.ca