Performance Evaluation of Boards and Directors

* S.K. Sachdeva

Board evaluation has emerged as a corporate governance priority and brought to the forefront many associated challenges. When a corporate crisis occurs, it is to the board that the shareholders, media, regulators and community look for answers. As the ultimate decision-makers in an organisation, the board is responsible for the organisation's actions and performance. The challenge for boards today is to add value to the organisations they govern. Performance evaluation is a means by which boards can ensure they have the knowledge, skills and ability to meet this challenge.

Boards have recognized that it would be important for them to continually assess how effectively they are performing their roles against the objectives and the goals they have set for themselves. This growing recognition has resulted in Board evaluations becoming widely established internationally as a critical structural tool for assessing Board effectiveness and efficiency.

> Corporate Board Evaluation is a new concept in India. Earlier, it was a non-mandatory provision for listed companies.

Corporate Board Evaluation is a new concept in India. Earlier, it was a non-mandatory provision for listed companies. However, it is only with the advent of the Companies Act, 2013 that it became mandatory for all listed companies and all public companies with paid-up share capital of Rs.25 crores or more, for it to be practiced in India.

Benefits of Board Evaluation

Some of the major benefits likely to accrue from the Board Evaluation are as follows :

1. **Compliance with legal requirements**

   There is a global trend toward mandatory provisions made by regulatory bodies such as stock exchanges, central banks and financial services commissions. The Ministry of Corporate Affairs, which has the responsibility to administer India's Companies Act (2013), now mandates the annual reporting of Board evaluations for designated companies.

2. **Investor and shareowner pressures**

   Board evaluation is increasingly used to demonstrate to investors the commitment to improving performance at the highest levels. Institutional investors consider Board evaluation a significant criterion in their governance ratings of companies. Positive results from Board evaluations signal to shareholders and key stakeholders that the company is well governed. When the Board is able to demonstrate an ethical culture and effective practices, the evaluation process raises the profile and reputation of the Chairperson, senior leaders and the company as a whole.

3. **Improved decision-making**

   In many cases, the assessment process leads the Board to reconsider Board practices, including priorities on the agenda and the efficiency of its communication systems and information architecture. The process of raising directors' concerns acts as an early warning system to the Board, which will allow changes to be implemented before more deep-rooted problems set in.

4. **Improved performance**

   Board and individual effectiveness improves as a result of developmental assessment. Improvements in Board practices and structures help to improve trust, respect and business confidence. Significant results may be recognized through corporate governance and Board leadership awards.

5. **Improved accountability**

   Board evaluation is a major method for a company to improve its accountability, transparency and disclosure.

6. **Identification of areas of strengths and weakness**

   Board evaluations, when completed properly, can identify areas of strengths and weakness, leading organisations to make changes that positively impact performance and shareholder value. Done well they can provide independent and impartial advice, objectivity and rigour especially if facilitated externally.

Internal vs External evaluation

Internal evaluations have many benefits, but in certain circumstances, engaging an external independent expert or consultant or advisor to facilitate the Board evaluation process may work better.

One view favouring independent external evaluation is that the evaluation process becomes more independent and transparent. Internal evaluation tends to become mechanical, while an external evaluator could bring in fresh perspectives and approaches.

In large international corporations, Board evaluations are usually conducted by the Governance and Nomination Committees with the help of outside experts. However, there are many companies, especially those in Europe and particularly in the UK, who advocate that the exercise should be conducted only by an independent external expert who would be in a better position to make an independent assessment.

Evaluation process

The evaluation process generally involves the critical examination of the following aspects :

- identification of areas for evaluation;
- formulating a questionnaire on the areas for evaluation;

- obtaining responses of individual directors to the questionnaire on a rating scale;
- conducting interviews with individual directors and
- analysing the responses to the questionnaire and interviews;
- reporting the findings resulting from the analysis to the full Board.

The process is usually tailored to the requirement of the company, the specific situation it is in, the stage of the company's lifecycle, the corporate structure, the Board culture and the embedded processes. However, there is no common format, which is universally acceptable and applicable to all companies.

Director's evaluation

Director's evaluation differs from the Board evaluation in several respects, though the evaluation methodology and the processes followed are largely similar. Both processes have qualitative and quantitative parts – questionnaire responded on a rating scale followed by interviews – but the parameters of evaluation may differ. For example, parameters for director evaluation could be contribution of the director to the Board's strategic thinking, leadership and commitment of the director, participation in Board and Committee meetings, communication and interpersonal skills of the director, ethical issues and dilemmas faced by the director and relationship of the director with the senior management.

Director's evaluation could be a self-evaluation or a peer evaluation, but many companies may have some reservations with peer evaluation. It is therefore important for Boards to build a consensus on the approach to be followed.

Outcomes of the Board evaluation

The outcomes of Board evaluation processes could range from relatively minor amendments to Board processes, changes in Board composition and alterations in Committee structures to significant steps towards rectifying the factors that contribute to Board dysfunctionality. To be a meaningful exercise, the outcomes must result in an actionable plan. The process of implementing the outcomes then naturally becomes a crucial step in the entire evaluation process and should deserve the full attention of the Board and in turn of the management.

Status of Board evaluation in India

The Companies Act, 2013 has mandated that Board of every listed company and of such other company as may be prescribed, must carry out a formal annual performance evaluation of the Board, its Committees, and individual directors and review the performance of the Chairperson. The process and methodology of evaluation has however been left open to the Boards but its responsibility has been assigned to the Nomination and Remuneration Committee.

The Nomination and Remuneration Committee of every listed company and any other class of public companies as may be prescribed by the Rules, are required to carry out evaluation of every director's performance.

Independent directors are required to bring an objective view in the evaluation of the performance of board and management.

The independent directors are required to hold at least one meeting in a year, without the attendance of non-independent directors and members of the management and in that meeting they are required to review the performance of the non-independent directors and the Board as whole; and also review the performance of the Chairperson of the company, taking into account the views of the executive and non-executive directors.

Performance evaluation of Independent Directors

The reappointment of the independent directors would be based on their performance evaluation report.The performance of the independent directors would have to be done by the entire Board excluding the director to be evaluated and the continuance or extension of the independent director would be determined by the performance evaluation report.

Conclusion

Internationally, the performance evaluations are either conducted in house by the Chairperson or the Governance/ Nomination Committee or by an external independent expert. In India, the intent of the Companies Act as well as the new SEBI regulations is that evaluations should be conducted by the Nomination and Remuneration Committee. There appears to be no bar for the Board and the Nomination and Remuneration Committee to seek the assistance and guidance of external independent experts.

Whether the evaluations are to be carried out internally or with the help of the independent expert is a question determined by the Board. The process and the methodology to be followed in the evaluation of Boards and Independent Directors has been left to the Board as it has not been laid down by the Companies Act 2013. The Boards also need to decide the nature and magnitude of disclosures related to evaluations in the Board report.Boards will be able to derive maximum benefits from the evaluation exercises, only if they collectively believe in the evaluation exercise and its ability to help identify the strengths, weaknesses and opportunities of the Boards. ■

**S. K. Sachdeva is working Sr. Manager, Board Research & Advisory with IOD*