Board Evaluation - Key Trends and Developments

An Indian perspective

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Introduction

The aftermath of the global financial crisis and the controversies surrounding the corporate landscape even after the evolution of landmark regulations has brought the focus and attention on the performance of the board as never before. The role of the board of directors has undergone rapid transformation over the past decade. Board evaluation has emerged as one of the corporate governance priority in recent times globally. Corporate governance practitioners have been applying Peter Drucker's idea that "what gets measured gets managed, and among senior leaders, what gets acknowledged and valued gets done even better".

Board evaluation is a key means by which boards can recognize and correct corporate governance problems and add real value to their organizations. A properly conducted board evaluation can contribute significantly to performance improvements on organisational; board and individual member level. According to Heidrick & Struggles Asia Pacific Corporate Governance Report 2014 "Foundations and Building Blocks for High performing Boards", regular Board evaluation is the core driver necessary to promote change and deliver best practice.

The "Review of the Role and Effective Functioning of Non- Executive Directors" carried out under the chairmanship of **Sir Derek Higgs in 2003 (the Higgs Review) in U.K.** for the first time noted the importance of Board performance evaluation. It stated that it is 'best practice that the performance of the Board as a whole, of its committees and of its members, is evaluated at least once a year' and that 'Companies should disclose in their annual report whether such performance evaluation is taking place.'

The evaluation of the performance of the Boards is essentially an assessment of how the Board has performed on variety of factors like-

- Board Structure: its composition, constitution and diversity and that of its Committees, competencies of the members, Board and Committee charters, frequency of meetings, procedures;
- Dynamics and Functioning of the Board
- Business Strategy Governance
- Financial Reporting Process, Internal Audit and Internal Controls
- Monitoring of policies, strategy implementation and systems;
- Supporting and Advisory Role; and
- The Chairperson's Role.

With a view to improve performance and effectiveness, progressive boards across the world are now increasingly deploying board performance evaluation to identify areas of improvement. An effective board evaluation exercise helps the board, committees and individual directors perform to their optimum capabilities. It improves leadership/ performance culture, clarifies differing directors' roles, improves board communication and facilitates board teamwork, improves decision making processes and efficiency of board operations etc.

Realizing the trends and challenges, the regulators around the world have mandated board evaluations. In India the Companies Act, 2013 has introduced a slew of regulations focussed towards enhancing overall governance standards. Effective stewardship by the Board has been amplified as one of the important cornerstones in the various requirements specified under the new Act. A clear mandate to the directors has been provided - *"A director of a company shall act in good faith in order to promote the objects of the company for the benefit of its members as a whole, and in the best interests of the company, its employees, the shareholders, the community and for the protection of environment."* Several other measures for increasing board effectiveness like performance evaluation of board of directors; training of independent directors, guidelines for remuneration of directors has been specified.

Legal Provisions

Board evaluation, until recently, was recognised as a good corporate governance practice and largely undertaken voluntarily. The erstwhile Clause 49 of the Listing Agreement as a non-mandatory requirement, provided for performance evaluation of non-executive directors by a peer group. Further, the Corporate Governance Voluntary Guidelines 2009 recommended that the Board should undertake a formal and rigorous evaluation of its own performance and that of its committee and individual directors. A few progressive companies however had been pursuing Board evaluation (and in some instances even peer evaluation of directors) voluntarily as they believed in its usefulness. In all these voluntary cases, the evaluation was led by the Chairperson and the assistance of independent external experts was seldom sought. However, the Companies Act 2013 has introduced mandatory provisions for board evaluation in India.

Currently legal provisions for board evaluation are provided under the Companies Act 2013 and the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 for all listed entities.

Requirements under the Companies Act 2013

1. **Disclosure requirement in the Board's Report on performance evaluation**

   Section 134 (3) (p) read with Sub-rule (4) of Rule 8 of the Companies (Accounts) Rules, 2014 provides that every listed company and every other public company having paid- up share capital of twenty five crores or more calculated at the end of the preceding financial year should include in the report by its Board of Directors, a statement indicating the manner in which formal annual evaluation has been made by the Board of its own performance and that of its committees and individual directors.

   However, the Ministry of Corporate Affairs vide Notification No. G.S.R. 463(E) dated 5-6-2015 provided certain exemption to Government Companies. This section does not apply in case the directors are evaluated by the Ministry or Department of the Central Government which is administratively in charge of the company, or, as the case may be, the State Government, as per its own evaluation methodology.

2. **The Role of the Nominations and Remuneration Committee in performance evaluation of directors**

   Section 178 (2): The Nomination and Remuneration Committee of every listed company and all public companies with a paid up capital of ten crore rupees or more; or having turnover of one hundred crore rupees or more; or having in aggregate, outstanding loans or borrowings or debentures or deposits exceeding fifty crore rupees or more shall formulate criteria for evaluation of performance of independent directors and the board of directors.

   Further, the Companies Amendment Bill, 2016 has proposed that the Committee shall specify the methodology for effective evaluation of performance of Board, its committees and individual directors to be carried out either by the Board, by the Nomination and Remuneration Committee or by an independent external agency.

3. **Independent Directors' role in performance evaluation of Boards, non-executive directors and Chairperson**

   Section 149 of the Act provides that the company and independent directors' shall abide by the provisions specified in Schedule IV.

   Schedule IV (Section II (2)): Independent directors are required to bring an objective view in the evaluation of the performance of board and management.

   Schedule IV (Section VII): 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.

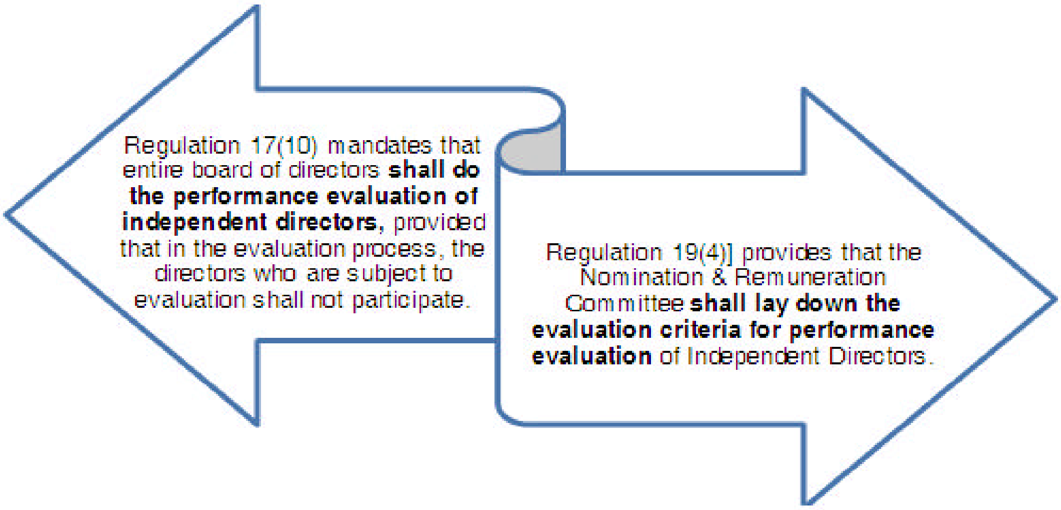
4. **Performance evaluation of Independent Directors**

   Schedule IV Section V: The reappointment of the independent directors would be based on their performance evaluation report.

   Schedule IV Section VIII: 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.

Provisions under the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015

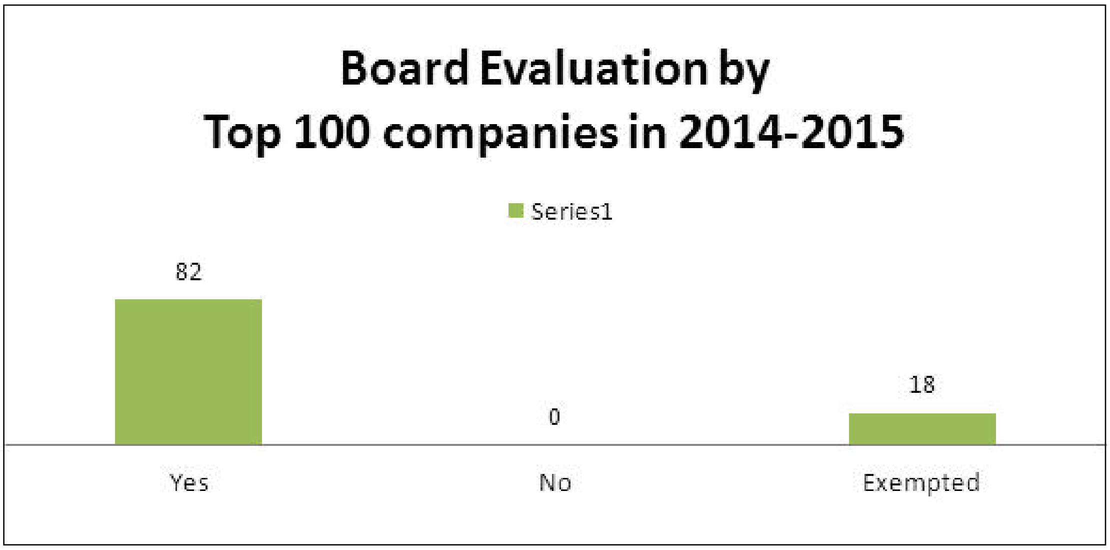
SEBI with a view to consolidate and streamline the provisions of existing listing agreements for different segments of the capital market and to align the provision relating to listed entities with the Companies Act 2013, has notified the SEBI (LODR) Regulations, 2015. The regulations prescribed in these regulations are applicable to all listed entities.



Current trends and practices

Out of top 100 companies listed in BSE, all companies have made a disclosure in its annual report regarding board evaluation. Eighteen companies were exempt from reporting on Board Evaluation as they were government owned companies. Of the eighteen, fifteen were public sector undertakings and the remaining three were public sector banks.

However, it is interesting to note that three public sector undertaking BHEL, Container Corporation and Rural Electrification Corporation reported on the Board Evaluation process followed, despite the exemption available to them. Voluntary reporting is a commendable practice, worthy of emulation by other public sector companies.



Though all companies have disclosed a para on Board evaluation stating that they have conducted evaluation of board, this approach does not focus on the mechanics of how the board evaluation process is conducted and analyzed. Investors value specific details that explain who does the evaluation of whom, how often each evaluation is conducted, who reviews the results and how the board decides to address the results. This type of disclosure does not discuss the findings of specific evaluations, either in an individual or a holistic way, nor does it explain the takeaways the board has drawn from its recent self-evaluations. Instead, it details the "nuts and bolts" of the self-assessment process to show investors how the board identifies and addresses gaps in its skills and viewpoints generally. This kind of disclosure can be an "evergreen" approach that remains the same in proxy materials from year to year, assuming the board's evaluation process does not change.

Process of Evaluation:

The Act does not prescribe any specific method for evaluating the board. Generally, Board evaluation is an elaborate process. Pre-evaluation process involves deciding the objective, criteria and method for evaluating the board. The board decides all those with inputs from the CEO. The most common evaluation method is to collect data by analysing governance documents (e.g., agenda and minutes), surveying directors through a questionnaire and interviewing directors. A robust board evaluation strategy employs all of these tools both in combination and rotation over time.

The data so collected is analysed and a report is presented for discussion before the full board. Performance of individual directors is assessed through self-assessment and interview. Feedback is provided to each director on a one-to-one basis. Usually, the chairperson of the Nomination Committee or the lead independent director supervises the whole process, interviews individual directors, provides feedback to each director and presents the report before the full board. Confidentiality is the hallmark of the evaluation process. Therefore, names of individuals are removed from all documents while collating and analysing the data.

Top listed companies in India like HDFC, HDFC bank, ICICI bank, Mahindra and Mahindra Limited, Godrej Consumer, Zee Entertainment and Bosch Limited have evaluated their directors and committees through questionnaires.

HDFC Limited in its annual report has mentioned that it has evaluated the performance of board at two levels. The process of board evaluation adopted by HDFC is given in following paras-

"The evaluation of the performance of the board is done at two levels. First, the overall performance of the board is evaluated through a questionnaire, based on criteria such as the board composition, compensation, strategic planning, role of the Chairman, non-executive directors and other senior management, assessment of the timeliness and quality of the flow of information by the Corporation to the board and adherence to compliance and other regulatory issues.

At the second level, the directors do a self evaluation of their performance. The Nomination & Remuneration Committee at its meetings discussed and reviewed the criteria and responses received from directors. The independent directors also held a separate meeting to review the performance of the non-executive directors, the Chairman of the Corporation and the overall performance of the board. Subsequently, at the meeting of the Board of Directors, the consolidated report of the responses received from the directors was tabled. The board reviewed the performance of each of the directors of the Corporation and the board as a whole and expressed its satisfaction on the same."

Criteria for evaluation

The Section 178 (2) of Companies Act 2013 and SEBI (LODR) Regulations provides that Nomination and remuneration Committee shall formulate criteria for evaluation of performance of independent directors and the board of directors. Some companies like Sun Pharma, HDFC, Tata Motors, ICICI Bank, Maruti Suzuki, Bajaj Auto, Hero MotoCorp, Eicher Motors, Dr. Reddy, Aurobindo Ltd, Shree Cements, Yes bank and Bajaj Finance have mentioned certain criteria for evaluation of board, directors and committees in their annual report.

One of the leading Pharmaceutical Indian Company – Sun Pharma Limited has stated in its annual report various criteria on which evaluation of directors has taken place. The company has made disclosure in its annual report of 2015 as – "The performance of the Board was evaluated by the Board after seeking inputs from all the Directors on the basis of various criteria such as Board Composition, process, dynamics, quality of deliberations, strategic discussions, effective reviews, committee participation, governance reviews etc. The performance of the Committees was evaluated by the Board after seeking inputs from the Committee members on the basis of criteria such as Committee composition, process, dynamics, deliberation, strategic discussions, effective reviews etc. The Nomination and Remuneration Committee reviewed the performance of the individual Directors on the basis of the criteria such as Transparency, Analytical Capabilities, Performance, Leadership, Ethics and ability to take balanced decisions regarding stakeholders etc."

Hindustan Zinc Limited, the second largest integrated producer of zinc and lead in the world has mentioned several detailed parameters for Board evaluation in its Annual Report of 2014-2015. *"The independent Directors have carried out a performance review of the Board as a whole on the following parameters*:

- *The size and composition (executive, nonexecutive, independent members and their background in terms of knowledge, skills and experience) of the Board is appropriate.*
- *The Board conducts itself in such a manner that it is seen to be sensitive to the interests of all stakeholders (including minority shareholders) and it has adequate mechanism to communicate with them.*
- *The Board is active in addressing matters of strategic concerns in its review of the Board agenda with the executive management.*
- *The Board makes well-informed high quality decisions on the basis of full information and clear insight into Company's business.*

- *The Board is effective in establishing a corporate environment that promotes timely and effective disclosure, fiscal accountability, high ethical standards and compliance with applicable laws and regulations.*
- *The Board meets frequently enough and for sufficient duration to enhance its effectiveness. • The Board meeting time is appropriately allocated between management presentation and Board discussion.*
- *The Board has a good understanding of the Company's key drivers of performance and associated risks, threats and opportunities.*
- *The Board devotes considerable amount of time in developing the business strategy and annual business plan.*
- *The Board has clearly defined the mandates of its various Committees and effectively oversees their functioning.*
- *The Board is effective in formulating and monitoring various financial and non-financial policies and plans.*
- *The Board is effective in developing a corporate governance structure that allows and encourages the Board to fulfill its responsibilities.*
- *The Board pays considerable attention to the quality of financial reporting process and internal financial controls and effectively oversees them.*
- *The Board regularly follows up on its decisions to ensure that action is taken on all its decisions.*
- *The Board gives effective advice and assistance for achieving the Company's mission and vision. After deliberation, the Committee of Independent Directors expressed its overall satisfaction.*

Evaluation by External Agency:

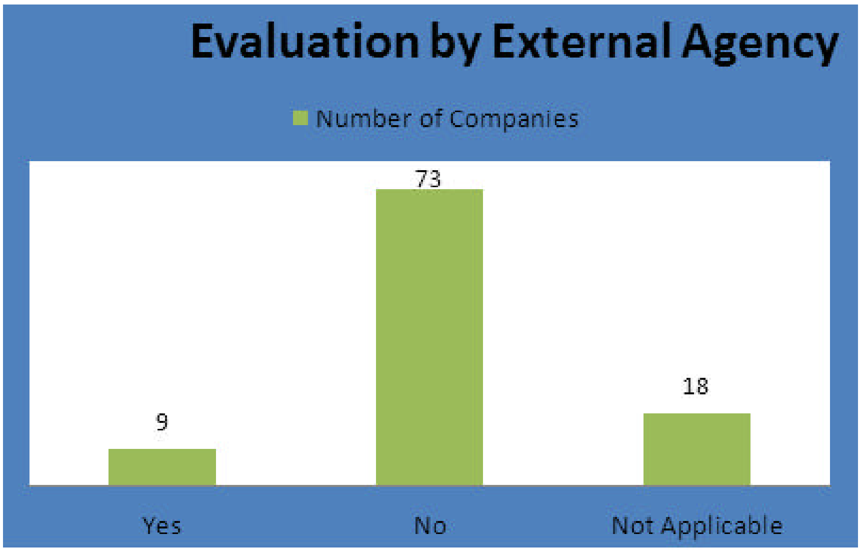
Board Evaluation by external agency helps to gain a view on how a board is doing compared to other boards. A good external facilitator can add much external perspective which a board would otherwise not be able to access. An external view can be both challenging as well as reassuring. Evaluation by external agencies provides independent and impartial advice, objectivity and rigour.

Internationally, the performance evaluations are either conducted in house by the Chairperson, or the Governance and Nomination Committee or by an external independent expert. Further, the Companies Amendment Bill, 2016 mentions that the Committee shall specify the methodology for effective evaluation of performance of Board, its committees and individual directors to be carried out either by the Board, by the Nomination and Remuneration Committee or by an independent external agency. Therefore, the Nomination and Remuneration Committee may seek the assistance and guidance of external independent experts.

While conducting board evaluation through external agencies, both the parties - the consultants and the companies/ clients should be clear about the levels of expectation associated with the assignment. Both the parties should communicate openly and transparently to avoid the risk of misunderstandings, and maximise the benefits of the engagement.

In connection with the party responsible for implementing the evaluation process, it is also important to note that these external consulting firms have no ties to the Board of Directors or senior management, and have full autonomy in tabulating the results and examining the appraised parameters.

On analysing the annual reports of top 100 companies listed in Bombay Stock Exchange in India, it is observed that only 9 companies Ashok Leyland, Bharti Airtel, Bharti Infratel, Cipla, Dr. Reddy's Lab, Godrej Consumer, Kotak Mahindra, Reliance Industries and Shree Cements have disclosed that they have appointed external agency for board evaluation. 8 companies are government companies and are not required to get board evaluation done. Other 36 companies have not appointed any external consultants for this process.



Post-Evaluation Activities

Most companies out of top 100 companies which have been analysed, have not mentioned anything about post evaluation activities done by them in the annual report.

Some companies like Hindustan Unilever Limited, Bosch Limited have reported that they have taken post evaluation activity also. The extracts from their annual reports are given below-

Hindustan Unilever Limited - *"The results of the Evaluation were shared with the Board, Chairman of respective Committees and individual Directors. Based on the outcome of the Evaluation, the Board and Committees have agreed on the action plan to improve on the identified parameters."*

Bosch Limited – *"The feedback from the Directors was summarized and ideas for further improving effectiveness of the Board processes, etc. were discussed."*

Though evaluations provide critical insights into how the board can become stronger and support the organization's strategic objectives. However, such assessments are merely superficial if they are not acted upon, if the strengths revealed are not leveraged, or if the weaknesses identified are not remediated. Boards look forward to evaluations for useful feedback, which can be used to develop specific action plans. The results must be communicated to the right parties in an appropriate manner, leading to generating an improvement action plan.

Generally a post evaluation activity should include-

- Preparing a summary report and analysis of the findings highlighting the degree of board effectiveness in each area examined, noting areas of effectiveness as well as areas of concern.
- Discussing with the nominating committee what was learned in the board evaluation process and share any additional insights.
- Submitting the report to each director and place the board's discussion of the findings as a high-priority agenda with sufficient time allocated.
- Discussing the findings candidly and openly with each director so that he/she can freely contribute his/her views.
- Agreeing on and approve an action plan to address areas of improvement.
- Assigning responsibilities and monitoring any improvement achieved.

A similar process may be followed for the evaluation of the board committees. Where the results of the evaluation concern individual director performance, the generally accepted approach is for the board chairman and/or the nominating committee chairman, with or without an external facilitator, to discuss the findings individually with each director. The success of such an approach depends very much on the introspection, confidence and honesty of the individuals participating in the process and the degree of trust and collegiality in their board culture. If the objective of the board evaluation is to assess the quality of board-management relationships, results of the evaluation should be shared with the executive management team.

Review of board by independent directors

The Act requires independent directors 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.

Independent directors should formally evaluate the board and non-independent directors. They may finalise the draft report in the separate meeting. Although, the law is silent on how the result of evaluation will be used, the draft report should be discussed with the full board to decide the actions for improving board effectiveness. Independent directors should involve the CEO and the full board in deciding the objective, criteria and method of evaluation.

TCS Limited in its Directors Report has mentioned that separate meeting of independent directors was conducted – *"In a separate meeting of independent Directors, performance of non-independent directors, performance of the board as a whole and performance of the Chairman was evaluated, taking into account the views of executive directors and non-executive directors. The same was discussed in the board meeting that followed the meeting of the independent Directors, at which the performance of the Board, its committees and individual directors was also discussed."*

Evaluation of independent directors

The laws and regulations also provided for the review of performance of the independent directors by the entire Board excluding the director and the continuance or extension of the independent director would be determined by the performance evaluation report.

However, discussion of report cards of individual directors with the full board is likely to be resented by directors and might drive away good directors. The best practice may be to use self-assessment and interview method to assess individual performance and to provide feedback to each director (independent or non-independent) on a one-to-one basis. The reports of independent directors should be submitted to the chairperson of the Nomination and Remuneration Committee. It should consider the same while deciding the continuation of the independent director as a board member. Boards should adopt the global best practices.

Mostly companies in India which have been assessed have evaluated the entire board including independent directors.

Concluding Remarks

Board evaluation provides an opportunity for companies to continuously improve and transform a 'good board' to a 'great board'. The objective of the evaluation is quite simple. It is to measure how the chairman, board, committees and individual directors have contributed to improving the company's health and ensuring perpetual success of the company. However, developing evaluation parameters and the process to achieve this simple objective is complex. The same size does not fit all. Therefore, like regulators in other jurisdictions, the government has not prescribed the review process. Every board has developed its own process and parameters. There are many factors that will determine the way the provision will be implemented in practice. The crucial one is the level of independence of independent directors. The Remuneration and Nomination Committee should be allowed to work independently. The board should deliberate and decide the process and designate the independent director who will lead the process. It should also decide how it would use the feedback. Board evaluation would certainly improve quality of the board and directors but time will only tell how effective the evaluation will be as it is an objective exercise which cannot be regulated.