Performance Evaluation of Boards and Directors
Board Evaluation

Mounting stakeholders’ expectations, challenges faced by companies to operate under fluctuating economic conditions, pressures of globalisation and increased regulatory requirements have brought the quality of performance of the Boards of Directors under greater scrutiny. 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 in rules-based as well as in principles-based jurisdictions, as a critical structural tool for assessing Board effectiveness and efficiency. In some jurisdictions, the directors are also evaluated along with the Boards.

Assessing Board Effectiveness

The Board performs three major roles in a company – it provides direction (i.e. sets the strategic direction of the company), it controls (i.e. monitors the management) and provides support and advice (advisory role). Board evaluation typically examines these roles of the Board and the entailing responsibilities, and assesses how effectively these are fulfilled by the Board.

The effectiveness of the Board depends on a variety of factors, some of which are:

- **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**: annual Board calendar, information availability, interactions and communication with CEO and senior executives, Board agenda, cohesiveness and the quality of participation in Board meetings;
- **Business Strategy Governance**: Board’s role in company strategy;
- **Financial Reporting Process, Internal Audit and Internal Controls**: The integrity and the robustness of the financial and other controls regarding abusive related party transactions, vigil mechanism and risk management;
- **Monitoring Role**: Monitoring of policies, strategy implementation and systems;
- **Supporting and Advisory Role**: and
- **The Chairperson’s Role**.

The evaluation of the performance of the Boards is essentially an assessment of how the Board has performed on all these parameters.
Parameters of Board Evaluation

**Board Structure**
- Board and Committee composition and constitution
- Diversity
- Competencies of the members
- Board and Committee charters
- Frequency of meetings
- Board processes

**Board’s Role in Governance**
- Direction: Business strategy governance
- Monitoring: Monitoring of policies, systems and strategy implementation
- Supporting and advisory role

**Dynamics and Functioning**
- Annual Board calendar
- Information availability
- Interactions and communication with CEO and senior executives
- Board agenda
- Cohesiveness and quality of participation in Board meetings
- Chair person’s role

**Financial Reporting Process, Internal Controls, Risk Management**
- Integrity and robustness of financial and other controls
- Risk management
- Abusive related party transactions
- Whistle blower mechanism
Evaluation methodology

In most companies globally, Board evaluation is an annual exercise by choice or by regulatory prescription. The evaluation methodology and the process have some degree of flexibility and international variance as well. 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.

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. Delineating the findings of Board evaluation is not enough. 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.

Evaluation cycles

Unless otherwise prescribed by regulations, annual evaluation is the most commonly followed cycle for Board evaluation. Most large corporations make the evaluation cycle consistent with the annual planning cycle adopted by Boards, others tie the evaluation to the strategy formulation process. The Boards usually determine the choice of the cycle.

The process and analysis of Board 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.

Whether the evaluation is conducted internally or externally by an independent expert, the methodology broadly remains the same. Discussions about evaluation of the Board and its Committees are initiated in the Board by the Chairperson and the consensus of the Board obtained about the need for the evaluation and whether the exercise should be conducted in house or with the help of an independent external expert. Good evaluations have quantitative and qualitative parts and usually the latter inform the evaluations with rich data, which brings greater objectivity to the evaluation exercise.
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.

Status of Board evaluation in India
In India, Board evaluation was a non-mandatory requirement under Clause 49 of the Listing Agreement, prior to the announcement of the Securities and Exchange Board of India (SEBI) following its Board meeting on 13th February 2014, to amend the Clause 49. 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. 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 rules for the relevant sections are currently awaited. 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.

Subsequent to the announcement by SEBI, evaluation of Boards and Independent Directors will become mandatory for all listed companies under the revised Clause 49 with effect from October 1, 2014.

International practices for Board Evaluations

The following table enumerates the practices related to Board evaluation adopted in some developed as well as developing countries.

<table>
<thead>
<tr>
<th>Institution/Source</th>
<th>Frequency</th>
<th>Recommendations</th>
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<tbody>
<tr>
<td>The U.K. Corporate Governance Code</td>
<td>Annual</td>
<td>(i) The Board should undertake a formal and rigorous annual evaluation of its own performance and that of its Committees and individual directors. (ii) Evaluation of the Board of FTSE 350 companies should be externally facilitated at least every three years (on a comply-or-explain basis).</td>
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<tr>
<td>U.S. National Association of Corporate Directors (NACD)</td>
<td>Regularly</td>
<td>The Governance Committee is responsible for ensuring that a process exists for the Board to routinely assess its own performance and the performance of its Committees, as well as for each director to perform a self-assessment.</td>
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<tr>
<td>IBGC Code of Best Practices (Brazilian Institute of Corporate Governance)</td>
<td>Annual</td>
<td>(i) A formal evaluation process of the performance of the Board, of individual directors and of the CEO. (ii) The process shall be conducted by the Chair. (iii) The participation of an outside expert may contribute to the effectiveness of the process. (iv) Evaluation system shall be adapted to each organization. (v) Disclosure of the process and of the evaluation results to the shareholders.</td>
</tr>
<tr>
<td>CNV (Argentina’s securities regulator)</td>
<td>Annual</td>
<td>A formal Board Evaluation.</td>
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<tr>
<td>Mexican Code</td>
<td>Not defined</td>
<td>Performance evaluation of the Board and its members’ fiduciary duties.</td>
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<tr>
<td>OECD</td>
<td>Annual</td>
<td>Board of listed companies should undergo annual internal evaluations covering both the competencies and performance of their members as well as the Board’s functioning as a whole.</td>
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Performance evaluation requirements under the Companies Act 2013
New provisions applicable to the boards of listed companies and every other public limited company as prescribed by the draft Rules

Disclosure requirement in the Board’s report on performance evaluation
Section 134 (3) (p):
Every listed company and any other class of public companies as may be prescribed by the Rules, is required to make a statement in the Board’s report indicating the manner in which formal evaluation has been made by the Board of its own performance and that of its committees and individual directors.

The Role of the Nominations and Remuneration Committee in performance evaluation of directors
Section 178 (2):
The Nominations 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.

Implication of the new provisions for the Boards
Now that performance evaluation of the Board, its Committees, directors and the Chairperson, have become mandatory for all listed companies and such other companies prescribed by the Rules under the Companies Act 2013 and for Boards and Independent Directors of all listed companies following the approval by the Board of SEBI to amend the Clause 49, Boards would have to become familiar with the concept as well as the processes involved and the methodologies to be adopted even if they may not have been practising these or may have had some reservations. Performance evaluations are time consuming and often sensitivities inhibit the evaluation exercise. Boards will need to invest considerable time and effort to make these exercises fruitful for the organisations. These exercises will demand high level of commitment and leadership skills from the Chairperson. Besides, it is important to always build a consensus in the Board on the entire evaluation exercise.

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

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.
Internationally, the performance evaluations are either conducted in house by the Chairperson, or the Governance and Nomination Committee or by an external independent expert. In India, the intent of the Companies Act as well as of the amendments to Clause 49 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.

The evaluations have quantitative part based on a questionnaire prepared after discussion with the Board and a qualitative part based on interviews with individual directors. It is common internationally to often seek assessment inputs from the key management personnel. Whether the evaluations are to be carried out internally or with the help of the independent expert is a question determined by the Board.

In many countries evaluation of individual directors is not a regulatory requirement, though in India, the Companies Act 2013 requires evaluation of individual directors, independent directors and a review of the Chairperson’s performance, for all listed companies and such other companies to be prescribed under the Rules. The amended Clause 49 would henceforth also require evaluation of Independent Directors of listed companies. The continuance and reappointment of the Independent Director would be determined by the performance evaluation report.

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.

Even though the board and independent director evaluation have been made mandatory, 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.

For the evaluations to be successful and the process smooth, the Chairperson must be prepared to lead the exercise and the Board shoulder the responsibility of managing both the process as well as the format of the evaluation.

Considerable investment of time and effort are required on the part of the Board and the Chairperson.

The performance evaluations must result in an action plan for the Board.

Trust in the process and its confidentiality are critical for success of the evaluation exercise, for Trust is the best incentive to encourage candid input and feedback from the Board members.
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