Board Evaluation

Overview of International Practices



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This report provides an overview of international practices and regulatory frameworks for the evaluation of board performance in publicly listed companies. Its objective is to inform policy makers and regulators about good practices in board evaluation and provide key takeaways to improve the effectiveness of board evaluations in publicly listed companies.

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1. Corporate Governance Debates Today

Contemporary corporate governance frameworks were developed in the 2000s. Yet, since then, they appear to have had little impact on the number, scale and effects of corporate scandals and economic failures. One reason for their ineffectiveness is that corporate governance has been overly focused on regulatory design of "checks-and-balances" in listed companies, rather than on the equally important issue of how governance structures can add strategic value to a firm. This Report explores the latter issue, with particular reference to the role of board evaluation.

In the conventional checks-and-balances model, authority and empowerment flows from the shareholders (the legal and moral owners of a company), through the board of directors/supervisory board, to management, and eventually, staff. Corporate governance mechanisms, which initially targeted executives, were intended to curtail agency problems, notably those that arise between potentially self-interested management and investors.

Since management is responsible to the board of directors or the supervisory board that, in turn, owes responsibility to the shareholders or owners of the firm, board members are also heavily affected by regulations that have emerged, particularly over the last decade.

Policymakers emphasised that the monitoring and oversight role of "independent" or "outside" directors is crucial in maximising shareholder wealth and preventing self-interested transactions. In countries with controlling shareholders, which is common in Europe and Asia, board members are also expected to protect the interests of "minority investors" and other stakeholders in the company. This is necessary because controlling shareholders may engage in self-interested transactions.

Following the 2008 global financial crisis, a predominantly independent board was considered essential to serve as a necessary and dynamic "wedge" between the company and its insiders, on the one hand, and the capital market and the short-term investors on the other. Such an arrangement reduced the three-way agency problems between executive managers and the varying types of investors and stakeholders.

There was a widespread view that the board of directors should be insulated from shareholder influence and interventions. Board independence was deemed necessary to offer resistance to the short-term mentality that prevailed (and often still prevails) in the investor community and capital markets.

Still, despite greater emphasis on the long-term prospects of a company, the dominant view has been to treat the board as a supervisor/monitor of senior managers. Consequently, the board of directors tends to focus on the *control* of management behavior and monitoring of the company's past performance and sustainability.

An alternative view looks *beyond control* of behavior and recognises that a well-balanced board plays a crucial role and can be a competitive advantage for a company in terms of innovation and value creation. The G20/OECD Principles of Corporate Governance (hereafter "the Principles") emphasise that: "Together with a guiding corporate strategy, the board is chiefly responsible for monitoring managerial performance and achieving an adequate return for shareholders, while preventing conflicts of interest and balancing competing demands on the corporation."

Also, many companies, as well as their investors, now recognise that the "monitoring" role is no longer sufficient and constitutes a missed opportunity.

More innovative firms now include a diverse range of individuals, who work in collaboration with the firm's CEO and other senior managers, to develop new business strategies. Directors help the firm to stay relevant by including diverse perspectives that are directly relevant to the company. A more

collaborative model of the relationship between board and senior management (and the companies' investors) ensures that these perspectives are incorporated into the decision-making processes in ways that can add genuine value to a firm's business operations.

It is in this context that policymakers and regulators seek to better understand the factors that impact the effectiveness of boards. So far, however, the discussion has focused on a number of legal formalities and requirements, including gender balance, optimal board size, remuneration, and the role of the chair of the board.

Recently board evaluation and evaluation processes have been added to the list. In particular, many boards have recognised the importance of frequent evaluations and assessments of their performance. This has resulted in more attention to board evaluations in both rules-based, as well as in principles-based jurisdictions. For example, the G20/OECD Principles recommend inclusion of regular board evaluations in a country's corporate governance framework. The New Paradigm[1] recommends that the board of directors evaluate its own performance, as well as assessing the performance of its directors and board committees.

This report answers some key questions regarding board evaluations, including:

- What is the role of the board of directors?
- What is the most effective mix of director skills?
- What are their responsibilities in terms of good governance?
- What are the key topics to be addressed in the board evaluation process?
- How frequently should a board be evaluated?
- Should the evaluation be conducted by a third-party consultant or by an insider?
- What are the current international practices for board evaluations?
- Should board evaluations be disclosed?
- What is the role of regulators in promoting board evaluations?

2. Key Issues to be addressed in the Board Evaluation Process

It has become a common refrain, particularly post-Enron and post-global financial crisis, that in order to be truly effective, a board needs to increase its role in the area of risk management and managerial oversight. This is also acknowledged in the G20/OECD Principles. But more is needed. Most legal systems worldwide now recognise that boards not only have a vital role to play in monitoring and risk oversight, but also in giving informal advice and strategic support to senior management.

This view is confirmed by an analysis of the boards of directors of the "100 Most Innovative Companies in the World", listed in the 2014-2016 editions of *Forbes* magazine. Such analysis indicates that boards can, and should, play a much larger strategic role in the creation of new products and/or processes.

A well-functioning board provides companies with a clear competitive advantage and can help build connections with government, society and other stakeholders. It assists company leaders in making better decisions and avoiding tunnel vision by providing relevant information on the current state of the business environment in which they operate.

Boards can also help identify new business opportunities and provide a more coherent sense of their peers and competitors. Finally, pro-active board members with relevant expertise can help business leaders to identify "expertise gaps" in their executive teams. It is in this collaborative context that boards can have the most impact on a company's business strategy and capacity for innovation.

[1] Publication, The New Paradigm: A Roadmap for an Implicit Corporate Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth, issued on 2 September 2016 by the International Council of the World Economic Forum.

The dynamics and functioning of the board are key in this regard. For a company to grow, thrive and reach its full potential, corporate boards are expected to be committed, alert and inquisitive. More importantly, they should be pro-actively engaged in the company's business and affairs. Only those board members who prepare for meetings and frequently attend them will add value to the discussions. Board members also need to ask hard questions and challenge the strategic assumptions of management. And they can only do this effectively when they possess relevant capacities and a willingness to devote energy to the tasks of both monitoring and strategy building.

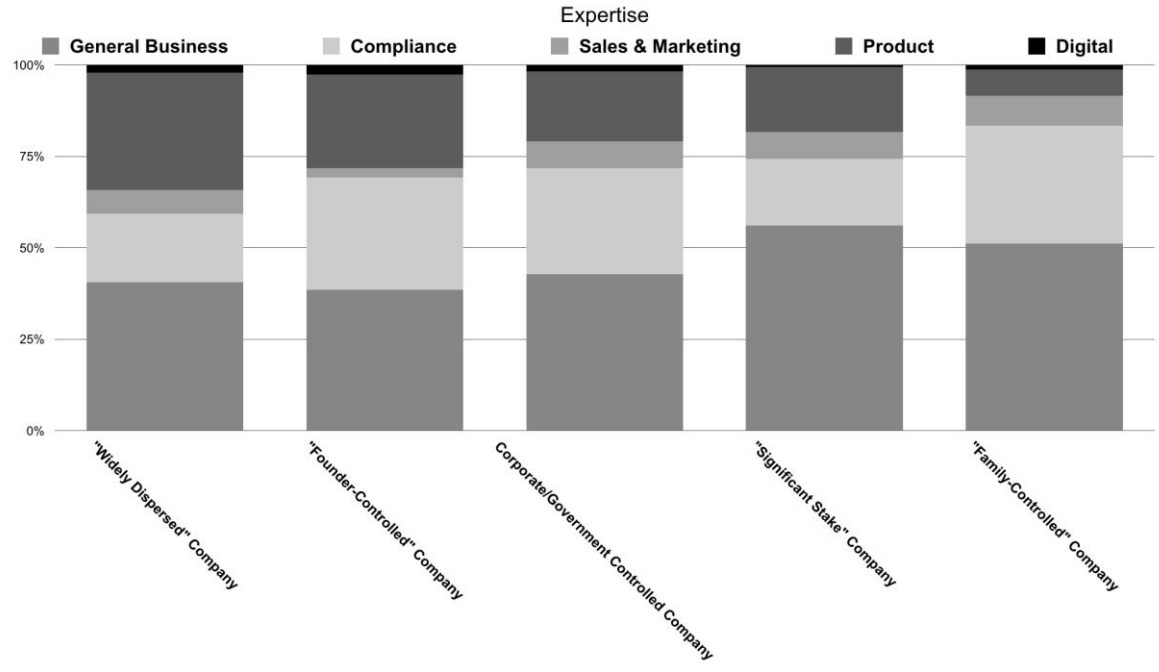
However, board members often complain that there is not enough time to discuss future strategy developments, innovation and value creation. It is an often-heard complaint at conferences that board members of listed companies often spend 80% of their time at board meetings on discussing issues related to past-performance and regulatory compliance. In such a context, the ability of board members to add genuine strategic value is severely limited. In some countries, such as France, it is becoming common practice for companies to organise an annual one-day strategy seminar which provides an opportunity for the board to engage with top management on implementation of strategy.

An important reason for this current over-emphasis on oversight, supervision and risk management (and the subsequent lack of time for boards to adequately perform their advisory function), is the monitoring-oriented composition of the board. If the balance of board members is tilted towards those with general business and finance expertise, then it is hardly surprising that the agenda (and time) of the board is devoted to backward-looking issues.

This is not to understate or dismiss the monitoring function. Obviously, in a contemporary regulatory context, it is vital that a board devotes time to monitoring compliance. But it is equally important to stress the value of board diversity and, in particular, the importance of board members who can help develop new business strategies in partnership with senior executives. After all, such strategies are crucial to the long-term success - possibly even the survival - of any firm.

Analysis of board compositions of "the most innovative companies in the world" (according to *Forbes*) highlights the importance of board diversity. *Figure 1* below presents evidence of board diversity in terms of different types of expertise.

Figure 1. **Board Composition by Industry in "the most innovative companies in the world"**



Most companies in the *Forbes* sample now have boards that consist of independent members, who not only have general management and global business experience and expertise (usually other CEOs, former CEOs and business leaders), but also "compliance-orientation" expertise, such as accountants, auditors and lawyers.

What is more important, however, is that boards have also selected a number of individuals with substantive and relevant knowledge of products, product-cycles and innovation. It is remarkable that technical experts outnumber members who are experienced and skilled in "sales and marketing".

Who then are these "innovation experts"? Some can be viewed as technologists or technical visionaries. Often such individuals have been responsible for product innovation or product development at companies that operate in similar markets, or in the periphery of a company's core business. Others may hold academic positions, particularly in the area of biotech, medicine, and engineering. This is consistent with the view that their presence can be invaluable in identifying issues and opportunities regarding disruptive innovation.

More importantly, such experts are able to add vision and drive to the board of directors. Evidence indicates that most companies realise they operate in uncertain, fast-moving and highly competitive global markets. Interestingly, the top-50 companies on the *Forbes* list have, on average, two "product-oriented" independent board members, compared to one product-oriented board member in the bottom-50 companies.

Another noteworthy feature of this data shows that the board of directors' composition is "fluid" and dynamic in nature. This is also reflected in *Figure 1*, which indicates that the composition of the board is dependent on the ownership structure of the company. For example, as can be seen from the first column, a greater than average number of board members with specific product-cycle expertise can be found in companies that are characterised by a widely dispersed ownership structure.

In "controlled" companies, managements' decisions regarding product innovation and development are usually challenged by significant or controlling shareholders. This is different in a founder-ownership structure. The most important reason for this is that such companies often operate in more volatile or unpredictable sectors, such as pharmaceuticals, biotechnology and software.

Since digital technology experts ability to add value in a digital age is beyond question, many more companies can be expected to appoint "digital technology people" to their board of directors. This is essential to deal with the digital challenges and opportunities in today's business environment. All firms need to become "technology" and "platform" aware or oriented firms to succeed in today's global and networked markets.

An example of a board with such digital and social media experience is *The Walt Disney Company*. Sheryl Sandberg (*Facebook*) and Jack Dorsey (*Twitter* and *Square*) were added to the Board of Directors to bring their requisite technology and platform expertise which was seen as:

> *Extremely valuable, given Disney's strategic priorities, which include utilizing the latest technologies and platforms to reach more people and to enhance the relationship we have with Disney's customers.*

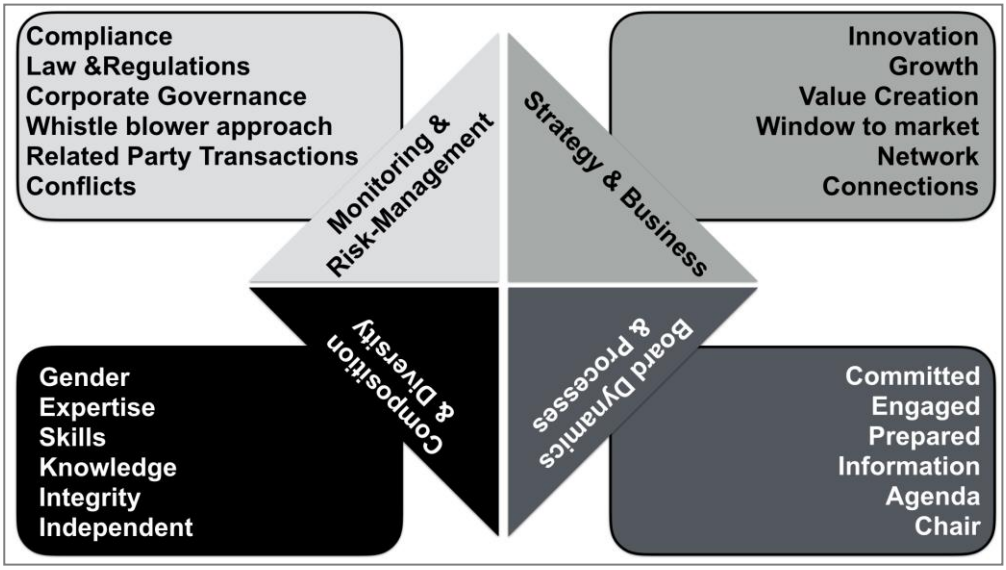
Indeed, *Disney* seems to understand that the directors help the company to stay relevant by including diverse perspectives. Moreover, this also facilitates a more collaborative approach with management and ensures that a platform perspective is incorporated into the decision-making process in a way that adds genuine value.

The performance and effectiveness of the board can be measured by the following "four dimensions" (see *Figure 2*):

1. Quality of the monitoring and risk-management role.
2. Quality of strategic and other business-related advice.
3. Board dynamics and board members' pro-active participation.
4. Board composition and diversity

A tool to examine *how* the board operates along these four dimensions is key to board evaluation today. Since this type of evaluation also helps improve the effectiveness of a board, countries are increasingly implementing rules and regulations regarding their use. The next section provides an overview of current international practice regarding board evaluation.

Figure 2. **The "Four Dimensions" of Board Evaluations**



3. International Practices for Board Evaluations

To further understand the board evaluation process, the OECD analysed board evaluation practices in the following countries:

Austria
Brazil
People's Republic of China (hereafter "China")
France
Germany
Hungary
India
Israel
Italy
Japan
Luxembourg
Netherlands
Poland
Singapore
South Africa
Spain
Switzerland
Turkey
United Kingdom
United States

The methodology used for the analysis, and an overview of different approaches to board evaluations, are described in sections 3.1 and 3.2 below. The key conclusion is that board evaluations are slowly, but surely, becoming the norm in the majority of those countries that were analysed. The analysis also shows that there are significant differences in the evaluation approaches adopted by countries.

Section 3.1 describes the methodology used for this analysis and Section 3.2 identifies the different approaches taken by countries to evaluate boards.

3.1. Methodology

To underpin the analysis, all jurisdictions were asked to respond to the following questions.

- Are there any legal or regulatory requirements or practices that require a board (or its committees) to engage in board evaluation processes?
- How frequently do these evaluations take place?
- Who conducts these evaluations?
- What do companies disclose regarding the evaluation process?

To explore these issues in depth, a review of current legal practice was conducted, focusing in particular on rules and regulations regarding board evaluations. Information was collected from a range of sources, including: (1) laws, regulations and corporate governance codes available online; (2) regulators' websites and other publicly available materials; (3) consultancy reports; (4) questionnaire reports published by "Getting the Deal Through" in July 2016; (5) publicly available research papers; and, (6) information obtained from local law firms/universities.

Jurisdictions were chosen from different continents and included countries with diverse legal origins and ownership structures.

The 20 selected jurisdictions can be broadly split into three legal traditions, namely English common law (**India**, **Israel**, **Singapore**, **South Africa**, the **United Kingdom**, and the **United States**), French civil law (**Brazil**, **France**, **Italy**, **Luxembourg**, **The Netherlands**, and **Spain**), and German civil law (**China**, **Germany**, **Hungary**, **Japan**, **Poland**, **Serbia**, **Switzerland**, and **Turkey**).

It is necessary to distinguish between legal origins as each system has its own approach to company oversight, organisation and structure of board of directors. For instance, under the common law system, the Anglo-American one-tier board system is usually used. A one-tier board consists of both executive and non-executive, usually independent, directors.

Although certain powers are usually delegated to board committees, such as nomination, audit and compensation committees, the board as a whole is responsible for the decisions it makes, based on the committees input. In theory, one-tier boards (in which independent directors interact directly with executive managers, particularly the Chief Executive Officer) are well equipped to contribute to, and support, planning and implementation of the company's strategy, without ignoring its oversight responsibilities.

Two-tier systems are common in German civil law countries in Asia, Europe and South America. In two-tier systems, the oversight of management is the responsibility of a separate supervisory board.

Civil law systems increasingly facilitate the establishment of one-tier boards. For example, although French law allows companies to choose between a one and two-tier system, French companies are increasingly deciding to follow the one-tier board model. In **Europe**, this trend is largely inspired by the Statute for the European Company, explicitly allowing companies to select a one-tier structure. In **Japan**, an amendment to the Commercial Code ostensibly introduced an Anglo-America style board structure in 2003.

There are also significant differences in prevailing ownership structures.Widely dispersed stockholders can be found in the **United Kingdom** and **United States** and concentrated ownership characteristics are present in most of the other countries in the sample. Moreover, countries can also be characterised by the type of controlling shareholder (for example, in **China**, state-owned enterprises play a pivotal role, whereas **Turkey** is mainly dominated by family-owned companies).

To map countries' board evaluation practices, they were categorised as follows:

- Specific rules or regulations on board evaluations have not been introduced.
- No specific rules and regulations, but board evaluation practices are emerging.
- Implicit "board evaluation" rules and/or principles are in place.
- Board evaluation principles have been introduced into corporate governance codes.
- Board evaluation rules and regulations have been introduced

3.2. Five Different Regulatory Approaches to Board Evaluation

3.2.1. Countries Without Board Evaluation Regulations

Of the 20 researched countries, **China** is the only one that has not yet introduced or implemented any specific rules, regulations or best-practices on board evaluation. Also, there was no indication that board evaluation processes are becoming widespread.

This is not to say that boards in **China** are not subject to any evaluation process. An implicit assessment of the supervisory board's functioning and operation exists in the members' commitment to renounce short-term self-interest and promote the company's welfare, rather than their own.

Several standards of performance can be distinguished: (1) duty of care; (2) duty of loyalty to exclude self-dealing transactions, personal use of corporate assets, usurpation of corporate opportunities; and (3) duty of good faith and fair dealing.

Supervisory board members who do not act with the same care that a person in a similar position would reasonably exercise, under similar circumstances, risk not being granted discharge from any liabilities that may arise from their "misbehavior". The decision to discharge the supervisory board and its members is taken at the annual shareholders' meeting.

In this "two-tier board" country, board evaluation processes do occur within listed companies, despite the nonexistence of explicit board evaluation rules and principles. Companies can introduce board evaluation provisions in their articles of association or bylaws.

More importantly, it appears that larger companies are starting to include very general "board evaluation" information in their annual reports. For instance, the largest listed companies in **China** include statements about: (1) how independent directors have performed their duties and, in particular, whether they objected to any proposals at board meetings; and (2) how each of the board committees have performed their duties, in terms of how many meetings were held and which items were discussed and approved.

3.2.2. Countries with Emerging Board Evaluation Practices

The realisation that boards must become more engaged, knowledgeable and effective in both one-tier and two-tier countries explains why more board evaluation practices are being implemented in countries without explicit requirements to do so. **Israel** is an example of this trend. So far, only financial institutions, such as banks, are required to evaluate their boards of directors every two years. They have full discretion on how to conduct the evaluation and there are no disclosure requirements.

It is not surprising that board evaluations are gaining attention in countries without any specific legal requirements. In **Israel**, for instance, consultancy and advisory firms encourage companies to put the issue of board effectiveness on the corporate governance agenda. This trend will become more apparent when consultancy firms start publishing their research reports on board evaluations. It should also be noted that **Israel** has a relatively large number of dual-listed companies.

3.2.3. Countries with Implicit Board Evaluation Requirements

In **Poland** and **Turkey**, there are no specific laws or regulations setting out the process or procedures for board evaluations. But, as in other researched countries, the general duties of care and loyalty apply to the supervisory board and its members.

It could be argued that continuous evaluation of the board and its members' performance is an integral component of the board's duties.

Interestingly, supervisory boards of listed companies in **Turkey** must (or are recommended to) prepare a written statement for the shareholders' general meeting, including information about their oversight and monitoring activities, as well as the number of supervisory board meetings and their level of attendance.

Similarly, self-assessment of the supervisory board occurs in **Poland**. Although it was expected that these types of requirement would encourage more in-depth evaluations of the board's performance, no evidence was found that Polish and Turkish boards are submitting themselves to the discipline of frequent board evaluation processes.

3.2.4. Countries with Board Evaluation Principles in their Corporate Governance Codes

Countries that explicitly introduce board evaluation provisions in company laws, securities regulations or corporate governance codes are more successful at increasing the number of boards engaging in formal board evaluation processes.

For example, **Japan** has risen in the Asian Corporate Governance Association rankings as a result of, among other things, adopting a corporate governance code in 2015. What is probably more important is that these initiatives spurred much greater interest in Japanese firms amongst international, and especially, US investors.

Japan's corporate governance code also contains principles regarding the evaluation of board effectiveness:

> *Each year the board should analyze and evaluate its effectiveness as a whole, taking into consideration the relevant matters, including the self-evaluations of each director. A summary of the results should be disclosed.*

As for the impact of provisions, no conclusions have been drawn yet. An empirical analysis of the impact of corporate governance code provisions seems to indicate that board assessments, in countries with general provisions, are falling short of their promise of genuinely enhancing board effectiveness.

Consider the experience of board evaluations in **Switzerland**. The 2014 corporate governance code states that:

> *The Board of Directors should self-evaluate its own performance and that of its committees annually.*

The impact appears to have been disappointing. Data published by Spencer Stuart in 2015 shows that just 5% of major Swiss companies conducted an external board evaluation. In 2016, it was reported that legal practice for board assessments and evaluations was still to emerge in **Switzerland**.

Interestingly, the corporate governance codes of other countries that fall within the German civil law tradition (and have a very strong two-tier governance tradition), such as **Germany**, **Austria** and **Hungary**, only describe board evaluation and effectiveness requirements very generally.

The German corporate governance code states that:

The Supervisory Board shall examine the efficiency of its activities on a regular basis.

The evaluation of individual members is not prescribed and consequently the assessment of members of supervisory boards is not common practice in **Germany**. The board evaluation provision in the corporate governance code of **Austria** is slightly more detailed, specifying the frequency of the evaluation:

> *The supervisory board shall discuss the efficiency of its activities annually, in particular, its organization and work procedures (self-evaluation).*

Spencer Stuart's data from 2015 shows that 23.3% of DAX30 companies in **Germany** submitted themselves to an external assessment (even though the involvement of external parties is not explicitly recommended). This percentage could be viewed as successful, but is still considerably lower than other European countries with more detailed "board evaluation" provisions in their corporate governance codes, such as **The Netherlands** (28%), **France** (30%), **Italy** (35%) and the **United Kingdom** (43.3%).

Since listed companies tend to take a compliance-oriented approach when it comes to corporate governance, the impact of more detailed board evaluation principles is arguably more effective.

The board evaluation principles in the **United Kingdom** are a good example of more detailed assessment requirements:

> *Main Principle*
> *The board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors.*
>
> *Supporting Principles*
> *Evaluation of the board should consider the balance of skills, experience, independence and knowledge of the company on the board, its diversity, including gender, how the board works together as a unit, and other factors relevant to its effectiveness.*
> *The chairman should act on the results of the performance evaluation by recognizing the strengths and addressing the weaknesses of the board and, where appropriate, proposing new members be appointed to the board or seeking the resignation of directors.*
> *Individual evaluation should aim to show whether each director continues to contribute effectively and to demonstrate commitment to the role (including commitment of time for board and committee meetings and any other duties).*
>
> *Code Provisions*
> *B.6.1.The board should state in the annual report how performance evaluation of the board, its committees and its individual directors has been conducted.*
> *B.6.2. Evaluation of the board of FTSE 350 companies should be externally facilitated at least every three years. The external facilitator should be identified in the annual report and a statement made as to whether they have any other connection with the company.*
> *B.6.3.The non-executive directors, led by the senior independent director, should be responsible for performance evaluation of the chairman, taking into account the views of executive directors.*

More detailed provisions specify the frequency of assessment, ranging from one year (**Italy**, the **Netherlands** and the **United Kingdom**) to two years (**Luxembourg**). In **France**, the evaluation should be performed as follows:

> *Once a year, the Board should dedicate one of the points on its agenda to a debate concerning its operation.*

There should be a formal evaluation at least once every three years. This could be implemented under the leadership of the appointments or nominations committee or an independent director, with help from an external consultant.

The shareholders should be informed each year in the annual report of the evaluations carried out and, if applicable, of any steps taken as a result.

The **United Kingdom** and **France** both have a recommendation to involve an external consultant at least every three years.

It appears that board assessments are more effective when corporate governance codes also detail the *objectives* of the evaluation process. In **France**, **Italy**, the **Netherlands** and the **United Kingdom**, code provisions specifically recommend that the composition and diversity of the board should be described (see also ***Table 1***).

Table 1. **Comparative Overview**

	France	Italy	Luxembourg	Netherlands	United Kingdom
When	Annually (Formal evaluation once every three years)	Annually	Every two years	Annually	Annually
What	The composition of the board Dynamics The individual contribution of each director Chairman of the board	The composition of the board Dynamics The individual contribution of each director	The composition of the board Dynamics	The composition of the board Dynamics The individual contribution of each director	The composition of the board Dynamics The individual contribution of each director Chairman of the board
Who	Nomination Committee/ Independent director (with help of an external consultant)	The Board (Chairman)	The Board	Chairman	Independent directors (external consultant once every three years)
How (Disclosure)	Annual report	Annual report	Annual report	Annual report	Annual report

The assessment of individual board members is recommended in **France**, **Italy**, **Luxembourg**, the **Netherlands** and the **United Kingdom**. In **France** and the **United Kingdom**, provisions state that evaluation of the chairman's performance needs special attention, due to his or her special position.

The more detailed code provisions also cover the disclosure of evaluation results. In particular, the corporate governance codes of **France**, **Italy**, **Luxembourg**, the **Netherlands** and the **United Kingdom** provide for publication in the annual report.

Frequent assessments of boards and their members have become the norm in European countries with more detailed provisions in their corporate governance codes. This practice is also gaining momentum in Asian, African and South American countries.

For instance, in respect of listed companies, the corporate governance code in **Singapore** recommends a formal assessment of the effectiveness of the board as a whole, and the contribution made by each director. The nominating committee is in charge of the evaluation process. Similar to European countries, the annual report contains the most important takeaways from the assessment.

Another recommendation in the code is that objective performance criteria are put together by the nominating committee.

An annual evaluation process is also included in the corporate governance code of **South Africa** and results should be disclosed in the integrated annual report. Self-assessment by the board is the most common practice although the code recommends the use of an external consultant at least every three years, similar to the **United Kingdom**.

In **Brazil**, the 2016 edition of the Code of Best Practices of Corporate Governance contains a detailed board evaluation provision that covers a majority of the previously discussed best practices in other countries. In the long term, it is expected that these principles will improve board effectiveness in **Brazil**:

> *Principle*
> *The evaluation of the board and board members contributes to the effectiveness of the body, is part of its accountability duties, and allows a greater level of governance in the organization.*
>
> *Practices*
> *In order to properly evaluate the board, its members must be committed to identifying the strengths and improvements of each board member individually and of the board as a collective body.*
> *The board is responsible for disclosing information on the evaluation process and a summary of the main points of improvement identified for the body and the corrective actions implemented, allowing shareholders and other stakeholders to have a proper understanding of its operations.*
> *The by-laws/articles of incorporation must define the specific number of tolerated absences in meetings before the board member is removed from office.*
>
> *Approach and scope*
> *The evaluation of the board may be carried out by board members, who may be aided by executives, other stakeholders and/or external advisors. The board of directors and its members must also undergo a self-evaluation (respectively, as a body and as members), as well as evaluate all other bodies that report to the board of directors. At more advanced stages of maturity, the board may also be evaluated by the executives.*
>
> *The scope of the evaluation should include:*
> - *the board itself, as a collective body;*
> - *committees, if any;*
> - *the chairman of the board;*
> - *board members, individually;*
> - *the governance secretariat, if any.*
>
> *The evaluation criteria for the board should include its duties, structure and operating processes. As with the board itself, its evaluation process evolves as the organization's governance system matures.*

3.2.5. Countries with Board Evaluation Rules and Regulations

Most of the countries examined provide recommendations in their corporate governance codes, based on a "comply-or-explain" principle. Therefore, deviations from the recommendations to assess boards, committees and board members are possible, if explained in an accurate manner.

India, **Spain** and the **United States** have a legal obligation to conduct annual board evaluations. In **Spain** and the **United States,** board effectiveness assessments are a common practice among major listed companies.

In the **United States**, listed companies are required to conduct an annual performance evaluation of the board under the NYSE listing rules which state that the "board should conduct a self-evaluation at least annually to determine whether it and its committees are functioning effectively."

The audit, compensation, nominating and governance committees must also conduct an annual performance evaluation. It is interesting to note that companies listed on NASDAQ are not required to engage in self-evaluations, but still do so as a matter of good practice.

The evaluation process is widespread in the **United States**. In 2015, 98% of boards of *S&P* 500 companies disclosed annual performance evaluation results regarding the full board. Full boards, including committees, were evaluated in 52% of cases. "Only" 33% of *S&P* 500 companies assessed the full board, its committees, as well as the individual directors. Yet, the trend to evaluate individual directors is increasing.

In general, "overseeing the evaluation of the board and management" is a responsibility of the nominating or governance committee. The boards themselves are responsible for the evaluation methodology, such as the use of written surveys, questionnaires and/or interviews. The boards must also determine who will lead the evaluation process (e.g., the Chair, lead independent director or an external consultant).

The regulatory requirements in **India** are generally in line with regulations and practices in the **United States**. The Companies Act of 2013 requires listed companies to disclose the annual evaluation process regarding the board, its committees and the individual directors. The nomination and remuneration committee is responsible for carrying out the evaluation of each director's performance.

Moreover, the 2015 SEBI (Listing Obligations and Disclosure Requirements) Regulations require evaluation of each individual director's performance, including the independent directors and chairperson of the board and the board's various committees. The entire board must participate in the evaluation of each independent director.

The mode, manner and evaluation criteria must be defined (and disclosed) by the nomination and remuneration committee. The full board is required to monitor and review the evaluation framework for the board of directors.

In **April 2015,** the Institute of Companies Secretaries of **India** (ICSI) published a "Guide to Board Evaluation" to help companies comply with the new rules. The following evaluation criteria were recommended by ICSI: (1) an analysis of the time spent by the board in considering matters, (2) an assessment as to whether the terms of reference of various committees set up by the board have been met, and (3) assessing the compliance with the Companies Act. Finally, ICSI recommended the involvement of external experts in the evaluation process.

Even though board evaluations are still at a nascent stage in **India**, mandatory rules and regulations led to a number of improvements in the evaluation and disclosure practice of listed companies. A report of the Institutional Investor Advisory Services (IiAS), in collaboration with the National Stock Exchange of India Limited (NSE), shows that 84% of surveyed companies evaluated their individual directors in 2016 (compared to 81% in 2015) and 83% of board committees were evaluated (compared to 78% in 2015). Evaluation of chairpersons increased from 59% in 2015 to 64% in 2016. Also, more companies disclosed evaluation criteria in 2016.

Even though the compliance rate in **India** appears to be impressive (particularly compared to other jurisdictions), there is still ample room for improvement. For instance, "only" 8% of the surveyed companies used external experts to assist in the evaluation process.

To encourage and educate the listed entities and their board of directors about the evaluation process, the Securities and Exchange Board of India (SEBI) issued a Guidance Note on Board Evaluation in January 2017.

The Guidance Note includes detailed recommendations and suggestions on how to conduct an evaluation process. For instance, it contains indicative evaluation criteria in the following areas: (1) the structure of the board, including the competence and experience of the individual directors; (2) the meetings of the board; (3) the independence of the board; and (4) the compliance, governance and strategy functions of the board.

The Guidance Note also describes methods to conduct the evaluation and offers guidance for internal assessments, as well as assessments performed by external experts. Detailed questionnaires or interviews are mentioned as the main techniques for evaluating a board and assessing its members.

India's approach to offer more detailed guidance appears to be a move in the right direction to increase awareness and, more importantly, acceptance of the board evaluation process. The next section will assess this approach and describe what lawmakers, regulators and companies can do to ensure that assessments improve board effectiveness. It is argued that boards derive most value from a board evaluation that is shaped by four best practices.

4. Good Practices

Board evaluation has attracted increased attention from investors, regulators, and other stakeholders. The reason for this is both simple and straightforward. When carried out properly and effectively, board evaluations can provide a vital tool for directors to review and improve board performance. This will eventually lead to significant value creation opportunities for firms.

But are increased regulations and regulatory guidance requiring board evaluations a realistic or sensible move? And is it necessary for regulators to make boards more active in the area of self-evaluation? As can often be the case, the risk of regulatory initiatives aimed at compelling, or even prodding, firms to take greater responsibility is that it simply encourages "box ticking" behavior in which managing the appearance of responsibility and compliance becomes the key objective. Resources devoted to managing an image of compliance are simply wasted and the genuine gains from meaningful self-evaluation are never realised.

Yet, empirical research seems to indicate that companies listed in countries with more detailed principles and guidance do tend to adopt a more substantive and accessible board evaluation practice than their counterparts/peers in jurisdictions with no, or less, detailed requirements. This does suggest that the "law matters" in this field.

This trend was also confirmed by a questionnaire survey. The respondents, who stated that no detailed or explicit rules regarding board evaluations were available in their respective countries, also described the lack of an "evaluation culture" in boards of directors or supervisory boards.

Remarkably, this culture is almost non- existent in strong "two-tier" countries. A possible explanation could be that boards with more direct interaction with executive management and involvement in determining business strategy and growth targets (as is the case in one-tier board systems), have a more profound interest in "evaluation" and in "improving board effectiveness".

So, what can policy makers and regulators do to make sure that boards get the most out of their evaluations? How can they help promote a culture in which boards, committees and their members are all genuinely committed to meaningful evaluation with a view to improve board effectiveness?

The research indicates that the most valuable and effective board assessments are built around four key principles which offer answers to the following questions:

- When should a board be evaluated?
- What should be evaluated?
- Who should conduct the board evaluation?
- How should the evaluation be reported?

4.1. Good Practice I: When Should a Board be Evaluated?

Clearly, the most common practice is for boards to evaluate themselves on an annual basis. It follows from most countries' experience that it makes sense to specify the frequency of the evaluation.

But it is important to realise that there is no "one-size-fits-all" blueprint for the evaluation of the board of directors, including the timing of such evaluations. Board requirements and the evaluation needs of a firm are all firm-specific and vary across life-cycle stages, sectors, and cultures.

For instance, if a company seeks to expand to emerging markets, it should follow that a board evaluation is necessary to assess whether more international experience and local knowledge of new markets is required on the board. Board evaluation must be dynamic in nature and responsive to changes in the firm's operations.

To give another example, companies and their boards tend to evaluate and address board composition and diversity issues when they encounter difficulties of some kind. Thus, if a company has accounting problems, it makes sense to add independent directors with more economic and financial skills to the company's board of directors.

Accordingly, the accounting issues that *Groupon* experienced in their post-IPO phase confirms this argument. To immediately address criticism of its financial reporting practices, *Groupon's* board evaluated and appointed two new directors with extensive experience in accounting and finance.

Moreover, the boards of companies with a disappointing stock price performance may also find it valuable to assess their performance and effectiveness.

Our research suggests that in an effort to improve market acceptance and investor confidence, boards usually evaluate immediately and appoint board members with specific market or sector expertise. This practice indicates that boards of directors may need to conduct evaluations more than once a year or even continuously assess their performance through a process of constant evaluation. However, reporting of evaluation may only be necessary once a year.

4.2. Good Practice II: What Should be Evaluated?

The regulatory approach in most countries is to include the board, its members (executive, non-executive and independent members) and board committees in the evaluation process.

As discussed above, evaluations need to move beyond the current focus on formalistic compliance and risk management matters. Organisational design within large firms needs to be re-directed to innovation, products and people.

In a digital and globalised world, boards should facilitate an environment that offers the best chance for their companies to retain the "best" talent, deliver the "best" products and maintain the capacity to constantly re-invent itself in the face of rapid technological, economic and social change.

The key then is to identify and implement processes that maximise opportunities to deliver more meaningful and relevant strategic advice to management and other stakeholders in a company. This is not to suggest that compliance does not matter, but rather to recommend that a broader range of considerations need to be incorporated into the evaluation exercise.

Figure 2 above reflects the key issues that need to be central to every evaluation process:

1. Quality of the monitoring and risk-management role.
2. Quality of the strategic and other business-related advice.
3. Board dynamics and board members' pro-active participation.
4. Diversity of the board.

4.3. Good Practice III: Who Should Conduct the Evaluation?

It is essential that boards adopt a robust process to evaluate themselves and their members/committees for an effective and efficient evaluation. In principle, to achieve this goal requires all board members to be involved and engaged. The recognition of the importance of all board members being involved does not mean that all hierarchy is to be eradicated and nobody takes the lead. A "kitchen table" approach to the evaluation process is not the solution.

Clearly, some sort of structure and discipline needs to be imposed. For instance, either the chair, lead independent board, or board committee (usually the nominating committee), should be explicitly made responsible for the process. They should drive the process, involve the right people (including third party consultants, if necessary), and ensure that their colleague-directors are actively engaged. They may also deliver feedback to individual directors, if the board is not working with a third party or software application to facilitate the process.

The potential use and importance of software solutions and applications to enable more effective board evaluation processes is often ignored in regulatory discussion. Exploiting new technologies to manage the extensive data generated by modern board evaluation is another area that needs further study. Regulators seem well-placed to offer support and advice regarding technological aspects and possibilities of evaluation today.

The leader of the evaluation process also needs to manage expectations about the process and the potential benefits that it may bring. Everyone needs to understand that evaluation is not a panacea to a firm's problems and that, although important, it is only one element in the firm's strategies for developing its operations.

Often, a questionnaire (with multiple-choice and open questions) dealing with the issues mentioned above, is sent to each board member with additional questions for committee members and specific questions for the board chairman. Subsequently, individual interviews are conducted by the leader of the board evaluation process to allow board members to freely express their views. The leader of the board evaluation process then provides a report (on an anonymous basis) to the board of directors/supervisory board, including an action plan and areas for improvement.

Here again, it should be noted that there is no "one-size-fits-all" blueprint for the evaluation process. Regulators should be cautious when issuing rules, regulations and guidelines that contain forms and procedures for conducting evaluations as they risk confusing and frustrating the evaluation process. For instance, a rule or guideline to use questionnaires may be construed as a test for board members, which they can "pass" or "fail". Although this may sound unlikely, confusion often dominates board evaluation discussions.

The same confusion can be observed in discussions about use of external experts. Who are these experts? Should these experts be certified as "board evaluators"?

Regulators should make clear that there are different ways to conduct the evaluation process and provide options to companies and boards to assess what works best for them. Take, for example, the reference to board evaluations in The New Paradigm, A Roadmap for an Implicit Corporate Governance Partnership between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth:

> *Ongoing candid assessments of director, board, and committee performance are a necessary tool in evaluating effectiveness and determining areas for improvement. There are a variety of approaches to formulating an effective evaluation process, and the board should not feel compelled to adopt any particular form of board review. Many consulting firms have published their recommended forms and procedures for conducting evaluations and have established advisory services in which they meet with a board and committee members to lead them through the evaluation process. While these services may be helpful, it is not required that the board receive outside assistance or that multiple-choice questionnaires and/or essays be the means of evaluation.*

4.4. Good Practice IV: How Should Board Evaluation Be Disclosed?

Our empirical study suggests that the "law does matter" and the requirement to disclose information about the "board evaluation process" has a positive effect.

The study does not refer to the disclosure of individual assessments of board members. Personal and confidential information should not be publicly disclosed. Yet, investors and other stakeholders appear to appreciate hearing about the assessment process. Clearly, they are interested in the "why", "what" and "how" of evaluations. They are even more interested in the "story" behind the boards: (1) where do they come from; (2) where are they now; and (3) where are they going.

But, at the same time, these disclosure requirements seem to have resulted in a standardisation of *how* the information is presented.

The current regulatory approach appears to breed a formalistic style of compliance. This usually reveals little about the actual mechanics of the evaluation process and the results and takeaways from the most recent evaluation. Also, companies have a tendency to use the same statement (with only some minor changes) every year.

There are exceptions, however. Some firms do embrace a more open style of communication regarding their evaluation procedures, criteria and methods. An illustration of "best disclosure practice" in this regard is *Randstad*'s statement in its 2015 annual report (see Box 1*)*. The statement contains an action plan that enables investors and other stakeholders to review the process on a year-on-year basis and also makes it possible to keep track of improvements and issues.

Regulators need to emphasise that adopting a detailed and open style of communication can improve a board's ability to provide a more meaningful disclosure to stakeholders, inside and outside the firm.

Regulators must make more effort to support, encourage, and persuade boards to recognise the rewards that come from the open disclosure of the evaluation process.

And the potential rewards do seem clear. At the very least, open communication of evaluation can increase the commitment and engagement of board members to participate in the (future) evaluation process, which will, in turn, improve the functioning and performance of the evaluation and of the board.

Box 1. **Disclosure of Self-Assessment – Randstad**

Induction, training and performance assessment

Ongoing education is an important part of good governance. New members of the Supervisory Board attend induction sessions at which they are informed on the financial, reporting, risk & audit, HR, marketing, legal, and governance related affairs of the company. Members of the Supervisory Board regularly visit Randstad's operations to gain familiarity with senior operational and functional management, and to develop deeper knowledge of operations, opportunities, and challenges.

At a separate meeting, the Supervisory Board discussed its composition, its own performance, and that of its three committees. Contrary to the previous year, this self-assessment was not facilitated by an external advisor, as this is not considered necessary each year. Items assessed and subsequently discussed by the Supervisory Board included (1) team effectiveness, (2) interaction and dialogue, (3) content related effectiveness, (4) relationship with the Executive Board, (5) effectiveness of the Committees, (6) effectiveness of the individual members, and (7) effectiveness of and engagement with the organization.

The Supervisory Board concluded that the large majority of these items were assessed positively. Team spirit is considered strong, encouraging mutual trust, open discussion, and clear understanding of each Board member's role. In 2016, good steps were made in further optimizing the balance, both with regard to the functioning of each Board and with regard to the Boards' mutual relationship. The effectiveness of the Committees of the Supervisory Board is good, although there is some scope for optimization. Some of the key findings and points for follow-up are:

- The Supervisory Board is growing in its advisory role, but further improvement could be realized through in-depth discussion and exchange of ideas about specific topics, strategic subjects, and dilemmas faced by the Executive Board.
- In both Boards, there is an ongoing need for ensuring diversity in terms of international influence and expertise.
- The Supervisory Board will design a more structured performance evaluation and feedback process for the individual members of the Executive Board and will pay more attention to leadership development and succession planning.

Source: Randstad’s website.

5. Key Takeaways

The board evaluation process is not just another formality in the corporate governance framework of a company. As stated in the G20/OECD Principles of Corporate Governance, boards should regularly carry out evaluations in order to appraise their performance and assess whether their members possess the right mix of backgrounds and competencies.

In order to improve board operations and the performance of its members, an increasing number of jurisdictions now encourage companies to engage in voluntary board evaluation.

However, the research suggests that the following key takeaways need to be taken into account:

- Board evaluations need to be continuous and an on-going process. There is no "one-size-fits-all" solution and the design of the evaluation should meet the needs of the individual company and the particular circumstances of that company.
- Board evaluation needs to be based on, and include the assessment of, both the committees and individual board members (executive, non-executive and independent directors).
- Evaluations should not only include compliance and risk-management competencies, but also competencies and experience in business-related and organisation-related areas, such as strategy, innovation, globalisation and growth.
- Board dynamics and processes should also be on the "evaluation agenda".
- The evaluation process should assess the composition and diversity of the board.
- Best practice principles, rules and regulations should provide enough detail to help companies implement and conduct adequate evaluation processes, but also leave enough flexibility for companies to tailor the process to their specific needs.
- Additional guidelines could provide more information about the criteria, methods and form of the evaluation process (without compelling companies to make use of them).
- Additional guidelines could also be used to update companies and their boards about any new developments and trends in the field of board evaluations.
- The board member or committee driving the evaluation process should actively involve external experts if, and when, necessary.
- Board evaluation software and applications can help facilitate the assessment process.
- Boards should engage in a more open and detailed form of communication about the evaluation process and its outcome. The disclosure should contain an action plan.

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Board Evaluation: Overview of International Practices

This report provides an overview of international practices and regulatory frameworks for the evaluation of board performance in publicly listed companies. Its purpose is to inform policy makers and regulators of good practices in board evaluation and provide key takeaways to improve the effectiveness of board evaluation in publicly listed companies.



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