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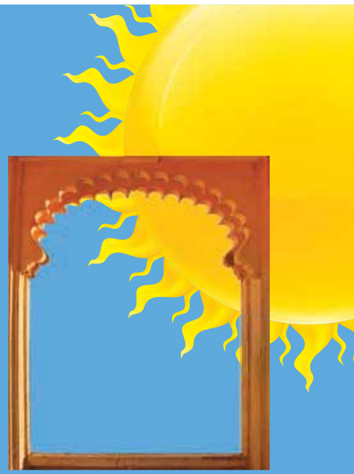

Board Evaluations

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Executive Summary

- Board and Director Evaluations help to improve board governance in companies and enhance personal effectiveness of directors—by both improving board composition and enhancing competencies.
- A recent legal mandate in India for a formal, regular and transparent board and director performance evaluation has compelled listed companies to adopt this value-adding practice with great urgency.
- A preferred model of board evaluation process should (a) address challenges typically found in India, (b) provide guidance for operationalising the mandate and (c) help the Board to see it as more than just a compliance exercise.
- To create the desired value, the preferred model should include its buy-in by the whole board, use of self- and peer-evaluation by all directors and an emphasis on sensitive communication and improvement orientation.
- External facilitation with a designated internal champion is the preferred option for such evaluations.
- It will be advisable to begin with simple and limited evaluation criteria (covering the contributing, counselling and controlling dimensions of board functioning) before graduating to more complex evaluation metrics.

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As the ultimate responsibility for sound governance and prudential management of a company lies with its Board, it is imperative that the Board remains continually energised, proactive and effective. An important way to achieve this is through a regular and objective stock taking by the board of its own performance. Boards have to commit enough time and resources to such evaluations. Besides assessing the Board's and its directors' individual performance, the aim of this exercise should be to help increase the Board's future effectiveness through evaluation takeaways for personal and group improvements, more focused understanding of training needs, and perhaps most importantly, identifying needs to enhance board balance, skill sets, and competencies. In India, barring a few leadership companies, very few others have adopted this practice. This is set to change now with legislation and regulation prescribing such evaluations for listed and even large unlisted public companies. This Briefing suggests some processes and practices of board evaluation that go beyond just compliance so as to realise its full benefits.

Experience: International and Indian

A 2012 Spencer Stuart report reveals annual board effectiveness assessments as a standard practice in major listed companies ranging from 44% in Germany through 84% in Italy, 98% in the UK and 99% in the US to 100% in Canada and France. There will obviously be significant differences in the structure, content, and methodology of such evaluations depending upon country and culture specific factors but the important message is that some kind of periodical assessment of board performance is clearly being considered beneficial. However, credible information on content, frequency, methodology or outcomes of such exercises is hard to come by globally, including in India. It is not surprising, since board evaluation is an extremely sensitive corporate governance process.

In India, as noted earlier, such evaluations have not been the norm. More frequently, however, an intuitive evaluation of what they 'bring to the table' is made whenever new outside directors are considered for appointment.

Legal Mandate in India

The Companies Act, 2013 not only mandates board and director evaluation, but also requires the evaluation to be *formal, regular and transparent*. Subsequently, through two circulars (dated April 17, 2014 and September 15, 2014), the SEBI has revised the standard Listing Agreement, to bring the requirements in line with the Act provisions (see Box 1). An important provision in the Listing Agreement is that the continuance of the independent directors is made dependent upon their respective evaluations.

Box 1: Mandates regarding Board Evaluation

Companies Act, 2013

Who will be evaluated?

Boards, its individual members and committees of all Listed Companies; and all other public companies with paid up capital of at least Rs 25 cr. (Section 134 (3) (p))

Who evaluates whom?

- Evaluation of each Director of the Board is to be done by the Nomination and Remuneration Committee (NRC) of the Board. (Section 178 (2))
- Performance review of the Board, its Chairman and non-independent directors is to be carried out in an executive session to be attended exclusively by independent directors. In reviewing the Chairman's performance, the independent directors have to take into account the views of executive directors and non-executive directors. (Para VII of Schedule IV)
- Performance review of independent directors to be carried out by the Board. (Para VIII of Schedule IV)

Disclosure Requirements:

In the Annual Report – Manner in which formal performance evaluation of the Board, its Committees, and Individual Directors has been carried out. (Section 134 (3) (p))

Frequency: Annual **Effective:** April 1, 2014

Listing Agreement, 2014

Who will be evaluated?

Independent Directors of listed companies excluding those with paid up capital and net worth not exceeding Rs 10 crore and Rs 25 crore, respectively and those exclusively listed on SME and SME-IT platforms (SEBI circular of September 15, 2014)

Who evaluates whom?

Nomination Committee to lay down evaluation criteria and entire board (except director being evaluated) to do the evaluation of independent directors. *(II-B-5 of SEBI circular of April 17, 2014)*

Disclosure requirement: Disclosure of evaluation criteria in Annual Reports

Action Arising: Decision on continuance of independent director to be based on evaluation results

Frequency: Annual **Effective:** October 1, 2014

An analysis of these mandates shows that while the Act and the above-mentioned circulars of SEBI have brought considerable clarity on who is to be evaluated, who evaluates whom, disclosure requirements and so on, clarity is yet to emerge in some areas, including:

- Who will evaluate the Board committees?
- The non-independent directors are to be evaluated by whom—the NRC (as per Section 178) or independent directors (as per para VII of Schedule IV)?
- Why should the continuance of non-independent non-executive directors not depend on their respective evaluations, while the continuance of independent directors does?
- Why has the focus of the Listing Agreement been only on the evaluation of the independent directors?

The other important thing to note is that the tasks of developing the criteria for and the process of evaluation have been (appropriately) left to the discretion of the companies, although companies are required to publicly disclose them. There is of course no requirement to disclose the results of the evaluation which may remain within the domain of the board.

Some Challenges in Indian Board Evaluations

A. **Concentrated ownership**. Despite increasingly strong regulations and internationalisation of Indian businesses, board composition and regeneration are yet to reach best practice levels in a large number of companies mainly because they are characterised by concentrated ownership and promoter control, whether in the private or public sector. The same factors are likely to inhibit objective implementation of the evaluation mandate in spirit. In such circumstances, the programme administrators[1] would have to use significant levels of inter-personal skills and tact to reach professionally satisfying results. Often, this would involve highlighting to the promoter directors the benefits that may accrue to them and 'their' companies as a result of such evaluation exercises and follow-up actions.

B. **Unrealistic expectations**. Expectations on independent directors' contribution at the board oversight level--both explicitly by regulation and or otherwise by best practice norms--have become increasingly challenging, demanding wide and evolved skill sets, which are not easy to find. Such unrealistic expectations should be appropriately moderated for evaluation purposes to ensure that the results reflect a fair assessment of performance.

C. **Cultural trait.** In India, people generally find it challenging to be brutally honest in evaluating peers to the point of hurting someone's interests or feelings. It is reflection of a cultural trait. So, devising appropriate methods of communicating unpleasant messages is a real challenge. Programme administrators may have to be extra perceptive in appreciating underlying messages even when they are clothed in pleasant articulation.

D. **Absence of experience.** Since there is a widespread absence of experience in Board Evaluation, it may be useful--especially for companies embarking on board evaluation for the first time--to begin with simple evaluation

[1] Programme administrators include in-house champions and External facilitators (see Box II).

criteria (covering the board's contributing (domain expertise), counselling and controlling roles in governance) and add new criteria subsequently in the light of experience gained.

A Model Evaluation Process

There is an urgent need for developing a 'model' evaluation process as time is running out for companies to fulfil the mandate for the first year, while clarity has yet to emerge in a number of areas. Further, the model must be designed to address the unique challenges facing board evaluation in India.

Box-II sets out one such model. It is a three-stage model comprising (a) getting a full board buy-in, (b) defining scope and methodology and (c) execution. Each stage serves a useful purpose. While the first stage strengthens corporate commitment to the process at the highest level, the second stage brings in discipline and fairness to the process. The third stage focuses on effective delivery and communication of the evaluation results.

A key component of the initial stage (that is, Getting Board Buy-in), which is worth elaborating, relates to tapping available expertise on such evaluations within the board (from multi-boarded members who may have undergone such evaluations elsewhere). This would help the directors to feel more reassured and receptive to the programme. Also, learning from their experience might help the Board to avoid difficult situations in the evaluation exercise.

Box II: Recommended Board Evaluation Processes[2]

Stage/ Goal	Sub-goal	Steps / Actions / Precautions
I **Getting Board Buy-in**		• Prepare and table for board discussion a *Concept Paper* on objectives and benefits. • Draw on directors' experience (favourable or otherwise) of evaluations elsewhere. • Participation of all directors is necessary.
II **Defining criteria and methodology**	**Defining criteria**	• Define performance *criteria* and agree on benchmark levels of expectations ✓ Recognise executive directors' dual role as directors and managers. • Criteria should cover the three basic roles of the board: contributing, counselling and controlling; • Criteria should also capture an individual director's commitment, diligence, loyalty and leadership. • Criteria will depend on who is being evaluated—board or board committees or Chairman or independent directors and so on.
	Defining methodology	• Identify an In-house Champion for the programme: (typically, the independent board chair or independent lead director or nomination committee chair or the senior most independent director) • Decide if programme is to be administered entirely in-house or along with the involvement of an external facilitator. The latter is preferable (see below). • Agree that peer evaluations of every director will be carried out by all the other directors individually; and each director will in addition carry out a self-evaluation. • Agree similarly that board and committee evaluations will be carried out by each director, providing an overall assessment and qualitative inputs on observed deficiencies • Design Evaluation Questionnaire—one for self/peer evaluation and the other for board/ committee evaluations--with user guidelines on measurement criteria, scoring range, and qualitative comments.

[2]The model has been developed by the author on the basis of his board experience and also on first principles of peer performance evaluation.

III Execution	**Inputs Administration**	• Evaluation kits comprising the appraisal questionnaires, guidance notes and any other reference material such as attendance details, directors' personal details such as qualifications, experience and other directorships, and so on to be distributed to all directors. • All directors to be appropriately briefed so as to facilitate uniform understanding of both the content and the process. • Adequate time to be allowed for directors to complete the questionnaire responses and return it confidentially to the nominated In-house champion / external facilitator for processing
	Outputs Management	• Programme Administrator [1] to derive a summary evaluation report for each director (including the board chair) and each committee and the overall board. • Each report pertaining to individual directors should preferably have, against each criterion, the self-assessment score and mean, median, maximum and minimum scores by peers, and selected qualitative comments offered by peers including any suggestions for improvements.
	Delivery & Follow-up	• Each individual evaluation summary report should be made available only to the respective director in confidence. • The in-house champion / external facilitator should provide a guidance note interpreting the results for each director. • A one-to-one confidential discussion between each director and the in-house champion / external facilitator is recommended, so that the latter can both elicit responses to the results and also provide required counselling inputs.[3] • Each director would also receive summary evaluation reports of the board and the committees • An important part of the evaluation exercise is the presentation to the full board by the in-house champion / external facilitator covering aggregate summary results of individual directors' evaluations as well as the summary results of board and committee performance. • Nomination committee and the board may also be advised on any inadequacies in the board composition brought out by the exercise for appropriate corrective actions.

An analysis of the recommended process reveals that it has four major underpinnings:

- The Board must make a formal commitment to adopt a given process.
- Involvement of an external facilitator is preferred (see below);
- Every director has a voice in the evaluation of every other director and the Board;
- Sensitive handling of interpersonal communication is key.

[3]Since outside directors' performance is strongly influenced by the availability of timely and comprehensive inputs from the company, their views on how their performance was impacted by any input inadequacies should be elicited and taken into account in the evaluation process.

Need for External Facilitation

Involving an external facilitator in the evaluation programme is advisable for the following reasons:

- People tend to open up more freely to an external facilitator than to an internal colleague, mostly due to some misgivings on confidentiality of their inputs.
- An external facilitator brings to the exercise a measure of objectivity and more importantly, will be seen as such by the individual directors. In fact, some jurisdictions like the UK prescribe external facilitation at least every three years in case of FTSE 350 companies' board evaluations. In the Companies Act, there is no bar against the board seeking external facilitation to assist them in the evaluation process.

If a company decides to opt for external facilitation, it has to be extremely careful in choosing an appropriate facilitator. Independence and integrity of the facilitator are absolutely critical. Further, the facilitator must have actual board experience, professional and behavioural skills, and a good understanding of not only the "what" but also the "why" of best governance practices.

Conclusion

If carried out in earnest, board evaluation has the potential to improve the Board's effectiveness. Very few Indian companies voluntarily follow this practice, although internationally the practice is far more widespread. There has been a recent legal mandate in India for board and director performance evaluation, which has led to a debate about its implementation issues. In this context, a model board evaluation process that addresses the challenges typically found in India, may provide guidance in operationalizing the mandate to companies that are constrained by lack of experience. A model process must include at a minimum a buy-in of the whole board, use of self- and peer-evaluation by directors and emphasis on appropriate communication. Further, an external facilitator can play a pivotal role in board evaluation, particularly in the Indian context.

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About NSE CECG

Recognizing the important role that stock exchanges play in enhancing corporate governance (CG) standards, NSE has continually endeavored to organize new initiatives relating to CG. To encourage best standards of CG among the Indian corporates and to keep them abreast of the emerging and existing issues, NSE has set up a Centre for Excellence in Corporate Governance (NSE CECG), which is an independent expert advisory body comprising eminent domain experts, academics and practitioners. The 'Quarterly Briefing' which offers an analysis of emerging CG issues, is brought out by the NSE CECG as a tool for dissemination, particularly among the Directors of the listed companies.