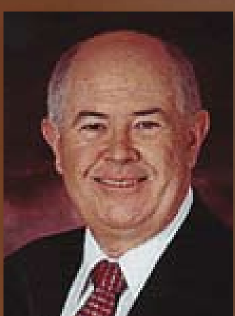
Seven Steps to Effective Board and Director Evaluations



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Board assessment is too often viewed as a necessary evil — a mechanical process of checking off items on a list that ultimately has little real value for the board apart from meeting compliance requirements. However ... an effective board assessment process has the potential to be transformational.[1]

When a corporate scandal occurs, such as those experienced at China Aviation Oil (Singapore) Corporation Ltd in 2005, it is to the board that the shareholders, media, regulators and community look for answers. As the ultimate decision-makers in the corporation, the board is responsible for the corporation's actions and performance.

The challenge for boards today is to add value to the organisations they govern. Performance evaluation is a means by which boards can ensure they have the knowledge, skills and ability to meet this challenge. This is recognised in numerous best practice guides and standards. For example, the Singapore Code of Corporate Governance first introduced by the Corporate Governance Committee in 2001 and revised in 2005, states that: "There should be a formal assessment of the effectiveness of the Board as a whole and the contribution by each director to the effectiveness of the Board".[2]

This article will provide a practical approach to effective board and director evaluations using a seven-step framework that asks the key questions all boards should consider when planning an evaluation.

Even good boards can benefit from a well-conducted evaluation. As summarised in Table 1, a properly conducted evaluation can contribute significantly to performance improvements on three levels: the organisational, board and individual director levels. It must be stressed, however, that these benefits can only be achieved through a properly executed board evaluation; if incorrectly executed, an evaluation can lead to distrust among board members and between the board and management.

Table 1 Potential benefits of board evalution[3]

Benefits	To organisation	To board	To individual directors
Leadership	• Sets the performance tone and culture of the organisation • Role model for CEO and senior management team	• An effective chairperson utilising a board evaluation demonstrates leadership to the rest of the board • Demonstrates long-term focus of the board • Leadership behaviours agreed and encouraged	• Demonstrates commitment to improvement at individual level
Role clarity	• Enables clear distinction between the roles of the CEO, management and the board • Enables appropriate delegation principles	• Clarifies director and committee roles • Sets a board norm for roles	• Clarifies duties of individual directors • Clarifies expectations
Teamwork	• Builds board/CEO/ management relationships	• Builds trust between board members • Encourages active participation • Develops commitment and sense of ownership	• Encourages individual director involvement • Develops commitment and sense of ownership • Clarifies expectations
Accountability	• Improved stakeholder relationships (e.g. investors, financial markets) • Improved corporate governance standards • Clarifies delegations	• Focuses board attention on duties to stakeholders • Ensures board is appropriately monitoring organisation	• Ensures directors understand their legal duties and responsibilities • Sets performance expectations for individual board members
Decision-making	• Clarifying strategic focus and corporate goals • Improves organisational decision-making	• Clarifying strategic focus • Aids in the identification of skills gaps on the board • Improves the board's decision-making ability	• Identifies areas where director skills need development • Identifies areas where the director's skills can be better utilised
Communication	• Improves stakeholder relationships • Improves board-management relationships • Improved board-CEO relationships	• Improves board-management relationships • Builds trust between board members	• Builds personal relationships between individual directors
Board operations	• Ensures an appropriate top-level policy framework exists to guide the organisation	• More efficient meetings • Better time management	• Saves directors' time • Increases effectiveness of individual contributors

Although boards may differ in the severity of their governance problems and the range of issues they face, there are still a number of key decisions that are relevant to all boards implementing an evaluation process. An effective framework relies on the board reaching agreement on the answers to the seven key questions illustrated in Figure 1. While these questions must be asked for all board evaluations, the combined answers can be quite different. Therefore, while the questions are common to each, evaluations can range markedly in their scope, complexity and cost.

Although the framework below is depicted sequentially, in practice most boards will not follow such a linear process. Some of these decision areas will be reached simultaneously; for example, 'Who will be evaluated' may be decided at the same time as 'Who will conduct the evaluation'. However, at some point, each of these questions will need to be answered.

Figure 1 Framework for a board evalution[4]

Step 1: What are our objectives?

Step 1 is to establish what the board hopes to achieve. Clearly identified objectives enable the board to set specific goals for the evaluation and make decisions about the scope of the review. Such issues as the complexity of the performance problem, the size of the board, the stage of organisational life cycle and significant developments in the firm's competitive environment will determine the issues the board wishes to evaluate. Similarly, the scope of the review (how many people will be involved, how much time and money to allocate) will be determined by the severity of the problems facing the board and the availability of sufficient resources to carry out an evaluation.

The first decision for most boards to consider is the overriding motivation for the evaluation process. Generally, the answer to this question will fall into one of the following two categories:

- corporate leadership — for example, 'We want to clearly demonstrate our commitment to performance management', or
- problem resolution — for example, 'We do not seem to have the appropriate skills, competencies or motivation on the board'.

Step 2: Who will be evaluated?

Comprehensive governance evaluations can entail reviewing the performance of a wide range of individuals and groups. Boards need to consider three groups:

- the board as whole (including committees)
- individual directors (including the roles of chairperson), and
- key governance personnel.

Considerations such as cost or time constraints, however, often preclude such a wide-ranging review.

Alternatively, a board may have a very specific objective for the review process that does not require the review of all individuals and groups identified. In both cases, an effective evaluation requires the board to select the most appropriate individuals or groups to review, based on its objectives. To make this decision, we recommend that a list of possible review participants be gradually filtered down to a pragmatic selection of review subjects.

A common issue in deciding who to evaluate is whether to concentrate on board-as-a-whole only or also include individual director assessment. Regular board-as-a-whole evaluation can be seen as a process that ensures directors develop a shared understanding of their governance role and responsibilities. Although board-as-a-whole evaluation is excellent as a familiarisation tool for inexperienced boards, one disadvantage is that group evaluation may give only limited insight into any performance/governance problems. Consequently, some boards choose to progress to the evaluation of board committees, individual directors and the chairperson to gain greater insight into how their board is functioning.

To gain an objective view of individual director performance, peer evaluation is preferable, since by having members of the board evaluate each other, it is possible to gain a more holistic picture of the strengths and weaknesses of each director and their contribution to the effectiveness of the board. It can also be used to identify skills gaps on the board or communication issues between directors. Should an individual director evaluation be conducted, it is paramount that the outcomes of this review be correlated with the whole-of-board outcomes to validate the appropriateness of any recommendations.

Step 3: What will be evaluated?

Having established the objectives of the evaluation and the people/groups that will be evaluated to achieve those objectives, it is then necessary to elaborate these objectives into a number of specific themes to ensure

that the evaluation:
- clarifies any potential problems
- identifies the root cause(s) of these problems, and
- tests the practicality of specific governance solutions, wherever possible.

This is necessary whether the board is seeking general or specific performance improvements, and will suit boards seeking to improve areas as diverse as board processes, director skills, competencies and motivation, or even boardroom relationships.
We suggest boards consider their specific objectives in light of a leading practice governance framework to establish the roles the board is expected to fulfil (see Table 2, for an example).

Table 2 Generic roles of a board[5]

Board role
1. Strategy
2. CEO
3. Monitoring
4. Overview of risk management
5. Overview of compliance
6. Policy framework
7. Networking
8. Stakeholder communication
9. Decision making
10. Effective governance

Of course, a comprehensive list of areas for investigation will need to be balanced with the scope of the evaluation and the resources available for the project. At this stage a realistic assessment of the resources available, a component of which is the time availability of directors and other key governance personnel, can be made.

Step 4: Who will be asked?

The vast majority of board and director evaluations concentrate exclusively on the board (and perhaps the CEO) as the sole sources of information for the evaluation process. However, this discounts other potentially rich sources of feedback. Participants in the evaluation can be drawn from within or from outside the company. Internally, board members, the CEO, senior managers and, in some cases, other management personnel and employees may have the necessary information to provide feedback on elements of a company's governance system. Externally, owners/members and even financial markets can provide valuable data for the review. Similarly, in some situations, government departments, major customers and suppliers may have close links with the board and be in a position to provide useful information on its performance.

After examining all potential sources of information along with their relative advantages and disadvantages, the facilitator must decide which sources to include in the review. This requires an understanding of three issues:
- in light of the specific questions identified in the previous step, who has the knowledge needed to make a valid and reliable assessment
- what is the level of board experience with, and openness to, the evaluation process and what is the impact on who should be asked, and
- what resources are available to collect the information from the required sources.

Step 5: What techniques will be used?

Depending on the degree of formality, the objectives of the evaluation, and the resources available, boards may choose between a range of qualitative and quantitative techniques. Quantitative data are in the form of numbers. They can be used to answer questions of how much or how many. Questions of 'what', 'how', 'why', 'when' and 'where' employ qualitative research methods.

Most boards undertake evaluations without a clear view of the issues before them. When the evaluation's objectives are to identify the key governance problems, screen alternative solutions and/or uncover new approaches, qualitative research comes to the fore. Qualitative data does, however, have several drawbacks.

The major drawback is that interpreting the results requires judgment on the part of the person undertaking the review and analysis. This is best addressed by using experienced researchers for the task and having several participants review the conclusions for bias. Bias can also be mitigated by using both quantitative and qualitative techniques.

The three main methods used for collecting qualitative data in governance evaluations are interviews, board observation and document analysis:
- the interview provides a unique opportunity to collect complex and rich data. It is an excellent way of assessing directors' perceptions, meaning and constructions of reality by asking for information in a way that allows them to express themselves in their own terms
- observation of a board meeting is especially useful when the evaluation objectives relate to issues of boardroom dynamics or relationships between individuals
- documents can also be a rich source of information in the governance evaluation process. It can be a method of triangulation for use in conjunction with other data collection techniques.

While quantitative data lack the richness of qualitative data, they have the advantage of being specific and measurable. Surveys are by far the most common form of quantitative technique used in governance evaluations and can be an important information-gathering tool. It is vital to understand, however, that surveys are attitudinal instruments.

There is no best methodology. Research techniques need to be adapted to the evaluation objectives and board context.

Step 6: Who will do the evaluation?

The next consideration is to decide who the most appropriate person is to conduct the evaluation. If the review is an internal one, the chairperson may conduct the evaluation.

However, for reasons of impartiality there are times when it may be more appropriate to delegate either to a non-executive or lead director, or to a board committee. Depending on the previous steps, and decisions made in Step 7 as to the audience for the results, mature boards are more frequently considering engaging in external evaluations to provide a level of independence and advice to proactively improve overall governance and board dynamics.

In the case of external evaluations, specialist consultants or other general advisers with expertise in the areas of corporate governance and performance evaluation lead the process. However, the specialised nature of a board review often requires skills outside the customary scope of many general advisers. Similarly, a consultant engaged specifically to carry out the evaluation can be perceived as more independent than a reviewer with an existing relationship with the firm (such as a general counsel or auditor). Specialist consultants will also have a broad range of exposure to different boardroom practices and performance benchmarks.

One compromise between the two approaches is to utilise an online board evaluation to confidentially develop an evaluation report that can be delivered by the chair or lead director.[6]

Step 7: What do you do with the results?

The review's objectives should be the determining factor when deciding to whom the results will be released.

Most often the board's central objective will be to agree a series of actions that it can take to improve governance. Since the effectiveness of an organisation's governance system relies on people within the firm, communicating the results to internal stakeholders is critical for boards seeking performance improvement. Given that virtually all governance reviews are conducted with a view to improving the governance system, boards are rarely faced with the decision of whether to communicate the results internally. Rather, the decision is who within the organisation needs to know the results.

Since the board as a whole is responsible for its performance, the results of the review will be released to the board in all but the most unusual of circumstances. Where the evaluation objectives are focused entirely on the board, board members will simply discuss the results among themselves. Normally, the board, CEO and company secretary will review the findings around the boardroom table, and there may be no need to communicate the results to anyone else. Where the results of the evaluation concern individual director performance, the generally accepted approach is for the chairperson and/or facilitator to discuss them individually with each director. Directors may be asked to discuss their own results around the board table, a process that can lead to a much greater extent of mutual understanding.

In circumstances where the objective of the board evaluation is to assess the quality of board-management relationships, results of the evaluation will generally be shared with the senior management team. Some organisations choose to communicate a summary of the board evaluation results more widely in the organisation.

In certain circumstances, the board will have an objective of building its reputation for transparency and/or developing relationships with external stakeholders. In such circumstances, the board should consider communicating some or all of the results of its review to those stakeholders. Communicating the results of the evaluation demonstrates that the board takes governance seriously and is committed to improving its performance. Obviously a balance needs to be struck between transparency on the one hand and the need for owners or members to retain faith in the board's ability and effectiveness on the other hand.

In summary

Aside from the seven key questions in an evaluation, boards need to consider how often they should evaluate their performance. The annual review is the most commonly recommended form of assessment. However, a predictable annual event can become stale and no longer add value; therefore, it is important to experiment with different evaluation styles and techniques to keep the process interesting and ensure that it continues to lead to performance improvements.

Performance evaluation can be an ongoing process, not just an annual event. High-performing boards tend to devise other mechanisms apart from an annual review to ensure ongoing performance improvement. One option is to review the effectiveness of each board meeting. This is a simple technique for keeping performance issues 'front of mind' for the board. It is an easy way to gain quick feedback and to encourage discussion and interaction between board members, and it requires little time or effort to put in place.

Performance evaluation is becoming increasingly important for boards and directors and has benefits for individual directors, boards and the companies for which they work. Boards also need to recognise that the evaluation process is an effective team-building, ethics-shaping activity. Our observation is that boards often neglect the process of engagement when undertaking evaluations; unfortunately, boards that fail to engage their members are missing a major opportunity for developing a shared set of board norms and inculcating a positive board and organisation culture. In short, the process is as important as the content.

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Notes

[1]Nadler, D A, Behan, B A, and Nadler, M B, Building Better Boards: A Blueprint for Effective Governance, Jossey-Bass, San Francisco, 2006, p230

[2]Corporate Governance Committee, Code of Corporate Governance 2005 – Board Matters, Principle 5, http://www.asc.gov.sg/attachments/CodeofCorporateGovernance.doc

[3]Kiel, G C, Nicholson, G J, and Barclay, M A, Board, Director and CEO Evaluation, McGraw-Hill, Sydney, 2005, pp 13-14

[4]Kiel, Nicholson, and Barclay, 2005, p 17

[5]For an elaboration of these roles see www.effectivegovernance.com.au/ and select 'Services/Board Evaluation'

[6]For more information on online evaluations see www.effectivegovernance.com.au/ and select 'Online Products'

Singapore Institute of Directors
Statement of Good Practice
Board Evaluations

1 Introduction

1.1 Principle 5 of the Code of Corporate Governance 2005 ('Code') recommends that there should be a formal assessment of the effectiveness of the Board of Directors ('Board') as a whole and the contribution by each director to the effectiveness of the Board. Guideline 5.2 of the Code further recommends that the Nominating Committee should decide how the Board's performance may be evaluated and propose objective performance criteria which should be approved by the Board.

1.2 Conducting board evaluations are increasingly becoming a norm internationally. With the passing of the Sarbanes-Oxley Act of 2002 in the United States, the New York Stock Exchange ('NYSE') adopted standards requiring boards of companies listed on the NYSE to conduct and disclose the results of board evaluations]. The NYSE also requires that the various board committees, and in particular the audit, nominating and remuneration committees, include in their terms of reference specific provisions on conducting evaluation of their respective performances.

1.3 Board evaluations are not mandatory in Singapore. However, the provisions as contained in the Code recommending the assessment and evaluation of the Board and its members have been around since the time the Code came into force.

1.4 There are clearly tremendous benefits to conducting regular board evaluations. However, the members of the Board should be aware of the risks that may arise if the board evaluation process is not carefully designed.

1.5 This Statement of Good Practice provides guidance on why board evaluations should be undertaken, the benefits and risks of board evaluations, and how the evaluation should be undertaken. Note that this Statement of Good Practice assumes that the board itself will be involved in the setting up of the actual evaluation process. No "bottoms-up" approach (ie, of staff or management evaluating the board) is proposed at this time.

2 What Are Effective Board Evaluations?

2.1 Board evaluations are processes of, whether formal or informal, identifying the effectiveness of a board in relation to how board members work with each other, how the board works with management, how the board as a whole has coordinated its efforts and marshalled the company's resources to increase or improve upon the performance of the company.

2.2 To be clear, a board should not be assessed only upon whether the company has become more profitable; the board can also be assessed on how it has dealt with a crisis for example.

3. Why Undertake Board Evaluations?

3.1 One purpose of board evaluations

is to allow the board as a whole and the directors individually to identify any possible gaps that may exist in the work undertaken by the Board and to identify ways of improving the process.

3.2 Another important reason for undertaking board evaluations is to assess how the board and the individual directors work together with each other and with other stakeholders of the company. To this extent, board evaluations aid in fostering communication amongst the directors and between the board and management on various matters, including corporate strategy, board composition and board processes.

3.3 A further important purpose of evaluations is to identify the "best" fit in board composition with the ultimate aim of increasing shareholder value.

4 Benefits And Risks Of Board Evaluations

4.1 Benefits

4.1.1 Improves director effectiveness by identifying gaps, if any, and correcting them.

4.1.2 Improves Board collegiality through the exchange of views on how the board as a whole is performing.

4.1.3 Helps the Board to focus on how it operates and identifies areas that can be improved.

4.1.4 Helps the Board to focus on long-term strategies.

4.1.5 Provides a written record to show that the Board is diligent in monitoring its own actions.

4.2 Risks

4.2.1 Written records of the Board evaluation process may be discoverable in litigation, with the possibility that negative conclusions not acted upon possibly being used adversely during the litigation.

4.2.2 Responses to written questionnaires for evaluation may not reflect the overall perspective of the Board.

5 Designing The Board Evaluation

5.1 There is no standardised design for board evaluations and each board should be careful about adopting an evaluation process prepared by another company for its own use.

5.2 Board evaluation materials must be designed as appropriate to each board. Boards should be mindful of the issues that, in the opinion of the Directors, such an evaluation process should address, the information that they want to gather, as well as the retention policy of the feedback that is received from the board members.

5.3 One of the most important aspects of the evaluation process is to elicit a frank evaluation of the board's operations and performance from the directors, both individually and as a group.

5.4 In designing the board evaluation process, the use of subjective questions should be avoided wherever possible.

5.5 Broadly, any board evaluation design should at least take into consideration the following:

(a) Board culture
(b) Board composition
(c) Board procedures and processes
(d) Information flow and accessibility
(e) Leadership on the board and how this is transmitted
(f) Management interface
(g) Shareholder interface and communications

5.6 Additionally, the board evaluation

design should also take into account the following two major areas, although external market conditions could also play a part:

(a) Company-related factors, including the size of the company, the nature of its business, the complexity of the operations, profitability, the structure and responsibilities assigned to the board, and the risks and challenges of the business.

(b) Director-related factors, including qualifications and experience of the directors, their availability (in terms of being able to attend meetings or at least provide feedback as may be required), involvement and actual participation at meetings, and additional responsibilities assigned to the relevant directors, including whether he is a chair or member of a sub-committee of the Board.

5.7 The Nominating Committee, whether on its own or with the assistance of external consultants, should be tasked with the design and formatting of the evaluation process. The Nominating Committee in designing or working with external parties to design the evaluation process, must ask: 'What is the purpose of the evaluation?' or 'What is it that we want to achieve?'.

5.8 The Nominating Committee must further identify, in the course of preparing the evaluation process, what factors constitute success to the company. In doing so, they should also identify the external factors that could have an impact on these success factors, the relevant information that is necessary to carry out the evaluation and the appropriate tools needed to carry out the evaluation.

5.9 In this regard, the Code suggest that relevant performance criteria that may be used could include the company's share price performance over a five-year period vis-à-vis the Singapore Straits Times Index and a benchmark index of its industry peers return on assets, return on equity, return on investment and economic value added over a longer-term period. As far as the relevant criteria in assessing the individual directors are concerned, the key factors include whether the individual director continues to contribute effectively and demonstrate commitment to the role (including commitment of time for board and committee meetings, and any other duties).

5.10 The Nominating Committee, working in conjunction with the Board, should also be tasked with determining who should be given the responsibility of conducting the evaluation, ie whether it should be done internally by another committee, by the Nominating Committee, by self-evaluation, or by an external consultant, as well as whether the process is intended to be conducted through a written questionnaire or via oral interview.

5.11 The Nominating Committee should determine how the company's record retention policies and practices should be applied to the data gathered in the course of the evaluation process and it should ensure that such record retention procedures are strictly adhered to.

6 Conducting And Gathering Information From The Board Evaluation

6.1 There is no definitive method for conducting a board evaluation. This can be done through a written questionnaire or through oral discussions, with someone recording the responses provided. The written questionnaire may be the preferred approach as it will ensure consistency from year to year, and will generally be easier for board members to respond to, if properly structured.

6.2 The board and director evaluation should be conducted at least once a year.

6.3 On the basis that a written questionnaire is to be provided, each director should be asked to respond to the same standardised questionnaire relating to the performance of the Board. The preferred and perhaps easiest approach is to have each director also be provided with a questionnaire pertaining to his performance to respond to. Some companies may prefer peer critiques as a form of assessment as well. Whilst this is to be welcomed, it is not something that companies would typically prefer given the deference that each director has to the other and the wish not to offend.

6.4 The information gathered from the questionnaires must be objectively analysed and feedback collated. There are queries as to whether this should be conducted anonymously or by say the remuneration committee. There is no one answer fits all, and the better approach is to always have this conducted internally in the first instance if the review is to be transparent in any event.

6.5 Based on the feedback gathered, changes should be recommended to improve the workings of the board. It must be recognised that not all suggested changes need be or can be implemented immediately. There may be good reasons to introduce changes in a gradual manner and in the order of priority of need.

6.6 The board as a whole should be involved in the decision-making process as regards the relevant next steps.

6.7 The Board, in conjunction with the NC Chairman, should take appropriate steps to counsel, or at worse, replace non-performing or errant directors.

6.8 The Code recommends that the process used to assess the effectiveness of the board as a whole and the contribution of each individual director to the effectiveness of the board, should be disclosed in the company's annual report. It is not necessary in all cases to disclose the detailed findings of the performance evaluation to shareholders or in the annual report. The degree of disclosure should be left to each company to decide on.

7 Conclusion

7.1 This Statement of Good Practice has provided only broad recommendations as regards how a board evaluation can be undertaken. It is imperative to note that there is no one approach fits all and hence no sample appraisal form has been provided.