Evaluation for board, board committees and individual directors

MCCG Intended Outcome 5.0

Stakeholders are able to form an opinion on the overall effectiveness of the board and individual directors.

MCCG Practice 5.1
The board should undertake a formal and objective annual evaluation to determine the effectiveness of the board, its committees and each individual director. The board should disclose how the assessment was carried out and its outcome.

For **Large Companies**, the board engages independent experts periodically to facilitate objective and candid board evaluations.

*(The application of this Practice in its entirety entails the **undertaking of a formal and objective annual evaluation to determine the effectiveness of the board, its committees and each individual director** as well as the **disclosure of how the assessment was carried out and its outcome**. In addition, for Large Companies, the application of this Practice in its entirety would also entail the **periodic engagement** of **independent experts by the board** to facilitate objective and candid board evaluations.)*

The internalisation and application of the content "Why" and "How" should be read in tandem with the line of sight outlined by the Intended Outcome.

Why — The case for change

Board evaluation or the process of self-evaluation by the board, is an essential process for the board to examine itself to ensure that the board is operating efficiently and effectively. This evaluation process allows the board to address issues such as leadership, delegation of duties and responsibilities and reviews of existing processes within the board[1].

The evaluation of boards has become a norm worldwide ever since it was first introduced in the Cadbury Report 1992 (United Kingdom).

Besides being a good governance practice, performance evaluation is a useful tool that is used by the board to consider the accomplishments of individuals and the groups of individuals within the board. It also provides an avenue for revisiting what could have been done better and incorporating lessons into future behaviour of the board. When done effectively, it could help the board to improve their relationship with management and stakeholders.

What could go wrong:

- Pertinent issues concerning the board, board committees and directors are not detected and consequently, opportunities for improvement are not identified.
- Lack of linkage between the evaluation exercise and the professional development programme for directors.
- Stakeholders are unable to appreciate the bases for governance changes at the leadership level.

[1] Larker, D et. al 2017, *How Boards Should Evaluate Their Own Performance,* Harvard Business Review

The most notable changes that can stem from an effective board evaluation are as follows:

- improvement in ways the board engages with management on strategy;
- better succession planning for the chief executive officer and outgoing directors;
- improvement in how meetings are conducted and information is disseminated;
- improvement in the function of the board through revised and enhanced meeting agendas; and
- more clearly defined roles of directors[2].

It is important to acknowledge that the board, like any group within the company, must be evaluated just like its employees. In broad terms, evaluation for the board, board committees and individual directors revolves around the themes outlined below[3]:

How the board leads

Examine how the directors were chosen, the skills and experience the director brings to bear and the leadership style.

How the board manages

Evaluate the manner in which board meetings and boardroom activities are conducted, including board dynamics.

Consider potential red flags such as "a board within a board"[4].

How the board contributes

Review the manner in which board members interact and participate as well as how decisions are made.

Given the importance of this process, it is no surprise to see that the evaluation of the board, board committees and individual directors has continued to gain increasing traction over the recent years. The rationale behind this Practice is that directors should not be excused from the process of review and improvement. Leading boards in fact have come to view the exercise in a positive light, i.e. as an opportunity to change the status quo.

However, it is no exaggeration to say that looking in the mirror is a much harder proposition than looking at someone else. Directors, in particular executive ones, are accustomed to evaluating their senior management, suppliers and the like, but when it comes to one's self, peers and the chairman, this becomes a much harder task.

Hot-button issue

It is not uncommon to find directors who have been on their boards for what seems like an eternity. Somewhat against conventional expectation, it is the non-executive directors who appear to be hanging onto their board seats.

Whilst not inferring that length of service has an inverse relationship with contribution and effectiveness, it would not be a surprise if one were to delve into the boards with such long-serving directors and find that the evaluation process is deficient.

As such, it is important for the board to leverage on the evaluation exercise as a platform to surface any areas of concerns and bring about constructive changes including in the area of succession planning.

[2] Behan, B 2017, *Engaging Directors on Board Composition,* Board Evaluation & CEO Succession Planning
[3] Larcker, D et.al 2017, *How Boards Should Evaluate Their Own Performance*, Harvard Business Review
[4] "board within a board" means a dynamic when a subset of directors has an outside influence on board decisions.

Why evaluations do not always work out:

Self-rater bias

The director has a view of himself or herself that far exceeds what he or she would score if measured objectively ("**Dunning-Kruger effect**").

Back scratching

Directors rate each other favourably and the end result is a consistent curve with no real opportunities offered for improvement.

The status quo feel

Despite signs of under-performance, there is resistance to change and in particular, outside assistance is rejected as such directors fear the results of an evaluation.

Further, although it is considered an important process in ensuring the boards effectiveness, the stumbling block with board assessments is also in terms of its disclosure. Whilst many boards across the globe disclose that they have completed an evaluation, very few have been able to provide details on how the evaluation process was conducted[5].

HOW The practice in substance

It is important for a board to ensure that its directors are capable and qualified to lead and contribute towards the company's growth. An effective board evaluation would result in constructive changes to the dynamism of the board, which would most often involve changes to board composition (e.g. succession planning). In fact, some of the best boards with highly engaged directors have developed action plans consisting of many different items, largely because their board evaluation process has stimulated many good ideas.

The following are some key issues that have to be considered in executing board evaluation:

- Does the board include discussions on governance matters in their meetings or are they overlooked for other matters of importance?
- Does the board have sufficient time to review and assess material information to provide quality and professional review?
- Is the composition of the board in terms of skills, knowledge, experience and business outlook well-suited for the company?
- Are there open and constructive conversations when discussing issues during board meetings?
- Are the performance of the board committees during the year evaluated?
- What are the weaknesses and shortcomings of the board and how to overcome them[6]?

In order to improve the disclosure on how boards are assessed and for the process to be transparent, **Bursa Securities Listing Requirements** have put the onus of driving the evaluation process on the nominating committee.

[5] Behan, B 2017, *Engaging Directors on Board Composition,* Board Evaluation & CEO Succession Planning
[6] Forrest P, 2012, *The importance of evaluating the board,* Singapore Institute of Directors

Paragraph 2.20A of Bursa Securities Listing Requirements

Qualification of directors and other key officers

Every listed corporation, management company or trustee-manager must ensure that each of its directors, chief executive or chief financial officer has the character, experience, integrity, competence and time to effectively discharge his role as a director, chief executive or chief financial officer, as the case may be, of the listed corporation, or the collective investment scheme.

Paragraph 15.08A(3)(c) of Bursa Securities Listing Requirements

The listed issuer must provide, in its annual report, a statement about the activities of the nominating committee in the discharge of its duties for the financial year. Such statement must include how the requirements set out in **paragraph 2.20A** of these Requirements are met and contain the following information:

(c) the assessment undertaken by the nominating committee in respect of its board, committees and individual directors together with the criteria used for such assessment.

Likewise, the need to conduct an annual evaluation of the board, board committees and individual directors is encapsulated in **Standard 13.1 of Bank Negara Malaysia's Policy Document on Corporate Governance**. Similar to **Practice 5.1 of MCCG**, **Guidance 13.2** of the said document by **Bank Negara Malaysia** also calls for a periodic externally facilitated evaluation. The evaluation process is therefore a significant portion of the nominating committee's work, and adequate time should be budgeted in order to achieve a meaningful outcome.

It is not uncommon for boards to enlist external advisors to facilitate the assessment process. Indeed, **Practice 5.1 of MCCG** calls for Large Companies to engage independent experts on a periodic basis to facilitate objective and candid board evaluations. However, it should be noted that regardless of which party executes the process, the outcome is very much dependent on the directors' mind set.

Point for reflection

Do evaluations work?

Box- ticking exercise

A director who views his board seat as a legal necessity would likewise regard the evaluation process as a chore to be dispensed with as quickly and painlessly as possible. This director's tendency is to give uniform ratings to all questions and pass on opportunities for suggestions.

Outcome:

Missed opportunity to identify improvement considerations.

Carefully designed and thoughtfully responded board evaluation exercise

A director who understands that whilst performance may be good, the evaluation process supports the "we can be better" mentality. For example, an evaluation of the board's composition may lead to recruitment of a director who can cover the board's "blind spot" within an industry.

Outcome:

Input obtained for potential governance changes that could lead to enhancement in effectiveness of the board, board committees and individual directors.

The most commonly used evaluation methods are **questionnaires**, **informal review** and an **interview**. These methods and the related processes are further explained in the ensuing paragraphs.

Questionnaires

Questionnaires are tailor-made to the company's needs to ensure that questions posed are pertinent as the requirement of the boards differ within the industries. They are circulated on paper or online. The questions are pre-set and the director fills in the answers. There is minimal interaction and discussion involved in this process.

The result or summary of the evaluation is then shared with the chairman of the board or the chairman of the nominating committee.

Informal review

An informal review process involves the board evaluating its members on a more frequent and less formal basis. This results in a more immediate feedback to the board on their performance. The directors assess the performance of the group or individual directors immediately after meetings based on the presentations, contribution of the directors during the meeting, communication between the members and how they reached their decisions during the meeting.

This process allows the board to respond to the issues that could impair the board on a timely basis.

Interview process

A widely recognised method that provides a positive contribution towards the assessment process is using an interview process. A properly structured and executed interview process which includes one-to-one conversation with each board members could yield multiple comments and observations. The board members involved in the process tend to be more engaged in communicating than in filling out forms and questionnaires. This leads to better results that allow the board to draw insights and formulate plans on recruitment and retention of directors.

It is also helpful to recognise that not all directors are expected to perform at the same level in order to merit a positive rating. For example, a director who has just joined the board would not be expected to exhibit the same familiarity as another director who has been serving for a longer period (e.g. five years). The key consideration is whether the new director has carried out his duties and discharged his responsibilities appropriately[7].

Evaluations can be broadly grouped into two categories, internal and external evaluation.

Internal evaluation

Internal evaluation of the board is often undertaken by the nominating committee, the board itself or facilitated by the company secretary. This process is normally conducted using questions that are either specifically tailor-made for

Dos

Directors should –

- ✓ in conducting their peer assessment, rate their peers based on the conduct and manner of their peers in discharging their duties, which includes the ability to ask probing questions.
- ✓ practise self-evaluation and not self-serving evaluation.
- ✓ take the opportunity to provide constructive comments and suggestions.
- ✓ challenge conclusions offered by management or external advisors.

Don'ts

The following would render the application of this practice ineffective:

- × Directors rating each other favourably, assuming that the company's good performance is solely the result of the board performing. The company's results may be due to an effective management team shoring up a poorly performing board.
- × Directors providing generic comments or monotonous ratings in the self and peer assessment or merely box-ticking (e.g. providing a singular rating for all the questions contained in the assessment form).

[7] Behan, B 2017, *Engaging Directors on Board Composition,* Board Evaluation & CEO Succession Planning

the board or using available templates. Where the board conducts the evaluation, the process is usually led by the chairman of the board or the chairman of the nominating committee. For this process to be successful, the board must ensure the questions posed are aimed towards the betterment of the company as a whole.

In conducting an internal evaluation, the board should also consider drawing input from those who have a close nexus to the proceedings and activities of the board (e.g. company secretary and senior management). This may help yield findings that may not have surfaced from conventional methods.

External evaluation

An external evaluation is undertaken to provide objectivity that could, at times, be lacking when carrying out the process internally. By enlisting a third party expert, the evaluation exercise will also benefit from a rigorous methodology and professional viewpoints. As stated in **Guidance to Practice 5.1 of MCCG**, "a board evaluation which is periodically facilitated by a professional, experienced and independent party will lend greater objectivity to the assessment by providing an unbiased perspective on a director's performance and his ability to contribute effectively to the board".

The action plan that can be drawn up upon conclusion of the evaluation is explained below:

When an evaluation has been completed, the nominating committee or the external evaluator must devise an action plan and consider how the findings should best be communicated to the board in the interest of improving its effectiveness. There are a number of options, including the following:

- the original assessment should be presented to the directors or as a perspective to which the evaluator (internal or external) has contributed the context, judgment and recommendations, on a no-name basis;
- quotes and comments obtained from the respective directors who were evaluated may be used (e.g. in relation to strengths and improvement considerations) whilst maintaining appropriate anonymity;
- recommendations and/or action plans for enhancements, based on the evaluation results are tabled to the board;
- concerns regarding individuals should be identified; and
- directors should have informal discussions on the evaluation process, i.e. structure, content, coverage, and to accord directors an avenue to voice their feedback.

The success of the evaluation process often depends on the board chairman. An effective board chairman will engage directors in an open and honest debate, and facilitate the identification of priorities, agreed actions, responsibilities and timeframes.

Investors and other stakeholders should request for the board to provide their action plan from the last evaluation to know the extent of the actions taken by the board. This would show how well the board functions and how strong the evaluation process is within the board.

Key considerations relating to the application of this Practice are discussed below:

What criteria can be used to evaluate the board, board committee or individual director's performance?

Guidance on the assessment criteria which should be customised to the needs of the company, is outlined below:

Board or board committee performance:

- key responsibilities as noted in the charter and legal and regulatory requirements;
- board mix and composition (including independence and skill sets);
- culture and approach for risk governance;
- oversight of risk management systems and internal controls;
- agenda setting and meeting preparation;
- board dynamics and cohesiveness; and
- boardroom activities, i.e. directors' involvement in providing input on matters relating to the company's strategic or financial operations.

Individual directors' performance:

- meeting preparation and attendance;
- will and ability to critically challenge and ask the right questions;
- active participation by providing constructive views and sharing their experiences during meetings in contribution to the development of strategy;
- commit to serve the company with due diligence, integrity;
- commit the required time to fulfil the role and perform their responsibilities effectively;
- technical knowledge on specific industry/company activities/processes;
- focus on creating shareholder value;
- understanding the company and industry in terms of risks and direction;
- willingness to listen and acknowledge other viewpoints;
- character and integrity in dealing with potential conflict of interest situations;
- ability to work with other directors and management; and
- confident to stand up for a point of view.

Sample evaluation forms for committees and individual directors are provided in the following Appendices of this Pull-out:

- **Appendix III**: Board and board committees evaluation form
- **Appendix IV**: Directors'/key officers' evaluation form
- **Appendix V**: Audit committee evaluation form
- **Appendix VI**: Audit committee members' self-evaluation and peer evaluation form

What should be disclosed for the evaluation of a board, board committee or individual director's performance?

As required by **paragraph 15.08A(3) of Bursa Securities Listing Requirements**, disclosure of the activities of the nominating committee in the annual report must, amongst others, include the assessment undertaken by the nominating committee in respect of its board, committees and individual directors together with the criteria used for such assessment.

However, disclosure in this area has not kept pace with the requirements and expectations of stakeholders over the recent years. The "Analysis of Corporate Governance Disclosures in Annual Reports 2015-2016 by Bursa Malaysia", an analysis of 280 listed issuers, noted that although listed issuers disclosed that they conducted performance evaluations of their board, board committees and individual directors, only 56% disclosed the criteria for evaluation of individual directors, 40% disclosed criteria for evaluation of board committees and 65% disclosed criteria for evaluation of the board.

In addition to the aforementioned requirement, companies should also endeavour to provide detailed information on its evaluation exercise to keep stakeholders well-informed by, amongst others, disclosing the factors taken into account in deciding on the method of evaluation, the results of the evaluation and how such results were utilised (e.g. training needs analysis of individual directors).

Further, **Guidance to Practice 5.1 of MCCG** states that the nominating committee of Large Companies should disclose the following information in its annual report:

- how the evaluation was conducted, the criteria used such as the assessment of fit and properness, contribution and performance, calibre and personality of directors;
- whether an independent expert was engaged, or was it internally facilitated;
- key strengths and/or weaknesses that were identified from the evaluation; and
- steps or enhancements proposed to be undertaken to mitigate or address the weaknesses identified.

In addition to the above, when an independent third party is used to carry out the board evaluation, the board should disclose the identity of the third party.

The illustrative disclosure on the following page provides an example of disclosure on an externally facilitated evaluation process carried out by SuperGroup PLC in United Kingdom.

Illustrative disclosure

As required by the Code, every third year the evaluation should be conducted by an external independent facilitator. This year's evaluation was conducted by **Lintstock Consultants ("Lintstock") who have no other connections with the Company**. The evaluation process involved Lintstock engaging with the Chairman and Company Secretary to agree on a tailored set of questions for completion by the directors, which was followed by a telephone interview by Lintstock where any issues were identified. The results were then analysed by Lintstock; discussed with the Chairman and the Company Secretary; tabled at a meeting of the relevant committee; and then presented to the Board at its meeting held on 24 March 2016. The anonymity of all respondents was ensured throughout the process to encourage an open and honest exchange of views.

The performance evaluation was positive with all responses indicating continued high or improved performance during the year. The performance of the executive directors during the year was monitored by the Chief Executive Officer and the Nominating Committee.

The external evaluation in 2016 covered:

- the board's balance of skills and experience, independence and knowledge, and diversity including the gender of board members;
- how the board worked together; how effectively it used its time and the support it received;
- strategic and operational risk oversight, risk management and internal control; and
- key talent and succession planning.

Following the evaluation, the board agreed on a number of **actions** that will be monitored through the current year. These centred on the continual evolution of the composition of the board to complement the strength of the existing directors and enhance the international experience and skills, refinement of the agenda planning process to ensure focus on the key issues and opportunities, and extending the board's oversight of talent management within the business to the senior management tier. Subsequent to the evaluation, the Board's composition has been strengthened further through the addition of Steve Sunnucks and Beatrice Lafon as non-executive directors, who both add further retail and international experience to the board and have recent executive experience.

Source: SuperGroup PLC Annual Report 2016 (United Kingdom)

What are the advantages of an externally facilitated evaluation?

Apart from an inherent level of objectivity, external advisors can frequently pinpoint areas of weakness as the advisor would likely have accumulated a database of results from their experience of conducting similar assessments for other boards and board committees. Based on their experience, the advisors can also share insights on what makes boards function well and what are the typical improvement areas for the board within its industry to consider relating to the company's current evaluation process. Consequently, the advisors could suggest improvements to methodology.

This evaluation method also presents a more objective view as the evaluation would be conducted by a third-party and not a person connected to the company. This would enable the evaluator to notice matters that would have slipped under the radar by an in-house evaluation.

How often should companies conduct an externally facilitated evaluation?

There are no numerical prescriptions provided on the frequency of an externally facilitated evaluation, as these will vary for each company based on its circumstances.

A review of annual reports across the top 100 Malaysian listed issuers in December 2016 (by market capitalisation) which have conducted an externally facilitated evaluation revealed that the average frequency for such an exercise is **once every three years**. This trend appears to be consistent with that in foreign jurisdictions. The United Kingdom's Corporate Governance Code, for example, calls upon FTSE 350 companies to enlist third-party experts for their evaluation exercise once every three years[8].

What measures can the nominating committee or board undertake to enhance the effectiveness of the evaluation exercise?

In a series of interviews carried out by Stanford University in 2016 with close to 200 directors, the following recommendations were identified[9]:

- conduct a diagnostic where each director's input is solicited around a variety of critical topics: board effectiveness, committee effectiveness, current board composition, the forward-looking needs of the board;
- provide a detailed report of the findings with the inclusion of recommended actions based upon short, medium, and long-term timeframes; and
- identify a point person on the board who is accountable for managing the process and following through on the recommendations.

What are the symptoms of or indicators that could affect and impede the effectiveness of an evaluation exercise?

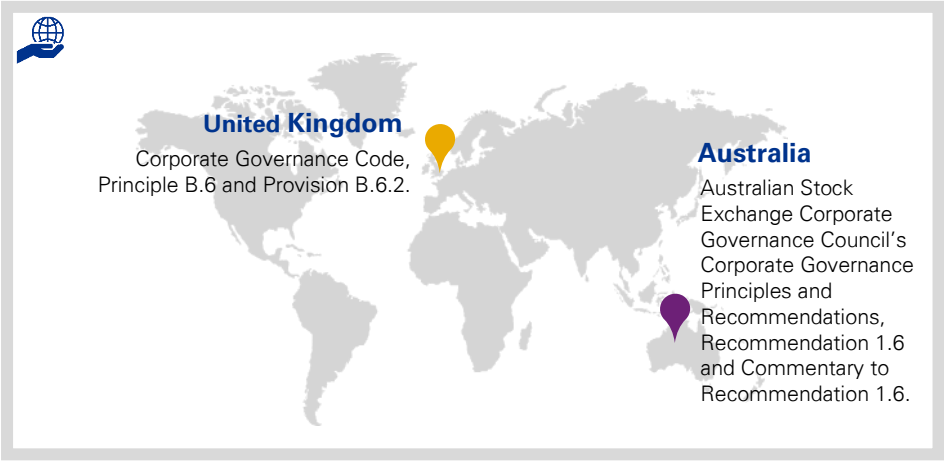
The following would be considered as a red-flag for the board, and in particular the nominating committee which may affect the evaluation process and their action plans:

- the evaluation method being used leans towards a box-ticking exercise;
- the issues of behaviour and attitude are overlooked in the evaluation process;
- a lack of imperative on the need to change and improve the board; and
- action plans are not part of the board's agenda once the evaluation process is completed.

[8] Provision B.6.2 of United Kingdom's Corporate Governance Code
[9] *Board of Directors Evaluation and Effectiveness* 2016, Rock Center for Corporate Governance at Stanford University and the Miles Group

Where — Regional/international perspectives

As with the **MCCG**, corporate governance provisions around the world, including those in United Kingdom and Australia have emphasised on the evaluation process as a key activity for the board.



Country	Provision(s)
United Kingdom	The board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors ***(Principle B.6)***. 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 ***(Provision B.6.2)***.
Australia	A listed entity should: (a) have and disclose a process for periodically evaluating the performance of the board, its committees and individual directors; and (b) disclose, in relation to each reporting period, whether a performance evaluation was undertaken in the reporting period in accordance with that process. When disclosing whether a performance evaluation has been undertaken the entity should, where appropriate, also disclose any insights it has gained from the evaluation and any governance changes it has made as a result ***(Recommendation 1.6 and Commentary to Recommendation 1.6)***.