BOARD

Board evaluation and director appraisal

With attention on corporate governance and accountability increased by the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, there is an enhanced expectation that the performance of boards and individual directors will be regularly evaluated and appraised.

Principle 1 of the ASX Corporate Governance Council's *Corporate Governance Principles and Recommendations*[1] (ASX Principles) states that in pursuit of laying solid foundations for management and oversight, listed companies should "clearly delineate the respective roles and responsibilities of [the] board and management and regularly review their performance".

Similarly, the Australian Prudential Regulation Authority Prudential (APRA) Standard CPS 510 Governance[2], effective from 1 July 2017, states in paragraph 44 that:

> *The board of a locally incorporated APRA-regulated institution must have procedures for assessing, at least annually, the board's performance relative to its objectives. It must also have in place a procedure for assessing, at least annually, the performance of individual directors.*

Past methods of evaluating board success purely by reference to share price growth, CEO performance or the success of strategic initiatives are now understood to be inadequate. Whilst the success of the organisation is the ultimate goal, it does not follow that a successful organisation is the result of an effective board. Sometimes an organisation's success can be 'in spite of' rather than 'because of' the board. However, it is equally important that the more board-focused process of board evaluation does not become an unproductive and burdensome box-ticking exercise.

Although these processes are now quite common, some directors are still resistant to the notion of board evaluation and especially of peer appraisal. This can be particularly so for unremunerated directors on not-for-profit boards, who may resent being evaluated themselves or resist evaluating their volunteer director peers. Hence it is critical to emphasise,

1. ASX Corporate Governance Council, 2019, *Corporate Governance Principles and Recommendations*, 4th edition, February, **https://www.asx.com.au/documents/asx-compliance/cgc-principles-and-recommendations-fourth-edn.pdf**, (accessed 8 May 2019).
2. Australian Prudential Regulation Authority, 2017, *Prudential Standard CPS 510 Governance*, July, **https://www.apra.gov.au/file/9436**, (accessed 8 May 2019).

preferably with leadership on the point from the chair, that board evaluation and director appraisal is not about critiquing one another but is about continuous governance improvement. It is about ensuring that the board work as effectively as possible for the good of the organisation.

The key message is that, handled correctly, board evaluation and director appraisal give the opportunity for constructive group and peer feedback to help the board as a whole and directors individually to improve their ability to contribute to the work of the board.[3]

Importantly Recommendation 1.1 one of the ASX Principles makes clear that a listed entity ought to disclose a board charter that makes clear the respective roles and responsibilities of its board and management as well as those matters expressly reserved to the board and those delegated to management.

Recommendation 1.2 suggests that appropriate checks are undertaken prior to appointing or recommending a director or senior executive for a role and that security holders be given all relevant information in respect to an appointment or reappointment. The listed entity ought to have in place a diversity policy with measurable objectives and disclosure of same (Recommendation 1.5). It is important for an entity to determine whether it is a "relevant employer" under the *Workplace Gender Equality Act 2012* and comply with the legislation.

Accompanying an appointment ought to be a written agreement with the director/senior executive setting out the terms of their appointment (Recommendation 1.3) and in the event that the appointment concerns the company secretary, that the company secretary be accountable directly to the board, through the chair, on all matters to do with the proper functioning of the board (Recommendation 1.4).

Once appointed, Recommendation 1.6 suggests the entity have and disclose a process for periodic evaluation of board, committee and individual performance and disclose whether or not performance evaluations have been undertaken and if so, in accordance with the process for the relevant reporting period. Recommendation 1.7 suggests evaluations of senior executives on the same basis as Recommendation 1.6.

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The important questions for the board

There are a number of questions to clarify before commencing with a board evaluation:

- What is the purpose, and what are the objectives, of the evaluation?
- What will be evaluated?
- How will the evaluation be done?
- What evaluation method will be used?
- What should be the outcome?

A suggested framework for an evaluation

Geoffrey Kiel, et al,[4] recommends a seven-step framework for a board evaluation as follows:

1. What are our objectives?
2. Who will be evaluated?
3. What will be evaluated?
4. Who will be asked?
5. What techniques will be used?
6. Who will do the evaluation?
7. What will you do with the results?

3. Refer to AICD, Governance Analysis Tool, [website], **http://aicd.companydirectors.com.au/advisory/governance-analysis-tool**, (Accessed 18 February 2019).
4. G Kiel, G Nicholson, J Tunny and J Beck, 2018, *Reviewing Your Board: A guide to board and director evaluations*, AICD.

While straightforward, the above questions are useful because they are likely on the mind of those subject to the process. By placing them in the open, it is suggested that the board when planning an evaluation will consider them in one order or another as a practical means to achieve both the evaluation and a measure of transparency as to process. Such a process, the authors suggest, goes to achieving benefits for the company, its board and its individual directors around: leadership; role clarity; teamwork; accountability; decision making; communication; and, board operations.

What are the purpose and objectives of the evaluation?

The immediate objective is continuous governance improvement: identifying board performance improvement opportunities and governance framework gaps. Specific and/or longer term objectives may include developing team work, better decision making, improving the effectiveness of meetings, gaining greater clarity of roles. As noted above in the suggested framework, some clarity as to the ideal improvements that evaluation will bring to the company, will help focus the process of the evaluations and give specific guidance to its undertaking.

What will be evaluated?

The board evaluation exercise is ultimately about the effectiveness of the board and its component parts.

Firstly, it's important to clarify which of these component parts will be evaluated and, in each case, what is to be evaluated. The potential component parts for evaluation comprise:

- **The board as a whole** – This assesses how well it is functioning, including in its key relationship with management, to deliver its governance role and functions, considered against the expectations of directors, (for example, as set out in the board's own charter/role statement and other relevant documents).
- **The board's committees** – This assesses the adequacy of the board's committee structure and how well they respectively function to support the board in its role, considered against the expectations of the committees (for example, the terms of reference/charters of committees).
- **Individual directors** – This assesses how well directors perceive themselves and each other to be contributing positively to the work of the board and the ways in which their contributions could be improved, considered against the expectations of directors (for example, the board's composition matrix, code of conduct for the board).
- **The chair of the board and chairs of committees** – This assesses specifically how well the chair/s fulfil their role/s, considered against the expectations of those roles (for example, chair's role statement and board/committee charters).

How will the evaluation be done?

Annual board evaluations are generally:

- **Internally managed** – managed by the board chair or a relevant committee of the board, this can incorporate the use of available survey tools (for example, the AICD's Governance Analysis Tool) and would usually include one-to-one meetings between the chair and each individual director. The benefit of the internally managed evaluation is that it is usually 'lighter touch' and less costly and less 'confronting' for directors.
- **Externally facilitated** – using an external consultant to manage the process. Whilst it will generally be a costlier exercise than an internally managed process, the benefit is that it enables greater objectivity, encouraging complete candour by directors (and management) and a level of benchmarking, or at least comparison, to the good governance practices of other boards through the consultant's wide exposure to other boards and their practices.

It is now common practice for boards to run an externally facilitated board evaluation every 3-4 years and to conduct lighter touch internally managed processes in each of the years between.

In addition to the formal annual evaluation, it is also now common practice to evaluate the effectiveness of the board in its regular meetings, at the end of each meeting, rather than being left to the annual board evaluation process. This has the significant benefit of allowing true continuous improvement and giving the chair and management constructive and real-time feedback on better structuring of agendas and development of board papers.

What evaluation method will be used?

Whether internally managed or externally facilitated, the precise method chosen by each board usually depends on the size and maturity of the organisation and the board and the issues it faces.

Methods are generally based on one or both of the following approaches:

- **Interview-based methods** – These are usually more qualitative in nature. They are good for delving into complex board/management dynamic and often sensitive interpersonal relationships issues in depth.
- **Survey-based methods** – Usually more 'quantitative' in nature these approaches help to focus the minds of the participants in the evaluation and can enable 'benchmarking' of results over time. Beware, however, that survey methods are ultimately largely qualitative in nature in so far as they will ask directors (and management if participating) to assess the performance of the board on a numbered scale in relation to various matters that are a matter of director and management 'opinion' and not a truly quantifiable measure in the strict sense.

In any case, whether the approach taken is interview-based, survey-based, or a combination of the two, the process should also involve a discussion by the board as a whole of the issues teased out by the interviews and/or surveys.

As implied above, in addition to the directors contributing their views to the evaluation, it is important to consider whether the opinions of senior executives will also be sought in relation to the operation of the board as a whole and its committees. Without input from executives, a board evaluation, even one managed by an external facilitator, amounts to pure self-assessment by directors. Hence management involvement ought to be encouraged, especially since board/management relationships are one of the most important contributors to an effective board.

For clarity, executives who are not also members of the board would not generally be asked to participate in the peer assessment of individual directors.

Occasionally the board may also seek input from outsiders with whom they have regular dealings (including for example major suppliers, substantial shareholders) although this is not common and will want handling with care. Where there is significant input from such stakeholders, for example in the event of restructure, then some input from them may be warranted. As a general rule these types of stakeholders do not have a true or deep understanding of the board's operation. They may have a very clear view of the performance of the company, and that is important for the board to understand, but does not necessarily correlate directly with the effectiveness of the board.

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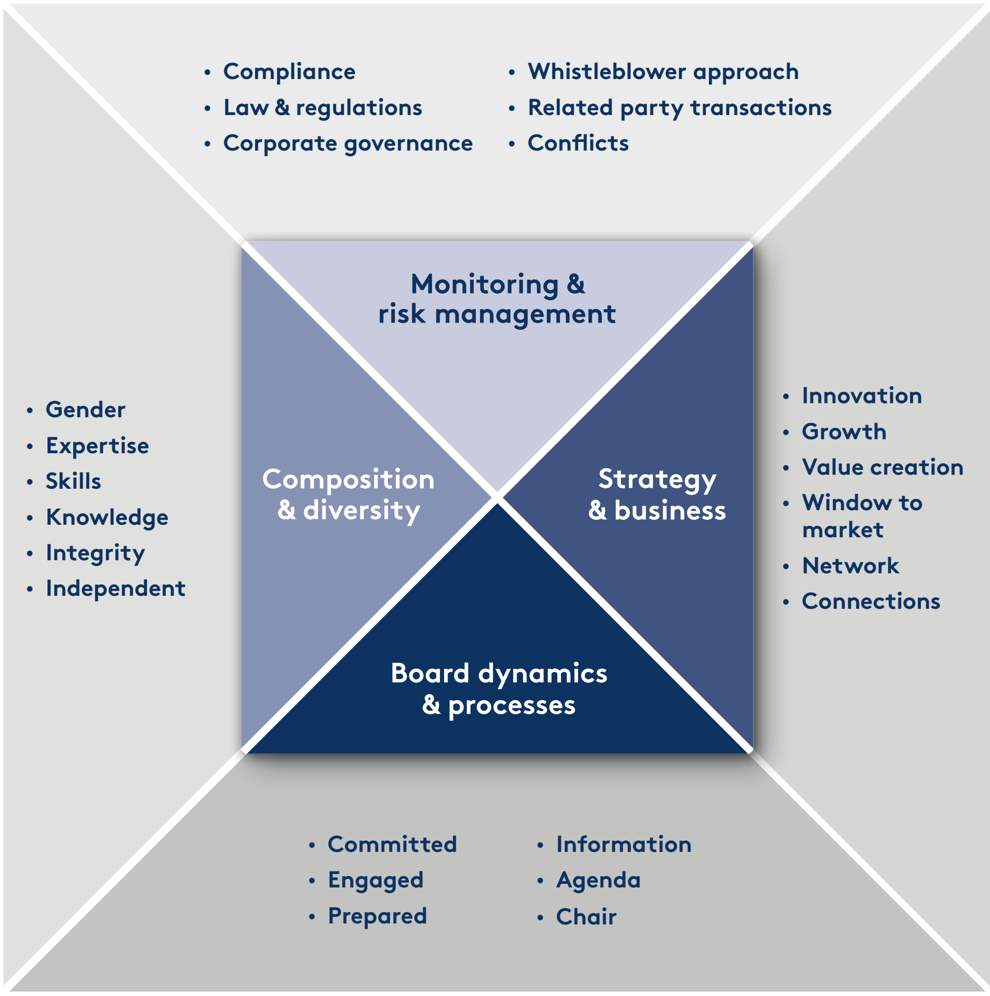
What should be the outcome?

Once the board evaluation and/or director peer assessment process has been completed, the resulting improvement actions should be agreed by the board, in the form of a board improvement action plan. Where the process has included appraisal of individual directors, personal director development plans may also result. The OECD's 'four dimensions' of board evaluations[5] provides the following measurement framework:

The board improvement action plan, like all performance appraisal approaches, will include specific and measurable KPIs and the chair of the board, or a relevant committee of the board, perhaps with support from the company secretary, should be responsible to oversee its implementation over the ensuing year. In this way the board's improvement action plan forms the basis, or at least the starting point, for the following year's board evaluation process.

FIGURE 1: The 'four dimensions' of board evaluations



5. OECD, 2018, *Board Evaluation: Overview of International Practices*, **http://www.oecd.org/daf/ca/Evaluating-Boards-of-Directors-2018.pdf**, (accessed 19 February 2019).

Underperforming directors that are identified through the board evaluation process ought to be promptly and carefully counselled by the chair or, in cases where there are issues of concern about the chair's performance, by one of the appropriate directors: perhaps the deputy chair or the chair of a relevant committee.

The broad outcome of evaluations is to achieve best practice corporate governance that allows for the company to improve and ultimately excel in its chosen field.

About us

The Australian Institute of Company Directors (AICD) is committed to strengthening society through world-class governance. We aim to be the independent and trusted voice of governance, building the capability of a community of leaders for the benefit of society. Our membership includes directors and senior leaders from business, government and the not-for-profit (NFP) sectors.

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