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1. Introduction

- 1.1 When the Combined Code on Corporate Governance (the **Combined Code**) came into effect in November 2003, it introduced a new requirement for quoted company boards to undertake an annual board effectiveness evaluation exercise. Initially quoted companies were slow to implement the requirement for annual board evaluation and, where such an exercise was undertaken, it was often conducted on an informal rather than formal basis. Since then there has been a growing trend towards a more formal process.
- 1.2 During the review of the Combined Code which took place during 2009 and 2010, the spotlight was placed on board behaviour. Consequently, the new version of the Combined Code – known as the UK Corporate Governance Code (the **New Code**) - now has a section specifically focused on Board Effectiveness which brings together the relevant provisions of the Combined Code and adds selected enhancements including a requirement that FTSE350 companies undertake externally facilitated board evaluation once every three years (Code Provision B.6.2).

2. The Requirement for Board Evaluation

Regulation at a Glance

Main Principle in section B6 of the Code states

'The board should undertake a formal and rigorous assessment annual evaluation of its own performance and that of its committees and individual directors'

Supporting Principles

'The Chairman should act on the results of the performance evaluation by recognizing the strengths and addressing the weaknesses of the board and, where appropriate, proposing new members be appointed to the board or seeking the resignation of directors.'

Individual evaluation should aim to show whether each director continues to contribute effectively and to demonstrate commitment to the role (including commitment of time for board and committee meetings and any other duties).'

- 2.1 The Board Evaluation exercise is expected to consist of three distinct components:
- evaluation of the board as a whole
 - evaluation of board committees
 - evaluation of individual directors

Both the Combined Code and the New Code offer minimal guidance on how to carry out an evaluation, sensibly recognising that one size does not fit all.

- 2.2 One useful approach to tackling the requirement for board evaluation is to deal with people and processes separately. Process related activities, for example evaluating the performance of committees can be done objectively, and can be assessed internally. People related activities, for example reviewing the performance of individual directors requires a degree of interpretation that may be more effectively handled by a third party.

**PRISM BRIEFING:
BOARD EVALUATION**

- 2.3 Some companies have changed the focus of their annual board evaluation exercise in different years focusing on one element – say the board as a whole – in one year and then focusing on a different aspect – say board committees – the next year. This has the benefit of keeping the process fresh each year.

3. What issues should be covered?

- 3.1 Some key metrics are easily quantifiable and lend themselves to a tick box approach, for example:
- the appropriateness and composition of the board and its committees
 - the availability of information to the board and its committees
 - the effectiveness of the board process generally
 - the regularity of board meetings

However, from the shareholders point of view this is not a broad enough perspective and it does not necessarily improve board performance. Other issues to be considered could, therefore, include:

- the board's contribution to the implementation of strategy
- the board's management of major risk
- the board's contribution to the management of investor expectations

- 3.2 As the root of the corporate governance debate is one of trust, good leadership is not just a matter of creating strategy and directing tasks, it is also a matter of creating the right environment. Setting values and standards, generating the right culture and climate for the board, and developing the trust and relationships between board members are equally important for the board to function effectively. This suggests that both quantitative and qualitative measures are needed to complete a rounded evaluation.

4. How should directors be evaluated?

- 4.1 Currently, the focus has been on process rather than people to ensure that the right things being done in the right way. There are two main methods to generate the information on which to base the evaluation – questionnaires and interviews. The former are quick, cost effective and comparable. However, they can appear impersonal and generic. Interviews are more personal and can be tailored but are time consuming and more expensive. Combining the two; using a robust questionnaire and some carefully constructed interviews, possibly undertaken by the company secretary or externally facilitated, offers an effective way forward.

4.2 Evaluation of the Board as a whole

The Good Practice Suggestions appended to the Combined Code outline a series of questions to assist boards evaluating their performance:

- Has the board met its performance objectives?
- What has been the board's contribution to robust and effective risk management?
- What has been the board's contribution to the testing and development of strategy?
- Is the composition of the board appropriate? Does it have the right mix of knowledge and skills to maximise performance in the light of future strategy?
- Are the board's relationships inside and outside the boardroom working effectively?
- How has the board responded to any problems or crises that have emerged? Could or should these have been foreseen?
- Are the right matters being reserved for the board?

- How well does the board communicate with the management team, employees and others? How effectively does it use mechanisms such as the AGM and the annual report?
- Is the board up to date with the regulatory and market developments?

Source: Related Guidelines and Good Practice Suggestions. The Combined Code on Corporate Governance 2003 (abridged)

4.3. Evaluation of the board committees

Key questions with regards to the evaluation of board committees include:-

- How effective are the board's committees?
- Are they fulfilling their duties under the terms of reference specified?
- Does each committee have the right composition?
- How do they interact with the main board?

4.4. Evaluation of the non executive directors

The guidance in the Combined Code focuses on:

- the effort and contribution that non-executive directors make to meetings
- the appropriateness of their skills and knowledge
- the effectiveness of their relationships with fellow directors
- how successfully they have brought their experience to bear in consideration of strategy

It also specifically identifies some key questions regarding the chairman's role;

- Is the chairman demonstrating effective leadership of the board?
- Are relationships with the shareholders managed well?
- Are relationships and communications within the board constructive?
- Are board members able to raise issues and concerns?

5. Implementation: Board Evaluation in Practice

5.1 How should the evaluation be conducted?

The New Code, like the Combined Code, leaves it open for each company chairman to determine which is the most appropriate process to adopt but does suggest that the use of third parties to conduct an evaluation 'will bring objectivity to the process'.

The initial view was generally that the evaluation of the board as a whole would be conducted internally with little fuss or cost; for example using the company secretary to collate questionnaires circulated to board members as the basis for a structured discussion under the leadership of the chairman. This is now changing.

Using external facilitation of the process provides an independent perspective and could obtain insights from a broader group, such as advisers or senior managers. It would also allow directors to bring insights from other boards they sit on. For FTSE350 companies it is mandatory every three years. A statement will also be required in the Annual Report as to whether an external facilitator has any other connection with the company.

5.2 Who evaluates who?

- The board as a whole will consider the performance of the board committees.
- The performance of individual directors will be considered by the chairman. This requirement has been reinforced by Code Provision B.4.2 which requires the chairman to regularly review and agree with each director their training and development needs.
- The senior independent director is required to lead a review of the performance of the chairman by the non-executive directors (Code Provision B.6.3).
- The nominations committee should consider any development or succession planning issues arising out of the board evaluation.

5.3 What are the key reporting requirements?

Companies are required to disclose how they are evaluating the performance of their boards in their annual report (Code Provision B.6.1). They have described the evaluation process, the issues it considered and the key areas identified for improvement in the coming year.

6. The Prism Perspective

- 6.1 The New Code implicitly recognises that there are a growing number of board evaluation service providers who have emerged since 2003. These service providers have raised the profile of board evaluation as these service providers have promoted their activities through marketing and lobbying (not least in the consultation that preceded the introduction of the New Code).
- 6.2 This has had the benefit of opening the debate about the best approach to board evaluation. Whilst the regulation sets the tone for board evaluation, the pressure from fund managers, investors and other stakeholders for increased transparency is increasing rather than diminishing, rejecting tick box reporting in favour of meaningful disclosure. This has raised many issues for public companies – objectivity, confidentiality, cost/value – to name three. This reinforces the need for a pragmatic approach; one that aims to get value from the process and uses it to improve effectiveness rather than just ticking the boxes.

7. Useful links and sources

www.icsa.org.uk

www.independentaudit.com

The Combined Code on Corporate Governance
Performance evaluation checklist July 2003

www.frc.org.uk

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