Building Better Boards
by M. Damodaran

"The Directors were chosen because they are good persons and have experience. What is the need for evaluating them?"

Evaluation, albeit in an informal manner, is one of the oldest activities known to mankind. People are always judging other people. However, evaluation as a concept is new in the Indian compliance and legal space. The scope of the exercise is to evaluate the Board, its directors and its committees in the manner envisaged by law. The provisions of the Companies Act, 2013 on Board evaluation are nothing less than a legal maze. In terms of Schedule IV of the Act, a review of the Board is to be done in a meeting of Independent Directors (IDs) without the attendance of non-IDs and management. There is no requirement of getting the views of Executive Directors (EDs) and Non-Executive Directors (NEDs) as an input in the review of the functioning of the Board. Schedule IV also provides that the performance of each Director is to be evaluated by the Board. Section 178 (2) provides that the Nomination and Remuneration Committee (NRC) is to carry out the evaluation of every director. Who should really evaluate the Directors? Also, should NRC evaluate a Chairperson as a director or should IDs do it? Further, the words "review" and "evaluate" have been used seemingly interchangeably in the Act. The performances of Board, Chairman and non IDs are to be reviewed while that of IDs has to be evaluated. IDs have to review the performance of the Board, Chairperson, and non IDs while NRC has been tasked with evaluation of every director's performance. In reviewing the performance of the Chairperson at a meeting attended only by IDs, the performance of the Chairperson has to be reviewed taking into account the views of EDs and NEDs. Considering that the review is to be done at the meeting, is it contemplated that the views of EDs and NEDs would be obtained in advance of the meeting? The statutory provisions on evaluation clearly fail the test of clarity.

Provisions of Companies Act, 2013

Section 134 (3) (p):
In case of a listed company and every other public company having such paid-up share capital as may be prescribed, a statement indicating **the manner in which*** formal annual evaluation has been **made by the Board*** of its own performance and that of its committees and individual directors has to be disclosed in the Board report.

Section 178 (2):
The Nomination and Remuneration Committee (NRC) shall "identify persons who are qualified to become directors ……………… , recommend to the Board their appointment and removal **and shall carry out evaluation of every director's performance"**.*

Schedule IV –
(II) (2) Role and functions of Independent Directors: Independent directors shall bring an objective view in the **evaluation*** of the performance of board and management.
(VII) (3) Separate meetings of Independent Directors: The meeting shall:

- **review*** the performance of non-independent directors and the Board as a whole
- **review*** the performance of the Chairperson of the company, taking into account the views of executive directors and non-executive directors

(VIII) Evaluation mechanism:

- The performance evaluation of independent directors shall be done by the entire Board of Directors, excluding the director being evaluated.
- On the basis of the report of performance evaluation, it shall be determined whether to extend or continue the term of appointment of the independent director.

(V) Reappointment of Independent Directors: The re-appointment of independent director (sic) shall be on the basis of report of performance evaluation.

* **Emphasis supplied**

Rationale behind board evaluation

While meeting regulatory and legal requirements may be part of the motivation for undertaking this exercise, the primary driver should be a desire to build a high-performing board, equipped to anticipate, and overcome, the challenges ahead. To live in denial about the lack of effectiveness of the board is to court disaster. It is no longer sufficient to have directors who are only "good enough". Board behaviour and effectiveness are fast becoming visible to all the stakeholders of business, including the investors. Consequently, getting the right board, and ensuring that it works well, are cornerstones of good governance. For Board evaluation to be effective, it should be a constructive exercise which provides a critical view of the performance of the Board. This exercise is, and should be seen as, an opportunity of improving the Board's functioning and its contribution to the company's performance.

Commitment of Board of Directors

"I was invited to join the Board. I did not apply for the position. Why should I be evaluated?"

Board assessment and consequent corrective or remedial steps constitute arguably the most powerful tools for turning a good board into a great board. The Board should be the owner of the process since it is integral to the process and is along with the company the major beneficiary of the process. It should commit itself to using this process not as a mere regulatory compliance exercise, but as an enabler to improve its own performance as well as the performance of every Director by addressing the issues that emerge.

Process of board evaluation

Evaluation is to be an annual, formal, confidential, rigorous and comprehensive process which considers both the hard and soft issues. Board performance has to be considered in the context of strategic objectives and financial performance while promoting stakeholder democracy. It should involve an understanding of how people work together in a complex environment involving two different constituencies namely, the Board and the management, with shared objectives and different roles.

All this necessarily involves clearly setting out the objective and scope of the process. Thereafter, parameters and techniques for evaluation should be selected. A team which will drive the process should be identified. The Board must be appropriately sensitized before implementing the process. Implementation itself can be driven by an internal team or by a team of outside consultants or jointly by the two. After the process is completed and views have been collated, company-specific recommendations should be brought up for implementation. As with all processes, the feedback loop is integral to this process.

With the Act stipulating that at least one exclusive meeting of IDs should be held every year, and with companies having looked at March 31st, 2015 as the date by which the exercise should have been completed for the first year, most companies followed/ are following oversimplified processes to tick the box of Board evaluation. Directors are being administered long, and often unproductive, questionnaires with a number of questions which ask them to rate the Board, the Committees or other Directors. Some others have resorted to one on one interviews of directors or peer reviews and group discussions. While in some companies, legal and compliance teams have created in-house processes, others have hired consultants to either design the process and/or implement it. This has given rise to a cottage industry of consultants with no practical boardroom experience or qualities which help companies conduct this process effectively.

While all this might work for a mere compliance activity, it does not help in furthering the true spirit of evaluation, and capturing its significant advantages.

Problems confronting evaluation in India

''No one told me what my role was. How am I to be evaluated? On what parameters?''

Many of the directors now being evaluated had no role clarity, partly on account of the fact that engagement letters setting out expectations had not been issued to them in earlier years. That shortcoming has now been addressed.

In Australia and UK where Board evaluation is mandated, NEDs own the process. The exercise is focused on improving the performance of Boards as well as individual directors and it is solution oriented.

However, in addition to internal inconsistency in law, in India, unlike in other jurisdictions that have mandated Board evaluation, there are some unique impediments to the process of evaluation. The all pervasive underpinnings of Indian culture ensure that evaluation is a "friendly" exercise leading to the formation of mutual admiration groups. Adverse frank opinion can cause a problem where none existed. This makes the exercise stressful since it involves considerable sensitivity. An exercise that does not factor in sensitivity with objectivity can destroy the cohesiveness of boards in India..

Success and benefit of board evaluation

"A good Board is the ultimate arbiter of a company's destiny."

Unless the Board is made the owner of the process and sees evaluation as a constructive exercise, the success of this process is doubtful. It should be a forward-looking endeavour with an effective follow up system. It should not be used for playing blame games or as a validation of the existing practices in the company. Going through the motions or treating it as a tick the box exercise will not help.

It has long been established that markets reward well governed companies. Hence a good board, with a learning attitude, becomes important. A meaningful and productive Board evaluation process gives a good return for a modest investment of time and money. In addition to identifying strengths and areas of improvement at the top, it helps in improving the effectiveness of the Board as a collective entity.