



# Enhancing evaluations for boards, committees, and directors

## Board Leadership Center



As most experienced directors can attest, board service is not for the faint of heart. Directors play a critical role in guiding their companies through a complex business environment that is filled with uncertainty, disruption, and other challenges. And given the pace of change companies face today, investor expectations for board performance are high. State Street Global Advisors, one of the largest asset managers in the world, defines its expectations for the role of the board as follows:

- “Help set and challenge current strategy, particularly under uncertain macroeconomic conditions, high market volatility and in a fast changing technological environment;
- Set risk appetite and mitigate or set mitigation standards for reputational and other risks;
- Influence firm culture and set ethical standards for doing business;
- Develop the right incentive structure that focuses management on the long-term strategy;
- Hold management accountable in a timely manner for the execution of strategy and long-term performance;
- Plan for the succession of directors and senior leadership; and
- Provide strong audit oversight to ensure that the financial reports are accurate.”<sup>1</sup>

Effective evaluations provide a pathway for boards, committees, and individual directors to objectively assess their strengths and weaknesses and implement plans for continuous improvement. Yet in a study conducted by the Rock Center for Corporate Governance at Stanford University and The Miles Group<sup>2</sup>, while 66 percent of the directors rated their board as highly effective at accurately assessing CEO performance, the percentage dropped to 36 percent when the question addressed the accuracy of the board’s assessment of the performance of board members. Only 23 percent rated their boards as very effective at giving

direct feedback to fellow directors, and 54 percent said that if they had sole power do to so, they would have one or more of their fellow board members removed. The stakes for companies are too high for boards to be satisfied with these results.

### The purpose of the evaluation

Separating the evaluation process from the renomination decision is emerging as a best practice. The NACD Blue Ribbon Commission Report, *Building a Strategic-Asset Board*, includes a critical insight: “Most evaluations at the individual director level tend to focus on historical performance and contribution, which does not necessarily equate to strategic fit with the needs of the board and the organization in the future—therefore, decisions to renominate directors should be largely separate from the evaluation process.”<sup>3</sup> The report suggests that the board take a “clean sheet” approach to board composition as it relates to the current and future needs of the company, and consider each individual director’s “fitness for purpose” when renomination decisions are made.

While evaluation results clearly are relevant to the “fitness for purpose” determination, the focus of the evaluation should be to assess and set priorities for continuous improvement. Put simply, a solid evaluation should offer insight into what is working, what needs improvement, and where the board, committees, and individual directors should devote their efforts over the coming year.

**“[The NACD Blue Ribbon] Commission’s discussions identified two significant imperatives for the director community, given the demands and expectations that boards now face: expanding the use of evaluations and upgrading their quality.”**

<sup>1</sup> Ronald P. O’Hanley and Rakhi Kumar, *Changing Board Practices and Culture to Meet Investor Expectations*, IQ INSIGHTS, August 2016.

<sup>2</sup> David F. Larcker, Stephen Miles, Taylor Griffin, and Brian Tayan, *Board of Directors Evaluation and Effectiveness*, Rock Center for Corporate Governance, Stanford Graduate School of Business in collaboration with The Miles Group, November 2016.

<sup>3</sup> Report of the National Association of Corporate Directors Blue Ribbon Commission on *Building the Strategic-Asset Board*, September 2016, p. 17.

## The evaluation process

If evaluations are approached as a matter of compliance and housekeeping, they will serve only as a “check the box” exercise and will not help the board—or individual directors—to improve. A strong evaluation begins with a process designed to facilitate an honest, constructive, and insightful assessment of strengths, weaknesses, and gaps that leads to meaningful follow-up. Evaluations may be performed in a variety of ways, and there is no one “right” way to do them. The discussion below highlights key variables for consideration: who will be evaluated, who will do the evaluating, and how the evaluations will be obtained. For each variable, suggestions include the essentials of a basic evaluation, one that is a step above, and a recommendation for a top-tier evaluation. As needs vary from board to board and from time to time for the same board, the evaluation process should not be cookie cutter. For some boards, a basic evaluation performed annually and coupled with next-level or top-tier elements every 3–5 years will be cost-effective and sufficient, while for others, an annual top-tier assessment will produce essential insight. Many top-performing boards alter the process from year to year as a means of avoiding “evaluation fatigue.” Whatever method is used in a particular year, the key is to ensure that thought has been given to the process and the needs of the board.

### Who will be evaluated?

**Basic:** Full board and, for NYSE-listed public companies, those key committees for which stock exchange listing standards require annual evaluation.<sup>4</sup>

**Next level:** Evaluation of the full board and all committees (whether or not required by stock exchange listing rule).

**Recommended:** All of the above, plus evaluation of individual directors.

As illustrated by data based on surveys of public, private, and nonprofit boards published by NACD, board evaluations do not always go deeply enough. While 85 percent of public companies engage in annual evaluations of the full board and committees, less than 45 percent of private companies and nonprofits perform board evaluations, and only 25 percent evaluate the board committees. Only about half of those who evaluate their full boards also engage in evaluations of individual directors (41 percent for public companies and 23 percent for private companies and nonprofits).<sup>5</sup>

Individual director evaluations can be tricky, as directors may be reluctant to offer criticism of their peers. Yet evaluations that serve to hold directors accountable and provide suggestions for self-improvement can be of enormous value. A global survey of large public company directors identified five individual behaviors believed to help create a high-performing board culture and drive board effectiveness: (1) ask the right questions, (2) possess the courage to do the right thing for the right reason, (3) constructively challenge management, when appropriate, (4) demonstrate sound business judgment, and (5) possess independent perspective and avoid “groupthink.”<sup>6</sup> Even top directors could likely benefit from a 360-degree assessment against those behaviors, and for lesser-performing directors, individual evaluations can provide the lead director with factual data needed to support a difficult decision about whether the director should be renominated.

## What will be evaluated?

**Basic:** Verification that board and committees have met the obligations imposed by law, regulation, stock exchange listing standards, and governance principles/committee charters.

**Next level:** Assessment of the effectiveness of the board’s operations—information, agendas, priorities, communication with each other and with management.

**Recommended:** All of the above, plus an assessment of board culture, individual director engagement, and periodic deep dives into key areas.

There are likely certain areas that the board will want to assess routinely to confirm that they are focusing on the right topics, receiving the information needed to do their work, and holding management, each other, and themselves, personally, accountable. In addition, there may be specific areas of focus, for example, whether the board’s oversight of cybersecurity needs enhancement, how the board can be more effective in a crisis, etc. The appendix includes sample questions for board, committee, and individual director evaluations.

### Who will do the evaluating?

**Basic:** Board members engage in self-assessment.

**Next level:** Board members engage in peer assessment.

**Recommended:** All of the above, plus periodic input from members of senior management and others who have significant interaction with the board.

Members of management who interact with the board can often provide valuable insight. Are the members of the board aligned and clear in their instructions to management? Does the board ask questions and provide guidance that evidences a deep understanding of the business, its strategy, and its culture? How would management describe the tone in the boardroom? Others who are in frequent contact with the board or a committee, such as external auditors and compensation consultants, may also provide valuable insight based on their observation of how the board/committee functions compared to others with whom they interact. And committees may benefit from input from directors who are not members of the committee.

### How will the assessments be obtained?

**Basic:** Survey.

**Next level:** Individual interviews conducted by the director leading the evaluation process.

**Recommended:** Varying the assessment method to keep it fresh, including periodic use of a third-party evaluation process. Company legal counsel should be consulted before creating documents.

Written surveys are useful since they are efficient, create a record that evaluations have been performed, and can help identify trends by comparing current results to results on the same topic over a period of time. In a well-functioning board, written surveys can also provide a quick pulse to help the chair determine which areas to focus on for a deeper dive. Online assessments can be particularly useful when they deliver the data in a graphic form that helps facilitate insight.<sup>7</sup>

<sup>4</sup> New York Stock Exchange Listed Company Manual, Sections 303 A 04, 05, 07, 09.

<sup>5</sup> Report of the NACD Blue Ribbon Commission on Building the Strategic-Asset Board, p. 18.

<sup>6</sup> Global Board Culture Survey: Understanding the Behavior that Drive Board Effectiveness, Russell Reynolds Associates, 2016.

<sup>7</sup> See for example [www.boardspan.com](http://www.boardspan.com).

Surveys as the sole means of evaluation, however, may not be sufficient to elicit insights and concerns that often come out only in the context of a free-flowing, open-ended discussion. The culture of the board and the skill of the person doing the interviewing will each help determine the value of the information gathered during a one-on-one interview. While a strong lead director or committee chair should be able to solicit valuable information during the interview process, a professional who specializes in board evaluations may bring a higher level of objectivity and depth to the process. Companies stand to benefit from third-party evaluations, particularly if there is a lack of trust among the board members, or if there is a crisis or significant concern that the board needs to address. In addition, as a matter of good governance, many high-performing boards of large companies routinely engage outside experts to perform evaluations on a periodic basis, for example every three years.

#### Who will be accountable for the evaluation process?

No matter how robust the process, an evaluation will only be as strong as the leader driving it. Whether a nonexecutive chair, a lead director, or the chair of the governance committee, a single leader must own the evaluation process in order to ensure accountability. The more the leader establishes a tone of candor, constructive criticism, and respectful challenge, the stronger the evaluation. And the director leading the evaluation process should be evaluated both as an individual director and in his or her board leadership role.

#### Results and follow-up

If performed in a spirit of thoughtfulness and transparency, evaluations can bring to light a wealth of observations and potential areas for improvement. High-performing boards use the results as the basis for a candid discussion that leads to specific action plans. As an example of a follow up at the board level, General Electric's 2017 proxy included disclosure of changes made in response to their evaluations, including recalibrating the risk management focus by restructuring the board's committee structure, increasing its focus on overseeing execution of the company's digital industrial strategy, and continuing its robust oversight of integration of an acquisition.<sup>8</sup> Other boards might choose to focus on matters such as the quality of prereads, meeting effectiveness, or full-board education. For individual directors, action plans might cover their communication style, subjects to consider for continuing education, or, in the unfortunate case of a director who is not performing up to expectations or whose skills are no longer the right fit for the business, a decision to part ways.

#### Disclosure

If continuous improvement takes place behind closed doors, how will investors know that the board is doing its job? According to the Council of Institutional Investors (CII), "Shareholders value detailed disclosure of the board evaluation process when making voting decisions about directors."<sup>9</sup> Note that the CII publication makes clear that shareholders do not expect disclosure of the details of individual director evaluations; they are, however, very interested to obtain a window that will help them understand how committed the board is to robust evaluation and effective follow-up. Most public companies include in their proxy disclosures a statement that the board and key committees engage in evaluations; however, it is clear that institutional investors with active corporate governance programs are looking for more.

<sup>8</sup> General Electric 2017 Proxy Statement, p. 23.

<sup>9</sup> Best Disclosure: Board Evaluation, Council of Institutional Investors, September 2014.

<sup>10</sup> General Electric 2017 Proxy Statement, p. 23.

Detailed proxy disclosure regarding the evaluation process is unusual for U.S. companies, but it does appear to be emerging as a leading practice. An example can be found in General Electric's 2017 proxy statement:<sup>10</sup>

"Each year, the lead director interviews each director to obtain his or her assessment of director performance, board dynamics and the effectiveness of the board and its committees. The interview focuses on:

- Improving issue prioritization
- Enhancing the quality of written materials and oral presentations
- Assessing how board matters from the past year could have been handled better
- Identifying specific issues to be discussed in future board meetings

At times directors may also complete written assessments. After consulting with the chair of the Governance Committee, the lead director summarizes the directors' assessments for discussion with the board committees. From time to time we engage an independent, third-party governance expert to conduct the interviews...."

#### Final thoughts: Evaluating the evaluation

As the board moves toward continuous improvement, these questions can be used for self-reflection on the strength of its evaluation processes:

- Do we assess effectiveness and fitness for purpose separately—and do we have the fortitude to part ways with a respected and well-liked director who is no longer the right fit when the needs of the company change?
- Do we tailor the evaluation process to the needs of the board and avoid "check the box" evaluations?
- Is our process sufficient to gain deep insight into the effectiveness of the full board, the committees, and individual directors?
- Do we allocate sufficient time to discuss the results of the evaluation and develop concrete plans for improvement?
- Do we monitor progress against our post-evaluation goals and hold ourselves accountable for meeting them?
- Do we stay current on best practices in board evaluations and incorporate relevant practices to enhance our process and keep it fresh?
- Does the nonexecutive chair (or other leader of the evaluation process) set the right tone by asking thought-provoking questions, facilitating candid reflection and discussion, and expecting individual accountability and continuous improvement?
- Do we disclose sufficient information about the evaluation process to instill confidence in our key investors?

# Sample evaluation questions

The NACD Blue Ribbon Commission Report on Building a Strategic-Asset Board suggests taking a deep dive into a different issue each year, such as the board's role in risk oversight, CEO succession planning, board dynamics, or board diversity. The report also includes the following sample board evaluation criteria:<sup>11</sup>

1. The board spends adequate time discussing strategy and the issues that affect long-term shareholder value.
2. Directors are independent from management and are diverse in their talents, expertise, and personal backgrounds.
3. Board culture is constructive, candid, and promotes rigorous decision making.
4. The board provides sufficient oversight of management.
5. The board receives reliable and complete information from management within a reasonable time frame.
6. The board revisits its fiduciary duties and makes necessary edits to its corporate governance guidelines and committee charters on a periodic basis.
7. The composition of the board overall is well-suited to the company's current needs, and also will support longer-term strategic requirements.
8. Directors invest in educating themselves about the company, its industry, and good corporate governance practices.
9. The board follows through on the recommendations that result from board evaluations.
10. The board works toward continuous improvement.

For committee evaluations, consider additional questions that track the key work of the committee, including:

- Do we have the right people on the committee?
- Are we focused on the right things? Where should we be spending more time/less time?
- Do we take an active role in determining the committee's agenda?
- Are we receiving the right amount and quality of information from management, our external auditors, and any external consultants?
- Do we set clear expectations for management?
- Do we set clear expectations for the third parties we employ (such as auditors or compensation consultants)?

- Do we insist on transparency, both external and internal, among the committee members, management, and third parties?
- Do we speak our minds? Do we listen? Do we build consensus?
- Do we encourage and actively support continuing education on topics of relevance to the committee?
- Do board members who are not on the committee receive information sufficient to help them understand the work of the committee and the basis for its decisions?

For individual directors:

- Does the director come to meetings prepared?
- Does the director:<sup>12</sup>
  - ask the right questions,
  - possess the courage to do the right thing for the right reason,
  - constructively challenge management, when appropriate,
  - demonstrate sound business judgment, and
  - possess independent perspective and avoid groupthink?
- Does the director proactively engage in continuous education on topics of importance to the company?
- Is the director sufficiently knowledgeable and engaged to add significant value during the meetings?

For the lead director and board and committee chairs:

- Does the chair focus the agenda on the topics of most importance to the company?
- Does the chair make sure the board/committee has the information needed to do its job?
- Does the chair encourage candor, constructive and respectful challenge, and deep engagement throughout the meetings and in between meetings?
- Does the chair set an expectation of commitment to continuous improvement?
- Does the chair give constructive feedback to committee members to help them improve their performance and address issues in a timely, respectful, and effective manner?

<sup>11</sup> Report of the NACD Blue Ribbon Commission on Building the Strategic-Asset Board, 2016, p. 35.

<sup>12</sup> These questions are derived from Global Board Culture Survey: Understanding the Behaviors that Drive Board Effectiveness, Russell Reynolds Associates, 2016

## About the KPMG Board Leadership Center

The KPMG Board Leadership Center champions outstanding governance to help drive long-term corporate value and enhance investor confidence. Through an array of programs and perspectives—including KPMG's Audit Committee Institute and Private Markets Group, the WomenCorporateDirectors Foundation, and more—the Center engages with directors and business leaders to help articulate their challenges and promote continuous improvement. Drawing on insights from KPMG professionals and governance experts worldwide, the Center delivers practical thought leadership—on risk and strategy, talent and technology, globalization and compliance, financial reporting and audit quality, and more—all through a board lens. Learn more at [kpmg.com/blc](https://kpmg.com/blc).

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