HKCGI Guide on Board Evaluations – An Overview

April 2024

Introduction

Board evaluation to review board effectiveness is becoming an increasingly important governance concern in many jurisdictions. While the Corporate Governance Code B1.5 in Hong Kong recommends it as a best practice[1], there are other markets where it is 'comply or explain' or 'mandatory'. In the Chinese mainland, for instance, it is mandatory. A listed company must set up fair and transparent standards and procedures for assessing the performance of directors, supervisors, and senior executives. The board, the remuneration and assessment committee, or another third party may conduct the assessment. However, independent directors and supervisors may adopt self-review. The listed company should disclose and report the assessment results to the general shareholders[2].

The UK, Australia, and Singapore adopt the 'comply or explain' approach. Hong Kong is expected to move towards the 'comply or explain' requirement from a recommended best practice. The UK position provides some practical thoughts on the purpose of board evaluations and the required disclosure in good governance.

The UK position

The UK Corporate Governance Code (2024), Principle L states that the 'annual evaluation of the board should consider its performance, composition, diversity and how effectively members work together to achieve objectives. Individual evaluation should demonstrate whether each director continues to contribute effectively.'

- There should be a formal and rigorous annual review of the performance of the board, its committees, the chair and individual directors. The chair should commission a regular externally facilitated board performance review. In FTSE 350 companies, this should happen at least every three years. The external reviewer should be identified in the annual report and a statement made about any other connection it has with the company or individual directors.'
- 'The chair should act on the results of the board performance review by recognising the strengths and addressing any weaknesses of the board. Each director should engage with the process and take appropriate action when development needs have been identified.'

1 https://www.hkex.com.hk/-/media/hkex-market/listing/rules-and-guidance/listing-rules-contingency/main-board-listing-rules/appendices/appendix_14
2 Article 55 to 57, China Corporate Governance Code http://www.csrc.gov.cn/csrc_en/c102034/c1372459/1372459/files/P020190415336431477120.pdf

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- 'The annual report should describe the work of the nomination committee, including:
    - the process used in relation to appointments, its approach to succession planning and how both support developing a diverse pipeline;
    - how the board performance review has been conducted, the nature and extent of an external reviewer's contact with the board and individual directors, the outcomes and actions taken, and how it has or will influence future board composition;
    - the policy and any initiatives on diversity and inclusion, their objectives and link to company strategy, how they have been implemented and progress on achieving the objectives; and
    - the gender balance of those in the senior management and their direct reports.'

Hong Kong and concentrated ownership

Concerning Hong Kong-listed companies, the Chinese state and families have concentrated ownership in many of them. As observed, board evaluation is required on the Chinese mainland, so there should be little resistance for State-owned enterprises. It may be that some family-owned businesses would prefer not to assess the performance of their close family and connections on their boards. Nevertheless, regulators, investors, and stakeholders increasingly expect board evaluations to align with international practices.

There is also a business sustainability case for understanding current strengths and weaknesses, developing a measurable plan for continuous improvement, and reinforcing the board's commitment to excellence in corporate governance, which are potential benefits of a review of board effectiveness. Additionally, board evaluations can enhance succession planning and highlight opportunities to increase diversity and inclusion. Thus, board evaluation has advantages and is relevant to the overall business strategy and its implementation. Most family enterprises nowadays are aware of the need to aspire to adopt good governance practices, which will include considering the adoption of board evaluations.

Methodology

There is no one-size-fits-all methodology for board evaluations.

1. Internal Evaluations

Internal evaluations have several benefits, chief among them being cost-effectiveness and internal knowledge. Internal reviews of board effectiveness are more affordable because they do not require outside experts, especially for smaller businesses with tighter resources. In addition, the board committee, typically the nomination committee, has a deep understanding of the business's dynamics, culture, and operations, making conducting a comprehensive evaluation that might not be possible with just outside viewpoints. Because of their knowledge of the company, the board committee would be able to have frank conversations and offer practical advice specific to the needs of the business.

However, internal reviews could be biased since board members might be reluctant to give candid criticism, particularly when evaluating their own or close colleagues' work. Furthermore, the absence of external objectivity may compromise the review process's legitimacy and thoroughness. The board members' already hectic schedules and conflicting interests may be strained by the substantial time, effort, and experience needed to perform thorough internal reviews, which will take time to get to the point of being efficient and effective compared to work done by external reviewers. For the governance professional, an internal evaluation, especially at the beginning, would be time-consuming and could detract from the focus, which should be the review of the board's effectiveness. It might nevertheless be a starting point for board evaluations.

2. Internal Evaluations (with Professional Support)

Professionally assisted internal evaluations provide an intermediary between internal knowledge and external objectivity. Companies can enhance their internal skills with specialised knowledge in evaluation methodology, facilitation techniques, and best practices for governance by hiring external consultants or facilitators with external review experience. Ensuring that all pertinent elements are considered, this increased competence improves the review process's rigour and completeness. Furthermore, external consultants or facilitators can encourage candid and productive communication among board members, establishing a secure environment for viewpoint exchange, problem-solving, and opportunity exploration. It also enables the governance professionals to share their unique perspectives as input to the review process and reduce their administrative burden.

There might be drawbacks to this approach. Employing external consultants or facilitators will come with some costs. It might not be easy to integrate external advice with internal dynamics and decision-making procedures; this calls for clear communication and goal alignment. Nevertheless, this approach is worth considering, especially when an organisation needs support to commence board evaluations to meet market expectations.

3. External Reviewers

There are benefits to external reviews from independent external reviewers, such as legitimacy, expertise, and impartiality. External reviewers provide the review process with an impartial and objective viewpoint unaffected by internal politics, relationships, or conflicts of interest. This guarantees a thorough evaluation free from personal intentions or biases. Additionally, external reviewers' industry insights and expertise enhance the research and benchmarking to international best practices. Their participation strengthens the evaluation results' transparency and reliability, giving regulatory bodies and stakeholders more confidence, including investors concerned with board effectiveness and performance.

There are obstacles to take into account. The involvement of external assessors requires a substantial financial outlay, which could be unfeasible for businesses with constrained funding. Also, some board members could be resistant to or sceptical about external assessments because they believe they are invasive or threaten their independence and authority. Disclosing personal information to outside assessors creates privacy issues requiring strong confidentiality agreements and data security protocols to preserve private information and individual privacy. In the UK, the model is that there should be an external review, and in the case of FTSE 350 companies, at least an external assessment once every three years. In practice, these companies also engage facilitators to support their internal reviews in the intervening years.

Confidentiality and anonymity

To mitigate sensitivities surrounding evaluations and promote a culture of transparency, accountability, and continuous improvement in corporate governance, boards can implement several confidentiality measures. One approach is to aggregate evaluation data at a high level, anonymising individual responses while still providing valuable insights into a review of the overall board performance and governance effectiveness. Presenting evaluation findings in aggregate form, without attributing specific comments or ratings to individual board members, preserves confidentiality and fosters a culture of trust and openness. By prioritising confidentiality and anonymity, boards can facilitate candid discussions, enhance stakeholder confidence, and drive meaningful improvements in corporate governance.

Independence

When selecting external reviewers, it is important to consider their independence from the organisation to ensure their findings cannot be influenced by pre-existing relationships and the potential to earn fees from other services.

Implementing Evaluation

Irrespective of whether a board evaluation is done internally, with facilitation, or externally, it could be carried out in various ways, each with pros and cons of its own. Among the popular techniques are:

1. Self-Assessment

Board members assess their work either separately or together. Board members are encouraged to reflect and become more self-aware through this approach. It might, however, be biased and fail to consider different viewpoints.

2. Peer Review

In this process, board members usually evaluate one another's work privately. This approach encourages cooperation and peer accountability. Nevertheless, it could result in conflicts or biases among board members if handled poorly.

3. Structured Interviews

An in-depth review of particular areas of board performance can be achieved by conducting structured interviews with board members one-on-one. Although it can be resource-intensive, it allows for subtle insights.

4. Surveys and Questionnaires

An efficient measurement of board performance is made possible by the distribution of surveys and questionnaires with evaluation criteria that have been predetermined. While it is an effective and scalable tool, it might not have the same depth as qualitative approaches.

5. Surveys with Interviews

Some reviews involve a short survey and questionnaire before interviews take place. The two phases of enquiry ensure comprehensive coverage of all areas in scope of the review of board effectiveness and can lead to especially rich discussions, where consensus builds on the key recommendations through the process.

6. 360-Degree Feedback

In addition to self-evaluation, this entails getting input from various stakeholders, including other board members, senior management, staff, and outside partners.

Inviting senior management to review board effectiveness is becoming increasingly popular, as this can provide a more holistic picture of the board's impact on the organisation.

Many organisations combine the techniques to customise the evaluation process to their unique requirements and circumstances. For a more thorough evaluation, 360-degree feedback, for instance, could be included in a self-assessment.

HKEX Disclosures

As an example, HKEX (on the business and not the regulatory side) discloses its board evaluation in the following terms[3].

- Continuing improvement and development of the board and its committee processes and procedures is key to ensuring that HKEX's governance structure remains in line with best practices. This can be achieved through Board evaluation which provides a powerful and valuable feedback mechanism for improving Board effectiveness, maximising strengths and highlighting areas for further development.

- The board recognises the value of a formal, structured and rigorous process whereby there is a comprehensive, objective and open assessment of their procedures and effectiveness in providing leadership to HKEX. The evaluation process also clarifies what actions need to be taken to maintain and improve the Board performance, for instance, addressing individual training and development needs of each director.

- The Nomination and Governance Committee is responsible for developing the procedures for a Board (including its committees and individual members) performance evaluation and conducting a Board performance evaluation regularly.

- Since 2010, the board has regularly commissioned a formal and rigorous evaluation of its performance as well as that of the committees and individual members by an external independent consultant to ensure objectivity and impartiality.

- The board will conduct a structured evaluation of the Board performance on a regular basis, and continue reviewing its performance and that of its committees with external facilitation.

- The performance evaluation will normally take the form of a detailed questionnaire supplemented by individual interviews with each director, certain senior executives and HKEX's regulators. The questionnaire is refined each time as appropriate to focus on the progress made in addressing the key issues raised in the previous evaluation process. The evaluation report will be presented to the board which will collectively discuss the results and the action plan for improvement, if appropriate.

- The results of the Board evaluation, if conducted, are disclosed in the Corporate Governance Report for accountability and transparency purposes.

3 https://www.hkexgroup.com/Corporate-Governance/Corporate-Governance-Framework/Corporate-Governance-Practices/Board-of-Directors/Board-Evaluation?sc_lang=en

Conclusions

Whichever board evaluation approach is selected, it is imperative to guarantee that the review procedure on board effectiveness is constructive instead of accusation or condemnation. Regular board evaluations, usually done once a year, are also necessary to monitor developments and promote ongoing enhancements to governance procedures. The evaluations could be done internally, with facilitation, or by an external reviewer. In the UK, an external evaluation is required at least once every three years and in the case of FTSE 350 companies. In practice, these companies also engage facilitators to support their internal reviews in the intervening years.

There is no one-size-fits-all, and the requirements under regulations, investors, and other stakeholders should be considered. Importantly, as noted, there is a business sustainability case for understanding current strengths and weaknesses, developing a measurable plan for continuous improvement, and reinforcing the board's commitment to excellence in corporate governance. These are potential benefits of an evaluation. Additionally, board evaluations can enhance succession planning and highlight opportunities to increase diversity and inclusion. Thus, board evaluation has its advantages.

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