

Developing Performance Evaluation Systems for Corporate Boards

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Extended Abstract

Corporate scandals of the past decade have focused stakeholders' attention on whether boards of directors are actively engaged in fulfilling their fiduciary duties and protecting shareholder interests. Key stakeholders have emphasized specific policies and processes that must be implemented so the board can effectively discharge its responsibilities. Among these processes, performance evaluation systems (PES) have been identified as essential for superior board performance [1,2]. Many have argued that, just as corporate performance evaluations provide feedback to improve performance, board and board members' evaluations represent a valuable opportunity to carefully assess both strengths and weaknesses and evaluate the board's role and contribution in creating and protecting shareholder value [3,4,5]. Accordingly, several securities regulators have specific requirements concerning performance evaluation [6].

Companies wishing to improve the overall performance of their boards must design evaluation systems that will allow them to closely monitor the inputs and processes leading to superior board performance [3]. In recent years, companies have placed greater emphasis on developing performance metrics aimed at measuring and managing corporate performance more effectively. Although some emphasis has been placed on developing improved performance metrics, they have generally not been applied to corporate boards. The reluctance to measure board performance has been identified as a significant barrier to improving internal governance and external accountability [7,4].

There is an abundance of literature describing the best practices that companies and boards should adopt in order to design and implement PES. This literature typically points to the need for a systematic, formalized, and rigorous approach to performance evaluation [3,8,7]. Surveys report that most listed companies in North America are in compliance with performance evaluation stock exchange requirements [9,10]. However, these evaluation systems are still relatively recent and we know little about their actual quality and their impact on board performance. Furthermore, when examining the information Fortune 500 companies disclose about their performance evaluation systems, Roy [11] has called attention to the generic and non-specific nature of the information provided in corporate governance guidelines. Undoubtedly, more information is necessary to gain a better understanding of these systems.

The focus of this study is on board performance evaluation systems. Specifically, three main research questions are addressed: (1) What types of performance systems corporate boards have been implementing? (2) Are these specific types associated with particular company characteristics? (3) Are these specific types associated with differing board characteristics and benefits?

In order to examine these questions, a structured questionnaire was sent by mail to the chairperson of the 400 largest Canadian public companies listed on the Toronto Stock Exchange (based on sales). The *Globe and Mail's* ranking of Canada's top 1000 public companies was used to create the initial list. The questionnaire had been pre-tested with three academics and ten board members. A letter explaining the purpose of the study and a self-addressed stamped envelope was included with each questionnaire. Four weeks after the initial mailing, the non-respondents received a replacement questionnaire. Forty-two questionnaires were returned unopened and eight respondents send a letter (or email) and explained that they refused to participate in this survey. The final sample therefore comprised 350 companies. The survey thus generated 88 usable questionnaires, for a response rate of 25.2%.

The first part of the questionnaire contained specific information about the board's PES (its level of formalization, its scope, and potential benefits) while the second part addressed more general questions about the board as a means to characterize its level of knowledge and experience and to describe its role in key board activities. For each of the 88 companies that participated in our survey, secondary data was also gathered to characterize the company (size, revenues, and financial performance) and its board (size, percentage of independents). The various constructs were examined to assess reliability and unidimensionality. Statistical reliability was assessed by computing Cronbach's alpha (α). Ahire and Devaraj [12] recommend a threshold of 0.50 for emerging construct scales and 0.70 for maturing constructs. Therefore, the coefficient values for the multiple-item scales employed in this study met these requirements and were considered reliable (see Table 1).

Table I: Construct Items and Reliability

Variables	Items	α
Formalization	<ul style="list-style-type: none"> ▪ We have developed specific rules and procedures to help us carry out board performance evaluations ▪ We have determined which specific aspects of board performance will be evaluated ▪ We codify the board's skills and expertise using tools such as a skills matrix ▪ We regularly review our PES 	0.76
Scope - role	<ul style="list-style-type: none"> ▪ Board's contribution to the company's long-term success ▪ Board's ability to discharge its duties effectively ▪ Board relations with senior management ▪ Board relations with stakeholders 	0.74
Scope - process	<ul style="list-style-type: none"> ▪ Board leadership and structure ▪ Board policies and procedures concerning meetings (e.g. length, frequency) ▪ Other board policies and procedures (e.g. information system, education programs) 	0.78
Scope – director attributes	<ul style="list-style-type: none"> ▪ Board diligence (e.g. attendance, degree of preparation) ▪ Individual director performance ▪ Board's composition (% independence, diversity, etc.) 	0.66
Benefits - integration	<ul style="list-style-type: none"> ▪ Our PES helps identify potential deficiencies concerning skills and expertise with a view to improving board performance ▪ Our PES helps the board determine which criteria will be used to identify and appoint new directors ▪ Our PES results help us develop appropriate educational programs to enhance board effectiveness 	0.78
Benefits – effectiveness	<ul style="list-style-type: none"> ▪ Our PES has helped clarify our expectations regarding the directors ▪ Our PES results have led to specific changes in board policies and procedures ▪ Our PES results could lead to a director's removal ▪ Our PES has resulted in more efficient meetings ▪ Our PES has resulted in increased participation of directors 	0.71
Board experience	<ul style="list-style-type: none"> ▪ Most our directors have prior board experience ▪ Most of our directors have management experience ▪ Most of our directors have a high degree of professionalism (e.g. attendance at meetings, degree of preparation) 	0.53
Board knowledge	<ul style="list-style-type: none"> ▪ Most of our directors have valuable industry knowledge ▪ Most of our directors are knowledgeable about company operations ▪ Most of our directors have knowledge of traditional business fields (e.g. marketing, finance, law) ▪ Most of our directors have valuable connections with key stakeholders 	0.71
Monitoring	<ul style="list-style-type: none"> ▪ Reviewing annual budgets ▪ Monitoring corporate performance ▪ Monitoring implementation of the strategic plan ▪ Overseeing major capital expenditures and asset acquisitions/disposals 	0.73
CEO evaluation	<ul style="list-style-type: none"> ▪ Monitoring and evaluating CEO performance ▪ Evaluating and selecting senior management 	0.70
Strategy	<ul style="list-style-type: none"> ▪ Setting long-term corporate objectives ▪ Reviewing the strategic plan ▪ Reviewing major corporate policies ▪ Reviewing risk policies 	0.78

A cluster analysis led to the identification of three distinct types of PES (Exemplar, formal, and minimalist) based on their scope (number of elements covered by the PES) and their level of formalization (see Table 2).

Table 2: Cluster Analysis – ANOVA Results

	Minimalist (n=21)	Formal (n=31)	Exemplar (n=33)	Significance level p
Formalization	3.01 (a)	4.39 (b)	4.14 (b)	.000
Scope/role	3.44 (a)	3.66 (a)	4.47 (b)	.000
Scope/process	3.29 (a)	4.01 (b)	4.59 (c)	.000
Scope/attributes	3.65 (a)	3.95 (b)	4.69 (c)	.000

Then, we examined whether these three groups were associated with differing board and company variables (see Table 3). Results show significant differences between the three groups. Particularly, results demonstrate that “Exemplar” boards are positively associated with greater benefits (overall effectiveness) and increased board involvement in strategy and monitoring activities.

Table 3: ANOVA: Benefits and Board/Company Characteristics

	Minimalist (n=21)	Formal (n=31)	Exemplar (n=33)	Significance level p
Benefits - integration	3.29 (a)	3.98 (b)	4.11 (b)	.000
Benefits – effectiveness	3.20 (a)	3.50 (a)	4.00 (b)	.000
Strategy	3.98 (a)	4.39 (b)	4.69 (c)	.000
Monitoring	3.67 (a)	4.05 (b)	4.48 (c)	.000
CEO evaluation	3.39 (a)	4.00 (b)	4.38 (b)	.000
Board size	7.89 (a)	9.73 (b)	10.26 (b)	.013
% independent	.7145	.7785	.7902	NS
Board knowledge	3.76	3.90	4.07	NS
Board experience	4.51 (a)	4.67 (a,b)	4.78 (b)	.088
ROA	.0148	.0436	.0487	NS
Size (employees)	11 526	7 025	2 602	NS

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