# EVALUATING THE PERFORMANCE OF BOARD MEMBERS: A PORTRAIT OF CANADIAN FIRMS

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**Abstract**

The object of this study is to examine how board members' performance is evaluated and how they are compensated. In the last decade, the board of directors of publicly traded firms has been under strict surveillance by market participants and regulatory bodies. However, although market regulators require the full disclosure of executive and directors' compensation plans, very few guidelines exist as to how directors should be evaluated. Hence, by thoroughly examining the information disclosed in management proxies, this study shows that publicly traded Canadian firms do indeed evaluate board members' performance. However, the information disclosed regarding the evaluation of board members is parsimonious and mostly generic. Based on a sample of 173 Canadian firms, our findings also indicate that equity based incentive plans through differed share units (DSUs) are most often used as means to compensate directors.

**Keywords:** corporate governance, board members, performance

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## Introduction

In the aftermath of financial scandals such as Enron, Worldcom and the recent Madoff ponzy over the last decade, closer attention has been drawn to the corporate governance of publicly traded firms. Accordingly, governments and market regulators have collaborated in defining laws and standards such as the Sarbanes Oxley Act in the United States and similar regulations worldwide, to ensure proper corporate governance practices and to protect investors from potential expropriation of their invested wealth. The level of transparency in the disclosure of corporate governance practices has also increased; particularly in regards to the board of directors (BOD) elected to serve as an intermediary between investors and the management of corporations. Through these disclosures, stakeholders having vested interests in corporations may evaluate the quality of the BOD and gain assurance that the governance practices are in line with corporations' long term interests (Roy, 2008).

In order to properly evaluate the performance of directors, their role must be clearly identified. Of the various functions occupied by the BOD, the three primary roles are monitoring management, constituting a strategic resource for corporations through their expertise and assuming a fiduciary role as trustees of shareholders (Magnan et al. 2010). The process of constituting an efficient board requires three phases. The first phase is to carefully select and recruit competent and knowledgeable directors (Brown, 2007; Conger, 2001). Once the directors are selected, they require an orientation period during which board members undertake certain activities to develop skills and competencies related to their roles as directors. The final phase is the performance evaluation of the BOD as a whole and the evaluation of each director on an individual basis. This distinction is important because the global performance of the BOD may differ from the individual performance of each director. To our knowledge, little is known or disclosed in regards to the parameters of an individual directors' performance evaluation.

While there has been an international trend requiring the disclosure of executives' and directors' compensation, very few guidelines exist in regards to the performance evaluation of directors and boards. Although market regulators such as the OSC (Ontario Securities Commission) require that firms disclose information on their board of directors' performance evaluation, they do not provide precise guidelines or specifications as to the extent of information to disclose. Hence, in this study, following Minichilli et al.'s (2007) model, we examine the publicly disclosed information in the management proxy circulars, and report descriptive statistics on the various parameters of directors' performance evaluation. In addition, to provide an exhaustive portrait of the governance practices in board evaluation and compensation, we analyze the directors' incentive compensation plans and provide statistics as to how directors of Canadian firms are compensated.

The first section of this paper presents a literature review on the processes of directors' performance evaluation and compensation. Section two describes our sample and research model. In section three, we present our findings. Finally, in the last section, we conclude our research and propose future research opportunities.

## 1. Literature review

### Board and individual directors' evaluation

The process of directors' performance evaluation has been examined by many academics throughout the world over the last decade. In an English study, Collier (2004) reports that the best practices in directors' performance evaluation involves three stages. First, the performance of each administrator should be evaluated. This initial evaluation should be followed and completed by evaluating the performance of the BOD as a whole. Finally, a report including the recommendations of the evaluators should be prepared and presented to the members of the board in order to maintain a constant improvement of the boards' performance.

The performance evaluation of directors may be assumed by either an internal or an external evaluator. Stybel (2005) argues that the evaluation process structure and the degree of confidentiality associated with the gathered information may influence the decision of choosing an external versus an internal evaluator. An external evaluator is more likely to be chosen when the process of performance evaluation is structured and the level of confidentiality is essential whereas an internal evaluator tends to be chosen when the evaluation process is rather informal and the need for confidentiality not very important.

The confidentiality throughout the process of directors' performance evaluation is a critical issue as it raises two important concerns: the risk of liability suits brought by shareholders when the outcome of performance evaluation is negative and the risk of hindering the well established reputation of directors who have served boards for a long period of time. These concerns may lead directors to refuse to serve on certain boards as well as resigning from the boards they are serving (Stybel, 2005).

Minichilli et al. (2007) propose a framework for performance evaluation processes based on the determination of four essential components: the evaluator (an external consultant or an insider), the recipient of the evaluation (for whom the evaluation is intended), the object of the evaluation and its content (existing procedures, individual evaluation of directors, evaluations according to specific criteria, etc.) and the method of evaluation used (open discussions, surveys, etc.)

In a U.S. study, Roy (2008) uses Minichilli et al.'s (2007) framework to examine three specific processes intended to develop and improve BOD members' expertise: the nomination of directors, their orientation and education as well as their evaluation. With a sample of 500 leading American firms, Roy's study shows that corporations disclose information in regards to the three examined processes, however, the information disclosed is often non-specific thus not allowing to determine appropriate measures which may contribute to firms' long term objectives.

### Directors' compensation

To provide incentives for directors to perform their duties efficiently and in line with a corporation's objectives, compensation plans elaborated for board members generally include stock grants. A considerable amount of research has focused on understanding the impact of directors' compensation on firm performance. From an agency perspective associating corporate ownership as a mechanism that favors monitoring and alleviates the horizon problem, most studies have analyzed the effect of equity based incentive plans on firms' investments, costs and performance. Accordingly, empirical findings show that a greater mix of stock options in directors compensation reduces the cost of corporate debt (Boumosleh, 2007; Ertugrul and Hedge, 2007), increases long term value enhancing investments such as R&D (Bryan and Klein, 2004) and contributes to the firms overall performance (Bryan and Klein, 2004; Becher et al. 2005; McClain, 2007).

On the other hand, granting stock options in incentive contracting is generally a form of remuneration for agents that have a significant impact on the management of the firms. However, unlike executives, directors (especially external and independent ones) do not participate in the day to day management and decision making process of a firm, hence they do not have a tangible impact on its management activities. Accordingly, Feltham and Wu (2001) argue that it would be more efficient to compensate directors by differed share units (DSUs) instead of stock options. In 2005, the Canadian Coalition for Good Governance published guidelines which do not encourage stock option granting for directors but endorses the granting of DSUs (Magnan et al., 2010). Hence, it should be expected that Canadian firms use DSUs as a form of directors' compensation.

Magnan et al. (2010) in a review of empirical research on directors' compensation plans report that equity-based compensation plans, whether through stock options or DSUs, have a significantly positive effect on firm performance. However no superior performance is noted for firms using DSUs over stock options. The authors conclude that firms tend to use DSUs when: their corporate ownership structures are widely held, their directors are mostly related, their stocks are not traded in the United States and when they exhibit high levels of free cash flow. Finally, the use of DSUs seem to be a substitute for the lack of other corporate governance mechanisms since firms endowed with strong governance measures tend to employ less DSUs in their directors incentive compensation plans.

In this study, we seek to understand Canadian practices in regards to board performance evaluation and compensation. Hence, inspired by Minchilli et al.'s (2007) model, we gather disclosed information from management proxies of Canadian firms by distinguishing the performance of individual directors from that of the total board. Then, we gather statistics on compensation packages to provide a complete portrait for board evaluation and compensation.

## 2. Data collection and methodology

The sample retained for this study is comprised of companies included in the S&P/TSX Composite Index of the Toronto Stock Exchange. This index represents the largest Canadian companies listed on the Toronto Stock exchange as measured by their market capitalization. We removed 47 Income trusts and 9 other firms without income from the initial 229 firms included in this index. Hence, our final sample is composed of the 173 largest Canadian firms operating in different activity sectors including petroleum, mining, manufacturing, financial, and retail industries.

According to Minichilli et al.'s (2007) methodology, and using management proxy circulars, for each of our sample firms, we manually collected information, on who evaluated the board and its directors, for whom the evaluation was intended (e.g. the board, some committee of the board), what performance aspects of the board or individual directors were evaluated (e.g. board processes, individual directors, or specific criteria) and how the evaluation process was carried out in specific terms (e.g. via questionnaires or open discussions). We also collected all available information on the components of the directors' compensation.

## 3. Results

### 3.1 Descriptive Statistics of our sample firms

Table 1 provides descriptive statistics of the all firms included in our sample. The sample is composed of the largest Canadian firms and the statistics presented in Table 1 are in millions of Canadian dollars. The mean (median) of total assets is 27, 883 (3, 006.43) million dollars, the mean (median) of the sales represents 5, 129.78 (1, 477.50) million dollars, and the mean (median) of the income for the year of the observation is 324.57 (101.70) million dollars.

**Table 1.** Descriptive statistics (in millions of Canadian dollars) (N=173)

| Variables | Mean | *SD* | Median | Minimum | Maximum |
|---|---|---|---|---|---|
| Total assets | 27,883.59 | 90,809.30 | 3,006.43 | 145.27 | 654,989.00 |
| Sales | 5,129.78 | 8,255.93 | 1,477.50 | 1.20 | 39,160.00 |
| Net Earnings | 324.57 | 763.14 | 101.70 | -4,471.03 | 3,858.00 |

### 3.2 Performance Evaluation of Directors and Board

Because the scope of our study is intended to draw a portrait of governance practices in terms of the performance evaluation of boards and directors, our results mainly represent compiled proportions of the various parameters in regards to performance evaluation. Moreover, because performance evaluation parameters may differ according to the evaluation of individual directors as opposed to that of the entire board as a group, we disentangle and present a survey of the Canadian governance practices of individual directors' performance evaluation separately from that of the boards'.

#### 3.2.1 Performance Evaluation of Directors (on an individual basis)

Based on the information collected from management proxy circulars, we found that only 9 % of our sample firms did not disclose any information on the evaluation of directors. Hence, for the rest of our sample (91%), we compile four specific parameters of directors' performance evaluation Minichilli et al.'s (2007) methodology. As such, statistics regarding the evaluator of the directors' performance in Canadian firms is presented in Table 2 while statistics concerning the recipient of these evaluations is reported in Table 3. We also address two other parameters concerning the object and content of directors' performance evaluation as well as the evaluation process itself which, because of their parsimonious nature and limited disclosure, are discussed but not reported in tables.

As shown in Table 2, a large majority (64% of our sample) of firms confer the task of evaluating directors' performance to the nominating or governance committee of the board. Moreover, in 17% of cases, the chairman of the board himself conducts the evaluations through individual meetings with directors. Finally, in 12% of cases, evaluations were conducted by independent experts, and, in the remaining 6%, the various boards ensured that the evaluation is conducted by a discussion group among directors.

**Table 2.** Who evaluates the Directors?

| | |
|---|---|
| Nominating or governance committee | 64 % |
| Board | 6 % |
| Chairman of the Board | 17 % |
| Independent Experts | 12 % |

Results revealed in Table 3 regarding the recipient of the directors' performance evaluation indicate that the majority of the firms in our study (approximately 57% of our sample firms) forward the evaluations directly the board. Therefore, it is from the resulting presentation to the board that individual directors can assess their perceived strengths and weaknesses and areas requiring improvement. On the other hand, 17 % of our sample firms forward the information to their nominating or governance committee so that they may take any necessary action if needed. In a few rare cases (6%), the Chairman of the Board is designated as the recipient, while 4% of firms forward the result to each individual director. Finally, in 17% of the cases, we found no information mentioning to whom the evaluation was presented.

**Table 3.** For whom is the evaluation intended?

| | |
|---|---|
| Entire Board of Directors | 57 % |
| Chairman of the Board | 6 % |
| Nominating or Governance Committee | 17 % |
| Individual Directors | 4 % |
| No mention | 17 % |

We also examined what aspects of directors' performance are evaluated (not reported). We found that only 17% of our sample firms disclose the particular elements used to evaluate the performance of their directors in their management proxy circular. Among the elements assessed are their knowledge of the business, the company and the industry, their skills and experience, their preparation, their attendance and availability at meetings, their communication and interaction, and their overall effectiveness in the discussion and decision-making process.

The last point of the study consists in determining if the firms disclose the sources of the information obtained during the evaluation process (not reported). We found that most firms (94% of our sample) use questionnaires and confidential discussions to assess their directors performance, while the remaining 6% of our sample firms make no mention of the type or source of information used to evaluate their directors.

### 3.2.2 Performance Evaluation of the entire Board (as a group).

In this section, we examine once again the four parameters of performance evaluation according to Minichilli et al.'s (2007) design, focusing on the entire board of directors as a group. When examining the management proxies, we found that 94% of our sample firms disclose information indicating that they conducted an evaluation of the entire board of directors. Hence, the results reported in this section concern only the 163 firms (94 % of sample) who disclosed this information. Similar to results reported in the previous section regarding the performance evaluation of individual directors, Tables 4 and 5 report respectively statistics identifying the evaluator and the recipient of board performance evaluations. Once again, the two other parameters of board evaluation in relation to the object and process of board performance evaluation is addressed but not reported in tables.

As reported in Table 4, our findings show that 70 % of our sample firms disclosing information on board evaluation, confer this task to their nominating or governance committee. Table 4 also shows that this task can also be undertaken by the board themselves (12% of the cases), an independent expert (11% of the cases), or the Chairman of the Board (6% of the cases). Finally only two firms did not mention who was designated as the evaluator for their board's performance, which represents 1% of our sample firms analysed in this section (n=163).

**Table 4.** Who evaluate the Board

| | |
|---|---|
| Nominating or governance committee | 70 % |
| Board | 12 % |
| Chairman of the Board | 6 % |
| Independent Expert | 11 % |
| No mention | 1 % |

Our findings pertaining to the recipients of board performance evaluation show that 70% of firms' studied present the board's evaluation to the board itself. On the other hand, a small percentage of firms (9%), send the results of their board's performance evaluation to the nominating or governance committee while 4% of the firms submit these results to the Chairman of the Board. Finally, out of the 163 firms disclosing board performance evaluation, 27 firms (or 17 %) did not mention any recipients. Table 5 presents a summary of the recipients of board performance evaluations.

**Table 5.** For whom is the evaluation intended

| | |
|---|---|
| Board of Directors | 70 % |
| Chairman of the board | 4 % |
| Nominating or governance committee | 9 % |
| No mention | 17 % |

In regards to the object of evaluation and its content, our findings are similar to what we observe in the previous section regarding the evaluation of individual directors. According to our observations (not reported), few of the firms studied (11 %) disclose the elements used to evaluate their board of directors and in a very evasive way. For instance, when analysing the management proxy circulars of these firms, we found statements indicating that the board's performance evaluation review includes assessing the performance on board effectiveness related to risk management, strategic planning and decision making on critical issues. On the other hand, the rest of the firms (89 %) declare having evaluated the board's performance without identifying the elements on which the evaluation was conducted.

Finally, our analyses show that 92% of the firms disclosing information on board performance evaluation conduct their evaluation through questionnaires and confidential meetings. These results are similar to those obtained in our previous section concerning the evaluation process of individual directors themselves.

### 3.3 Directors' compensation

In this second phase of our study, we report Canadian practices in regards to directors' compensation. We first report some statistics on all the types of monetary arrangements with board members whether it takes the forms of compensation or fees paid to board members. Then we directly examine directors' compensations by identifying the different components of directors' incentive compensation plans and the extent to which each component is used by Canadian firms.

In Table 6, we report statistics on all types of monetary components of compensation (or meeting fees) offered to the directors of our sample firms. The various types of compensation for Canadian directors include, in most cases, a mix of different financial components. Among these, we find directors' fees, lump sum payments tied to committee chairs, as well as fixed or variable compensation. We see that fees for board meetings vary from $0 to $10,000 with an average of $1,166 per director per meeting. Lump sum payments for different committee meetings vary between $0 and $4,000 with an average of $1,096 per director per meeting. Lastly, our results also indicate that the chair of any non- audit committee, receives on average an annual fee of $8,036.

It must be noted that many firms do not offer compensation for assisting committee meetings, which may explain the minimum amounts of $0 shown in Table 6. In such situations, compensation is provided by fixed and variable compensation. With regards to fixed compensation, the average amount per director in our sample firms was $51,558. A significant part of a director's revenues seem to derive from variable compensation, for which the average amount of $91,262 largely surpasses all other forms of compensation. With a maximum of $1,171,634 and a standard deviation of $170,212 this variable form of compensation is the one that truly distinguishes the salaries of the directors of different Canadian firms.

**Table 6.** Individual Director's compensation in Canadian dollars

| | Minimum | Maximum | Mean | Standard deviation | Median |
|---|---|---|---|---|---|
| Director's fee for board meeting | 0 | $10,000 | $1,166 | $1,026 | $1,500 |
| Director's fee for committee meetings | 0 | $4,000 | $1,096 | $799 | $1,500 |
| Annual fee for Chair of a non-audit committee | 0 | $25,000 | $8,036 | $5,477 | $7,500 |
| Fixed compensation | 0 | $180,000 | $51,558 | $34,884 | $40,000 |
| Variable compensation | 0 | $1,171,634 | $91,262 | $170,212 | $37,891 |

Table 7 provides an overview of the total compensation for the entire board of directors of a firm as a group. Our findings indicate that total cost for directors' fees for meetings and committee chairs represents on average, $211,676 per board while the average cost for total board compensation represents $ 1,474,157.

**Table 7.** Total Cost of Total Board compensation

| | Minimum | Maximum | Mean | Standard deviation | Median |
|---|---|---|---|---|---|
| Total Directors' fee | 0 | $1,801,833 | $211,676 | $261,739 | $174,200 |
| Total Directors compensation | $144,895 | $4,694,066 | $1,474,157 | $937,579 | $1,203,710 |

Next we survey Canadian practices in regards to variable compensation components, for which the results of our findings are reported in Table 8. In line with the guidelines and recommendations stated by the Canadian Coalition for Good Governance, promoting the use differed share units as incentive compensation for directors while banning the use of stock options, our results tend to demonstrate that stock options are increasingly less popular with directors as a form of compensation. In fact, only 20 % of the firms in the sample awarded stock options to their directors. It seems that many of them are now oriented towards differed share units to align their interests with those of shareholders. Differed share units constitute, in effect, a variable compensation used by 40% of the firms our 173 sample firms in order to encourage directors to consider the long-term effects of their decisions. This proportion climbs to 60% when we reduce our sample to consider only the subsample of 116 firms offering variable forms of compensation to their directors. Offering shares or restricted shares are alternatives employed by 7 firms in our study, thus representing 4% of our total sample. Finally we note that 3% of the firms prefer a combination of stock options and deferred share units as compensation for their directors.

**Table 8.** Components of Variable Compensation

| Compensation components | Frequency observed on whole sample | Frequency observed for the subsample of firms offering variable compensation |
|---|---|---|
| | N=173 | N=116 |
| Shares (or restricted shares) (n=7) | 4 % | 6 % |
| Stock options (n=34) | 20 % | 29.3 % |
| Deferred share units (n=70) | 40 % | 60.4 % |
| Stock options and deferred share units (n=5) | 3 % | 3.3 % |

## 4.Conclusion, future research venues and limitations

The objective of this study is to assess and report a portrait of Canadian practices regarding the evaluation conducted by Canadian firms on the performance of their individual directors and the board, as well as their compensation. The results of our analysis tend to demonstrate that Canadian firms do indeed conform to the requirements of regulatory bodies as many Canadian firms disclose the information concerning the evaluation of their board of directors as well as the board members themselves. However, the information presented in the management proxy circulars often does not provide sufficient data precise enough to identify the exact nature of the evaluation process nor its efficiency. For example, Nuvista Energy Ltd. informs its shareholders that the evaluation of the board was conducted and the results are as follows: "We annually conducted a formal assessment of our board and its committees and the individual directors under the direction of the Governance and Nominating Committee. Our board is satisfied its committees and individual directors are performing effectively." (Management proxy circular, 2009, p. 35)

Granted that this example represents the most egregious case of disclosures in our sample, nonetheless, a number of firms are satisfied with simply mentioning that they evaluated the board, its committees, and directors and that the evaluation was carried out by the governance committee, that it consisted of questioning directors and that the answers were thus returned to the board of directors in the form of a report emanating from the governance committee.

To our knowledge, this study is the first to describe Canadian practices in regards to the various dimensions of board and directors' performance evaluation. As such, we believe that this study may pave the way to future empirical research testing the effectiveness of each of the four different parameters of board and directors' performance evaluation by linking it to overall corporate performance in terms of market returns and firm value. Moreover, this study can be extended to examine whether certain determinants of firms may be linked to their processes of boards' and individual members' performance evaluation. Furthermore, it is argued that equity based incentive compensation may be endogenous to firm performance. Hence, when studying the relationship between board compensation and corporate performance, researchers may use robust econometric techniques to determine the interdependence between the boards' and/or directors' performance evaluation parameters, the components of their compensations and firm value.

This study, however, is not without limitations. The evaluation process of the board of directors and their individual members stems from the firms' disclosures as described in their management proxy circulars. In their communications, the firms may not disclose all the information related to the evaluation process for various reasons. By relying exclusively on disclosures by firms, it becomes difficult to determine if the evaluation process is concise or if it only lacks transparency. In addition, certain firms do not totally comply with the somewhat evasive directives provided by Canadian regulatory bodies responsible for financial institutions. Hence, these firms may not publish all the information regarding the compensation of their directors and their evaluation. Thus, in the absence of standardized disclose formats for board (and its directors) performance evaluation, results obtained in this study greatly depend on the level of transparency in the disclosure of that information.

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