Improving Board Effetiveness

CG FOCUS
Issue 3 | July 2017

The Financial Services Authority of Indonesia (OJK) introduced OJK Regulation No. 21/POJK.04/2015 concerning the Implementation of the Corporate Governance Guideline for Public Companies. Principles 3-6 of OJK's Circular Letter No. 32/SEOJK.04/2015 (hereinafter 'the CG Guideline') provide additional requirements for the size and composition of the Board of Commissioners (BoC) and Board of Directors (BoD) as well as their roles and responsibilities. This note provides guidance on how to implement the CG Guideline *only* based on OJK recommendations and leading international practices.

Other Regulations Applying to the BoC and BoD

In Indonesia, several other regulations and company documents also apply to the BoC. These must be complied with as appropriate and include:

- Law No. 40/2007 on Limited Liability Company;
- OJK Regulation No. 33/POJK.04/2014 on the BoC and the BoD of Issuers and Public Companies;
- OJK Regulation No. 34/POJK.04/2014 on the Nomination and Remuneration Committee of Issuers and Public Companies;
- Industry-specific legislation on banking, investment, and insurance; and
- The Articles of Association (AoA) of the particular company.

1. STRENGTHENING THE MEMBERSHIP AND COMPOSITION OF THE BoC AND BoD

Principle 3 and 5 of the CG Guideline recommend companies to take into account the following principles in determining the size and composition of the BoC and BoD to support corporate sustainability.

Principle 3[1]: Strengthening the membership and composition of the BoC.

Rec. 3.1: Determining the size and of the BoC to take into account the conditions of Public Companies.

Rec. 3.2: Determining the composition of the BoC members to take into account the required diversity of skills, knowledge and experience.

1 This refers to Principle 3 consistent with its sequence in the CG Guideline

IN PARTNERSHIP WITH

Schweizerische Eidgenossenschaft
Confédération suisse
Confederazione Svizzera
Confederaziun svizra

Swiss Confederation

Federal Department of Economic Affairs, Education and Research EAER
State Secretariat for Economic Affairs SECO

IFC International Finance Corporation
WORLD BANK GROUP

Principle 5[2]: Strengthening the membership and composition of the BoD.

Rec. 5.1: Determining the size of the BoD to take into account the conditions of Public Companies as well as effective decision making.

Rec. 3.2: Determining the composition of the BoD members to take into account the required diversity of skills, knowledge, and experience.

Rec. 3.2: The Director who oversees accounting/finance should have expertise and/or knowledge in the field of accounting.

In Indonesia, there is a clear distinction between the role of the BoC and that of the BoD. The BoC's main role is to oversee the company and to provide advice to the BoD, *not* to participate in operational decision making. Therefore, the BoC should be effective, professional, and independent, acting in the best interests of the company and its shareholders and with collective competency to both oversee the company and advise the BoD. Meanwhile, the BoD is responsible for implementing the company's strategy and managing the company's daily operations.

The size and composition of the BoC and BoD will be controlled by legal requirements and should be particular to each individual company, its stage of development, the complexity of its business, and the size of the business. A bank with diversified operations in several jurisdictions throughout Asia will have very different requirements for the BoC and BoD compared to that of a small textile manufacturer operating only in Indonesia. The bank is likely to have a larger board size to address the greater complexity of its business. The determination of the size and composition of the BoC and BoD should be taken together as they are inter-dependent.

Size of the BoC/BoD

Having too few or too many commissioners/directors may pose a problem. A BoC with too few members may not have the breadth of skills and experience needed to oversee and advise the BoD. Meanwhile, a BoD with too few members may not have the breadth of skills and experience needed to focus on and implement the company's strategies. Too large a BoC/BoD, on the other hand, is more difficult to manage and can make consensus building time-consuming and difficult. Indonesia has a two-tier board system and typically two-tier boards are larger than one-tier boards. However, even in Europe where there are several countries with a mandatory two-tier board system, the size of boards varies.[3]

Country with Mandatory Two-Tier Board	Average Number of Directors *(includes employee representation on the Supervisory Board)*
Germany	17.1
Austria	11.8
Poland	8.3

Companies should choose the size of BoC/BoD that will enable them to:

- Hold productive, constructive discussions, since a BoC/BoD with too many members may hinder this process;
- Bring an independent perspective (for BoC) and functional expertise (for BoD) on strategy, risk, and control functions;
- Enable the BoC to add new skills and knowledge that may not be available within the company;
- Make prompt, rational decisions;
- For BoC: efficiently organize committee work with sufficient independent commissioners to populate the committees;
- For BoD: efficiently organize BoD with sufficient skilled directors to populate business functions.

2 This refers to Principle 5 consistent with its sequence in the CG Guideline

3 Statistics are taken from Heidrick & Struggles 2014 study, *Towards Dynamic Governance 2014: European Corporate Governance Report*, Brussels, 2014

Composition of the BoC and BoD

As a good practice, companies should apply the following principles:

- Design, articulate, and implement policies relating to the size and composition of the BoC and BoD, which include considerations of the mix of skills desired, and the breadth of experience, diversity, and expertise of BoC and BoD members. Members should collectively possess the necessary skills commensurate with the size, complexity, and risk profile of the company. Gender diversity is recommended.
- The size and composition of the BoD should be collectively sufficient for the BoD to ensure sustainable company operation and control, to take timely decisions, to complete the business annual work plan as approved by the BoC, to control and represent the company, to fulfil daily management roles and responsibilities, and to communicate and report on company performance to the BoC, shareholders, and regulatory authorities.
- Meanwhile, the size and composition of the BoC should consider both its oversight responsibilities and advisory roles with adequate experience and competence for both roles. Its size and composition should have a built-in flexibility to anticipate changes to the BoC's composition without undue disruption.
- Ideally, a BoC should be led by an independent commissioner. BoC committees should also be led by independent commissioners and have a predominance of independent members sufficient to support their activities. For each BoC committee, such as the Audit Committee or the Nomination and Remuneration Committee, the BoC should ensure that there is sufficient expertise among its members to chair and sit on these committees. As an example, the BoC should ensure that its members have sufficient expertise on issues relevant to an Audit Committee, such as knowledge and experience in dealing with the External Auditor, Internal Auditor, and management involved in the financial, economic, and other activities of the company. If the Audit Committee is also responsible for risk oversight, then the BoC should ensure that the Audit Committee has risk expertise among its members.
- The BoC and BoD should consider a balanced mix of members:
  1. With experience in local, regional, and, if appropriate, global economic and regulatory environments;
  2. With expertise in relevant areas, such as corporate reporting, corporate governance, strategy, risk management, information technology, and particular experience in the industry of the company; and
  3. Skilled in communicating with other board members, collaborative in style and yet capable of critical debate in the decision making process.
- In addressing the BoC's size and composition, there also needs to be an explicit procedure for the appointment of new commissioners to the BoC, which takes into account careful examination of nominees against objective criteria based on the company's particular needs at that time. The nomination process should consider orderly succession planning for both BoC and BoD members to maintain an appropriate balance of skills and expertise within the company. Each member of the BOC should be sufficiently financially literate to be able to understand the financial aspects of the business and to agree to the financial statements.
- The BoC should regularly review BoD member performance and plan for BoD succession so that company management, risk management, internal controls, public relations and social responsibilities are continuously and sustainably fulfilled.
- The BoD member leading the accounting/finance function should be professionally qualified, be a current member of a professional accounting organization, have expertise and recent experience

in financial reporting, and lead an appropriately resourced team of competent individuals. Other BoD members should be sufficiently financially literate to read, understand, and agree to the company's financial statements.

2. BoC AND BoD'S ROLES AND RESPONSIBILITIES

Principle 4: Improving the implementation quality of BoC's roles and responsibilities.

Rec. 4.1: The BoC has a self-assessment policy to evaluate its performance

Rec. 4.2: Disclosure of the BoC's self-assessment policy in the Annual Reports of Public Companies

Rec. 4.3: The BoC has a policy requiring the resignation of its members if involved in financial crimes

Rec. 4.4: The BoC or the Nomination and Remuneration Committee to develop a succession policy in the nomination of BoD members.

Principle 6: Improving the implementation quality of BoD's roles and responsibilities.

Rec. 6.1: The BoD has a self-assessment policy to evaluate its performance

Rec. 6.2: Disclosure of the BoD's self-assessment policy in the Annual Reports of Public Companies

Rec. 6.3: The BoD has a policy requiring the resignation of its members if involved in financial crimes

BoC and BoD Performance Evaluation – Self-Assessment

Boards should regularly evaluate themselves in a forward-looking process with the goal of improving board practices and the performance of individual commissioners/directors, and to determine board development needs. There is no "one-size-fits-all" approach, as each board evaluation will have a different focus. However, such evaluations normally include an evaluation of the President Commissioner and President Director, the overall board, board committees, individual commissioners and directors, and board dynamics. In most jurisdictions (e.g., Italy, Netherlands, UK, Japan), annual self-evaluation has been made either mandatory or is required under a 'comply or explain' code, and many jurisdictions encourage periodic externally facilitated evaluation (e.g., the UK, France, and 21% of European companies voluntarily use external facilitators annually to conduct the assessment process). Of key importance is the evaluation of the BoC's oversight role of company controls, compliance, and risk management as well as the quality of the BoC's advice to the BoD on strategy and other business related issues. Meanwhile, the BoD should be evaluated partly based on its performance in management, risk management, internal controls, public relations, and social responsibilities against preset disclosed targets. The BoC and BoD should work closely with the Nomination and Remunerations Committee in the formulation of policies and practices for the evaluation of BoC and BoD members.

An effective board evaluation policy, leading to successful evaluations, should provide some structure and discipline to the process and may include:

- A clear statement of commitment to board improvement and an annual board evaluation;
- The purpose, objectives, and accountability for undertaking the evaluation;
- The role of the BoC (or the Nomination and Remuneration Committee) in determining the self-evaluation process;
- An outline of the process (who is evaluated, what is to be evaluated, who is to be asked in the evaluation, the techniques used in the evaluation, who will do the evaluation);
- A commitment to confidentiality throughout the process;
- An explanation of how the results will be used and disclosed; and

- An explanation of the assessment's linkage to board induction, board development/renewal, board appointments, and board succession planning processes.

Disclosure of Self-Assessment in the Annual Report

Disclosure of the self-assessment policy in the Annual Report is mandatory under the CG Guideline. It is not expected that self-assessments of individual commissioners/directors be published, as this would be counter-productive to the openness required of the self-assessment process. However, limited disclosure of the policy should be enhanced.

Global leading practices recommend that the disclosure of the policy and its implementation should include:

- a statement that the assessment took place according to the policy;
- a discussion of the process itself;
- a summary/discussion of the results of the self-assessment; and
- company/BoC and BoD actions arising from it.

Two examples of good full disclosure of board evaluation processes are to be found in the following Annual Reports:

- Integrity, Resilience, Growth – Annual Report 2016, BHP Billiton, accessible at www.bhpbilliton.com
- Tech & Touch, Annual Report 2015, Randstad AG, accessible at www.ir.randstad.com

Resignation if Involved in Financial Crimes

In normal practices, it is a shareholder right to appoint and remove a commissioner/director under Company Law. In addition, the CG Guideline requires the company to have a policy requiring the resignation of a commissioner/director if involved in financial crimes. If the person does not resign, a simple mechanism, usually included in the company Articles of Association or the Code of Conduct, should be available to the BoC to remove that individual from the board, whether s/he be a member of the BoC or BoD. The company should make clear the right of the BoC to remove a commissioner/director from office, the criteria for a commissioner/director's removal, including when s/he is required to vacate office because of a board resolution passed by a specified majority of the other commissioners, perhaps on the advice of an Ethics Committee deliberation.

Good practices should include the following in company policies (e.g., the Code of Conduct/Ethics) applicable to all commissioners/directors:

- A clear statement of the expectation of commissioners'/directors' behavior, including the requirement to comply with all laws and regulations and company rules, policies, and guidelines;
- A clear definition of the criteria by which a commissioner/director may be required to resign;
- A structure and process to assess if the Code has been breached (usually in the form of an Ethics Committee of the board comprised of independent, non-conflicted commissioners only);
- A clause in the Code of Conduct that all commissioners/directors and former commissioners/directors will abide by the decision of the BoC/Ethics Committee and accept its determination as binding; and
- Acceptance of the role of the BoC/Ethics Committee becomes binding on a commissioner's/director's acceptance of his or her mandate as commissioner/director.

Succession Policy in the Nomination of BoD Members

A succession policy should form part of the policies and criteria for nominating BoD members, in order to ensure business continuity and to guard the company's long-term objectives and leadership regeneration.

The BoC or the Nomination and Remuneration Committee should ensure proper succession planning to support the nomination process to the BoD. Good practices include a policy requiring:

- Transparent BoC planning for all company leadership/BoD positions, with clearly defined roles and stated competencies for each role. The competencies should be cognizant of the company's changes in strategy and suit future needs. The competence assessment should consider any gaps caused by BoD members' retirement.
- The current BoD composition should be mapped against the desired future competencies and any gaps identified. Diversity should be factored into the mix.
- A process should be established to identify individuals of high potential/future leaders within and from outside the organization. Talent within the organization should be targeted for development opportunities.
- Succession planning should link to the board assessment and nomination processes and lead to a definition of recruitment specifications for BoD searches.
- Consideration should be given to BoD academic/professional qualifications, experience, demonstrated abilities, understanding of the industry, behaviors and leadership qualities.

ABOUT IFC CORPORATE GOVERNANCE GROUP

The Group brings together staff from investment and advisory operations into a single, global team. This unified team advises on all aspects of corporate governance and offers targeted client services in areas such as increasing board effectiveness, improving the control environment, and family businesses governance.

The Group also helps support corporate governance improvements and reform efforts in emerging markets and developing countries, while leveraging and integrating knowledge tools, expertise, and networks at the global and regional levels.

Contact us:

Chris Razook
Corporate Governance Lead
crazook@ifc.org

Mohsin Ali Chaudhry
Corporate Governance Officer
mchaudhry1@ifc.org

IN PARTNERSHIP WITH

Schweizerische Eidgenossenschaft
Confédération suisse
Confederazione Svizzera
Confederaziun svizra

Swiss Confederation

Federal Department of Economic Affairs,
Education and Research EAER
State Secretariat for Economic Affairs SECO

IFC International Finance Corporation
WORLD BANK GROUP