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Non-Executive Directors Review
Department of Trade & Industry
Room 2142, 1 Victoria Street
London SW1H 0ET

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Dear Mr Higgs

NON-EXECUTIVE DIRECTORS REVIEW

Thank you for giving the Audit Commission the opportunity to respond to the consultation document on the role and effectiveness of non-executive directors.

The Audit Commission is a non-departmental public body with statutory responsibilities to regulate the audit of local government and health bodies in England and Wales, and to promote improvements in the economy, efficiency and effectiveness of local government services. In relation to the audit of financial statements, the Commission is responsible for the appointment of auditors, setting the required standards for its appointed auditors, and regulating the quality of audits.

The Commission's response to the consultation document is drawn from our work with the National Health Service, with the intention that experience gained from this sector over recent years may assist in informing best practice applicable to other sectors in the UK economy.

In 1995, the Commission published a management paper entitled 'Taken on Board' which dealt with corporate governance in the NHS at that time and, specifically, developing the role of non-executive directors. While it is a little dated now, I have attached a copy of this publication as it provides a useful overview of the role of boards and non-executive directors in the NHS.

Please find specific comments below referenced to the key issues identified in the consultation document.

A: Role

The role of the board of directors, the Chairman, and non-executive directors in the NHS is set out in the 'Code of Accountability for NHS Boards' which was issued by the Department of Health in 1994 (attached for information).

NHS boards comprise of executive directors and part-time non-executive directors under a part-time chairman and, together, they share corporate responsibility for all decisions of the board. The overall role of non-executive directors is described as 'to bring an independent judgement to bear on issues of strategy, performance, key appointments and accountability...to Ministers and to the local community'. Specifically this role may include working with the chairman in the appointment of the chief executive and other executive directors; sitting on the remuneration committee which is responsible for appraisal and remuneration decisions affecting executive directors; sitting on the audit committee; and, other functions agreed by the board.

The roles of chairman and non-executive directors in the NHS are part-time, although the commitment expected will vary according to the specific appointment. In general, the time commitment expected from a non-executive director is approximately 5 days per month, although a chairman may be expected to commit between 2 – 4 days per week depending on the appointment.

B: Attracting and appointing non-executives

The following are examples of some of the key skills, personal qualities and experience required to be an effective non-executive in the NHS:

- Understanding of the needs of the local community
- Personal commitment to the NHS
- Ability to work as part of a team
- Leadership and motivational skills
- Strategic thinking
- Communication skills
- Personal integrity
- Willingness to challenge proposals and decisions
- Business /management experience
- Experience as a carer or user of the NHS
- Voluntary sector experience
- Active in the local community

In practice, boards look for a balance of skills and experience from their non-executives. This might include, for example, professional skills to support those of the executive directors, and experience of the NHS to help the board focus on patient services. Maintaining the appropriate balance of skills is a key part of the appointments process.

All non-executive directors to NHS bodies in England are appointed independently by the NHS Appointments Commission which follows guidance set by the Commissioner for Public Appointments. This helps to ensure that the appointments process is open, transparent and fair. In respect of diversity, the Department of Health has set targets for increasing the representation of women, people from ethnic minorities, and people with disabilities on NHS boards, and the NHS Appointments Commission is working towards meeting these targets.

In respect of the personal liability of non-executive directors, NHS bodies are advised by the Department of Health to issue a standard indemnity. Commercial insurance is not permitted

although there is a Liabilities to Third Parties Scheme, administered by the NHS Litigation Authority, which provides cover for this risk (see Health Service Circular 1999/104 for further details).

C: Structures and accountability

Audit committees are mandatory in parts of the public sector, including the NHS where they have been a requirement since 1994. Audit committees in NHS bodies must have a minimum of three non-executive directors and a quorum of two; the chairman cannot be a member of the audit committee, although he/she can be invited to attend meetings that discuss issues pertinent to the whole board.

The Combined Code encourages listed companies to set up audit committees but does not make them mandatory. The Commission strongly supports the creation of audit committees and considers that all organisations, but particularly public interest organisations, should have effective arrangements in place to discharge the functions of an audit committee. There may also be a case for making it more explicit that members of the audit committee should carry out their role primarily on behalf of shareholders.

Whilst recognising that executive directors and the main board have the primary responsibility of maintaining adequate and effective internal control and of overseeing the preparation of accounts which give a true and fair view, the audit committee should have sufficient status within the organisation to make a positive difference to corporate governance. For listed companies this means ensuring that the non-executive directors on the audit committee have the skills, time and support needed to carry out their role. Support here includes ensuring that both internal and external auditors have appropriate, timely and adequate access to the audit committee.

Audit committees should have an overview role in relation to the following areas and, in all these areas, be able to challenge and probe management decisions and assumptions:

- risk management arrangements;
- systems of internal control;
- reasonableness of financial and accounting policies;
- adequacy and effectiveness of internal audit, including the proposed priorities and work programmes; and,
- adequacy and effectiveness of external audit, including monitoring the extent of non-audit work.

The audit committee could take on a role in relation to the appointment and remuneration of the external auditor but, as has been mentioned by other commentators, consideration would need to be given to how best to achieve this given that, technically, shareholders appoint company auditors. The suggestion made by the Co-ordinating Group on Accounting and Audit Issues (CGAA) and the House of Commons Treasury Committee that the audit committee should have a role in making recommendations to shareholders on audit appointments would seem to offer a way forward. It should be noted, however, that the model for public sector audit appointments is different in that, by law, public bodies do not appoint their own external auditors.

In order to support chairs and non-executives and to enable them to maximise their contribution to the board, the NHS Appointments Commission has established a formal annual appraisal process. This process involves setting objectives at the start of the review year, self-assessment against those objectives, and an independent review and assessment of performance. This is an approach which provides at least some measure of accountability for the performance of non-executives, and ensures that any areas of weakness are identified in order that remedial action can be taken.

D: Relationships with shareholders and others

Relationships between non-executive directors and shareholders are not an issue on which the Commission has the relevant knowledge to comment. However, the equivalent relationship for non-executive directors in the NHS is that with the local community. The Code of Accountability states that one of the key functions of NHS boards is 'to ensure that there is effective dialogue between the organisation and the local community on its plans and performance, and that these are responsive to the community's needs'. Non-executive directors have a clear responsibility to contribute to this by informing the public, taking account of the public's views, and answering to the public. This is achieved in a variety of ways, for example by holding public meetings, consulting with community groups, undertaking public surveys, and inviting local branches of health charities and pressure groups to meet with non-executive and executive directors.

The Code of Accountability also sets out the role of the chairman in relation to non-executive directors. It is the chairman's responsibility to:

- provide leadership to the board;
- enable all board members to make a full contribution to the board's affairs and ensure that the board acts as a team; and,
- ensure that the board has adequate support and is provided efficiently with all the necessary data on which to base informed decisions.

E: Support

One of the major barriers to the effectiveness of non-executive directors is acknowledged to be insufficient understanding of the business, and this experience is shared by the NHS. In response to this problem, the NHS Appointments Commission has produced an Induction Guide for non-executives and also runs a programme of induction training. In addition to this central induction, it is also important for non-executives to have a local induction which can be tailored to reflect individual experience and address specific knowledge gaps. Perhaps a similar concept of both centralised and organisation-specific induction training for non-executives could be applied to the private sector.

In respect of guidance for non-executives, as mentioned previously the role of chairmen and non-executive directors is set out in the Code of Accountability issued by the Department of Health. In addition, the annual appraisal process provides an opportunity for non-executives to receive structured and formal feedback on their performance.