

A Response to the Consultation Paper on the Review of the role and effectiveness of non-executive directors

Foreword

Since 1986 I have been a non-executive director simultaneously or sequentially on twelve boards. These range from major plcs, through medium and small companies to the subsidiaries of plcs. Included are two major organisations which, while not public companies, ran their affairs as if they were in this category in terms of public accountability, organisation and corporate governance issues. I have also chaired audit and remuneration committees.

The following response to the consultation paper should not be assumed to reflect on the organisation, composition or effectiveness of any individual board but to be the result of my own accumulated experience. Above all, these are purely personal observations and should not be attributed to any of my colleagues, past or present

Introduction

The role of the non-executive director, and how this may be made more effective can only be understood within the context of total board dynamics. All boards are different and the role of the non-executive director must be seen in the light of the way in which the executive directors and chairmen relate to one another. To generalise about this relationship is dangerous because, by definition, boards consist of extra-ordinary people in the true sense of the word.

Understanding how the executive directors are inter-relating is a pre-requisite to understanding how a non-executive director might best contribute.

A: Role

1) When appointed to the board, executive directors are sometimes told to leave their departmental interests at the door. This is unrealistic but it exemplifies the concept that the board is responsible for the running of the company in the best interests of the shareholders. This will inevitably lead to strategic and investment decisions and discussion of how assets might best be deployed to the benefit of the long terms interests of the company

As the executive directors also have specific interests, it is up to the chairman to make sure that a balance is kept and that a positive relationship is maintained with the shareholders.

2) Executive directors often appear to act as a united and integrated team. While not excluding non-executives the executives will sometimes support each other to a degree which may not be in the long term interests of the company. It is important that non-executive directors recognise that unanimous support by a proposal from the executive directors does not necessarily mean an informed thought-through position or personal conviction. It is essential that the non-executive directors have enough knowledge, information and self confidence to challenge the apparent united front of the executives.

It is not unusual for key matters to have been discussed and agreed in a management meeting or a meeting of the executive directors in advance of the board meeting. It is then difficult for an executive director to 'break ranks' in the subsequent board meeting however powerful the arguments of the non-executive directors. A change in the agreed position is most likely to occur when the executive directors have a considerable respect for the non-executive(s) putting forward an alternative position.

The key role of the non-executive is to bring to the board his wisdom and knowledge from the way in which other companies and industries operate. Many executive directors find it difficult to 'think outside the box' because their experience of other ways of doing things is limited (this may be particularly so of SEMs). However this role relates particularly to the management of the company rather than to the technical functions within it. For a non-executive director to become involved in the technical work of a department is divisive and non-constructive, unless they are specifically asked for their input.

This means that they should not be selected for their professional or technical expertise but for their broad managerial experience. The exception to this is that there must be at least one non-executive with professional financial training to ensure that the audit committee is competently run.

Thus within the board all non-executive directors should be expected to be able to fulfil each different role but perhaps to a different degree. Today it is probably important to have at least one non-executive with in depth experience of the complexities of remuneration systems.

In practical terms the four key activities are to:

- say 'no' when a proposed activity supported by the executive directors seems unwise or unsound;
- chair the key committees;
- monitor performance;
- ensure that the strategy is in the best interests of the company and that the executive team is competent to carry it out.

3) Although it is possible to consider what role non-executives should perform it is probably unrealistic to try and generalise about how they do so because each company is different and has different board dynamics. Much also depends on the personality of the chairman.

Some boards embrace the non-executives and their contributions, welcoming all interest shown in the company. Others quite subtly exclude them by turning board meetings into a formality, using obscure insider language and obstructing or over-structuring visits to operating units.

4) There is a current concept that if a non-executive director is on a board too long he ceases to be independent. This is an example of box ticking. There can be situations where longevity and an intimate knowledge of the company, its people and its history, can be invaluable and this does not of itself imply a lack of independence.

What must be avoided at all costs is allowing the head of a function to join or continue on the board as a non-executive director after he has relinquished management responsibility for that function.

5) The interaction between companies means that at a certain level of seniority some conflict of interest is almost inevitable. I know of no way of avoiding this except openness and a declaration of interest.

6) At a time of crisis, being a non-executive director can become a full time job and other commitments will suffer. This may be particularly true in small and medium sized companies where executives may need help in a takeover situation or when the executive directors themselves need to be replaced. At such a time a non-executive may have to take over as chairman or become a major player in the executive team. This in my opinion constrains the number and type of non-executive positions any individual can and should take. More generally I believe that a non-executive director should be able to commit at least 30 days a year to the company he joins.

7) Maybe.

8) No.

B: Attracting and appointing non-executives

9) I believe that the most important key skills, knowledge and experience needed by non-executives are in the field of financial literacy, and additionally:

- knowledge of how companies work - this will lead to the demand for non-financial information about the company's performance;
- curiosity;
- understanding of board dynamics.

Non-executives cannot have the same knowledge of the industry or company as the executive directors so they must be willing to ask questions and if necessary make a fool of themselves. They must be willing to speak out but must not dominate.

10) The personal qualities needed are willingness and an ability to truly listen; courage to speak; humility and common sense.

11) Over the last several years non-executive directors have brought to boards their corporate governance experience from elsewhere. This is difficult to illustrate explicitly without breaching confidentiality. This 'cross fertilisation' was also evident in the discussion of IT systems in the run up to 2000 and has also been evident in the general area of managing IT.

12) and 13) Currently it does seem more difficult to recruit non-executive directors. This is partly due to the codes which indicate that a non-executive should only exceptionally serve after the age of seventy and that six years should be the maximum on a board. This means that people who begin to take on non-executive roles at the age of 60 find themselves falling from the lists of the executive search companies at 66 because they could only serve 3 years. There is also an unrealistic drive to hire people in their mid 50s when many able executives are at a crucial point in very challenging careers and do not want to be distracted by any outside involvement however valuable.

It does seem that the pool from which non-executives are drawn has widened with more coming from overseas, and this is valuable but beyond the financial reach of SMEs. As I see the greatest value of non-executive directors to be bringing personal wisdom and knowledge from one industry to another, I am doubtful about the value of introducing people with no corporate experience, I am not convinced of the value of diversity per se but I have seen major contributions made by senior ex-civil servants.

14) I do not believe that the pay levels for non-executive directors are a disincentive because I do not believe that people work purely for money. Being a non-executive is intrinsically interesting and rewarding in other than monetary ways. I do, however, believe that the work load has increased and that the chairmen of the audit and remuneration committees should receive additional fees.

15) Indemnity insurance is essential and should be borne by the company but it can ever cover serious neglect, nor should it.

C: Structures and Accountability

16) The Combined Code has made a major contribution to the debate about how boards should and do operate and has also had an effect on well-intentioned companies who are eager to follow best practice.

Focusing on the contribution of non-executives or the lack of it has in itself improved standards.

I think a further definition of independence might help. The present one is much too simplistic and encourages box ticking rather than serious consideration.

17) Yes. Board meeting procedures work well in companies which want them to. Small boards are more productive and there should be an even balance between executive and non-executive directors where this can be afforded.

18) Currently there is a spotlight on audit committees and rightly so. This could be the most powerful instrument for positive influence by the non-executive directors. Some work very effectively and some are rubber stamps. I would like to see discussion of whether the audit committees of all companies over a certain size should have one member with professional financial qualifications. Such a person must be distanced from the auditors and other financial advisers. Arguably many financially literate CEOs are better at reading audit reports than their more qualified advisers.

19) The quality of those serving on the nomination and remuneration committees is key to the success of the company and the duties of those who serve on the remuneration committee grow increasingly complex.

20) This varies very considerably between companies but there is probably less consistent evaluation than there should be and certainly the performance of the board as a whole is rarely reviewed.

21) Perhaps - I am neither convinced nor sure how this would be done.

22) Non-executive directors can challenge executive decisions and expose serious problems. This is most usually done in committee or one to one with the chairman. Access to the company secretary and the ability to hire outside advice separate from the board or the executive is crucial to this process.

D: Relationships with shareholders and others

I do not believe the non-executive directors represent the company, nor is that their role, so one has to be very careful about the relationship with outside bodies. Further it is important that the non-executives do not undermine the executive directors and their relationships.

However if non-executive directors are concerned about the company and feel they would get constructive advice from the company's advisers were they able to approach them then they should be able to do so.

23) The effectiveness of the non-executive directors is significantly impacted by the behaviour and role of the chairman. If the chairman identifies too closely with the executive directors he can nullify the effectiveness of the non-executives. It is essential that he should ensure that there is a sensible balance between executive and non-executive directors on the board, and in the timings of board meetings due regard must be paid to the likely availability of non-executives. Failure to do this can substantially reduce the contribution of the non-executives.

The Chairman's post is sometimes described as the loneliest job in the world. Some chairmen of a dominating nature do not experience this, but others find that access to one or more non-executives who have an intimate knowledge of the company and whose integrity and confidentiality they can trust is helpful.

This concept cross relates with the discussion of non-executive remuneration and their personal identification with the company. If they are too financially dependent on the company they may not be

prepared to give the unpleasant and contrary advice which is sometimes in its long term interest. They may not be able to take the detached position the chairman needs from them.

The key issue of the relationship between a chairman and his non-executives is whether he sees his role as enabling or controlling. A sarcastic bully can ease a non-executive into silent compliance.

26) The company secretary must always be as available, and helpful, to the non-executive directors as he is to the executives. Access should be unrestricted and he should be able to facilitate outside advice for them when this is necessary and without referral to the rest of the board or the chairman.

E: Support

27) Access to information is usually open and the main problem is selecting significant information. Only once have I been with a company where management tried to restrict the information available to the outside directors. While not refusing information, management can sometimes obfuscate and use technical language in the hope that you will give up. This is not always because they are hiding something significant. Sometimes they are just asserting their power.

Availability varies by company and the key issue is whether you are getting the right information in a timely fashion. Good and timely financial reporting is essential but there should also be other performance measurements against targets. (Many retailers for example can give you daily sales and monthly comparisons with their major competitors. More industries could probably give meaningful data than they currently do).

28) Most of the companies with which I have been associated run indoctrination procedures for the individual but all expect basic competence in management and board skills and a reasonable degree of facility with statistics and financial data. Some with reporting systems which go beyond financial data will give a detailed teach-in on how the data are collected and can be evaluated. I think continuous and regular exposure to the activities of the company outside the board room is important

29) Yes

30) No

F: Smaller listed companies

For the SME the cost of three non-executive directors to man the key committees and perhaps an outside chairman is a very considerable overhead. Also producing the information and backup for the non-executive directors can be expensive and time consuming unless the company is already collecting and using such data. There is also a danger of the non-executive becoming a consultant or adviser rather than remaining objective. This is particularly so if there is only one non-executive director.

G: International context

I do not know enough about this to comment in detail but I believe that any contribution along the lines of 'this is done differently elsewhere' can be constructive if handled in the right way. This elsewhere can be a different company or a different country. To assume that the boards of companies in other countries are better run and more effective than ours is probably fallacious.

Comment

I would be particularly interested to see how any conclusions from this review would impact small and medium sized companies

I am already concerned that the insistence on the separation of the roles of CEO and chairman, while laudable in principle, may be impractical in small companies. Insisting that the key committees should have three non-executive directors could also be a substantial cost to a small company. In an attempt to meet this requirement companies may appoint cheaper people with less competence leading to a counter-productive outcome. Ideally this review should produce some principles which can be extended to smaller companies in a modified form. The important thing is that they should benefit from any changes in practice and in monitoring rather than being forced into expensive and not-necessarily improved management practices.

Ann Burdus

Thursday, 8 August 2002