

The non-existent non-executive

Response to the DTI Review of the role and effectiveness of non-executive directors

2 September 2002

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1.0 Executive Summary

- There is a flaw in the terms of reference for this Review. This is because there is a conflict between law and practice in the UK. The law does not recognise a separate category of “non-executive” director. In law all directors are the same.
- In everyday business practice executives and non-executives are treated differently, but there is no evidence that this separation has led to an improvement in governance. The effective choice is whether to reflect current practice in the law, or whether to change practice to reflect the unitary principle implied by the law.
- The Review should take the second option and recognise that direction of the company is distinct from management. All directors are part time and should have the same contract. Some, “the inside directors”, have a separate role as executives.
- This has implications for the engagement, appraisal, remuneration, training and development of all directors. To fulfil their duties effectively directors should not have more than four directorships.
- Directors owe a duty to the company. They are accountable to shareholders and responsible for the company’s purpose, values and success and for all stakeholder relationships.
- To fulfil these duties the board must widen the scope of its agenda and competence in an inclusive way which covers not only financial risk but the drivers of future success – for example reputation, innovation and key relationships.
- The chairman’s role needs strengthening to reflect the legal position of chairman of the board and to ensure the proper recruitment, operation and professional development of the whole board.
- Targets should be established to reinforce the continuing professional development of all directors. Within 5 years every listed company should have at least two directors who have achieved Chartered Director status. Within ten years every member of the board should have this or be undergoing the necessary training.
- There should be a new corporate governance code for all directors. The code would be values-based, and derived from the “Ten duties of directors” currently being developed by the Commonwealth Association of Corporate Governance. Enforcement of the code should be by disclosure, not box-ticking compliance.

2.0 Introduction

The vision and purpose of the Centre for Tomorrow's Company (CTC) is to create a business future that makes as much sense to staff, shareholders, and society and much of its work is concentrated upon the effective leadership and governance of companies for the achievement of their long term success.

With this interest in mind, CTC has prepared this response to the DTI review of the role and effectiveness of non-executive directors which deals with the key issues identified by the Review, namely:

- What role should be performed by NEDs?
- What knowledge, skills and attributes are needed, and how to find the best people?
- Do existing structures and procedures facilitate effective performance?
- Do existing relationships with shareholders need to be strengthened?
- How can NEDs best be supported?
- Smaller listed companies
- International experience.

The key part of the evidence is to be found in the following sections:

- Section 3 sets out the rationale behind this submission and offers a challenge to the underlying logic of the Review's Terms of Reference
- Section 4 describes CTC's view of the role of the board and its chairman
- Section 5 sets out the need to make all directors better equipped and more professional and suggests the elements that could be included in a new code for directors
- Section 6 sets out a summary of our recommendations.

The appendices cover the following:

Appendix 1 - answers to the questions posed by the review, within the limitations imposed by its terms of reference

Appendix 2 - copy of CTC's paper 'Lessons from Enron'

Appendix 3 - an example of a 'menu style' appointment letter for an independent director.

3.0 The rationale behind this submission

3.1 The context

Corporate governance is ultimately not about structures and compliance, but about leadership and accountability, and the creative tension between them. All good governance flows from clarity about the purpose, the values, the relationships, the responsibilities and the measurement of success in a business.

This inclusive approach to durable success has been forgotten in the UK discussion of corporate governance. All too often this perspective has been narrowed into a preoccupation with financial audit, financial remuneration and financial risk.

Directors need to add value. They should be accountable for the total value delivered to shareholders and stakeholders. A business is not the private property of its shareholders. Nor is it simply a bundle of transactions. It is an economic and a social entity. Economic results are only possible because there is responsibility, trust and loyalty in its relationships. Directors need to understand how all these elements come together to create the success and the survival of the business. They must be able to assure themselves not simply that the financial results are robust but that the constituent functions of the company are healthy, and therefore capable of delivering enduring value.

It is nearly ten years since the publication of the Cadbury Report. From Wickes to Marconi, we have continued to see company failures which can be traced to failures in governance. There has been good work done which sets a clear agenda for the board as a whole. This includes the Chartered Director qualification awarded by the Privy Council and administered by the Institute of Directors, the ICAEW's initiative which led to the Turnbull Committee on risk and the DTI's Company Law Review.

Yet in spite of this work, the prevalent reaction to corporate failure is to look in isolation at the role and performance of "non-executive" directors – that if they are better selected, better paid, less incestuous, or better informed this will lead to effective change in the way companies are led and the way they perform.

The truth may be much simpler and harsher. Independent directors could undoubtedly do more, but why ignore directors as a whole? There is some evidence that links good governance generally with stock market performance. However, there is no research, or practice, which shows "the crucial role played by non-executive directors in improving company performance and accountability" as the introduction to the Higgs Review puts it.

3.2 The non-existent non-executive

3.2.1 The unitary principle

In law, there is no such thing as an “executive director” or a “non-executive director”. The law treats all directors as equal, with a common duty (about to be clarified in the proposed reform of Company Law) owed to the company and one vote each around the boardroom table. Therefore, in law, all directors are effectively part-time, and should be treated as such. Some are internal: apart from their duties in directing the company they have a separate executive role. Some are external: they cannot fulfil their role unless they dedicate sufficient time to place their fingers on the pulse of the organisation, and to manage risk for shareholders by looking beyond financial measurements to the values, behaviours and relationships on which success depends.

This submission therefore follows this unitary principle, which is also consistent with the logic of the Company Law Review. In setting out CTC’s future vision of the roles of different board members, this submission uses terminology that better reflects the unitary principle. The term “independent” is used in preference to “non-executive” and a distinction is made between “inside”(executive) directors and “independent” (non-executive) directors.

3.2.2 Law vs practice: the dilemma for this Review

Everyday business practice does not follow the legal logic, and this is part of the problem. There are two tribes who meet in the boardroom, each with their own chief. The “executives” will usually have discussed matters in the executive committee. The chief executive will do the talking at the board meeting. It would be rare for the “executives” to say anything discordant. The “non-executives” will not usually have met separately, and socially they may move in different circles. In knowledge terms this isolation puts them at a disadvantage, because they may find it difficult to know enough about the technical background to the issues raised or the hidden agendas to challenge the views taken by the “executives”. Unless the chairman is unusually forceful and effective they are in danger of being marginalised.

3.2.3 The real question for this Review

The terms of reference for the Higgs Inquiry may therefore be compatible with much of current practice, which does separate “executives” and “non-executives” but are incompatible with the law as it stands. To comply with the law all directors must take seriously and separately their responsibility for contributing to the direction of the company. It is a role for which they must

have clear terms of reference, good induction and appraisal, continuous professional development, and devote sufficient time to perform their role effectively.

The real question for the Higgs Review is this. Do we want to change the legal position to reflect current practice? This would mean accepting independent directors as a different tribe, and formalising a two-tier board structure with the executive committee as one tier and the independent executives as the other.

Or do we want to follow the logic of the unitary principle, and start to make it work in a more professional fashion? CTC believes the unitary principle is sound. It just needs to be applied in practice. This means weakening the tribal differences between inside and independent directors. It means an important strengthening of the role of the chairman of the company. And it means a fresh approach to the way directors are inducted, developed, appraised and deployed.

4.0 The responsibilities of the board and its chairman

4.1 The role of the directors

Different directors will have different contracts and roles in the organisation. Some directors will be independent. The law and the courts will accordingly expect different levels of knowledge and skill. But on becoming directors of a company all directors effectively go through a change of role.

Executives appointed to the board should therefore remove their specialist, functional hat to which they were appointed by the CEO, with a division or a department to run and budgets to defend and control, and take a view of the organisation as whole, exercising their accountability to the shareholders who have elected them.

The independent directors must equally understand that they owe their duty to the company and that by becoming directors they, along with all their board colleagues, have been elected by shareholders to act as stewards of the long-term health of the enterprise. They cannot fulfil that role unless they dedicate sufficient time to allow them to place their fingers on the pulse of the organisation. If they are to manage risk for shareholders they will need to look beyond financial measurements to the values, behaviours and relationships on which success depends. Fraud may be impossible for them to detect, but it is not difficult for a board to insist on following the behavioural as well as the financial audit trail. (See Appendix Two - Lessons from Enron for an explanation of this concept). This means patiently learning the way the business works.

Within a unitary board, there is a special role for directors appointed from outside. Externally appointed, independent directors are in a special position to challenge their inside colleagues in the discharge of their separate, executive roles. They can bring a different perspective; hold the CEO accountable to the purpose and responsibilities of the company, and monitor and control sensitive matters such as remuneration and audit. The Cadbury Report identified two roles particular to independent directors:

1. reviewing the board and its effectiveness
2. taking the lead where conflicts of interest arise, for example over takeovers, remuneration of executives, or boardroom succession.

In future independent directors will need to be better paid, trained and inducted into their responsibilities, more challenging of and more open to challenge by their colleagues and stakeholders, more visible and dedicated to working in fewer organisations. They will need to spend enough time with their inside colleagues so that the board becomes an effective team, and not, as too often happens, an effective two tier board with the independent and inside directors inhabiting separate universes.

Inside directors should have two contracts and separate and professional preparation for their role in directing (as opposed to managing) the company. As today's inside directors are a prime source for tomorrow's independent directors on another board, the insistence on such training for the inside directors will have a major impact in on the effectiveness of tomorrow's independent directors.

4.2 The role of the chairman

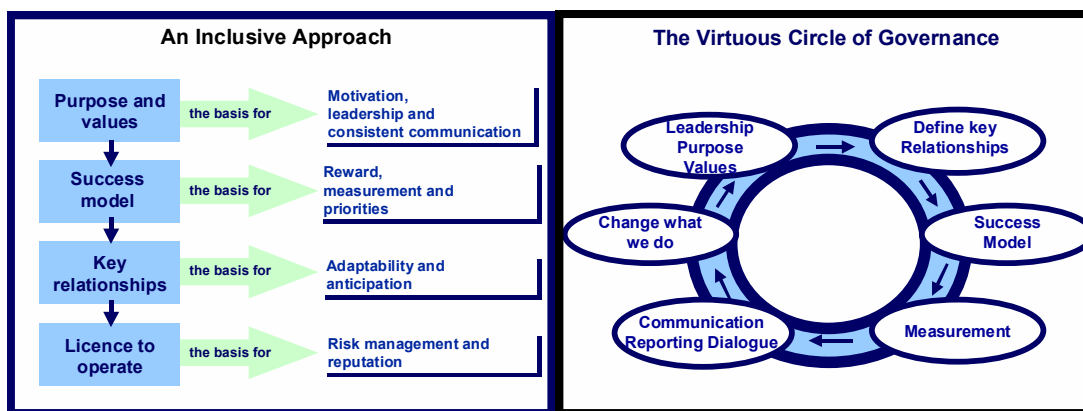
The chairman's duties need strengthening to reflect the legal position. These duties are as chairman of the board – not the company!

It is the job of the chairman to ensure that directors are recruited in a balanced and professional way, and not selected by the CEO or a ruling clique. Once the directors are appointed, it is the chairman's job to ensure that the board has the necessary competence to understand the business and its accounts, and that it acts responsibly, accountably and as an effective team.

Teams are only effective if they have shared clarity about the job they are there to do and respect the division of labour that is necessary among them to do that job.

Having ensured that the board is clear about its own role, the chairman should then ensure there is clarity about:

- the purpose of the organisation – why it exists
- the company's values – what it stands for and what it will not stand for
- the company's key relationships – who it depends on for success
- the company's success model – the combined ingredients of its success
- its strategy – the route by which that success will be achieved
- its measurement – the financial and non-financial indicators it needs that point to future as well as past performance
- its accountability and communication – the processes of dialogue and reporting by which it informs its stakeholders and learns from their feedback.



It is also the chairman's job to review the effectiveness of the CEO. When things go wrong it is for the chairman, in consultation with colleagues, to decide whether changes are needed in the leadership of the organisation.

4.3 Directors and shareholders

Directors have to balance leadership and accountability, performance and conformance. They are the trustees of the long-term health of the enterprise.

The Institute of Directors describes the responsibility of directors as being "to act on behalf of the shareholders of the company and everything they do should be done with that in mind". This advice is only sound if directors recognise that acting on behalf of shareholders is not the same as seeking to inflate the share price or following every trend set by the capital markets. Companies can and should take the initiative in deciding what kind of balance sheet they want to see (for example debt to equity ratio) and what kind of shareholders they want to attract.

Companies are established to fulfil a purpose, and, in the fulfilment of that purpose, to deliver a return to their shareholders. Some companies express their purpose as the creation of shareholder value. Others express their purpose in a broader way, with profitability and distribution of value to shareholders viewed as a necessary pre-condition of fulfilling that purpose.

All directors are there to serve the enterprise, to hold it to its chosen purpose, and secure its future well being. They cannot serve present or future shareholders if they fail to understand the financial health of the business. Equally they will have failed if they do not understand the linkage between the things managers are doing today and the future value and performance of the business.

As shareholders in Marconi will testify, it is also a serious dereliction of any director's duty to believe that directors are simply there to give shareholders whatever they want. To paraphrase Edmund Burke's famous defence of representative democracy 'what directors owe the shareholders who elected them is not their obedience but their judgement'.

It is therefore a mistake to start treating particular directors as special representatives of the shareholders. All directors are elected by and accountable to shareholders. In fulfilling their duty to the company they may need to confront the CEO on behalf of shareholders, or equally confront the shareholders in order to defend the company over the short, medium and long term against the pressures brought by them.

5.0 Company direction as a practical profession

5.1 The role and responsibility of the director: separate contracts

All directors need to be given separate contracts for their services as directors and paid equal fees. Some of the directors would be independent, the rest combining the role of director with executive responsibilities in the same organisation. This means that executives who are also directors will have two employment contracts – one as a director and one as an executive. Each would specify roles, tasks and accountabilities and the time commitment. The practice of "directing" the company would therefore be given proper acknowledgement as the prime method of adding shareholder value across the business. (See Appendix Three for a 'menu style' appointment letter for an independent director).

All directors should:

- expect to receive appraisal on their performance as directors at least annually
- undertake continuing professional development as a norm.

The board as a whole should review its collective performance. While due respect should be paid to past experience and practical judgement, it should be recognised that experience in one context may not necessarily protect the company against risk in another: hence the importance of all directors following a rigorous process of review and development.

5.2 The director's understanding of duties and responsibilities

One of the most surprising findings of the RSA Inquiry Tomorrow's Company was that directors did not understand their duties. In legal terms, this will be clarified by the new statutory statement of directors' duties under the proposed reform of Company Law.

The recent White Paper on Modernising Company Law rejects the recommendation that directors be required to sign a statement to the effect that they had read and understood their duties (Modernising Company Law, paras 3.15 to 3.17). Instead, every new director will continue to receive a leaflet setting out their duties.

There is a limit to what government can achieve. Leaflets, however well designed, will not be enough. All directors need to become more professional. This process starts with understanding their duties as directors.

In the long term, developments such as the IOD's Chartered Director programme could be used to ensure that directors understand the duties unique to the role, and are equipped to fulfil them. We propose a new target: that within 5 years at least 2 members of every listed company board will have qualified as a Chartered Director, and within 10 years every listed company director will be undergoing or have completed this qualification.

Care should be taken, however, to avoid the impression that the acquisition of a professional qualification is any guarantee of commercial judgement. Boardrooms need to strengthen the rigour of their governance and the clarity of their processes through this professionalisation, but without weakening the value placed upon business experience and judgement.

There are other moves towards professionalisation of all directors. The whole spirit of the Company Law Review, which CTC supports, has been to give companies freedom but make them accountable through disclosure.

The last thing we need is another round of box-ticking compliance. What is needed is a values-based code drawn from practical experience, and disclosure by listed companies of the steps they are taking to abide by the code. This approach could be adopted /reinforced by building on the comprehensive “Ten duties of directors”.

5.3 The Ten duties of directors

The “Ten duties of directors” are particularly apt, because of their origins. The Commonwealth Association for Corporate Governance (CACG) was formed out of the recognition that it is not declaration by government, but self-help and initiative by practitioners that could do most to improve the standards of governance across the widely differing circumstances of 54 Commonwealth countries.

The spirit of CACG, and their approach, is not only global but also very close to the spirit of “Think Small First” which has been a priority in the Company Law Review.

In 1998, CACG published a Code of Good Practice for Boards developed by practitioners across six continents. It then went further, commissioning the author and corporate governance expert Bob Garratt to develop the “Ten duties of directors” which are a set of globally applicable duties for directors and boards. He reports that in China, the Muslim world and in South East Asia they have been readily accepted as the basis for good practice in corporate governance.

They are summarised here by permission of Bob Garratt. They are available on the Commonwealth Business Council Website (www.CBC.to) and are as follows:

1. Legitimacy: upholding the law
2. Upholding the three fundamental values of Corporate governance:
 - Accountability – corporately as a board and individually for directors’ actions on behalf of owners
 - Openness
 - Probity – the responsibility to act honestly and in a trustworthy manner, never putting personal interests or the interests of another organisation above those of the company
3. Transparency - openly following an agreed and rigorous process of decision-making, and a willingness to be appraised for effectiveness in doing so
4. Upholding the primary loyalty of a director – which is to the company
5. The duty of care – to exercise the roles and task of a director competently
6. The duty of critical review and independent thought

7. The duty of delivering the primary roles and tasks of the board: formulating policy, strategic thinking, supervising management ensuring accountability
8. The duty of protecting minority shareholders
9. The duty of corporate social responsibility
10. The duty of learning, developing and communicating.

5.4 A new code of practice

The ten duties offer a framework, which could be widely adopted as the basis by which all directors could understand and continuously develop towards a fulfilment of their duties.

Out of these ten duties the UK could evolve its own code of practice which moves away from the narrowness of past codes and addresses the need to treat all directors as a single group. We therefore propose that the Review develops a new code of practice for all directors based on the commonsense principles embodied in the ten duties. The code would be designed to work in line with the spirit and intention of the Government White paper “Modernising Company Law”.

6.0 Summary of recommendations

- a new corporate governance code for all directors should be established. This would be in line with the unitary principle, and the spirit and logic of the Company Law White Paper. The code, which would be values-based, would be derived from the draft “Ten duties of Directors” currently being developed for the Commonwealth Association for Corporate Governance. It would set a standard against which companies could report and cover
 - the difference between duty (owed to the company) accountability (to shareholders) and responsibility (in all stakeholder relationships)
 - level of competence and continuing professional development for all board members
 - time commitments for all board members
 - appraisal and review for all board members
 - model letters of appointment
 - the right of any director to table any item for discussion
 - the support needed for directors to fulfil their function

- executives who become directors (described by CTC as “inside directors”) should receive and sign a clear letter of engagement, separate contract, training and development, separate appraisal and remuneration for their role in directing (as distinct from managing) the company
- independent directors (previously known as non-executives) would receive the same.
- because of the need for every director to be trained, prepare and make regular site visits and talk to shareholders and other stakeholders, this will in practice mean limiting the number of independent directorships undertaken by an individual to four with a significant increase in remuneration
- the chairman’s duties need strengthening to reflect the legal position. This as chairman of the board (not the company). In this role, the chairman should ensure
 - the balanced and professional recruitment of the board
 - the integrity, competence and accountability to the board of the CEO
 - the board’s clarity and unity about the purpose, values and strategy of the organisation
 - clear contracts, letters of engagement, appraisal and professional development for all board members
 - that the board agenda covers not simply financial risks and results, but the drivers of future success – reputation, innovation, key relationships
- professionalism: within 5 years every listed company should have a minimum of two directors who have completed the Chartered Director qualification awarded by the Privy Council and administered by the IOD. Within 10 years every listed company director should be undergoing or have completed this qualification
- disclosure, not compulsion, would be the key influence. In reporting on their response to the new code companies would report on:
 - time spent by each board member on direction of the company
 - the continuing professional development of each board member
 - the statement of reasons for any director leaving the board.

It should be recognised that different considerations apply in smaller companies, and those where ownership may be different. In some companies management may have a strong stake, or the controlling interest may be held by venture capital. Others may be employee owned. The code should be flexible enough to guide the principles of governance without specifying the amount of time, remuneration or number of independent directors required.

Appendix One

The issues posed by the Higgs Review

What role should be performed by NEDs ?

They are part of a unitary board, owing their accountability to shareholders but their duty to the company. As suggested in the draft statement of directors duties in the DTI Company Law Review, the basic goal of directors should be the success of the company in the collective best interests of shareholders, but that directors should also recognise, as the circumstances require, the company's need to foster relationships with its employees, customers and suppliers, its need to maintain its business reputation, and its need to consider the impact on the community and the environment.

All directors are there to seek to ensure that the company has the right strategy, the right resources, and the right behaviours. Within this unitary framework the unique contribution of independent directors is that of independence but this can only be effectively carried out in a context of:

- good induction and training. Regular exposure to real people across the business and its relationships
- shared purpose and values throughout the board
- sufficient time – the commitment will vary with the scale of the enterprise but we suggest that for every formal day of attendance (board meetings, board subcommittees, AGM), it should be assumed that an independent director spends a minimum of two days in preparation, whether this means studying papers, discussing issues with board colleagues or executives, plus further time talking to shareholders and people inside and about the business. For international and geographically dispersed businesses time for travel needs to be added to this to calculate the number of days.

What knowledge, skills and attributes are needed, and how to find the best people?

All directors, whether executive (inside) or NEDs (independent), should agree upon appointment to undergo a programme of learning and development. Each director would agree with the chairman what learning is suitable and the director and the company would make a commitment as part of the terms of engagement of the director that this learning is ongoing and progress on it will be reviewed by the chairman once a year. In the fullness of time every director would be expected to have qualified as a Chartered Director (the IOD's

professional qualification). Within 5 years from now at least two members on the board of every listed company should be a Chartered Director. Within ten years all board members should have or be undergoing this qualification.

There should be greater diversity in the sourcing of independent directors, providing those coming from outside a strong business background are prepared to undergo a full business induction. For example at BG, NEDs without previous experience agreed to take training in the full understanding of the business which ranged from visits to see pipe laying through to introduction to the reading of the balance sheet.

Given the greater risks, and the time that is needed for independent directors to do their work properly, the public needs to understand that the pay of independent directors of a major FTSE 100 company with international reach will have to be increased substantially.

Do existing structures and procedures facilitate effective performance?

There is at present inadequate focus on the purpose of the company and the drivers of its success. There is too much reliance on existing financial reporting. Too little effort is made to review key elements of future success, such as culture, succession, reputation or customer loyalty. As a result shareholders are exposed to additional risk. In particular the behavioural audit trail needs to be followed with the same rigour as the financial. (See Appendix Two - Lessons from Enron). But this cannot be mandated by any new code. The new Company Law Review framework and the Turnbull Code are there to be used but will only provide protection if directors define opportunity and risk with sufficient breadth.

Too little time and access is allowed for independent directors at present to expose themselves to ordinary people who work in the business and to feel the pulse of the organisation. In Enron an outsider who flew into Houston for a board meeting and flew out again the next day was unlikely to get behind the rhetoric to the reality.

All directors, including independent directors, should be able to decide for themselves which sites they want to visit anywhere in the world and procedures should allow for these visits to be accommodated with a minimum of advance warning.

There should be an annual process of individual and mutual appraisal between the chairman and each board member, and the Annual Report should confirm that this has happened, together with any outcomes from it.

Do existing relationships with shareholders need to be strengthened?

The relationship with shareholders should revolve around the chairman and CEO. In the event of dissatisfaction with this relationship, then there should be shareholder access to the independent directors as a body.

It should be remembered that institutional shareholders cannot represent individual shareholders. Independent directors need to explore ways of making themselves reasonably accessible to the concern of these and other stakeholders.

The experience of companies backed by venture capital offers is instructive, if only because they see it as part of their role to support and equip independent directors to do a good job. As a result the accountability and objectives of independent directors are clearer. For example 3i also invest heavily in the sharing of experience and learning among different directors.

How can NEDs best be supported?

3i have extensive experience in training and supporting independent directors so that they learn from each other and support each other. In Appendix Three is an appointment letter for an independent director. This is taken from the book “Running board meetings” by 3i Director, Patrick Dunne.

In BP, a unit exists to support independent directors and help them obtain information that they need.

Directors should understand that they have the right to table any matter for consideration by the board through the company secretary, and the company secretary should be empowered to achieve this.

Smaller listed companies

It should be recognised that different considerations apply in smaller companies, and those where ownership may be different. In some companies management may have a strong stake, or the controlling interest may be held by venture capital. Others may be employee owned. The code should be flexible enough to guide the principles of governance without specifying the amount of time, remuneration or number of independent directors required.

International experience

See Appendix Two for CTC’s “Lessons from Enron” paper. This paper outlines a series of questions designed to help directors identify the “behavioural audit trail”.

Appendix Two

Lessons from Enron – by Mark Goyder

Enron is an extreme case. The scale of shareholder value destruction is still to be counted. The fraud and the linked shredding of documents by one of the world's leading accounting firms, are still being investigated. But can general conclusions about good governance be drawn from Enron, or is it an isolated case, an exceptional scandal?

There are many views about Enron and the lessons to be learned. We have heard about the role of the auditors and the Audit Committee; differences between the UK principle based and USA's rule based system of accounting; the need to separate audit from consultancy and the role of the non-executive directors. In recent speeches and media interventions, Peter Wyman of the Institute of Chartered Accountants of England & Wales has been telling us that there is no systemic failure; that if this had happened in the UK the accounts would have flagged everything that was going on. I don't think this is good enough.

I find the current debate extraordinarily narrow. What it ignores is the reality that a company is a living entity, not a machine. Consider a human analogy. If we want to help someone to stay lean and healthy, we have to do more than merely take his or her pulse. We have to understand the risks to their health and their motives and characteristics that may put at risk our attempts to make them healthier.

..a company is a living entity, not a machine.

The accounting and audit systems are useful sources of information about the health of a company. But on their own they provide no guarantee of that health. They will not tell you about the motivations driving the behaviour of managers, or the likelihood of anyone acting decisively to deal with uncomfortable outcomes from the audit.

The existence of a group of non-executive directors may seem reassuring, alongside the panoply of independent committees such as the auditor and the remuneration committee. But take two companies with similar financial performance and governance arrangements. In the first shareholders may find nothing to lose sleep over: in the second they may find a disaster waiting to happen. The differences are human. Who dominates whom? What are the pressures to massage the results? Who dares to ask embarrassing questions? What are we here to achieve – the earnings we promised this year or value in the long-term? What is the way we all behave round here?

What is the way we all behave round here?

I was recently visiting a large quoted company, which was involved in an acquisition that had recently turned seriously sour. All kinds of cost overruns and customer claims started to emerge in the year after the deal was done. I asked one of its directors what he had learned from the experience. He told me that he was dissatisfied by the way they had gone about their due diligence. To have done the job properly, he believed, they would have had to have uncovered the underlying culture and behaviours of the organisation. As he had got closer to the acquired business over the past year, he had discovered that it had a culture in which people were terrified of admitting mistakes and therefore accustomed to covering things up. The usual due diligence would not have worked. The questions they should have asked, which they never asked, were about the ethics of the

organisation and the appetite for bad news. Any organisation scoring low marks on these criteria could not be regarded as having trustworthy management information and the existence of traditional audit would have been no protection. Or, as he summarised it to me:

“A culture of fear is always a danger sign you should look for in your due diligence. If people are afraid, they learn to cover up bad news.we had no tools to look for this.”

...reviewing the technicalities of auditing and accounting is not enough.

The Sunday Telegraph (3rd May 02) gives another example:

“Lord Hindlip, the chairman of Christie’s, has admitted that he had prior knowledge of the price-fixing arrangement with Sotheby’s which scandalised the auctioneering world. Lord Hindlip said he ‘knew something of what was going on’ with regard to collusion by the two companies, which has left two Sotheby’s executives facing jail in America. ‘It was such a blinding failure’ he said. ‘It was perfectly obvious it wasn’t going to work. Well perfectly obvious to me it wasn’t going to work. ‘I told them [the other executive] I didn’t think it was very clever idea.’”

This is not new. The common feature of nearly every corporate disaster is that afterwards, you will find good people inside the organisation who will say, “If anybody had asked me I could have told them something was not right.” It was true in Marks & Spencer, in Maxwell, in Christies and it was true in Enron where the FT tells us that executives kept asking how on Earth the rest of the company could be making money if it was managed as their part was managed.

That is why reviewing the technicalities of auditing and accounting is not enough and certainly will not tell us whether “it could happen here”. Take a closer look at Enron.

Avoiding another Enron

“Respect Integrity Communication Excellence”

These, we are told, were the stated core values of Enron. They were the words that appeared on banners in Houston. But, as a recent Financial Times report by Joshua Chaffin and Stephen Fidler shows, they do not describe the behaviours through which people in Enron would be rewarded or promoted. Employees say Mr Lay’s true interest was performance. The flaw was that performance, as defined by Enron, was limited to actions that boosted the company’s bottom line – and ultimately its stock price.

“There were no rewards for saving the company from a potential loss. There were only rewards for doing a deal that could outwardly be reported as revenue or earnings’ says one former employee. FT, 9 April 02, p 30.

A savage peer review process, called the Performance Review Committee, had the effect of instilling fear into people who might otherwise have challenged the integrity of the off-balance sheet arrangements. People worried that if they negotiated too hard on behalf of Enron with the ‘arms length partnerships’¹ (which had been set up to transfer risk from Enron’s balance sheet) they would suffer because the people

¹ ‘Arms length partnerships’ were apparently separate businesses set up by Enron managers and directors to trade with Enron without the usual accounting transparency: they were effectively conspiracies by Enron managers against Enron shareholders

responsible for the partnerships were also responsible for the peer review. An aggressive clique of ambitious young managers was promoted to run the new businesses created by Enron.

“These guys understood the game which was get earnings, get earnings, get earnings” said one former employee.’ ‘They knew how to use mark to mark² accounting and aggressive projections.”

This is an old, old story and there will be more, unless we seriously apply an inclusive approach to governance. How could non-executive directors have managed their risk and the risk carried by the shareholders and stakeholders whose savings and livelihoods were being jeopardised? At the moment all the argument is about the failure of the Audit Committee to spot the conflict of interest between consultancy and audit. Much less attention has been paid to a far more common-sense line of questioning that could have been adopted by any non-executive director.

Way back in 1995 the Tomorrow’s Company report suggested boards (executives and non-executives) should ensure that the following questions were being asked.

Company purpose and values

- Have we adopted a clear statement of purpose?
- Have we adopted an explicit statement of values which indicates how the company will conduct business and behave in its key relationships?

Key relationships

- Do we know which relationships are crucial to the success of the business?
- How do we ensure that the company is maintaining consistent and open two-way communications with people in all relationships?
- How do we ensure that the risk of failure is being managed?

Success model

- Have we adopted a success model for the company, which demonstrates how value is added?

Measurement

- Do we review the company measurement system annually against its ability to support our goals, purpose, values and key relationships?

Reward system

- Do we review the reward system against its ability to reinforce business goals and motivate the right behaviours? Do we monitor positive behaviours such as teamworking and empowering?
- Do we seek reports on levels of behavioural risk in key areas of the business?

Fiduciary responsibilities

- Are we satisfied as fiduciaries that we are acting in the interests of the general body of shareholders as it exists from time to time and not simply current shareholders?

These questions are not technical. They are common sense. They point to a behavioural audit trail. They ask; what do we demand of people? How do we know if

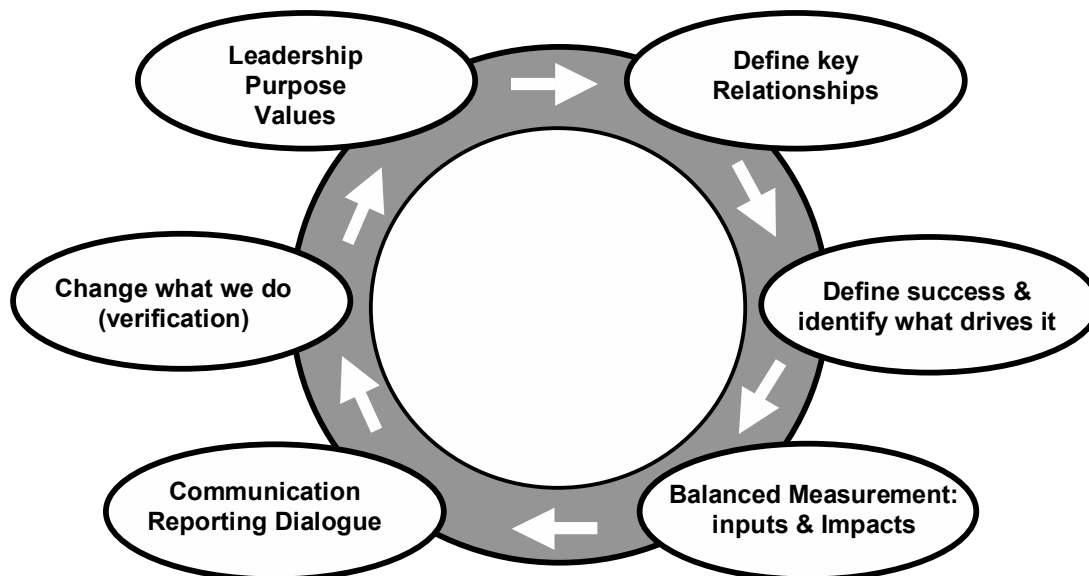
² ‘Mark to mark’ accounting is another name for booking anticipated profits before they have been earned.

we are getting it? What kind of performance are we looking for? If it is purely financial, what is our protection against fiddling and fraud? The subtext is: never mind the fine words: what kind of behaviours actually get people bonuses and promotion round here? Never mind the carefully honed numbers that keep fund managers happy. What is really going on in the business and how robust is it? Non-executive directors need to know what kind of behaviours get rewarded in the business. They need to have their own ways of connecting with the real DNA of the business. How often did any non-executive director in Enron ask a question such as:-

- Can we say that respect is one of our key values?
- How do we audit whether we live by that value?
- Can I see the recruitment criteria for senior positions? Are the values reflected there? “
- Can I see the criteria used by the Performance Review Committee?
- Are the values reflected there? Or are they simply words?
- What is the secret to getting on in your career in this organisation?

A non-executive director in Marks & Spencer five years ago, before the collapse in the company's share price, could if he had asked the right people, have discovered that the HR department wanted to do an employee attitude survey, but felt unable to do so, because they feared that they would not be allowed to publish the results if these were unfavourable. These are the danger signs in organisations that have become too complacent or too narrow in their view of success.

The truth is that purpose, values and relationships are the leading indicators that tell you something is wrong before it hits the bottom line. If you focus on financial indicators, you will be too late. The Enron story reminds us that many people inside the business know that things stink long before the whistle is blown. And people on the edge of the business have the opportunity to manage their risk by following the behavioural audit trail. Of course we need proper protection against conflicts of interests and greater seriousness and independence in the conduct of the Audit Committee. But as long as we see governance in narrow terms and seek new technical rules to guard our companies against fraud, these things will continue to happen. We need a values-based, as well as a compliance-based, approach to governance, based on what CTC calls the *'Virtuous Circle of Governance'*.



Part of the reason for failures like Enron, is that our investment system is losing its grip on the concept of long-term shareholder value. The investment community has shifted the emphasis from shareholder value to share price. Companies can be congratulated for increasing shareholder value when all they have done is (often temporarily) boosted the share price. Companies can be accused of destroying shareholder value when the share price goes down. Yet, as the technology boom reminds us, the share price is heavily influenced by opinion, assumptions, sentiment and investors' beliefs about which way other investors will jump. It has become an increasingly poor indicator of the underlying health of the business.

There can be no better example of this subversion of shareholder value than the Marconi case. A few months ago Marconi's former CFO gave an account of his actions in the Financial Times. He produced figures to demonstrate that, in terms of total shareholder return during his term of office, the company had really done quite well. His biggest regret, he went on to say, was that he had failed the board by not selling the company to someone else when the share price had gone down to £7, well off its high of £12 but long before it collapsed to under 20p. In other words, the value-destroying decision to put all the eggs in the telecomms basket was not the biggest mistake. The real failure was not cashing-in in time by finding someone else willing to take on this basket case. This is what is sometimes described as the 'greater fool' school of shareholder value: it doesn't matter how foolish your strategy, as long as you can find a greater fool to take it off your hands.

This is a corrupted view of shareholder value. It concentrates not upon the organic capacity of a company to create future value, but on the potential to come out ahead after undertaking a series of transactions. It is instructive to observe the difference between Marconi and BAE Systems, the company formed from the acquisition by British Aerospace of all the GEC Marconi defence operations. Here are two companies that restructured themselves. In BAE Systems there was a leadership who believed in making profound changes in the attitudes and the competence of the people running the business, so that the new company was ready for the challenges that lay ahead. In Marconi the attention was on reshuffling the portfolio and not on the development of the capabilities of those running the business.

The primary pressures to which most business leaders have to respond are the perceived shareholder pressures. Without an inclusive approach, the risk is that what shareholders will get is what Enron gave them – earnings today and nothing tomorrow.

There is an expectations and timescale problem. As a German working in the USA put it to me: "You Anglo Americans are all the same. You want the harvest at Easter." Research last year by Fortune magazine showed that of the top 150 American companies over the last 40 years, only three or four have been able to sustain earnings growth at an average of 15% a year for a 20 year period. But, as Terry Smith has pointed out (article in FT Business News, 3 Feb, 02), this does not stop many CEOs from claiming that they will double earnings within five years, equivalent to compound growth of 15% a year. CEO tenure has shortened. Rewards for executive performance are increasingly linked to share price over periods significantly shorter than the investment cycle of the industry or the time taken to effect cultural change or to implement strategy. And, of course, we have stopped rewarding CEOs for long-term

performance. More and more we are giving them stock options – an incentive for them to manipulate upwards the price of the business rather than its ultimate value.

Some questions for...

So here is the agenda which I would like to offer to the many bodies that will play a part in ensuring that the Enron story is not repeated here.

...boards

You are the company's ethics and risk committee. Clear your agenda so that there is time for the serious examination of corporate values and the gap between what is preached and what is practised in your company. It may tell you more than the report of the audit committee. Ask repeatedly what kind of behaviours and what kind of managers get on round here? Do the answers fill you with confidence? If not, dig deeper.

Are you encouraging a game of presentation, rather than underlying substance

...Institutional shareholders

Re-examine your time horizons. What kinds of performance are you rewarding and how durable is it? Are you incentivising people to boost the share price without regard to the future? Challenge the remuneration. Is it one-dimensional? If it is, how can you be sure that you are getting real or cosmetic improvements?

Question CEOs about the kind of atmosphere and culture they seek to create in their companies. See if they are managing the risks that go with big rewards for performance. You are right to invest a lot of credibility in CEOs and teams who deliver what they promise. But how much do you trust the earnings reported to you? What about cash and what about the underlying health of key relationships in the business? Are you encouraging a game of presentation, rather than underlying substance?

...Pension trustees

Question the more active of your fund managers. What are they doing to promote the underlying health of the businesses they invest in and to manage the risk around values, culture and governance? How are they rewarded? Are they encouraging an approach that delivers expected numbers at the expense of building value for the future? Is this what you want?

...Company secretaries

Open up the AGM. Encourage awkward questions as an insurance policy and a sign that the CEO and chairman of your company are role models for open behaviour.

... the Remuneration committee

Is your approach to performance one-dimensional? If it is focussed on total shareholder return - over what timescale? How are you protecting tomorrow's shareholders against today's creative accounting? Where in the remuneration system are you sending signals that results are not to be achieved at any price to the values and integrity of the organisation?

...Business Journalists

How often do you ask the CEOs you profile about the things they are doing to ensure the business is still robust in ten years time? Do you ask them about the ethos of the business? Is the emphasis exclusively on performance and the next few quarter earnings? What about following the behavioural audit trail? Do you talk to employees and customers and at the underlying health of the organisation that is expected to continue delivering these results?

Conclusion: an inclusive approach to governance and risk management

The company is a living system. Employees are its life-blood. Management is the heart which keeps the blood pumping. Strategy is the brain and measurement and communication the central nervous system. Culture is the DNA. Leadership and continued entrepreneurial energy are its soul and spirit. Governance and accountability are its rhythms and disciplines, like exercise, a means of keeping this living organism fit and lean. Unless we understand governance in this wide context, we will continually fail to manage risk, sustain performance and earn trust.

July 2002

Appendix three

The ‘menu style’ appointment letter for an independent director*

Objective: To align the expectations of the company and the independent director (ID) from the outset and set the tone of the relationship.

Method: A brief punchy letter between the company and the ID. Where the ID is a nominee there will also need to be a nomination letter from the shareholder concerned.

Points to cover

- background to appointment
- formality of appointment
- basis of ID role
- if chairman, additional description of chairman’s role
- how the ID will gain familiarity with the business
- information flow
- membership of board committees
- meetings with auditors
- intended term/rotation, termination process
- time commitment
- notification of other appointments
- fees and how payable
- insurance arrangements
- independent professional advice
- review process
- security

Background to appointment

For example: ‘Following our recent MBO/MBI/raising of investment capital/acquisition of/decision to move into the German market etc the board has decided it could benefit from the appointment of an/additional independent director/chairman.’

Formality of appointment

The board has/will approved/approve a resolution appointing you as a director; as from 1 January 200* the terms of your appointment as an independent director of this company are

set out in the following paragraphs. I understand X has set out the terms of your nomination in a separate letter.

Basis of the independent director role

Independent directors have the same responsibilities to the company as any other director.

Your primary role is to:

- bring an independent and broad view to the board
- be involved in the creation of a robust strategy
- review and monitor the detailed plans and budgets needed to make it work.

We expect you to provide practical guidance in a wide variety of other areas including:

- being a confidential sounding board for the directors
- enabling the board to make best use of time so that sufficient consideration is given to the development of strategy and the management structure
- objective assessment of the company's performance and guidance on the principles of corporate legislation and compliance
- financing
- communication with customers, suppliers, government authorities and, most importantly, employees
- ensuring the board has adequate systems to safeguard the interest of the company where these may conflict with the personal interests of individual directors, eg to exercise a duty to the company in such areas as board remuneration
- ensuring that all shareholders are being provided with sufficient and timely information with which to monitor the performance of the company
- to help ensure that the company maintains a high standard of executive leadership
- to help ensure that the company makes and implements proper and timely plans for management successions.

Chairman's role

(if an independent chairman is being appointed)

- to lead the board in the determination of its strategy and in the achievement of its objectives
- to take responsibility for organising the composition, business and efficiency of the board
- to ensure the board has accurate and clear visibility of results achieved and likely trends

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- to ensure board committees are established and adequately composed
- to take responsibility for ensuring effective relationships are maintained with all major stakeholders in the business: shareholders, employees, customers, suppliers, government, industry, etc
- to take overall responsibility for enhancing the company's public standing
- to take responsibility for developing a strong working relationship with the chief executive/managing director and ensure there is clear definition and agreement of the division of responsibilities.

How the independent director will gain familiarity with the business

Obviously the ID will have had extensive information (written and verbal) in getting to this point so the list below is over-comprehensive.

- we are delighted to provide you with the attached information pack containing:
 - copies of the last five years' audited accounts, together with the management letters from our auditors
 - management accounts for the year to date
 - a sample of our promotional literature
 - general information about the company
 - our latest strategy (four-page business plan exec summary)
 - an organisational chart/CVs of board members
 - our 'Who's Where' telephone guide
 - shareholding analysis
 - memorandum and Articles of Association
 - a summary list of our current banking covenants and the terms investment by X
 - papers and agenda for our last board meeting
 - list of key dates
 - latest company newsletter.
- during your first three months of office we would like you to visit each of our three sites and spend one day working in the business at a front-line level
- as a first project we would like your informed views on how effective our current contract review process is
- we would like you to take part in our board awayday at Noggings Hotel on 10 January 200* (papers attached)
- we would like very much, if you agree, to do a profile of you for the next edition of our newsletter. Jane Banks will be in touch to discuss this with you.

Time commitment

Overall we anticipate two days/month after the induction phase. This will include:

- our monthly board meetings, one of which will be on the same day as the AGM. Board meetings are held at our three sites in rotation
- our annual board awayday
- half a day at our annual customer exhibition
- the staff Christmas party!

Any time commitment above and beyond that currently envisaged will be paid for as described below

Information flow

On a regular basis we would expect to provide you with:

- monthly management accounts
- board discussion papers
- information on any other matters material to the board.

Notification of other appointments

We will expect you to discuss potential new appointments with our chairman and keep us informed of any changes.

Membership of board committees

We would very much like you to become a member of our audit/remuneration/ appointments committee/s. The composition, terms of reference and recent papers of this/these committee/s are attached.

Meetings with the auditors

We would expect your to have an annual meeting with our auditors to discuss relevant matters. Our current audit partner is R Moxill of Grabit and run (tel no).

Intended term/rotation/termination process

We are appointing you with the intention of the appointment lasting for a three-year period subject to annual review and termination by either side on a month's notice. There is to be no compensation due for loss of office.

Review process

We think it would be a good idea for you and I (the chairman) to have a discussion as to how the appointment is working out after the initial three month induction phase. Thereafter it would be good practice for us to sit down annually and discuss effectiveness. I would hope and expect in the interim if there were any matters which caused you concern about the role you would discuss them with me as soon as is appropriate for you.

Fees and how payable

The fee payable to you will be £20,000 per annum payable monthly in arrears. I understand you would like this paid to your company IND Ltd. You should submit your invoice before the 21st of each month to ensure you meet our payment run.

Reasonable out-of-pocket expenses incurred by you in carrying out your duties will be reimbursed. To obtain payment please submit one of the attached expense claim forms.

If you have incurred unforeseen, but agreed, extra time on our behalf over the anticipated 24 days pa, we will make an additional payment of £1,000 per day.

Insurance obligations

We expect you to make your own arrangements with regard to directors' and officers' liability insurance.

The company purchases and maintains directors' and officers' liability insurance for all of the directors with a current indemnity limit of £10 million. Our Finance Director, John Honest, will be in touch with you to arrange details.

Independent professional advice

Occasions may arise when you need to seek legal or financial advice in the furtherance of your duties. If this arises and you wish the company to pay for it you must give prior written notice to the chairman of the subject of such advice and an estimate of the level of expenditure to be incurred.

Security

Our three sites have a card security system to control entry. We would like you to have free access to the business. Could you contact our Personnel Manager, John Henry, to arrange your card?