

REVIEW OF THE ROLE AND EFFECTIVENESS OF NON-EXECUTIVE DIRECTORS

Introduction

- 1 In compiling its response to the consultation paper on the role and effectiveness of non-executive directors, the Chartered Management Institute sought views from members of its Management Leaders Panel in the form of written submissions and by means of two policy discussion forums. Panel members are drawn from the top echelons of organisations across all sectors – public, private and not-for-profit – and have been able to draw on their considerable experience in a number of relevant roles.
- 2 In responding, the Institute has chosen to focus on those areas where, as the champion of professionalism in management, it believes it has a particular contribution to make to the debate in terms of raising standards and performance and sharing best practice.

The current situation

- 3 The role of non-executive directors has been denigrated in recent times in the light of high profile scandals and spectacular failures. Not only have these called into question the competence and diligence of boards of directors, but they have made the job more demanding by placing much greater emphasis on the role. It is a valuable role – and of which there are many good examples - but one that calls for the highest degree of professionalism.
- 4 Standards of corporate governance have improved since the introduction of the Combined Code, but the situation is more variable than may be implied in the consultation paper in terms of its impact on board effectiveness leading to greater UK productivity and competitiveness.
- 5 There is a need to professionalise the role of the non-executive director, in terms of the competence and diligence demanded and in the training required to bring people up to standard. It needs to be viewed as a worthwhile and desirable role requiring a particular set of skills, knowledge and understanding that can truly make a difference to the success of an organisation. It needs to be valued by those within the organisation and well regarded by those outside if it is to attract candidates of high calibre.

The role of the board

- 6 In broad terms, the role of the board is to ensure the organisation's prosperity, to agree strategic direction, to oversee executive management and to be accountable to the various communities of stakeholders. Its areas of responsibility are to:
 - determine the main aims of the organisation and ensure that there is a sound strategy in place to achieve them
 - ensure that there are sufficient human and financial resources to enable the organisation to pursue its strategy, and to approve their allocation

- ensure that the executive acts within agreed policies and guidelines approved by the board
- monitor performance against the strategic and financial objectives and initiate any necessary corrective measures
- be responsible for the selection, monitoring, compensation and succession planning for the senior executives
- ensure compliance with statutory obligations and appropriate standards of corporate governance.

In addition, the board should have a view as to how it wishes to operate, monitoring its own performance and redefining its role in the face of changing circumstances.

- 7 However, the precise nature of the non-executive director's role can differ from one organisation to the next, depending on the nature of the organisation, its size, structure and stage of development. In a small organisation, for example, in addition to fulfilling statutory obligations, a non-executive director may act as mentor, guide and support to the chief executive, whereas in a larger organisation, emphasis is more likely to be on the strategic, monitoring and governance functions. Tight definitions of the role are unlikely to be helpful to organisations across the board, because of the differing contexts in which they operate.

Underlying principles

- 8 Despite the differing contexts, there are a number of underlying principles that are common to the role.
- 9 There must be clarity between the role of the non-executive directors and those of the management team. It is not the role of the board to become involved in the operations of the organisation; that is the preserve of management. Even when the role of chairman and chief executive are combined – which can be desirable in small entrepreneurial companies – distinctions should be drawn between the roles at board meetings and management meetings.
- 10 There must be openness between the non-executive directors and the executive team. Non-executive directors are expected to bring judgement, wisdom and an external perspective to the organisation. They should, therefore, maintain independence from the executives, whilst working with them strategically as part of a team.
- 11 Non-executive directors should perform no representative or partisan function on the board; rather, they should represent and promote the interests of the organisation as a whole and be accountable to its communities of stakeholders. This applies as much to institutional investors as to any others with an interest in the organisation, including employees.

Composition of boards

- 12 Board structures and styles vary considerably, from the owner-manager dominated board to that of a major public company, leading to considerable differences in the composition of boards. To tackle the issue of board effectiveness, attention is better placed on the mix of skills and experience required to enable it to provide leadership to the organisation and fulfil its strategic, monitoring and accountability responsibilities, than in the definition of detailed requirements for all boards.
- 13 Non-executive directors should be chosen for their relevance to the organisation. The board needs people with strategic management experience, who can bring breadth of knowledge to the role without necessarily having in-depth functional expertise, though there are instances where specialists, say, in health and safety operations, have contributed to a board's H & S responsibility. However, with regard to corporate governance committees, where there are additional roles and responsibilities, particular competences, training and diligence are required.

Skills, knowledge and attributes

- 14 Non-executive directors should have general management experience over a number of years, at or near board level, but not exclusively in business, and have a keen strategic sense. They should be good communicators and, ideally, have mediation skills. They should be forward-looking, fair-minded, independent and supportive – and have integrity beyond question.

Recruitment and selection

- 15 The recruitment and selection of non-executive directors should be treated with the same care and diligence as the appointment of executive directors.
- 16 Methods of recruitment, selection and appointment will vary from organisation to organisation, depending on its size and structure, but as a general principle, the processes should be transparent and consistently applied.
- 17 There should be defined conditions of appointment, with fixed-term contracts in place, but the period of the contracts should be determined according to the needs of the organisation.
- 18 Selection should be made against defined job specifications and candidate profiles that reflect the competences and qualities required for the post. Whilst diversity on the board is highly desirable, suitability for the role should be the overriding criterion for selection.
- 19 Candidates should be fully aware of the demands of the post and the level of involvement required, to enable them to judge whether they are capable of fulfilling the role in a professional manner alongside other commitments, including other non-executive directorships. If a proper assessment is made at this stage, it should be unnecessary to prescribe limits to the number of directorships one should reasonably hold.
- 20 Whilst advertising of vacancies may be inappropriate in some circumstances, there should be a pool of candidates from which to choose.
- 21 More should be done to make known the routes to selection and appointment – whether through head-hunters, registers for non-executive directors or other avenues – to broaden access to such appointments, not least to aspiring directors.
- 22 Good practice in the realms of recruitment and selection should be established and promoted, if not codified.

Training and development

- 23 Non-executive directors are not beyond the need for training and development and they should be open to that possibility. It should be the responsibility of the board as a whole, and the chairman in particular, to ensure that they have non-executive directors of the highest calibre who can help to drive the organisation forward. Development needs, including those of the chairman, should be identified and signposts provided to appropriate training.
- 24 There should be induction programmes, not only to alert them to their legal obligations and accountabilities but also to aid their understanding of the organisation and its operation. To become fully acquainted with an organisation takes time, and whilst knowledge can be imparted 'on the job' by fellow directors, much can be learned from interaction with staff at different levels within the organisation.
- 25 The standards for directors, created and published by the Institute of Directors, should be promoted as base-line expectations for serving and aspiring directors.

Reward and risk

- 26 In view of the growing demands and liabilities placed on directors, remuneration cannot fully reward non-executive directors for the risks they increasingly assume. It is acknowledged that many take on such roles out of interest and that reward may be a relatively minor consideration for them. However, remuneration should be fair and recognise the time commitment involved.
- 27 Remuneration should also be sufficient so as not to exclude those who can make a valid contribution but have limited resources, nor discourage sectors of the community who may currently be under-represented in the boardroom.
- 28 It should also be recognised that there are those for whom a portfolio of directorships is a career and that remuneration should adequately reflect the contribution that they bring to the board.
- 29 It is impractical to suggest levels of remuneration, not only because different types of people have different motivations, but also because organisations differ in their ability to reward the contribution made. Each potential non-executive director will take a view as to what is adequate recompense for the job.
- 30 Generally speaking, non-executive directors should not receive profit-related bonuses, though allocation of shares is acceptable.

Evaluation and assessment

- 31 There should be mechanisms in place for appraisal of the contribution made by individual directors, to ensure that they are providing value for money and are contributing to the success of the organisation.
- 32 The board also should assess its performance in terms of the extent to which it is fulfilling its responsibilities. This should include periodic examination of its role, its strategy, composition and conduct of business. Whether this is a role best undertaken by the board itself or a third party is a matter for debate. The important thing is that it should happen.

Public and not-for-profit sectors

- 33 Whilst the focus of the review appears to be on improving the effectiveness of boards of companies within the private sector, most of the issues raised are as pertinent in the public and not-for-profit sectors. If the underlying principles were adopted across all sectors, this would enable people to move more freely between them. Perhaps consideration could be given to this in a follow-up study.

Summary and recommendations

- 34 Non-executive directors perform an important role. They add value to the management of an organisation, bringing experience to provide direction and advice and independence to make informed challenges.
- 35 In seeking to improve the effectiveness of non-executive directors, a best practice approach should be adopted in preference to prescriptive legislation, recognising that there is no 'one size fits all' solution to the diverse range of organisations and their differing needs.
- 36 The non-executive director role should be seen as that of a skilled and competent individual, who demonstrates the highest standards of professional management practice, so improving the reputation of corporate governance.

- 37 In seeking to professionalise the role, models of best practice in the recruitment, selection and appointment of non-executive directors should be adopted, based on more rigorous and open procedures.
- 38 There should be an expectation that prospective non-executive directors will prepare fully for the role, undertaking training, as required, and being subject to regular review and continuing professional development.
- 39 Those contemplating directorships in organisations of any size should take a realistic view of their ability to contribute fully and professionally to more than a limited number.
- 40 Reward should be sufficient, without being excessive, to attract suitable and qualified candidates.

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