
SUBMISSION TO THE DEREK HIGGS' CONSULTATION PAPER 'REVIEW OF THE ROLE AND EFFECTIVENESS OF NON-EXECUTIVE DIRECTORS' by THE CHARTERED INSTITUTE OF MANAGEMENT ACCOUNTANTS

EXECUTIVE SUMMARY

Post Enron and WorldCom, the focus should be on incremental improvements to corporate governance structures which can engender a culture of good governance throughout UK industry. This review of non-executive directors is opportunity to strengthen NEDs' key role in the running of both small and large listed companies and their contribution to good corporate governance in the UK. We would welcome an outcome from this review that would see NEDs get clear guidance on what is expected of them and how to ensure that their contribution is effective. It is perhaps not surprising that there is a wide variation between the performance of boards given the lack of any widely agreed guidelines in this area.

As a solution, **CIMA is proposing a Code of best practice for NEDs**, which would clarify the status of NEDs, and how they can contribute to Board effectiveness. The absence of a formal Code of best practice means that NEDs rely on what happens on other Boards that they have experience of as to how they should operate. The Code should be subject to possible FSA adoption for all listed companies on a similar basis as the Combined Code. Our preferred option would be for such a Code to be incorporated into the Combined Code itself. In addition to having guidance that all major stakeholders can sign up to, this approach would be principle based allowing individuals flexibility to 'comply or explain'. Areas to be covered should include:

- Process – selection, performance reviews, tenure and dealing with serious issues if they arise
- Obligations – guidance on their role on the Board and its sub-committees, including the need for and appropriate probing and questioning with diligent follow up and relevant training and experience required
- Knowledge – including regulatory and ethical issues, of practices such as insider dealing and market abuse and aggressive earnings management and how these manifest themselves in practice.

Previous Codes of corporate governance have stopped short of specifying precise criteria that have to be met in order for an NED to be independent. We believe that the proposed code of best practice is an opportunity to outline those situations where independence is compromised. Of fundamental importance to independent NEDs being able to play an effective role is independence of spirit and judgement and as such we would recommend that independent NEDs be referred to as **independent directors**. NEDs is a title that should be reserved for individuals who are not independent but also play a part in driving companies forward, for example where a previous senior executive becomes a non-executive director of the same company.

The Chairman's role is fundamental to the relative success of the unitary board and as such the recruitment and selection process for Chairmen is one of the most important aspects to corporate governance working effectively in listed companies. We recommend that the proposed Code formalises the process for senior independent NEDs and/or outgoing Chairmen working closely with the institutions in selecting and recruiting Chairmen and NEDs. We also propose that all Chairmen, in their role of running boards, must be independent. Their ability to ensure the equality of all board members and ensuring the effectiveness of NEDs may be inhibited if they have a conflict of interest.

It will continue to be difficult to improve the numbers of prospective independent directors and to increase the diversity of appointments if their liability is not capped. We recommend limited liability for all directors in cases where due process and diligence have been observed. This can encourage responsible risk-taking without undue fear of being sued. The onus should be on the importance of due process and the proposed Code of Best Practice for non-executive directors will help define what due process actually is.

CIMA

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CIMA Working Group on non-executive directors

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Introductory comments

UK corporate governance

Over the last ten or so years, there have been several attempts to improve the UK regime of corporate governance, culminating with the publication of the Combined Code in 1998. Recent accounting scandals in the US have thrown it into spotlight yet again, with the recent report from the Treasury Select Committee claiming it would be 'dangerously complacent' to assume that Enron-type failure is inherently less likely to happen here. This is despite the general acceptance that there are substantial differences in corporate governance requirements between the US and the UK.

There is no doubt that it would indeed be dangerous to presume that the UK corporate governance system is infallible. But we should also remember that, since the changes implemented throughout the 1990s, it has not been proven to be ineffective which is why a knee-jerk reaction – resulting in major structural reforms – is in our opinion inadvisable. We should focus instead on incremental improvements which can engender a culture of good governance throughout UK industry.

It is also important not to automatically assume that non-executive directors are the weakest link as many seem to have done in the last few months. The effectiveness of every part of the chain of corporate governance should be challenged and that includes shareholders, analysts, banks, auditors, advisers and so on.

If anyone needed convincing, the fiascos of Enron and WorldCom have clearly demonstrated that corporate governance is not about making sure all the relevant boxes have been ticked. It is not enough to say 'we have x many non-executives' or 'we hold y many board meetings per year'.

There are no corporate governance systems that can guarantee against fraud and corruption, which are attributable to greed and the lust for power and/or money on the part of one or more individuals. In trying to prevent such infrequent occurrences, it would be detrimental to the growth of the economy if the vital entrepreneurial spark is inhibited or dulled. Many smaller private firms would fail the governance model test relevant to public interest companies but their more irrational approach is often more conducive to being innovative and totally focussed on customer demands that is crucial to their survival. Furthermore, even for listed companies there is no Holy Grail to a perfect governance structure. Some companies will choose to ignore the Combined Code whether it is because they continue to combine the role of chief executive and chairman or because a senior NED has not been appointed for example. There are two crucial issues. The first is that companies are transparent, which means that an explanation for non-compliance is provided and that the company is accountable. The second is that companies re-evaluate their corporate governance structures so that they can adapt to changing times. The ultimate objective is that the board,

shareholders and management must be motivated and informed enough to make decisions and act correctly.

Guidance and Codes must foster an environment where whistleblowers are not ignored, where NEDs have the courage and power to challenge executives when they feel it is necessary and where lines of accountability are clear. The channels of communication – both internal between management and NEDs and external between the board and shareholders and investors – must be open. The guidelines of what constitutes ethical behaviour should be drawn up and observed. Above all, the onus should be on transparency and improved disclosure. Only in this way can we restore investor confidence in capital markets.

The importance of non-executive directors

In the Anglo-Saxon model, non-executive directors are crucial in ensuring effective corporate governance processes. But while it is widely believed that NEDs have a key part to play in the running of both small and large listed companies, it is often difficult to define their exact role and contribution.

The recent reports from the Government, together with this consultation, have highlighted the need to clarify NEDs' roles and responsibilities and pay a closer look at the skills and competencies needed to perform the role effectively. The challenge is to strike a balance between awarding non-executive directors more visibility while not undermining management authority.

As a solution, ***CIMA is proposing a Code of Best Practice for NEDs*** which would clarify the status of NEDs and how they can contribute to board effectiveness. The Code could be subject to possible FSA adoption for all listed companies on a similar basis as the Combined Code or indeed within the Code itself (which we believe would be the preferable option). To be widely accepted the Code would have to be prepared by an appropriate group of relevant stakeholders.

Its aim would not be to create further legislation, nor would we want to prescribe a universally applicable job description for non-executive posts. Instead, it is meant to help define expectations on both sides – what managers and investors should expect of NEDs and vice versa – as well as outline some of the major risks and safeguards of the NEDs' role with practical examples and applications of both. It should also demarcate boundaries of roles and functions with a little more clarity than is presently the case. We believe that the wide variation between the performance of Boards is due the lack of any widely agreed guidelines and a Code of best practice in this area.

We recognise that different sized companies may require different approaches to the question of NEDs' roles and functions. In our response, we have chosen to concentrate on publicly listed companies as we believe this is crucial to help restore confidence in capital markets.

A What role should non-executives perform and how does this compare to the present situation?

1 What is the role of the board? What is the role of the Chairman and how does it relate to the non-executive directors?

CIMA agrees with the role of the board as defined in the Combined Code. We would advocate that no structural changes are made for the time being, as UK boards in their current state are generally functioning effectively on these principles.

We are in favour of the concept of unitary board as the most appropriate mechanism for discharging collective responsibility of the board as a whole. Boards act as teams and need to have a common purpose. Creating a separate agenda for NEDs would result in a two-tier board structure which we oppose. Although there is no perfect corporate governance system, we would not support proposals for a pluralist approach to reformulating directors' duties, as this would be a radical change to British corporate culture. It could effectively mean companies becoming accountable to everyone and to no one at the same time. That is not to say companies do not need to establish long-term and trusting relationships with stakeholders. We support the mandatory operating and financial review that would improve transparency and information flow to stakeholders. It would rectify the current anomalies by redefining director duties to take into account wider stakeholder interests while maintaining their legal accountability to shareholders alone. Furthermore, the principles behind good governance transcend national boundaries and the OECD reflects these in their international guidance.

The Chairman's role is fundamental to the relative success of the unitary board, as s/he should be responsible for running the board and ensuring it functions effectively. As such, the recruitment and selection process for Chairmen is one of the most important aspects to corporate governance working effectively in listed companies. Paradoxically, there is a real shortage of good Chairmen caused in part by a lack of real diversity in the NEDs being recruited into the population from which Chairmen are ultimately drawn. A Chairman has the opportunity to set the tone for the Board so that it works effectively as a team to further a company's interests. We must not forget the sentiments in the Hampel report which stated 'Executive Directors share with their non-executive colleagues overall responsibility for the leadership and control of the company.' The Chairman does, however, have a major role to play in facilitating NEDs so that they are objective and effective, rather than passive and uninvolved. In ensuring the effectiveness of NEDS, Chairmen must make certain that the NEDs receive timely, relevant information relevant to their needs. To achieve this will require the building of trust between all members of the Board.

In ensuring that a board operates effectively, a good Chairman will:

- Be **Independent** themselves
- Be concerned that there is the right balance and mix of individuals. No director, however, should think that they owe their place on the Board to the Chairman and a formal process of appointment via a nomination committee (which the Chairman may well also chair) is crucial.
- Ensure that no director is inhibited to speak his or her mind and reaffirm the equality of all board members when necessary.
- Play a major part in establishing procedures for reviewing board performance and the performance of individual directors.

It is difficult to regulate for an increase in the NED population and a consistent quality of Board Chairmen. We recommend, however, that the proposed Code formalises the process of senior independent NEDs and/or the outgoing Chairmen working closely with the institutions in selecting and recruiting Chairmen and NEDs. This practice would not prevent companies from appointing non-approved individuals but it could extend the pool of candidates by providing companies which recruit NEDs the ability to tap into a broader base while also knowing that such individuals are acceptable to the major constituencies that they are supposed to represent. Such a scheme, which happens in many circumstances on an informal basis, needs the serious involvement of the institutions and companies in order to work and again, the proposed Code is an opportunity to include a provision on this issue.

Finally, we also believe that company annual reports can be used to usefully describe to shareholders why the Board structure is right for a particular company.

2 **What should be the key roles of non-executive directors on the board and what should be the balance between the different components? Within a board, should all non-executive directors be expected to fulfil each of the different roles?**

The main roles of NEDs are monitoring and control and contributing to strategy setting and formulation. Of these two core functions, contributing to a company's direction and strategy is what NED's should be primarily using their skills and experience for. There will be times, however, where they need to monitor the current performance via appropriate probing and questioning. NEDs do not get involved with the tactical and detailed operational side of an organisation.

Executives may also be in charge of monitoring and strategy setting but NEDs should do so in the wider context of corporate governance. In other words, their role is to ensure that the company is well run and on the right course for the future and their responsibility is to

shareholders is appropriately discharged. They should therefore be able to assess the effectiveness of the board's chosen frameworks and processes.

They must question, probe and exercise diligence in pursuing and testing answers. In this context, it is a balancing act to perform the dual role of assisting in the strategy of a company, while at the same time exercising a monitoring role. The Audit Committee is a forum where independent directors will be more concerned with challenging and monitoring more than any other responsibility.

Companies should ensure that there is a sufficient number of NEDs with the adequate intellect, knowledge and courage to undertake the monitoring function. Also, amongst the independent NED group there must be an adequate level of financial literacy and acumen which allows them to critically examine the company's financial statements and management information. This is vital if the Audit Committee is to consist entirely of independent directors. An understanding of finance can also be relevant to the work of the Remuneration Committee. For example, NEDs should be able to assess the link between the structure and form of executive remuneration and the potential for aggressive earnings management. Above all, however, this whole debate must not discuss rules but rather principles and values, including those which govern the nature of interaction between board members. Strong Board teams invariably have members that have enough trust in each other to be able to challenge each other's assumptions and views. We strongly feel that the Code of Best Practice must be principles and values based.

The roles adopted by the NEDs will inevitably be context-dependent. They should not be rigidly delineated in advance, as this could restrict a board's flexibility. On the other hand, a board should strive to avoid creating 'floating' members. It is best left to the judgement of the board itself to determine how best to manage the balance between various functions according to the skills and experience of its directors and the present needs of the company, including its state of growth.

A recent paper from Fédération des Experts Comptables Européen (The European Federation of Accountants – FEE) broadens the NEDs' roles as the following:

- reviewing the performance as well as the risk management practices of the management (monitoring);
- solving potential conflicts of interest (specific interests of management versus wider interests of the company);
- provision of expertise otherwise not available to management, acting as mentor to relatively inexperienced executives;

- monitoring the effectiveness of the relationship of management with the internal and external audit function;
- reviewing and monitoring the ethics policy for the company.

It is the chairman's role to ensure that board members, especially non-executives, have the necessary skills to perform their roles properly, although the CEO will be particularly interested that s/he has a board team that they are comfortable with.

3 How does this compare to the present position?

There is enormous variation between boards, their composition and the role played by NEDs. Again, this is not a surprise considering the lack of a Code of Best Practice which would provide clear guidance.

4 How independent do non-executive directors need to be for the different roles?

We recognise that it is almost impossible to draw up hard and fast rules about the definition of independence, as it is very much an issue of judgement. This is why the previous codes of corporate governance stopped short of laying down more precise criteria. We believe that an overarching principle should be that of transparency, with an open disclosure of any conflicts of interest and appropriate safeguards put in place as a result (the ultimate of which is to withdraw).

The threats to auditor independence outlined in the International Federation of Accountants (IFAC) Code of Ethics for Accountants – which is based on such 'risks and safeguards' approach – are:

- Self interest;
- Self-review;
- Advocacy;
- Familiarity;
- Intimidation.

These could be adapted to NEDs' situation and expanded in the proposed Code of Best Practice.

In CIMA's view, in addition to not having a conflict of interest, what really matters is the possession of an independent frame of mind and the willingness to ask incisive questions and pursue answers to these. This means being independent of the favours of the CEO. Because independence of spirit and judgement is crucial in order for NEDs to play an effective role, we would prefer to refer to independent NEDs as independent directors. NEDs is a title that should be reserved for individuals who are not independent, for example where a previous

senior executive becomes a non-executive director of the same company. As said previously, in order to run a Board effectively, Chairmen need to be seen as independent.

5. **What are the main potential conflicts of interest which may arise within a company where non-executive directors can play a role in protecting the interests of the company? What can be done to help non-executive directors to be effective in relation to these conflicts?**

Conflicts of interest can fall into one or more of the following categories:

- Previous employment with the company
- Family relationships/familiarity
- Financial interests
- Potentially compromising relationships with other companies
- We also believe that ex-auditors should not be permitted to become independent directors of past clients.

Again, the onus should always be the independence of mind, rather than a formal definition. Those individuals who cannot demonstrate reasonable independence should not be called independent directors so it clear to all which individuals are insiders and which are outsiders.

6. **What time commitment is needed for the role of Chairman and for non-executive director roles, and how far does this vary between different companies? Are there any implications for the number of non-executive posts that one person can sensibly take on?**

CIMA believes that a prescriptive approach to both the number of directorships and the time commitment needed should be avoided but recommendations for different circumstances could be included in the Code of Best Practice.

If a NED holds a dozen directorships as can currently be the case, it is of course questionable how much time and effort he or she can devote to each one. This can be especially alarming when a director also holds an executive position elsewhere. In this case, it is unlikely that they would be able to act as NEDs to more than two companies.

However, some people are undoubtedly capable of holding a number of positions. We would therefore advocate against prescribing the upper limit but would, nevertheless, expect companies to be entirely open and transparent about the risks that such situations bring and the safeguards they have put in place as a result.

Likewise, the amount of time devoted to an individual company will be contingent on many external factors and should therefore not be strictly prescribed. People taking on the role, however, must recognise the

time commitment required, including preparation, board meetings and other requirements.

The stated time commitment should also allow for a certain amount of slack for the times of crises when the NEDs' presence is essential. Again, a Code of Best Practice can provide guidance.

Length of tenure is also a contentious issue. The practice of re-electing NEDs after three years should continue because there is a danger that longer tenure can blunt the director's independent frame of mind and objectivity. We therefore propose that if his or her cumulative tenure exceeds nine years (i.e. the equivalent of 3 terms), companies should give an explanation of why independence is not compromised. However, it should be noted that selection of NEDs in the first instance is the most crucial issue. It is important to ensure that a Board has the right NEDs to ensure an effective and cohesive Board and it is often the case that an excellent NED is wanted to continue on a Board for a long period.

7. Should there be a special role for a “senior independent” non-executive director?

CIMA believes that a senior non-executive director should only be appointed where the role of the chairman and the chief executive are combined. He or she can then form an additional channel of communication independent of company's management.

The senior NED should always be demonstrably independent, as should be the chairmen of all public interest companies.

8. Do you have comments on the proposed statutory statement of directors' duties, which does not seek to distinguish between the legal duties of executive and non-executive directors?

There should be a parity of treatment between executive and non-executive directors if the UK model of unitary board is to be preserved. We therefore support the proposal outlined in the statement of directors' duties which seeks to treat their legal duties as identical.

We would argue for a case of limited liability for all directors in cases where due process and diligence have been observed. This can encourage responsible risk-taking without undue fear of being sued. It would also encourage individuals to take up posts as independent directors who at the moment are often put off by imbalances in the risk/reward ratio. The onus should be on the importance of due process and the proposed Code of Best Practice for non-executive directors will help define what due process actually is.

At present, English case law allows for limited liability to be argued, albeit in a slightly roundabout manner. A director can apply to the court

for relief from liability and a court can grant it if it is satisfied that the director acted honestly and reasonably.

However, this position is not definite nor assured, which is why there have been recent calls for the introduction of the so-called business judgement defence, already used in the US and Australia.

Although its introduction was rejected during the Company Law Review, we believe it is something regulators and companies should revisit.

B Attracting and appointing non-executives

9. What are the key skills, knowledge and experience which are needed by non-executive directors to perform the role effectively, and how is this likely to change over the next, say, 10 years? Are some skills essential and, if so, what are they?

The mixture of skills and experience will depend on the company and the context in which it operates. It is impossible to prescribe the exact mix likely to be successful in every case. However, strength of character is crucial as in some cases a NED may have to make themselves unpopular and even resign if necessary. Some would also argue that the reason for resignation should be made public.

There are some general areas where non-executive directors should be aware:

- Regulatory issues and other guidance such as codes of ethics. This would include appreciation of the framework of corporate governance and, for example, how this interacts with ethical codes and Auditing Practices Board (APB) statements to promote auditor independence.
- Factors determining price sensitive information. There are issues around insider dealing and market abuse, as well as being alert to their relationship to share buy-backs and what determines price sensitive information.
- Aggressive earnings management – management's use of aggressive accounting which can – and has – bordered on fraud when it becomes excessive. The APB published an excellent 16-page consultation document on this subject in June 2001. CIMA believes this should be required reading for all NEDs of public interest companies.
- The basics of remuneration schemes and structures and the benefits and risks of different approaches. In addition, some of the issues regarding termination packages, mitigation, pension structures and so on.

We believe that at least one non-executive director should have comprehensive financial background and experience. The chairman of the board should ensure that this is the case, together with the Nomination Committee.

Conversely, we recognise that a Board consisting solely of directors with financial background is unlikely to function effectively. Diversity of skills and experience should be the key to success as should trust between all of the Directors.

We would encourage companies to aim for genuine diversity not only in terms of background and experience but also ethnicity and gender. Of course, this should not be done for the sake of doing it but should be contingent on company's strategy, markets and individual context. This is the only way to ensure that a Board consists of people with complementary skills and worldviews, each of whom can bring new and unique insights into the running of a company.

Increased globalisation means that NEDs will have to have a broader knowledge of foreign markets and the accompanying cultural issues. Directors with international experience could be helpful at times of international expansion but may also be more tolerant of alternative points of view and more sensitive to local issues.

10. What personal qualities and attributes are needed?

In addition to knowledge and experience, personal qualities are crucial for NEDs' position, though they are difficult to define and assess. Above all, as previously suggested, NEDs should possess an independent frame of mind. This should manifest itself as objectivity – an ability to appraise situations with critical detachment and without bias.

The concept of objectivity is necessary in order to overcome the inherent fuzziness around the definitions of NEDs' independence. Its practical expression is the ability to challenge executives and ask awkward questions when required. NEDs should also be able to diligently follow up any of the issues raised in such discussions. A Code of Best Practice can include some key questions that a NED should ask of the executive management and auditors.

The skill of objectivity should, however, extend throughout the review chain. Equity markets cannot rely solely on non-executive directors to provide an objective assessment of performance. Analysts, bankers, credit rating agencies, advisers and other key players in the corporate governance process should approach their duties with an independence of mind.

NEDs, being appointed also for their contribution to a company's strategy, need the qualities to work effectively in a cohesive team with their executive colleagues.

11. **What sort of mix of experience and attributes is desirable on a Board? Specific examples of cases where non-executive directors have contributed with particular effect to company performance, or to corporate governance, would be helpful.**

Multinational firms such as Tesco and British Airways derive significant benefit from the international experience of their NEDs. They also have the experience of serving executives from other industries.

12. **How easy is it to recruit non-executive directors with the right skills and attributes? Could recruitment and appointment mechanisms, including Nomination Committees, be improved?**

First and foremost, as mentioned earlier the recruitment of independent directors would be made easier if there was capped liability.

It is our experience that many companies are finding it difficult to recruit NEDs with the right skills and attributes, and in the current climate it is likely to get worse.

If the NEDs competencies are to be defined more precisely, then the process of recruitment and selection – as well as induction, training and performance assessment – should reflect this. Failing to inaugurate an objective selection process could result in biased judgement and therefore expensive mistakes. There have been many accusations of self-selection or powerful CEOs appointing their preferred candidates.

The Combined Code recommends that NEDs should be selected through a formal process and that this should be a matter for the board as a whole (A.5). This means the chairman's role is crucial but that personal patronage is avoided.

The nomination committee, consisting entirely of independent non-executive directors and the CEO, should approve a job description, outlining main responsibilities, and a person specification. The nomination committee, as recommended in the Combined Code, should make recommendations to the board on all new appointments.

More than one candidate should always be interviewed and the process should be transparent and equitable.

This means that NEDs should expect a rigorous selection process rather than assuming that the appointment will be automatic.

13. What could be done to widen the pool of potential non-executive directors and introduce greater diversity into appointments? What are the constraints on this? Is there scope for greater international representation on UK boards?

There have been concerns that the pool of potential candidates for independent NEDs positions is severely limited, resulting in a large number of directorships for a small group of individuals. Moreover, the average profile of NEDs is seen to be relatively uniform.

CIMA would encourage companies to become more proactive and start recruiting a wider range of candidates. Some options include:

- Retired executives and directors likely to possess a breadth of experience;
- Managers just below the board level – being a non-executive director would help them develop boardroom skills as well as adding value to their own companies. In a company as big and multinational as Tesco for example, non-Board Directors will be equivalent of Board directors in medium sized companies;
- Professionals with appropriate business/consultancy experience e.g. accountants, academics, civil servants or investment bankers.

However, to realistically widen the range of available candidates, companies themselves have an active role to play. They need to be more proactive in searching for candidates rather than relying on friends or acquaintances as has often been the case in the past. Headhunters and recruitment agencies - supplied with a clear job and person specification - can be used.

NEDs need to be afforded more visibility by companies who employ them – and not just when things go wrong. There needs to be more training and awareness of how to become a NED and what the chief roles and responsibilities are and that NED roles can enhance career prospects. In that way, potential candidates may be more likely to express an interest in the role. In other words, what the Review should seek to do is create some positive role models for NEDs in order to encourage more people to consider such positions. Above all, independent NEDs should be offered a whole support package which consists of critical aspects such as training, mentoring, professional advice, independent liability insurance.

14. Are the rewards for non-executive directors appropriate, both in terms of levels of pay and the form that remuneration takes – e.g. cash/shares/share options? Are current pay levels a significant factor in whether good non-executive directors can be attracted?

There are concerns that NEDs' pay is out of proportion with the level of responsibility and rising shareholder expectations. In terms of liability,

the law does not recognise the difference between the executive and non-executive directors, yet executive remuneration is significantly higher.

The pool of NEDs could be restricted even further if the potential candidates perceive the risks to be utterly disproportionate to rewards. On the other hand, the knowledge and experience gained by being a non-executive director or the cross-fertilisation between the companies (if the NED is still in full-time employment), can represent a reward in itself.

The weight of responsibility some would like to place on NEDs could lead to them devoting more time to companies and therefore demanding higher fees. We believe this is not necessary if the scope of their responsibilities is intelligently mapped out – primarily policy, general strategic objectives and major investment decisions – leaving tactics and operations in the hands of executives.

Companies should determine the reasonable level of pay needed to attract the right candidates. The guiding principle ought to be that a NED should not be dependent on the position as the main source of income. The role of the Nomination Committee and the objective selection process is therefore instrumental in getting the balance right.

Pay should be linked to experience and tied to performance in a way that can be clearly demonstrated to shareholders and investors. It should be regularly reviewed and compared to market rates.

CIMA supports the practice of not rewarding NEDs with variable pay such as bonuses and share options as there are no safeguards that can sufficiently reduce the risks of short-termism and aggressive earnings management.

We do, however, believe that having a stake in the company in the form of shares can align directors' interests with those of shareholders to whom they are ultimately accountable.

NEDs should not receive any other fees or rewards from companies on whose boards they sit.

15. **Do you have comments on the issue of risks or insurance provision for non-executive directors?**

Newly appointed NEDs should be informed whether they are covered by their companies' insurance for liability. They need to be happy with the cover provided. It usually has to be an appropriate level for attracting and retaining NEDs in the first place.

The Economist (10/08/02) recently reported a sharp rise in D&O (Directors and Officers) insurance premiums, especially in 'scandal-

prone' sectors such as telecoms, technology, energy and financial services. But companies should be aware of the new stringency and toughness in such contracts being introduced by the insurers.

C Structures and Accountability

16. **How is the Combined Code working in practice? In particular, how are the provisions on the balance between executive and non-executive directors and the role of independent non-executive directors working? Is further definition needed of independence in the Combined Code and, if so, what would a sensible definition be?**

Company Reporting, published in July 2002, reports that only 17% of UK listed companies disclose full compliance with the Combined Code. It goes on to say:

If companies are going to continue to do little more than describe the processes they have in place, then corporate governance statements will continue to be one of the least read sections of the annual report. But it is not just internal controls - generally there appears to be an antipathy towards corporate governance in general. (...) Given that the Code has been in place for four years it does not bode well that the majority of UK listed companies are not taking its requirements on board fully. Further, the areas of Code non compliance, such as a lack of senior non-executive directors and the longevity of executive notice periods, are principles that are fundamental in the Code's approach.'

There is no doubt that at times Executives feel the Combined Code to be too prescriptive but full compliance with the Code is helpful in ensuring Directors acknowledge the demands placed on them by shareholders. The main issue is that there is a proper explanation why an aspect of the Code has not been adhered to. The 'comply and explain' approach is far more effective than a 'one size fits all' system.

17. **Do the recommended structures for board committees facilitate governance and an effective contribution by non-executive directors? Are board meeting procedures working effectively? Do you have comments on board size?**

The size of a board will be contingent on the company's unique circumstances. There are generally three factors which will influence Board size:

- ✓ Complexity of the business
- ✓ The rate of change the company is pursuing
- ✓ Geographical spread

So a large multinational company, with a vast product range that is growing and adapting rapidly will need a different board and numbers of people on it than a smaller firm, offering limited products or services in a single market.

In large companies, there need to be enough executives to cover all the functional areas. There should always be a sufficient number of non-executive directors to make up the membership of the board committees. The size and board effectiveness will also depend on the ability of the chairman – a skilful chairman will be able to control a larger board.

A Code could also clarify best practice for different types of company.

18. **Do you have comments on the composition and duties of Audit Committees? How effectively are Audit Committees working in practice? Do you see a need to strengthen the existing Combined Code provisions on Audit Committees?**

In July this year, CIMA issued a report by its Audit Review Working Party, entitled 'An independent view on the independence of auditors'. We are well placed to deliver an independent view on these matters, as our members do not practice as statutory auditors.

The paper sees non-executive directors as a key link in a chain of corporate governance as it is their duty to rigorously challenge the auditors. In other words, the fully independent audit committee must take responsibility for both internal and external auditors on behalf of the shareholders and closely monitor the auditors' relationship with the company's management.

CIMA's key recommendations include:

- The level and extent of audit work should be routinely reported to the audit committee which should satisfy itself that the auditor providing non-audit services does not compromise independence.
- A guide to best practice for audit committees should be introduced, including a minimum level of financial literacy amongst audit committee members.
- The audit committee should have ultimate authority on the scope of the audit and satisfy itself on an annual basis as to the adequacy of the audit scope and the associated fees and the appropriateness of any non-audit services being provided by the auditor.
- The head of internal audit should have a senior status within their organisation, reporting to a board member and with direct access to the audit committee.
- The chairman of the audit committee should be on the remuneration committee and vice versa. It is also advisable

for the Chairman to be either a qualified accountant or have had executive responsibility for a finance department.

- Audit committee must meet reasonably frequently – at least three times a year.

Most importantly, it is the key responsibility of non-executive directors – typically through the audit committee – to understand the risk framework and therefore the context under which the company operates and determine the Board's risk appetite.

19. **Similarly, do you have comments on the composition, duties or operation in practice of Nomination and Remuneration Committees?**

The work of NEDs on these committees is vital. Through their work on the Nomination and Remuneration Committee, NEDs are responsible for making recommendations to the Board in relation to the appointment, retention, monitoring, and if necessary, the termination of Executive Directors, as well as Board evaluation and succession and development plans for high potential individuals. These Committees should be comprised of both independent directors and other non-executives and should use outside advisers where appropriate. It is difficult to stipulate formally what the composition of such committees should be because it will depend on the nature of a Board and its members.

Concerning the Remuneration Committee in particular, there needs to be clearer guidance on how they operate. Many argue that the main problem with governance is compensation related. The Remuneration Committee needs to discuss compensation matters away from the influence of the CEO and Executive Directors and the independent Chairman should brief a remuneration consultant if used.

20. **What processes are in place for setting objectives and reviewing performance against those objectives, for the board as a whole and for individual directors?**

In some companies, the remuneration committee is responsible for these processes based on recommendations from the CEO. The involvement of the Chairman is crucial. Whatever the process in place, the objectives of NEDs need to be understood and agreed by the whole Board. In other companies, no such processes are in place. A critical issue is that the recruitment and selection procedure is robust so that companies have the right NEDs on their Boards in the first instance.

21. **Could more be done to review performance? Should more information on board performance be reported to shareholders? Should companies provide more information on the performance of non-executive directors?**

In order to evaluate the effectiveness of the board as a whole and NEDs in particular, some form of performance assessment needs to take place on a regular basis. We can, in fact, see no reason why directors should not be subject to the similar appraisal procedures as any other member of staff. Fixed assessment should provide a formal opportunity to part company with a director who is not performing effectively.

Regular review can help any board objectively assess its strengths and weaknesses. This can be helpful prior to recruitment as it ensures that a complementary set of skills can be more easily identified and selected.

At its simplest, there should be an open disclosure of the number of meetings attended in the year but it could be more sophisticated in terms of the individual contribution made.

Individual performance assessment can be conducted by the chairman on a regular basis. It is important to develop some kind of concrete criteria or benchmarks for evaluation as it can be difficult to judge performance when the role is inherently amorphous. There should be some sort of a reciprocal system of assessment for chairmen as well as other members of the board. The issue of how to depose of an underperforming chairman could in fact be a highly sensitive one, which is why structures that facilitate this should be put into place in advance.

The 'prudential' committees – i.e. Audit, Remuneration and Nomination should review their terms of reference every year.

22. **Are non-executive directors able successfully to challenge executive decisions or expose serious problems? Should it be made easier for them to do so and, if so, how?**

In order for NEDs to be able to sufficiently challenge executive decisions and expose serious problems, there needs to be a flow of relevant and timely information to them. This needs to be done in a structured and managed way rather than on an *ad hoc* basis. If this is the case, and the NEDs do not have a conflict of interest and use the powers that they have, serious problems should be exposed. In the event that a NED receives an unsatisfactory answer to an enquiry, s/he should take the matter to the CEO or Chairman.

D Relationships with shareholders and others

23. **How well do relationships between non-executive directors and shareholders and stakeholders work, and could they be improved? For example, we would be interested to hear views on what the relationship might be between non-executive directors and institutional shareholders. How could this relationship be strengthened?**

We do not agree with the Myners' suggestion that NEDs should have separate meetings with the institutions. While some companies may wish for this to be the case, others may not feel it to be appropriate. Besides, in some instances the Institutions may not wish to meet the NEDs. For example, none of the NEDs on the Board at Tesco has particular retail experience.

Furthermore, NEDs may not be briefed well enough to be able to deal with analysts' questions. There may also be a risk of advocacy if they feel 'obliged' to only be positive about the company. We do, however, believe that NEDs need to be aware of the investor sentiment and market expectations. They should be informed of what the analysts', investors', stockbrokers', etc views are on a regular basis.

24. **To what extent are Chairmen creating the conditions for non-executive directors to be effective? Is there more that they could do, by promoting constructive relationships, managing the discussion processes, encouraging challenging and effective contributions in board meetings and ensuring appropriate information flows, or otherwise?**

We believe that the recent discussions about the effectiveness of boards have not placed enough emphasis on the role fulfilled by the chairman.

The Combined Code states:

There are two key tasks at the top of every public company – the running of the board and the executive responsibility for the running of the company's business. There should be a clear division of responsibilities at the head of the company which will ensure a balance of power and authority, such that no one individual has unfettered powers of decision.

The chairman is therefore instrumental in ensuring that appropriate and effective corporate governance processes are applied and observed consistently. If the CEO is in charge of running the company, the chairman is in charge of running the board. His or her responsibilities

should also include playing a major role in the selection and management of other NEDs to ensure they can exercise their duties with due care and diligence. If the right tone and attitude is not set by the chairman, it is difficult for other NEDs to exercise their duties properly.

The chairman should also be involved in investor communications. However, other than in crisis situations, this should only apply to matters of corporate governance with the CEO remaining answerable to issues of company strategy and performance. In other words, we do not see it as inappropriate for investors to contact the chairman to discuss issues regarding corporate governance.

25. **What should be the relationship between non-executive directors and executive directors, and with senior management? What should their relationship be with the Chairman and the Chief Executive? What should their relationship be with key advisers to the company?**

As specified at the beginning of this response, companies should strive to afford more visibility to NEDs without compromising management authority. Although we see NEDs as providing some sort of a counterbalance to executives when needed, we do not envisage their role as the board policeman. Rather, their knowledge, experience and attitudes should complement those of executives.

26. **How can Company Secretaries support effective performance by non-executive directors?**

Company Secretaries can be crucial in ensuring a regular and structured flow of information to NEDs.

E Support

27. **How much access to information from management do non-executive directors need to be effective? In practice, are information flows and communication channels sufficiently open and unrestricted?**

The performance of any board is dependent to a large extent on the quality of information flows within the company. A great deal of attention should therefore be paid to the procedural issue of reporting to boards. We propose that the right to access company information – and what course of action to take if it is not forthcoming – should be set out in the Code of Best Practice.

The Code might also encourage NEDs to go on site visits and talk to staff at all levels of the company rather than rely solely on information delivered to the Board. Enron has shown the importance of this – a powerful CEO or FD can easily mislead directors if they are the only

source of information about financial (and other) performance. NEDs may therefore end up asking the right questions but getting the wrong answers.

Boards cannot micromanage. Information provided to them should therefore be more than the sum of information used internally by management. It should be tailored to their needs by virtue of being succinct and providing an overall picture.

It could also be said that the information the Board receives not only enables it to exercise its duties in the appropriate fashion but is also a good indicator of the relationships that exist between the Board and the management. NEDs will have little chance of being effective without receiving the right information.

28. **What training and development opportunities are available? Could they be improved and, if so, how?**

Despite their extensive knowledge and experience, NEDs should receive ongoing training. The concept of lifelong learning should apply to them as much as other members of staff.

Although the role of training has been emphasised in the Hampel report, the take-up is reported to be disappointing. The skills of good judgement, objectivity and sound assessment of commercial situations may already be present in some individuals but the rest can undoubtedly benefit from formal training. CIMA proposes that training should address the following areas:

- Corporate governance concepts and theories;
- The role of NEDs including legal responsibilities;
- Risk management;
- Financial management;
- Corporate social responsibility;
- Strategic planning;
- Basic principles of working of capital markets.

Training is particularly important in case of NEDs who have retired from their 'main' jobs. As such, they will not have on-the-job exposure to emerging organisational issues. A good example is corporate social responsibility which has rapidly risen up the corporate governance agenda in the last few years. NEDs might also need specific training in, for example, IT in order to keep their skills up to date. Training needs to be tailored to particular needs and can be delivered internally or externally.

Many of the 'soft' skills needed by NEDs cannot be taught in a conventional manner through one-off courses or workshops. For example, the ability to ask awkward questions or developing an independent frame of mind are about less about specific 'teachable'

skills and more about personality traits. Because of this, coaching and mentoring can be a valuable addition to traditional training methods.

Companies should also consider coaching their existing managers to become board members in other companies.

29. **Can induction for non-executive directors be improved?**

All NEDs should be properly inducted upon joining the company. The structure of induction programme and the number of days devoted to it will depend on the individual context of company size, location, complexity and so on.

In general, induction should include the following:

- The relevant documentation – for example, annual reports and a selection of briefing papers;
- Site visit/s and other interactive sessions;
- Meeting the other board members as soon as possible.

The induction should include the company's constitution, group structure, significant contracts, joint ventures, strategic alliances, competitors, roles and responsibilities of directors and the company's risk management process.

In addition to induction, there needs to be a continued programme of involvement with the company as a whole, rather than just the Board.

30. **Do non-executive directors get clear guidance on what is expected of them and do they get feedback on whether they are meeting expectations?**

CIMA's submission to the Treasury Select Committee on the Financial Regulation of Public Limited Companies included a proposal for a Code of Best Practice for NEDs. The Code, as mentioned at the beginning, could be subject to possible FSA adoption for all listed companies and it should be developed in conjunction with the relevant stakeholders. It is our view that such a Code would be clear guidance to all NEDs on what is expected of them and on how to ensure their contribution is effective.

The Code would need to be:

- Principle-based with a 'comply and explain' approach for companies covered. This is similar to the tried and tested approach used in the Combined Code;
- Set out within a 'risk and safeguard' framework wherever possible. This is similar to the Code of Ethics for Accountants published by the International Federation of Accountants.

The European Federation of Accountants echoes this approach to a NED code in its recent paper on the subject.

In addition to outlining the fundamentals of objectivity as mentioned in response to question 4, we believe the following areas should also be addressed:

NB: The following are only examples of areas to be covered and are by no means comprehensive.

- **Process**

- The right way to orchestrate a selection process and the subsequent proposal to shareholders while ensuring transparency at all times (subject to constraint of personal confidentiality).
- Recommendations on how to conduct a performance appraisal.
- Maximum tenure for a NED.
- Outlining a best practice approach as to how NEDs express concerns and how they escalate them, ultimately through resignation and public disclosure.

- **Obligations**

- Guidance on questions to be asked and action to be taken when contacted by a whistleblower. Also, people in key governance positions throughout the organisation should be alerted to the existence of such guidance.
- The absolute need for probing and questioning with diligent follow up where required. Specifically, members of the Audit Committee must be questioning of both the management and the auditors, internal and external.
- Disclosing the training and experience of NEDs.
- Disclosing the number of directorships and reasons why they are confident they have sufficient quality time to contribute to the one in question.

- **Knowledge**

- Of regulatory issues and codes of ethics.
- Of practices of insider dealing and market abuse, as well as aggressive earnings management.
- Of remuneration schemes, plus termination packages, mitigation, pension structures and so on.

F Smaller Listed Companies

31. To what extent do different factors apply in the case of smaller listed companies? Is different provision necessary?

We do not believe that there should be structural differences in how the NEDs of small companies approach their duties. There may be more emphasis on the mentoring role, especially in growing businesses. The need for objectivity and independence is arguably even greater in a smaller company because of its family-like atmosphere.

The issue that should be tackled is that of remuneration – the rewards in smaller companies are very modest and it is therefore not surprising that suitable candidates are unwilling to accept the risks involved.

The review should also address the recruitment problem at the level of smaller companies. While there is perhaps relatively less of a problem in recruiting NEDs for the upper echelons of the FTSE 100 (although lack of diversity is a real issue), the companies towards the bottom and outside it face a real shortage of talent. The real thrust of the Government's review should therefore be how to make the position more appealing.

G International Context

32. What lessons can be learnt from international experience, either in terms of structures or behaviours?

Although the US capital market undoubtedly dominates the world scene, the recent scandals have demonstrated its deficiencies. The dominant CEO model means that he or she can deceive or mislead the board, even when it has a majority of independent directors. We believe non-executive directors should be charged with more than supervising which is why we would not advocate a German model of a two-tier board. Unitary board means that they are actually involved in decision-making. Their influence is thus inevitably greater.

33. Do other models of corporate governance or different boardroom roles or dynamics contribute more to company performance?

Any model of corporate governance is only as good as people who are in charge of it. No system is infallible. There is no room for complacency, either in ensuring the highest standards of ethics and personal integrity or in remaining vigilant about lessons that can be learnt from international experience. A recent study by McKinsey demonstrated that there is in fact a premium for good governance. Their research showed that in emerging as in developed markets, companies that adopt strict corporate governance practices are being rewarded by institutional investors.

34. Would it be beneficial to bring UK practice more in line with that in any other countries? If so, why and how?

CIMA supports the unitary board concept. As there is no evidence of a relative deficiency as compared to alternative approaches to corporate governance, we see no reason to change it.