

A response to the Consultation Paper

Review of the Role and Effectiveness of Non-Executive Directors

submitted by

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Review of the Role and Effectiveness of Non-Executive Directors

Introduction

We welcome this opportunity to respond to this Consultation Paper.

As befits our background as Chartered Accountants now in the academic world but formerly in practice, our comments are based both on that earlier experience in the audit of listed and unlisted companies, and on our academic research into financial regulation in the UK and the relationship between directors and auditors (e.g., "Behind closed doors: what company audit is all about", Palgrave, 2001.)

Before addressing your specific questions we wish to make a number of observations which we believe should inform any detailed consideration of the function of non-executive directors (NEDs):

- UK Company Law makes no distinction between the duties and responsibilities of members of a Board of Directors. This concept of a unitary board is quite different from the two-tier board structure on the continent of Europe, and also from USA where the CEO is a director but normally no other of the officers who run the company are directors. Examples of, e.g., US experience should therefore be treated with caution.
- Until the fairly recent emphasis on corporate governance (Cadbury and the rest), NEDs had no role other than to support the chairman and executive directors in furthering the success of the Company, as shown by increases in its profits, dividends and share price. The allocation to NEDs of specific duties on committees of the board (audit, remuneration, nomination, etc) could disrupt the unity of the board if it becomes seen as a means of monitoring the performance of chairman, CEO and executive directors. It could end by a de facto splitting of the board into those monitoring and those managing—effectively a two-tier structure where the executives meet and decide informally and only subsequently bring formal decisions to the board.
- If enhancement of the role of NEDs leads by default to the destruction of the unitary board, we should think very carefully of the possible wider effects before embarking on this course, since so radical a change as from a unitary to a two-tier structure should be a positive decision.
- No system can guarantee good governance. A good corporate governance structure and effective non-executive directors can help to limit fraud and contribute to management effectiveness. There will always be rogue elephants and poor management decision making. Non-executive directors did not prevent the Marconi debacle or the dot.com bubble.

- There is, however, a role for NEDs, the effective discharge of which depends on the personal attributes of the individual NED, particularly objectivity, courage and experience, not the rules and expectations of regulators. When the crunch comes, it is down to the individual whether he or she fights their corner, or is content to be the chairman's poodle.
- Whatever good governance may achieve in improving management and reducing fraud, it cannot ensure commercial success – nor is it an alternative to effective audit and effective regulation. Financial regulators and auditors must do their jobs properly.

Comments on issues raised

Turning now to the issues raised, under the seven headings:

A: Role

1. The board is the ultimate authority in the company. The duty of the chairman is to manage the board. How he does this is up to him. He may be a tyrant or a benevolent despot, a Speaker of the House of Commons or a Lord Chancellor in the Lords. What matters to shareholders is that he is successful (witness support for Rowland at Lonrho). He should be a NED, but not necessarily independent. Above all, he needs to embody and speak for the company as a whole. The role relates to all directors, both executive and not.
2. The key role of the NED is to contribute to the board one or more qualities that it does not already possess. NEDs can also usefully serve as a sounding board and give the benefit of their wide experience. While there they can usefully fill positions on board committees, provided these do not stray into a management role – which is for the officers. Duties other than at board meetings must depend on the situation and needs of the company.
3. All companies are different. One cannot generalise.
4. NEDs do not need necessarily to be independent. Non-independent NEDs may fulfil a useful role in the board, e.g., major shareholders, former executive directors, former advisors. However, the chairmen of audit and remuneration committees, and the majority of their members, should be independent. They should come to their role without previous involvement with the company in another capacity. Independence in appearance, i.e., formal independence is not, however, enough; they must also act independently.

Incidentally, independence is an absolute, and it is not meaningful to ask how independent NEDs should be. As with virginity and pregnancy, you either are, or are not, independent.

5. The principal sources of conflict seem to arise from chairman's and executives' remuneration – particularly share options. The NED's role is therefore as a member of the audit and remuneration committees and as a restraining influence in board meetings. No help from outside is possible. It is up to the individual – so a NED of courage, who can fight his or her corner, is needed.
6. One cannot lay down time commitments – except 'enough'. Nor can one lay down the number of appointments an individual should accept. There must be enough time for each – so five may be possible, but not twenty-five; or five may be too many.
7. Yes – even if the chairman is a NED.
8. Yes. The proposed statutory statement of directors' duties is correct. There are no differences between the responsibilities. They are all directors, whatever their duties and remuneration. If you seek to distinguish, you may end with a two-tier board.

B. Attracting and Appointing NEDs

9. There is a need for wide business skills, knowledge and experience, particularly financial – but other experience such as legal, regulatory, banking, investment and other institutions and, indeed, perhaps selling, engineering and knowledge of the company's business sector, may also be useful.

The NED must also be able to work with the executive members, gain their confidence and get his or her advice accepted by the board. There is the need therefore to be able both to communicate and to command respect.

However, the most essential skill is to provide whatever the rest of the board lacks – be it age, grey hairs, specialist knowledge, or a particular access, e.g., to Government, the city institutions, or the Stock Exchange.

The nature of the skills required may change over the years, but not the need.

10. Honesty and integrity above all, coupled with the ability to communicate that which his or her hearers may not wish to hear and to be listened to, and the willingness to resign for proper reason.
11. We have dealt with this in para. 9.
12. It is never easy to recruit NEDs with the right skills and attributes. Obviously there is room for improvement in the means, which currently seem limited to the

chairman's and board's various (not necessarily Old Boy) networks, and self selection by putting one's name forward. But beware reciprocal arrangements ("You sit on my board and I'll sit on yours"), and the danger to independence of cross membership of boards.

13. We have no magic solution to widening the pool of potential NEDs. A knowledge of how business works is a fundamental requirement, and searching for a solution among those who have not this knowledge is self defeating. The merely intelligent, even academics and civil servants, however eminent, may not be the answer.
14. Current rewards are probably not adequate, and if the number of a NED's appointments are to be restricted, they become even less so. And if you pile on more responsibilities you may further upset the balance between risks (including reputation risks) and rewards. But cash please! Not shares or options – which bind the NED too closely to the company and make it more difficult to resign if that is what should be done.

However, remember the kudos of being a NED in a prestigious company – cash may be only part of the problem of getting good NEDs. There is the question also whether enough aspirants of quality are available.

15. NEDs share with the rest of the board all the risks of being a director, and should be covered by the company's insurance – to the extent that this is adequate. The risk of, say, the chairman of the audit committee in an Enron-like situation is probably uninsurable (how many billions?). One should not forget, also, the criminal exposure of NEDs equally with the rest of the board.

C: Structure and Accountability

16. The best examples of the Combined Code working in practice are in those well managed companies which do not need it. Elsewhere there seems much lip service (including the expected wording in the annual report) without much thought or effort to act on it. It really depends on the company. If the chairman is a bully (a Tiny Rowland or a Maxwell), he will ensure that no NED or anyone else causes him aggravation, and high quality NEDs will resign or decline appointment.

We are not overpersuaded of the usefulness of constant definition making. Of themselves definitions produce nothing. Independence is as difficult to define as the proverbial elephant – but you recognise it when you meet it.

17. We have no specific comments on structures for board committees or the board. Each company must find what suits it best, as also with procedures. Regarding size, the smaller the better – 12 is better than 20; 6 is better than 12.

18. Audit committees provide an excellent opportunity for two-way communication between the auditors and the NEDs. They should consist only of independent NEDs (not, as one of once met, the CEO and CFO chaired by a NED.). But here again, care is needed not to split the board into executives and NEDs.

Audit committees and auditors do not however always see eye to eye. Our research produced an instance of an audit committee siding with the CFO against the auditors, and another where the chairman of the audit committee (himself a former auditor) set out each year to intimidate the audit partner by threatening to put the audit out to tender.

Our research also shows that audit committees and NEDs can contribute to good governance and to auditor independence. Finance directors, audit partners and financial journalists all rank the existence of an audit committee consisting of a majority of independent NEDs as the most significant factor enhancing auditor independence. We also found examples of NEDs standing up against aggressive management to support the auditors, but as cited above, not in all cases.

19. We have no particular comments on nomination and remuneration committees – save our *caveat* about splitting the board.
20. Is this a meaningful question? The object of the board is for the company to succeed, measured by profits honestly made, dividends and share price, which the shareholders approve at the AGM. The CEO appraises the executives and the chairman appraises the CEO. We do not see individual objectives as meaningful for NEDs, and we are sceptical of the usefulness of their appraisal. Our experience is of considerable form, but little substance.
21. Again, is this meaningful? The information on board performance is in the annual report, as stated above. With a unitary board it is invidious to single out individuals, unless the chairman wants to say something in his statement – but that is for him, not the board.
22. We just do not know how far NEDs successfully challenge executive decisions or expose serious problems (unless they hit the press). NEDs are bound by board confidentiality, and much may be achieved which does not see the light of day. One occasion which did become public, though a long time ago, was the unsuccessful attempt by NEDs led by the deputy chairman of Lonrho to resist Tiny Rowland. One cannot assume that all challenges will succeed.

D. Relationships with Shareholders and Others

23. We cannot see what role NEDs can play with shareholders (let alone stakeholders). Generally they only see them across the table at the AGM and over lunch or a drink with them afterwards, though the chairman may ask one or more NEDs to host a party for a chosen few at Ascot.

You should also bear in mind the short-term nature of most small shareholders' objectives, generally limited to growth in dividends and share price.

Institutional shareholders have an even shorter term agenda, looking solely at portfolio growth. Many do not even bother to vote at the AGM, unless the share price drops, when they may seek to arrange a takeover. Loyalty is a scarce commodity.

24. To answer this question meaningfully one would need to be a fly on many walls! Others may be better equipped to do so. The answer to the second part of your question must be Yes.
25. There should be constructive communication and cooperation with fellow directors - and with senior management, to the extent that NEDs meet them. Also, mutual respect, if this is possible. We do not see a 'relationship' with key advisors. These need to keep their independence too. NEDs should meet the auditors in the audit committee, but we do not regard that involvement as a 'relationship'.
26. Company Secretaries support NEDs by obtaining information, etc., requested and volunteering anything else which is helpful - like every good secretary down the ages.

E. Support

27. NEDs need access to whatever they think they need, but they must take care not to get submerged in detail. (A good company secretary can be most helpful - see above.) They must also make sure they know the business, by enquiry and visiting offices and sites. One of us recalls visiting a number of a group's factories with the CEO, and at the end being told they now had seen more than the NEDs had bothered to ask to inspect.
28. The company secretary can help if the NED's knowledge of the duties of directors is deficient, but their experience should have given them all the training they need - or they should not be NEDs.
29. See 28.
30. They have their previous experience, they can read the Combined Codes and ask each other. Do they need anything more?

F. Smaller Listed Companies

31. The need for specific experience among NEDs, which is not available among the executive directors, may be greater with smaller companies. Otherwise the dividing line is between listed and unlisted, not larger and smaller.

G. International Context

32. We can certainly learn from international experience, provided we make allowance for the different cultures involved. Generally, what we learn is what to avoid.

In this context one must emphasise that the US system is not a unitary board as we know it, and that French and German supervisory boards containing union representatives may not be given parity of information with the management board.

33. The argument is open and at least not proven. In considering our structures one may bear in mind Churchill's comment on democracy, that it is quite the worst system of government – except for all the others.
34. In the absence of any evidence supporting this suggestion the answer must be No.