

Non-Executive Directors Review
Room 2142
1 Victoria Street
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REVIEW OF THE ROLE AND EFFECTIVENESS OF NON-EXECUTIVE DIRECTORS

We welcome the opportunity to provide input to the review and hope that you will find value in our comments which follow. We apologise for the fact that we were unable to submit this submission by 6 September.

BACKGROUND

Grant Thornton is the leader in providing accounting and professional services to mid-corporate, entrepreneurial businesses and their owners. Our clients frequently regard us as their financial and business advisors. These companies both want and need a variety of assurance and advisory services and tax services to help them compete, grow and prosper in today's global market place.

These companies, including those that have sought finance from the public by a listing of their shares, provide the drive and flexibility needed by the UK economy. It is therefore essential that whenever new regulatory or other requirements are being considered, full account is taken of the cost:benefit relationship for these companies so that changes are not made to address issues primarily affecting larger companies whose impact would restrict or destroy key features of smaller enterprises. We comment on this factor later in this submission.

INTRODUCTORY COMMENTS

The future enhanced role for non-executive directors

Both the report of the House of Commons Treasury Select Committee and the interim report of the Co-ordinating Group on Audit and Accounting Issues placed emphasis on an enhanced role for non-executives, particularly in their capacity as members of audit committees.

We agree with the reports' belief that quoted companies should have an effective audit committee which plays an active role in the appointment/re-appointment of the auditors, the challenging of the audit (and its findings) and the vetting of proposals to purchase non-audit services from the audit firm. These measures should provide a basis for improved public confidence in the independence of audits and auditors, which is a matter that was the subject of concern in the wake of the collapse of Enron and other recently reported instances of corporate failure and accounting irregularities.

However, our submissions to the two enquiries suggested that non-executives also have a key role to play in ensuring that executive management is adequately challenged in connection with periodic financial reporting (namely interim and preliminary announcements and the publication of annual accounts), particularly the accounting bases and policies that are applied by the company. In a situation such as that of Enron, this would include the treatment by executive management of special purpose companies in the group accounts. As noted later, such an extended role has implications for the skills and knowledge that would need to be present amongst the non-executive members of a board.

Removing disincentives for candidates to fulfil the enhanced role

We are concerned that the vital restoration of public confidence (particularly within the capital markets) could be prejudiced by a shortage of suitable candidates for the role. In deciding whether to accept an appointment, an individual will weigh up the related responsibilities and exposures (both legal and reputational) against the rewards arising from the role. In our view, a review and reform of the legal position of "non-executive" directors (which is a status that is not distinguished in law from other - "executive" - directors) is vital if sufficient, suitable candidates are to be prepared to volunteer to fulfil the enhanced role.

Some commentators have suggested looking to Europe for an alternative governance model. We are not persuaded that adoption of a two-tier board structure (which is normally designed to facilitate worker participation) would be an appropriate approach in the UK context. Instead, we should like to see formal recognition of these new-style non-executives for what they are, namely directors who would be solely charged with defined responsibilities in respect of corporate governance (referred to below as "Governance Directors").

This recognition could be achieved through legislation or, in our view preferably, by the development of a code of practice which could be given authority by the Listing Rules. It would be the intention that the defined role of a "Governance Director" would be clearly and sufficiently distanced from the general legal duties and powers of other directors (whether "non-executive" or "executive") to persuade a court that liability for the collective actions of the board would not be attributable to a Governance Director. For example, we would not expect a Governance Director to be held liable where executives committed (but concealed) financial impropriety in situations that he/she could not reasonably have detected. However, a Governance Director would be liable if he/she had failed to discharge his/her defined role to an expected standard.

Other features that the code of practice should include are as follows:

- setting out the key attributes which directors would be expected to exhibit (in the way in which Nolan has set out expectations of behaviour in the public sector);
- establishing the main skills requirements which should exist in the board as a whole;
- requiring boards of directors to carry out regular reviews to demonstrate how they achieve and maintain the attributes and skills required.

The role of a Companies Commission

We have already placed on record our view that should the new enhanced audit committees not result in renewed public confidence, we would favour the introduction of an independent Companies Commission to oversee audit appointments, fees and non-audit services in the listed company sector. However, before taking such an important step, we would expect Government to allow the new arrangements time to prove themselves.

OUR RESPONSES TO THE "ISSUES FOR CONSIDERATION"

The remainder of this submission sets out our responses to the questions posed within the consultation paper.

What role should non-executive directors perform and how does this compare with the present position?

In our experience of small to medium sized quoted companies, the role played by non-executive directors is shaped by the expectations of the Combined Code, namely to provide:

- a sounding board for the executive members of the board
- a degree of detached oversight of the actions and performance of the board
- a means of overcoming conflicts of interests that may affect decision-making by the board.

Non-executives also play a vital role in board committees, particularly audit and remuneration committees. These roles impact on the attributes that are needed for a non-executive director to be effective, as discussed later in this response.

What knowledge, skills and attributes are needed and what can be done to attract, recruit and appoint the best people to non-executive roles?

We believe that the current role of non-executives is best discharged by individuals who have the following skills and knowledge:

- a background in business, preferably at a senior level within an organisation of similar size;
- an appreciation of finance and an awareness of the requirements for periodic financial reporting;

- an appreciation and acceptance of the relevant compliance regimes affecting quoted companies, particularly the Combined Code;
- an understanding of risk management assessment techniques and the implementation of appropriate internal control processes;
- an understanding of modern remuneration standards;
- personal attributes, including integrity, independence of mind and commitment to the role of non-executive director (which includes having sufficient time to devote to the role).

It is not necessary that each non-executive should have all of the above skills (although all should demonstrate the same high level of personal attributes) merely that among the non-executives as a whole that those skills are present to an adequate degree.

A fundamental attribute of the non-executives acting as a whole is that they should have the ability to challenge and if necessary replace members of the executive management team, including, if necessary, the chief executive.

In our view, the enhanced role envisaged by the two committee reports referred to earlier will require individuals who sit on the audit committees of quoted companies to have a more in-depth understanding of the following:

- the nature of the audit and the role of the auditor, including the statutory and professional requirements that shape that role;
- how an audit is conducted and the interfaces between the auditor and the company's management and staff;
- the factors that might argue for or against the provision of non-audit services by the auditor.

Whilst an independence of mind is an important attribute in all of these aspects of the role of non-executives, we believe that there should be a renewed focus on the actual and perceived independence of individuals who are currently serving as non-executives and who will sit on companies' audit committees.

We believe that public confidence in financial reporting, of which the audit is but one important element, will only be restored if there can be public confidence that the proposals of executive directors that impact on accounting and periodic reporting are subject to informed and independent challenge from within the board, not just by the auditor. This would require non-executives to have no business or personal relationships with the company and its executives which could be *perceived* as prejudicing their willingness and ability to act, if necessary in the extreme by resigning as a director.

We believe that many currently serving non-executive directors are not equipped to discharge the enhanced role envisaged by the two review reports and that if their recommendations are to be implemented there will be a vital need for guidance and training to be made available to individuals who propose to serve as members of audit committees in the future.

Our recommendation for non-executives to be seen to be independent is likely to mean that some existing non-executives would either need to withdraw from existing appointments or, if they are to continue, would need to terminate financial or other arrangements which may be viewed as incompatible with independence.

Do existing structures and procedures facilitate effective performance by non-executive directors?

Our introductory comments describe the tensions that we believe will arise from the enhanced role that non-executives will be called upon to play if the changes are not accompanied by appropriate measures to protect "governance directors" from the financial consequences of the actions of fellow directors.

As we noted above there is clearly a vital need for more guidance on skills and attributes required of non-executive directors.

Do existing relationships with shareholders or others need to be strengthened?

An enhanced role for audit committees (whether based on our recommendations or the model put forward by the review reports) will operate on a continuous basis, and therefore will not be 'visible' to shareholders. However, we do not agree with the recommendation that has come from some quarters that the non-executives should therefore have a more direct ongoing relationship with shareholders or others, such as financial analysts. We believe that both would be contrary to the concept of a unitary board.

Instead, we believe that the appropriate interface between the shareholders and non-executives is via the annual report and at the AGM. On this basis, the outcomes of the enhanced role of audit committees should be reported each year through the medium of a report from the audit committee within the company's annual report; shareholders would be able to question the chairman of the audit committee at the AGM so as to obtain their own (direct) comfort that the role was being discharged effectively.

How can non-executive directors best be supported to perform their role?

As noted earlier, if non-executives are to have an enhanced and more formal role, it is essential that they have the means to discharge that role in line with the reasonable expectations of the company's shareholders and the public in general. We therefore support the recommendation of the Co-ordinating Group on Audit and Accounting Issues that the current Combined Code should be reviewed and updated; we also recommend that a clear practical guide on best practice for non-executives should be produced, perhaps by a representative body such as the IoD or the CBI.

Many individuals are likely to need to enhance their current knowledge if they are to continue to serve as a non-executive so the availability of appropriate, quality training is likely to be a key issue for the implementation of any new role in the future.

In what ways is the position different for smaller listed companies?

In our view, the public concerns that were generated by the collapse of Enron and other subsequent business and accounting failures are greater in the context of large listed companies with professional management who are distant from public stakeholders than is the case with owner-managed businesses, the characteristics of which are shared by many smaller listed companies or whose shares are quoted on AIM.

We would not wish to see enhanced requirements for non-executive directors to be appointed (and with an enhanced role) in situations where the benefit (in terms of addressing the issues identified by the two review reports) would not repay the undoubted additional cost. This is not to say that effective governance should be restricted to the larger (say FTSE 350) companies but there needs to be recognition that what may be "required" practice in a large company context may be unnecessary or unachievable (say on cost grounds) in smaller companies, so the Code of Practice recommended earlier needs to be sensitive to the different context of smaller entities.

Given our focus on mid-corporate entities, we are currently developing an aide memoire of the particular matters that we believe non-executive directors of our own listed company clients should have at the top of their personal agendas: for example, whether the board(s) on which they sit contains an appropriate mix of expertise in business, risk management and financial reporting. We would be happy to provide a copy when this becomes available.

What can we learn from international experience?

We would support research of practices overseas but would be wary of "importing" apparent solutions from legal and/or business contexts that are different from the UK's. As noted earlier, we do not believe that changes need to be made to the current unitary board structure.

CONCLUSION

Should you require further input from us on any of the matters discussed in the submission, contact should be made at the first instance with Steve Maslin, Head of Assurance Services, or Peter Rowley at this office address.

Yours faithfully



Grant Thornton