



The Institute of Internal Auditors
UK and Ireland

Review of the Role and Effectiveness of Non-Executive Directors

Consultation Paper

Response by the
Institute of Internal Auditors – UK and Ireland

September 2002

1. Institute of Internal Auditors – UK and Ireland

The Institute of Internal Auditors – UK and Ireland (IIA) is the primary body representing, promoting and developing the professional practice of internal auditing in the UK and Ireland.

The IIA qualification (MIIA) is regarded as the leading professional qualification for internal auditors. Qualified members of the IIA are grounded in risk management and control, corporate governance, financial and management accounting, and business information systems. The commercial relevance of the IIA's qualification is ensured by the fact that membership of the Institute is only granted when a student has recorded a career profile demonstrating at least three years' relevant experience. Through constant monitoring of the syllabus, the IIA ensures that its qualification covers the latest business issues in a rapidly changing marketplace.

All IIA Members are expected to observe high ethical standards of professional conduct. They share the fundamental principles of the profession - the *Code of Ethics* and the *Standards for the Professional Practice of Internal Auditing* - with over 75,000 internal auditors worldwide.

2. Detailed Response

A. Role:

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

- A.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?

The principal role of the board is to direct and govern the business, increase shareholder value and safeguard the interests of the stakeholders.

The Chairman must exercise authority in leading the board and in driving the organisation's corporate vision, mission and values. He/she should challenge the decisions of the Chief Executive in a constructive way and provide balance and perspective where necessary.

The Chairman should be responsible for selecting and ensuring the right mix and quality of non-executive directors on the board and for promoting and maintaining a sound governance culture. In addition, the Chairman should act as the senior point of contact for the non-executive directors and should ensure that they perform their oversight role effectively.

- A.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 key role for every non-executive director is to bring an independent, objective and external perspective to the boardroom and to use that perspective to challenge the executive directors in a constructive way.

As a body, the non-executive directors should ensure that the executive directors are acting in the best interests of shareholders and other stakeholders and are not allowing their decisions to be clouded by their own personal interests.

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The oversight and control relationship that the Chairman has with the Chief Executive should be mirrored in the relationship that the non-executive directors as a body have with the executive directors. The role that each individual non-executive needs to perform to ensure this relationship is effective will vary from one organisation to another.

As a group, the board's non-executive directors should possess a balance of skills, experience and knowledge that are specific to the organisation's existing or planned business activities. Some of them may be specialists such as lawyers, actuaries, engineers or scientists, for example, but not all non-executives should be expected to have specialist expertise. However, each of them should make a clearly defined contribution to the effectiveness of the non-executives as a group.

A.3. How does this compare to the present position?

The extent to which organisations achieve best practice governance in the boardroom is not clear. Research suggests that non-executive directors generally do not spend sufficient time on their duties and do not receive the right depth of information to challenge the Chief Executive and executive directors.

A recent survey carried out by the IIA revealed that non-executive directors do not make the best use of support functions such as internal audit. We have attached a copy of the survey results for information.

Today's businesses are often extremely complex, rapidly changing and technologically advanced. In addition, corporate governance, risk management and internal control have become more formal processes in recent years. Many mature non-executive directors built their business experience in a very different environment. We are concerned that the current pool of non-executive directors has not changed to reflect this shift and may not contain sufficient individuals capable of performing the role of the modern non-executive director effectively.

In the past non-executive directors have tended to be recruited through the "old boys network" and had general business/management experience, whereas what is now required is a proper analysis of the skills required by the board and a recruitment exercise based on filling the knowledge/experience gaps identified by this analysis.

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

We believe that the provisions of the Combined Code should be extended so that all of the non-executive directors on a listed company's board are independent from that company. In other words, non-executive directors should not have served the company in any previous capacity, for example as an executive or manager. Once appointed as a non-executive director, that individual should not serve the organisation in any other capacity, for example by carrying out paid consulting work. If this approach is to be adopted then a list of criteria for independence will need to be drawn up.

However, ensuring that non-executives meet the agreed criteria for independence will not, on its own, ensure that once appointed they act and think independently. The key to the success of non-executive directors is their objectivity and integrity and this will need to be carefully challenged when such people are being recruited to the board of directors.

The corporate culture – in terms of the attitude of the Chief Executive, the atmosphere in the boardroom and the culture of the wider organisation – can also make it difficult for non-executives to express objective views. To be effective, non-executives need to work in a culture where honest challenge is welcomed, valued and encouraged. Where the corporate culture is not conducive to good governance, the non-executive directors will need to decide whether they can work to change that culture or whether they should resign.

- A.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?

One of the biggest potential conflicts of interest that face executive directors is maximising shareholder value at an acceptable and responsible level of social and ethical cost.

As a body, the non-executive directors can help to ensure that the executive directors are acting in the best interests of shareholders and other stakeholders and are not allowing their decisions to be clouded by their own personal interests (such as ego-driven deal making, inappropriate incentives, reluctance to re-assess strategic business direction) and achieving business performance at any cost. The non-executive directors can help to protect the shareholders interests from the executive directors taking high-risk business decisions by subjecting them to a robust challenge process and ensuring that accountability for such decisions is clearly established.

The non-executive directors on the audit committee should also make better use of their internal audit function to support them in this role. They should direct internal audit to review and report on issues such as those outlines above to ensure that the company has an effective business code of ethics and that procedures are in place to monitor and report compliance with this code. In addition, internal audit could ensure that any novel and potentially contentious business practices are identified, reported and sanctioned in advance, that there is a clear framework of authority delegations and that compliance with such delegations is monitored and reported.

- A.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?

Time commitments are likely to be determined by the size and complexity of the organisation's business activities. It is more important to suggest guidelines on the frequency with which the main board and its committees should meet and to emphasise that interest in the organisation need not be restricted solely to attendance at meetings. Good practice dictates that audit committees should meet around four times each year.

As a means of ensuring that non-executive directors dedicate sufficient time to the companies they serve, a simple cap on the number of non-executive directorships that a single individual can hold would be a crude control as it would not take into account the varying levels of commitment that each organisation requires. Also, a limit on the number of directorships that a particular non-executive can hold might make that person more financially reliant on a smaller number of companies, which could in turn affect their independence.

Shareholder confidence could be improved if all directors were to disclose all their directorships in the annual report.

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

We believe that the Combined Code provides for a sufficiently robust framework by splitting the role of Chairman and Chief Executive. If this happens then the Chairman should effectively play the role of a senior non-executive director. As long as he/she can be seen to be independent we believe this to be sufficient.

However, where an individual performs both roles then we would support the appointment of a senior independent non-executive director who will effectively lead the other non-executive directors. This appointment should be declared in the organisation's annual report.

A.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?

All directors are and should be treated equally in the eyes of the law. However, any new legislation that relates to the specific duties of directors needs to reflect the fact that on occasion the roles and responsibilities of the non-executive directors and those of the executive directors can be very different. There are also differences in the ease and speed with which each group can access information and discuss issues with management. In some instances of governance failure information has been deliberately withheld from the non-executive directors.

On a wider point, while we believe that non-executive and executive directors should both be equally accountable in law, this needs to be reflected in the levels of remuneration paid to non-executives.

Any change to the liabilities of non-executive directors without a matching change in the rewards and risks faced by non-executive directors will only serve to make recruitment of good candidates even more difficult.

B. Attracting and appointing non-executives:

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

B.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?

We believe that the essential skills that every non-executive director should have include:

- strategic perception;
- decision making;
- analysis and evaluation;
- communication skills, including good interpersonal skills
- ability to challenge authoritatively.

Useful experience would include:

- previous boardroom experience;
- broad business experience;
- an understanding of good governance principles including risk management and internal control.

Key knowledge might include:

- finance;
- audit;
- legal and compliance;
- new technology;
- risk management and control;
- specific industry sector experience.

B.10. What personal qualities and attributes are needed?

Non-executive directors need to be able to think independently, have integrity, and between them have sufficient understanding of the business to probe executive assertions. There will remain a need for common sense and an awareness of the organisation's role in the bigger business picture, as well as recognising wider stakeholder pressures that are becoming more vocal. In this respect, non-executive directors should possess:

- an independent frame of mind;
- strength of character;
- courage to robustly challenge the executive directors and senior management team;
- tenacity;
- wisdom;
- firm ethical principles.

In addition, non-executive directors must be able to:

- analyse and assimilate information rapidly and to sort the important issues from the more mundane;
- identify the key questions that relate to the company and to keep asking them until a satisfactory answer is received;
- intervene wherever there is a risk that the interests of management, company and shareholders diverge;
- provide an objective view on board and management performance and push for a change in management where conflicts of interest begin to adversely impact the achievement of business objectives;
- take a diligent attitude towards their role and responsibilities, to understand how these are different from those of the executive directors and to respect those differences.

On contentious issues, the aim should be to provide a robust but positive contribution. However, the non-executive directors should have the courage and integrity to resign if they believe that it would be in the best interests of the company for them to do so.

B.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.

The mix between executives and non-executive directors is key to the successful performance of the board and the organisation it serves. Executive directors are expected to bring operational and industry expertise while non-executive directors bring the more intangible attributes, i.e. independence, ethics, etc. Not every individual will need to possess the same skills, experiences and personal attributes but there should be a balance across all the directors.

A wider mix of age, sex and race is also required to supplement the current – perceived or otherwise – "old boy network".

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- B.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?

Recruiting the right non-executive directors is a difficult task, but time spent on identifying key gaps in the board's make-up, defining clear job descriptions and drawing up detailed person specifications are essential pre-requisites.

Experience has demonstrated that some non-executive directors tend to be drawn from a relatively limited pool. This may also lead to such individuals taking on an excessive number of appointments and hence diluting the time they are able to spend on each appointment. We believe that the recruitment net for non-executive directors should be spread more widely and that mechanisms should be developed to allow this to happen.

- B.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?

A mix of options should be explored including:

- allowing potential candidates to spend some time with the business getting to understand the culture etc enabling them to come to a proper decision as to whether they wish to serve;
- possible employee nominations seconded to the board;
- inviting applications at a share holders meeting;
- establishing a register of non-executive directors maintained by the Institute of Directors.

We believe there is scope for greater international representation on UK boards as long as companies are prepared to assess and accept the additional cost against the value received.

- B.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?

It is important to reward non-executive directors adequately for their contribution to the success of the organisation and to reflect the personal risk they bear as a result of their position, particularly with regard to their reputation.

Salaried positions are preferable to shares, share options or any other form of remuneration that is linked to the performance of the company, as these can all affect independence.

It is difficult to know whether current levels of pay are making it more difficult to attract good non-executive directors. A more likely deterrent is the increased risk of damage to the non-executive's personal reputation, higher expectations about what non-executives should be held responsible for and the increased likelihood of litigation against the director personally – or even prosecution.

As said above, any future change to the liabilities of non-executive directors without a matching change in the rewards and risks faced by non-executive directors will only serve to make recruitment of good candidates even more difficult.

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

We believe that a company should provide its non-executive directors with the same level of insurance cover that is accorded to its executive directors.

C. Structures and accountability

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

- C.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?

The IIA firmly believes that executive directors, senior management, specialist board committees, internal auditors, and external auditors are the six pillars on which effective corporate governance is built. In the Combined Code, the UK has an excellent framework for sound corporate governance, but we need to beware of complacency. In some areas – particularly with regard to internal control – the Combined Code does not go far enough. In many other areas too many companies are taking the “comply or explain” opt out, under which they can ignore parts of the Combined Code as long as they give their reasons for doing so.

- C.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?

Our comments on this issue are specifically related to Audit Committees and are, therefore, dealt with below.

- C.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?

Audit Committees are an essential mechanism for enabling the board to demonstrate formal and transparent arrangements for applying the financial reporting and internal control principles and for maintaining an appropriate relationship with the company's auditors. (Combined Code Principle D.3).

For many years it has been the policy of The IIA to recommend that companies should have audit committees. We have observed over the years that whilst most companies do have Audit Committees, their operation does not always conform with the best practice we recommend.

In our view Audit Committees should be standing committees of the main board and should comprise exclusively independent, non-executive directors, though executives and others may be in attendance.

Audit Committees should be answerable only to the board and their core role should be to oversee on behalf of the board and to report to the board on the

- financial reporting process
- audit thereof
- assurance on risk management and internal control of the business and
- review thereof by internal audit

There is growing evidence from research that many companies have introduced Audit Committees in word but not fully in deed. We believe that Audit Committees can be made to work more effectively if they:

- have integrity and can exercise unfettered independence of mind.
- are given unfettered access to all necessary information to enable them to properly discharge their responsibilities and
- can raise robust challenges.

We see Audit Committees as being fundamental to the discharge of effective corporate governance responsibilities. As such their implementation and effectiveness within companies must become a key company performance criteria.

In addition, they should make greater use of their internal audit functions to obtain a clearer picture of whether their organisation's risk and control frameworks are effective. A recent survey conducted by the IIA revealed that many Audit Committees are missing out on this valuable source of independent assurance. A copy of the results of this survey is attached for information.

All Audit Committees should be reviewing the scope of the assurance that they expect to receive from internal audit. Both WorldCom and Enron show that boards and shareholders cannot rely solely on the views of their external auditors, particularly given the high-octane commercial pressures of the markets. Internal audit is an essential, independent viewpoint that Audit Committees should be making full use of.

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

All such committees should have clearly documented terms of reference approved by the Board. The Remuneration Committee should comprise solely of non-executive directors and should exercise great care and attention in addressing the reputational risk arising from the award of large remuneration packages.

- C.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?

This question is outside the scope of our expertise and we would prefer not to comment.

- C.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?

Shareholders and other stakeholders should be able to challenge the performance of both executive and non-executive directors. To enable this to happen, companies should disclose good quality information about the performance of directors against reasonable targets.

The effectiveness of the board as a whole and of the various board committees should be assessed on an annual basis. This could most usefully be achieved as a self-assessment exercise facilitated by an external third party. The Chairman should review the performance and attendance of the non-executive directors. The results of this review should be reflected in their pay and whether or not their employment continues.

- C.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?

We believe that, at present, some non-executive directors do not have the knowledge and skills or are not in a sufficiently independent or informed position to provide a robust challenge to executive decisions or to expose serious problems.

The comments that we have made elsewhere in this document about improving the quality of non-executive directors and ensuring their independence will help to improve the situation.

The process could also be made easier through better-informed, more frequent dialogue between the executive and non-executive directors and better training to help non-executives to work together as a group. We would also encourage more frequent contact between the non-executive directors and the company's head of internal audit.

The continental European model of an executive managing board and a non-executive supervisory board may be worth exploring.

D. Relationships with shareholders and others.

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

- D.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?

It would be beneficial if non-executive directors and institutional shareholders were encouraged to discuss the quality of corporate governance, risk management and internal control processes at the company. IIA research shows that, at present, there is little discussion between companies and their shareholders on these important issues and, partly as a consequence, excellence in these areas is not reflected in the company's market value. Encouraging shareholders to put a value on good governance is one way of influencing the executive's attitude towards governance issues.

- D.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?

The Chairman must:

- promote the right culture for open dialogue and constructive challenge;
- moderate inappropriate Chief Executive/executive behaviour;
- encourage non-executives to speak up and recognise the importance of their role;
- secure sufficient and reliable information for committee members and sufficient time to review prior to meetings.

Meetings must be sufficiently frequent and long enough to ensure adequate discussion.

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- D.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?

All such relationships must be built around mutual respect and trust.

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

Company Secretaries can help by making sure that information for discussion at board meetings is available ahead of time and is of the right quality and quantity. They must maintain accurate minutes of meetings and distribute these promptly after meetings. They may also be able to help non-executives obtain ad hoc information on request.

E. Support

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

- E.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?

Non-executive directors should be provided with as much information as they believe is necessary to perform their roles effectively. They should be able to ask for any information they want from management and should at the very least have a clear agreement with management about what is to be reported to them on a regular basis. The flow of information should be one of the things covered in the annual review of board performance.

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

High quality training, perhaps supported by a certification programme, is essential if non-executive directors are to discharge their responsibilities effectively. Training should cover their role, duties and responsibilities as directors and also specialist skills and behavioural training, e.g. the ability to ask challenging questions. Such training could form part of a mandatory core programme developed by the Institute of Directors.

The following might also be useful:

- formal business induction training
- making more use of organisational resources such as internal audit to provide risk management and control "refresher" training
- regular new technology or business opportunity updates
- getting to meet and know new executive management
- being made aware of changes to executive management, business roles and responsibilities and organisational structures

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

There should be a good standard of induction training for all new non-executives which should be supplemented on a regular basis by updates, particularly when legislation and regulation change.

- E.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?

Clear terms of reference and specific performance measures should be agreed with all non-executives. We believe that this is not always done at present.

F. Smaller listed companies.

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

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

We do not believe that different criteria should apply to smaller listed companies. Investors should get the same level of protection whether they invest in a large or small company.

G. International context.

What can we learn from international experience?

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

This question is outside the scope of our expertise and we would prefer not to comment.

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

The continental European model of an executive managing board and a non-executive supervisory board may be worth exploring.

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

The New York Stock Exchange has recently brought in a requirement that all listed companies have an internal audit function. This should become a requirement in the UK. All publicly held companies should establish and maintain an independent, adequately resourced and competently staffed internal audit function to provide management and the audit committee with ongoing assessments of the organisation's risk management processes and the accompanying systems of internal control.

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