

A ROLE

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

Q1. 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 role of the board

The board is *ultimately* responsible for virtually every aspect of a company's activities. In particular, the board's role is to provide general direction to the company and to represent and safeguard the long-term interests the shareholders. This can be achieved only by having regard to the other relationships on which the company depends - such as those with employees, customers, suppliers and the community, as well as to the impact of business decisions on the company's reputation and the environment.

In addition to its statutory duties, the board should *inter alia*:

- set the company's strategy and its objectives;
- ensure that the company has business plans to achieve the objectives;
- ensure that the company has a good executive team that is properly remunerated and motivated to achieve the objectives, strategy and business plans;
- ensure that the company conforms with best practice in corporate governance and business methods, and that its performance against objectives is reviewed on a regular basis, taking appropriate action where necessary; and
- communicate clearly and regularly to shareholders.

Role of the chairman

Chairmen play a critical role in the functioning of company boards. Their formal functions are as follows:

- chairing board meetings;
- chairing annual general and general meetings of shareholders; and
- liaising with the CEO and company secretary on the agenda for board meetings.

However, beyond these formal duties, most chairmen exercise considerable power and influence. Typically they influence the effectiveness of boards in a number of ways:

- they control the "tone" of board meetings, keeping discussions on track, encouraging all members to make a contribution, and defusing personality clashes;

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- they serve as the main point of contact with the CEO, working towards a harmonious relationship between board and management, acting as an informal channel for conveying board concerns to management and reinforcing board responsibility for all major decisions affecting the company.
- they play a key role in the selection and nomination of directors, identifying gaps in board competencies that should be addressed by new appointments, and dealing with under-performing directors. (A chairman's influence on board composition might be modified, but not eliminated, by the existence of a board nominating committee.);
- they act as a focal point for the assessment of board performance, discussing performance assessments with individual directors; and
- they can become the public face of their companies at shareholder meetings, and on other occasions when actions are taken, or statements made, in the name of the board (eg takeover bids).

We believe that the role of chairman and CEO should generally be separate, though the relationship between chairman and CEO is clearly of the utmost importance. Effective chairmen will seek to be supportive of their CEOs, but without compromising board prerogatives. High-level interpersonal skills are useful in this respect.

Not surprisingly, chairmen tend to spend considerably more time on company business than other non-executive directors.

Q2. 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?

Non-executive directors are normally appointed to the board of directors both for their contribution to the development of the company's strategy, and to fulfil a control and monitoring function. In some smaller companies non-executives may contribute valuable expertise not otherwise available to management or may act as mentors to less experienced executives. Nevertheless, by not being involved in the day to day management of the business, they bring an independent and objective view to the board room.

Some of the key aspects of the non-executive directors' role are:

- recommending appointment of the CEO and other executives;
- challenging strategy; reviewing business risks;
- challenging the effectiveness of the system of internal control and risk management;
- challenging business plans, budgets and projections;
- reviewing actual performance against plans;

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- reviewing the scope and results of internal and external audit;
- reviewing the performance of executive directors and management; and
- recommending the remuneration of the executive directors.

It is unreasonable to expect all of the non-executive directors to fulfil each role and the balance will depend on the individual company. Some non-executives may tend more to an advisory role and others more towards a monitoring role. Members of board committees, and in particular the audit committee, should have the requisite experience and background to discharge their responsibilities properly. Although each individual non-executive director is hand picked for their skills, together they should act collectively as part of the unitary board.

As part of our survey of non-executive directors, we asked participants to indicate the extent to which they considered various aspects of their role to be important on a scale of one to five (where one is very important and five is not at all important). Respondents considered the following areas to be particularly important (rating the aspect of the non-executive's role either one or two):

- Reviewing the strategy (98%); reviewing business risks (97%); reviewing business plans, budgets projections (89%); reviewing financial information against plans (86%); and reviewing the scope of internal and external audit (81%).

The following areas were considered much less important:

- Providing specialist technical advice (17%); communicating with other stakeholders such as bankers analysts and lobbyists (15%); and communicating with key shareholders (28%).

We consider this analysis to be appropriate.

Q3. How does this compare to the present position?

Many companies have already dealt with these issues. When asked non-executive directors about the time spent on each aspect of their role, on the whole, respondents spent most of their time on those areas consider most important.

Notwithstanding the above, we believe that the role of the non-executive is vital to the health of UK boards and therefore, we support any initiative that further *clarifies* the role of the non-executive director.

Q4. How independent do non-executive directors need to be for the different roles?

While independence is above all concerned with the integrity of the individual in question, it is not unreasonable to suggest that financial ties, whether personal, business, political or

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philanthropic, potentially threaten the independence of non-executive directors and therefore their motivation to actively challenge management. However, we do not support formal definitions of independence. Rather than simply meeting some checklist of independence criteria, it is imperative that non-executive directors are able in practice, not just in theory, to express views to the board that are different to those of the chief executive officer and be confident that, provided this is done in a considered way, they will not suffer.

Investors are entitled to draw their own conclusions as to the independence, or otherwise, of non-executive directors. But to enable them to do so, companies should be required to disclose all connections or circumstances which could lead to potential conflicts of interest. Transparency is paramount.

Turning to the three main board sub-committees - the audit, remuneration and nomination committees - it could be argued that all audit committee members should be independent non-executive directors (currently it is all non-executive, a majority of which should be independent). However, we are not aware of any evidence to suggest that the current Combined Code recommendation and practice is flawed. Similarly, we see no evidence to support a change to the recommended composition of nomination committees. Nevertheless, while we do not believe that changing the recommended composition of audit and nomination committees will improve UK corporate governance, it may improve the perception of governance in the eyes of the media and public at large. However, the benefits of any proposed change to the Code recommendations, would need to be balanced against the increased burden placed on smaller companies (and in turn their shareholders) who sort to comply with 'best practice'. See question 19 also.

Q5. 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?

Most potential conflicts of interest are likely to have their origin in issues related to meeting short-term expectations, such as earnings targets. Short-termism is a major issue, and a balance has to be struck between keeping the capital markets regularly updated and creating unrealistic short-term expectations. This is not an insurmountable problem. Responsible narrative disclosure of the company's strategy and long-term aims together with progress to achieving such aims should be encouraged. In this regard, we support the statutory operating and financial review proposed in the DTI's recent White Paper. Other areas where potential conflicts of interest arise include contracts or transactions in which a director has a material interest.

Conflicts also arise as a result of targets which trigger performance related directors' remuneration eg, bonus, long-term incentive and share option awards. Here, the remuneration committee should help prevent conflicts arise by ensuring that compensation

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packages are appropriately designed and monitored. Similarly, the audit committee should be alert to this issue when overseeing financial reporting and the associated risks and controls.

In general, non-executive directors can help focus attention on longer-term sustainable growth by taking a dispassionate view and maintaining a focus on what is in the best long-term interests of shareholders - even if it is not good for the executive directors in the shorter-term.

We note with interest the recent US developments regarding ethical codes, in particular, the NYSE proposals recently submitted to the SEC which propose the adoption and disclosure of a code of business conduct and ethics for directors, officers and employees, together with prompt disclosure of any code waivers for directors or executive officers.

No code of business conduct and ethics can replace the thoughtful behavior of an ethical non-executive (or executive) director, however, such codes can focus the board and management on areas of ethical risk. They can also provide guidance on the recognition of ethical issues, provide mechanisms to report unethical conduct, and help to foster a culture of honesty and accountability. We encourage the use of such codes, but would not support the development of a statutory code.

Finally, it should be remembered that conflicts of interest are not limited to the non-executive directors (and auditors). Potential conflicts also arise with executive directors, bankers, lawyers and many other professional advisors.

Q6. 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?

To be fully effective, audit committee members must be diligent and prepared to invest the time necessary to understand their businesses. Time commitments will, of course, vary a great deal and depend on the size, complexity and the circumstances of the business. If a company is not in good financial health, is particularly complex or has a 'difficult' culture, then more time will be required.

The time individuals need to devote to their non-executive duties is also affected by their professional background and experience. For example, a non-executive director with a financial background is very much more likely to be drawn into issues than if they have (say) a marketing background. This is especially true in a financial crisis.

The minimum time input for a non-executive is impossible to quantify and will vary with the role being undertaken. Non-executive directors who are audit committee members

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will have greater demands on their time than those that have no committee duties. Likewise, chairmen have to devote considerable time to the business.

The increasingly demanding corporate environment in which we find ourselves today may mean non-executive directors need to devote a greater amount of time to their role than previously and this may mean accepting fewer appointments. Nevertheless, prescribing strict rules governing the number of non-executive appointments an individual may have is the wrong approach. Some audit committee members will have executive positions, others will not. Even those candidates that no longer have executive positions may have other commitments that take up large amounts of time. Each individual and organisation is different. A practical constraint is the number of days in each month to read papers and attend board meetings. There should, however, be no prescription by legislation or regulation on the number of posts an individual may have.

Procedures in some companies may need to be more rigorous in this area. During the appointment process, nomination committees should specify the time commitment expected and ensure that potential appointees are not over committed. Furthermore, the Chairman should annually review with each non-executive their time commitment and satisfy themselves that each individual is spending sufficient time with the company to properly fulfil their duties.

It is worth noting that 69 percent of respondents to our survey cited lack of available time as a significant impediment in taking on more non-executive positions.

Q7. Should there be a special role for a “senior independent” non-executive director?

That companies identify a senior non-executive director in addition to the chairman and chief executive officer is one of the more controversial Combined Code recommendations. It has been argued that the senior independent director role is redundant where the roles of CEO and chairman are separated. However, even where the roles of chairman and CEO are not combined, there can be occasions where shareholders and other interested parties may need to convey concerns to the board other than through the chairman or CEO – though this is a position of last resort. On balance, we support the role of the

Q8. 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?

Any attempt to distinguish between the statutory duties of executive and non-executive directors would be very difficult and might undermine the unitary board concept. We support the view of the Company Law Review that does not seek to distinguish between the legal duties of executive and non-executive directors.

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Nevertheless, whilst we appreciate that the liability of directors is a complex area, we are concerned that the legal and reputational risks are too great given the average non-executive directors fee. Whilst ensuring the unitary board concept is not undermined, some form of equitable protection for non-executive directors, such as proportional liability, should be considered. We have evidence from the US that suggests that the arguably excessive exposure to liability that exists today may discourage good individuals from becoming non-executive directors.

When we asked what factors prevented non-executives taking on new appointments, reputational risk (69%) and inadequate reward (55%) were considered to be significant impediments.

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?

Q9. 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 key skills, knowledge and experience that non-executive directors should possess will vary from company to company. However, taken as a whole, the range of skills possessed by non-executive directors should support the organisation in its achievement of strategic objectives.

While not every non-executive will need to have every skill, collectively a company's non-executives should demonstrate:

- Accounting and finance expertise
- Sound business judgement
- An understanding management "best practices" and their application in complex, rapidly evolving business environments.
- The ability and time to perform during both short-term and prolonged crises.
- Relevant industry-specific knowledge and experience
- Where relevant, business experience in international markets.
- The ability to provide strategic insight and direction by encouraging innovation, conceptualising key trends, evaluating strategic decisions, and continually challenging the organization to sharpen its vision.

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- Leadership and people management skills to align the board (and thus the workforce) with the company's business objectives.

As part of our survey, we asked participants to indicate whether they considered non-executive directors had sufficient knowledge in a number of areas. Respondents generally considered non-executive directors to be sufficiently knowledgeable in the following areas:

- financial performance and indicators (94%);
- cash flow analysis and projections (89%); and
- the system of internal control and its effectiveness (76%).

By contrast, the areas in which respondents considered non-executives to be least knowledgeable were external benchmarking and competitor analysis (44%), and non financial performance indicators (60%).

We are particularly concerned that non-executive directors should consider themselves ill informed about non-financial indicators as this suggests that many non-executives are distanced from the business process and therefore less likely to identify key risks and signs of failure at an early stage. We are not sure whether this apparent knowledge gap arises because non-executives are not supplied with relevant non-financial information, or whether such information is not monitored by management in the first place.

Q10. What personal qualities and attributes are needed?

Non-executive directors cannot be expected to provide meaningful protection for shareholders unless they are *independent* of mind, *diligent*, *knowledgeable* and in possession of relevant and reliable *information*. They must be in a position to challenge management and draw sufficient attention to dubious practices – even in apparently successful companies - and be confident that, provided this is done in a considered way, they will not suffer.

Non-executives also need to understand how to strike the right balance between excessive interference and abdicating their primary responsibilities. A key quality is understanding that the role of a non-executive is very different from the role of an executive director.

Furthermore, individual directors should process the following personal characteristics:

- Integrity and accountability - Character is the primary consideration in evaluating any candidate for board membership.
- Informed judgement - The ability to provide wise, thoughtful counsel on a broad range of issues ranks among the qualities sought in any director.

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- Financial literacy - One of the important roles of the board is to monitor financial performance.
- Mature confidence - Directors who value board and team performance over individual performance, and who possess respect for others, facilitate superior board performance.
- Openness to other opinions and the willingness to listen should rank as highly as the ability to communicate persuasively.
- High performance standards - In today's highly competitive world, only companies capable of performing at the highest levels are likely to prosper.

Q11. 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.

See questions 9 and 10 above. We do not feel it is appropriate for us to provide examples of where non-executive directors have contributed with particular effect to company performance, or to corporate governance.

Q12. 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?

Historically it has not been that difficult for large FTSE companies to recruit non-executive directors - many have come from other quoted companies. However, in the current climate, we believe it is becoming harder to find good people willing to take on the non-executive directors role, especially in those companies that perhaps need them most.

Not only is there a certain amount of anecdotal evidence to suggest that that this is the case, but research conducted in the US suggests that that fewer executives want to take on the responsibilities or commit the time required to be effective. KPMG's own research in the US suggests that potential directors are especially wary of serving as members of audit committees - a significant number feeling that their exposure to liability had increased in some way as a result of the introduction of new SEC regulations governing the membership, processes, and disclosures of US audit committees.

In the UK, our recent survey of non-executive directors reveals a strongly held view that individuals are unwilling to take on the role when the risk reward ratio is so distorted.

When we asked on a scale of one to five, where one is very significant and 5 is not at all significant, how significant a number of factors were in preventing non-executive directors accepting further appointments, we learnt that the following factors were significant impediments:

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- lack of available time (69%);
- reputational risk too high (68%);
- lack of adequate reward (55%);
- executives perceived as being too dominant (51%);
- lack of trust in the current board (44%);
- insufficient information received in carrying out their own due diligence (35%); and in sufficient access to the board (35%).

By contrast, far fewer respondents considered the following factors to be a significant impediment to taking on new non-executive directorships:

- lack of adequate training (7%);
- lack of adequate dialogue with key investors (10%);
- lack of formal appraisal mechanisms (15%);
- lack of adequate formal appraisal mechanisms (16%).

The Combined Code has it about right as far as nomination committees are concerned. While the appointment of the right individuals, and succession planning, is vital, there should be no hard-and-fast rules as each company's needs are unique and change over time, as does the available pool of talent from which a new non-executives can be drawn. However, it is vital that there be a formal and transparent process in place. Key competencies should be considered and agreed upon and non-executives recruited against such competencies. Such competencies should take into account both the current state of the organisation and the strategy for the future.

Greater transparency and disclosure about the selection process and criteria used for the selection of directors should be encouraged. Also, when disclosing directors' biographical details in the annual report (as recommended by the Combined Code) a description of the particular attributes and experience each non-executive director brings to the Company should be included.

Greater transparency in the recruitment process could be demonstrated by openly advertising NED appointments in the public domain. Traditionally board level appointments are done discretely and the rationale for secrecy is generally compelling for executive roles. The majority of non-executive appointments will however be scheduled replacement of retiring incumbents so there will be no intrinsic need for secrecy. Soliciting interest from a wide population coupled with a more rigorous and transparently objective approach to the recruitment would robustly confront the current, generally wrong, perception that such appointments are unduly subjective. This approach may well be seen as unnecessary or even radical by some current non-executive directors, but the

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approach has the potential to be widely supported by regulators and the broader stakeholder community.

Q13. 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 might be merit in widening the pool to include those currently unrepresented on UK boards. Nevertheless, boards should recruit individuals who are best qualified for the job – and this may, or may not, include representatives from overseas, academia, the public sector and not-for-profit organisations. The debate should focus on setting open and transparent appointment criteria, not defining any particular class currently unrepresented on UK boards.

There is anecdotal evidence to suggest that some busy executives do not have the time to take on a non-executive directorship. Nevertheless, we believe executives can broaden their experience and perspective by taking on some non-executive positions, but should resist the temptation to take on positions that will place too onerous a commitment on their time. The danger facing those who do not have executive positions is that they risk falling out of touch with current issues.

Nomination committees, and the recruitment consultants they may engage, should also be encouraged to go further down organisations to find talent. Large organisations should encourage top management (the so-called ‘marzipan’ layer) to take on non-executive positions in other organisations. Not only would this grow the pool of talented non-executive directors, but also would enhance the abilities and therefore contribution of the individuals concerned.

As part of our survey of non-executive directors, we asked participants to indicate, on a scale of one to five (where one is strongly agree and five is strongly disagree), the extent to which a number of suggested changes would increase the pool of people willing to put themselves forward as non-executive directors.

Respondents indicated that the following suggestions would increase the pool of people willing to put themselves forward as non-executive directors:

- capping or otherwise limiting the liability of non-executive directors (69%);
- greater financial rewards (69%);
- greater focus on strategic rather than control aspects (64%); and
- greater clarification of the role and responsibilities of non-executive directors (46%).

By contrast, respondents considered that the following would have little impact on the pool of people willing to put themselves forward as non-executive directors:

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- fees based on hours worked (18%);
- fees based on a proportion of executive remuneration (23%);
- fees paid in share options (36%); and
- an increased focus on risk management (42%).

Finally, while many are quite rightly looking at how the pool of potential non-executive directors can be widened, it should not be forgotten that the appointment of an inappropriate board member is dangerous and can make a board dysfunctional.

Q14. 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 is a trade off between potentially compromising independence and aligning non-executive remuneration with shareholders interests. Non-executive directors should be paid fees commensurate with the skill and diligence required by their role, but not so much as to make them financially dependent on the company. It was clear from our survey that a majority of respondents considered that inappropriate rewards both prevented non-executive directors from taking on new roles and contributed to the small pool of individuals willing to take on non-executive directorships in the first place.

We believe that non-executive directors should not participate in share option schemes as this may undesirably compromise their independence. The leverage inherent in share options is inappropriate for non-executive directors. Furthermore, the ability of a non-executive director to resign is threatened where options previously granted can not be exercised upon resignation.

By contrast, part payment of non-executive directors in shares is legitimate. (It is little different from taking cash and buying shares on the open market.) However, share based payments are not without their problems as some would see non-executive directors as having a potential financial interest in driving up the share price – especially if the non-executive directors shareholding is large. Packages in which shares or options vest some time after the NED's directorship ceases could be explored.

Q15. Do you have comments on the issue of risks or insurance provision for non-executive directors?

Currently the liabilities of non-executive directors are *prima facie* the same as executive directors (though ultimately this is for the Courts to decide). It is questionable whether it be equitable that a non-executive is exposed to the same liability as an executive who, by definition, has a much greater knowledge of the company's affairs. We sympathise with those who argue that the legal and reputational risks facing non-executive directors are too

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great when compared to the average non-executive director's fee, and consider that the benefits of capped or proportional liability should be investigated.

Insurance is essential and all companies should take out adequate insurance for all board members. In the current market, it is likely that insurance will be more expensive and less comprehensive and this may cause problems in recruiting or retaining non-executive directors.

Almost all those who responded to our survey were provided with directors' liability insurance, four percent were not.

C STRUCTURES AND ACCOUNTABILITY

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

Q16. 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?

It is ten years since Cadbury identified many of the key governance issues and left the UK with a strong framework of checks and balances between the CEO and NEDs. Subsequently, the Combined Code has worked well in practice – and in particular the framework of 'comply or explain'. Compliance with the Combined Code is high (a fact often distorted by some governance observers who create 'headlines' by imposing their own definition of independence). This contrasts favourably with continental Europe where their equivalent codes do not appear to be as revered as the UK Code.

The Combined Code should be kept under review, and there may be a need to update its guidance from time to time. However, it should be recognised that the Combined Code provides recommendations, not requirements. It would be a mistake to expect all companies to be governed in the same way.

We believe that the Combined Code provisions on board balance are appropriate. The balance between executive and non-executive directors should be flexible and allow for the needs of different companies at various stages in their development.

Turning to the vexed question of independence – a quality essential to the non-executive role. We continue to support the current regime in which the determination of independence is left to the board to resolve - though it does not follow that shareholders should necessarily accept the board's view. Shareholders may well draw their own conclusions as to the independence, or otherwise, of the non-executive directors, and this may well influence their voting decisions

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Above all, independence is concerned with the integrity of the individual in question. Rather than simply meeting some tightly drawn definition of independence criteria (or 'checklist') as some have suggested, it is imperative that some degree of judgement is maintained. Effective non-executive directors cannot be conjured out of thin air simply by ticking the right boxes.

Whatever definition might apply, it is essential that non-executive directors are able in practice, not just in theory, to express views to the board that are different to those of the executive directors and be confident that, provided this is done in a considered way, they will not suffer.

Q17. 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?

As discussed earlier, the Combined Code appears to work well in practice and the board committee structure appears to have widespread support - a regime in which NEDs are 'tough but fair' is good and generally doesn't lead to bad relationships and dysfunctional boards. Over 90 percent of non-executive directors responding to our survey believed that the board committee structure recommended by the Combined Code facilitated governance and the effective contribution of non-executive directors.

The number of directors on a board is an important factor in determining its effectiveness, but board size can not be mandated. Each company needs to determine the appropriate size for its board based on consideration of its specific needs. However, boards should not be too large - all directors must be able to fully participate. Conversely, boards must be of sufficient size to benefit from a diversity of viewpoints, skills and backgrounds, yet be manageable by the chairman. In determining the size of the board, consideration should be given to what additional skills are qualities are required to enhance the board's performance. Factors might include:

- the evolving circumstances and needs of the company. Shareholders of a small company with a tightly focused business might regard a large board as an expensive luxury, while a large company with diverse and complex operations would almost certainly overstretch the resources of a small board;
- the need to achieve an appropriate mix of executive and non-executive directors;
- the establishment of board committees (audit committee, nomination committee, etc) becomes impracticable with very small boards; and
- the absence of a handful of directors can make it impossible for a very small board to raise a quorum.

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Q18. 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?

We strongly believe that an effective audit committee can play a key role in safeguarding the integrity of financial statements, driving up audit quality and preserving auditor independence.

Generally, we have seen little evidence to suggest that the current Combined Code recommendations are flawed or ineffective in practice. However, in the current climate, it is appropriate that the role of the audit committee be reviewed. Many governance commentators and recent reviews have called for an extension of the audit committee's role to include a specific duty to recommend appointment of the external auditor, to approve non-audit services and to make an explicit statement on their consideration of the external auditors' independence. Each of these statements has merit, but there have also been demands for a more rule based approach including a tighter definition of independence and for audit committees to comprise only independent non-executive directors.

The temptation to introduce a system of rigid rules should be resisted. Effective audit committees will not be created simply by ticking the right boxes. For some time there have been specific rules to determine both the composition and independence of audit committees in the US. Disclosure of the audit committee process and the committee's discussions on auditor independence have also been a part of US reporting for a number of years. However, in the light of recent events, it is questionable whether the UK should look to the US rule based approach as a paragon of good governance and the effectiveness of such measures must be questioned.

Instead, the debate should focus on the qualities required by audit committee members and the procedures that encourage those qualities. After all, audit committees cannot be expected to provide meaningful protection for shareholders unless its members are *independent* of mind, *diligent*, *knowledgeable* and in possession of relevant and reliable *information*. To encourage these qualities, any guidance developed as part of, or to supplement, the Combined Code should focus on appointment, training and appraisal (and disclosure thereof) rather than on rules to determine composition and independence.

We support the audit committee taking a greater role in reviewing the audit appointment and consideration of non-audit services. In our view, this would be more effective than other proposals to strengthen the audit process such as mandatory rotation of the auditors and the prohibition of certain categories of non-audit services. Auditors are already required under auditing standards to engage in a constructive dialogue with the audit committee over matters of independence and to make an annual confirmation of independence to the audit committee. Any cases of uncertainty should be discussed with

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the audit committee before any engagement is accepted. We are already seeing audit committees demonstrate their active consideration of these issues.

While we believe that the audit committee has a key role to play in recommending the appointment, removal and remuneration of the external auditors, we are wary about formally removing this role from the remit of the board itself and potentially weakening the unitary board concept. In our view, audit committees will have legitimate concerns regarding the appointment of auditors and will make strong recommendations to the board on their appointment (or removal) – this should be part of their terms of reference. It is inconceivable that the board would override an audit committee’s strongly held recommendation or that the board would not, in practice, ‘approve’ the appointment recommendation before it is put to shareholders even if it were no longer the formal duty of the board. (If this is were not the case, the recommendation of the auditor is very likely the least of the board’s problems.) Notwithstanding the above, clarification of the audit committees role in the appointment process may increase the media and general public’s perception of governance, and this alone would be beneficial.

Turning to the vexed question of non-audit services, we believe that the audit committee should keep under review the provision and extent of those non-audit services provided by the audit firm to the company. That is not to say that the audit committee should approve *all* non-audit work to be undertaken by the external auditors, however, the audit committee should ensure that appropriate *procedures and controls* are in place to determine what work should, and should not, be carried out by the external auditors. This may include pre-approval of certain types of non-audit service or engagements in excess of a *de minimus* limit set by the audit committee.

The audit committee’s deliberations in this regard should be supported by disclosure. There are already existing statutory disclosure obligations regarding the respective fees paid to the audit firm for audit and non-audit services and these should be extended to included fees in respect of services supplied to non-UK subsidiaries and include a general description of the non-audit services carried out. Over 50 % of those non-executive directors responding to our survey believed this was a good mechanism to increase public confidence in the role of the non-executive.

We have other thoughts on the role, duties and disclosures of audit committees and these are outlined below:

- In an age of ‘smoke and mirrors’ where both financial transactions and accounting standards are becoming increasingly elaborate, it is no longer possible for audit committee members to operate effectively with only a passing knowledge of finance. They must have expertise, or access to expertise, that goes beyond familiarity with financial statements. They must understand the principles that underpin the preparation of financial statements, why critical accounting policies are chosen, how they are applied, and satisfy themselves that the end result fairly reflects their

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understanding. It is therefore tempting to suggest ‘qualifications’ for audit committee members. Recommending ‘financial literacy’ or an ‘accounting background’ is at first sight laudable. But consideration has to be given as to what such terms mean in practice. What level of expertise? How recent should the experience be? Should all audit committees be treated the same? Sarbanes Oxley has gone some way to defining the appropriate level of expertise for audit committee members, but we would prefer the focus to be on continual training, access to appropriate expertise, and greater communication with both internal and external auditors.

- The audit committee (and other non-executive directors) should be able to hold meetings with the auditors, in the absence of the executive management, to discuss matters arising out of the audit. Such meetings should take place as often as is necessary, but we would expect them to take place prior to publication of the preliminary announcement and, where reviewed by the auditors, the interim results.
- Disclosure and transparency are of paramount importance and should be encouraged. Greater disclosure relating to the role of audit committees would in our view, increase public confidence in the role of non-executive directors and in governance generally. Of those responding to our survey, over half believed that statements regarding the steps taken by audit committees to ensure auditor independence would increase public confidence in the role of non-executive directors. The disclosure should be ‘company specific’ and focus on issues such as the qualifications of the audit committee members, the training they have received and the steps taken to consider the quality of the external audit. The recent experience in the UK around the disclosures required by the combined code is positive. The public disclosure of the audit committee’s activities and its terms of reference should of course have regard to the benefits relative to the associated costs. Also it will be important to guard against the statement deteriorating into boilerplate disclosure, which takes up several pages of the annual report and accounts (or proxy statement), as has been the case in the US. Audit committee charters could be made public, but we suggest that this is best done via the company’s website rather than the annual report and accounts.

Q19. Similarly, do you have comments on the composition, duties or operation in practice of Nomination and Remuneration Committees?

We do not believe that there are problems in practice with the composition, duties or operation of remuneration and nomination committees. However, in the light of the recent Directors Remuneration Regulations 2002 (requiring greater disclosure of performance conditions, performance graphs for LTIPs and an annual vote on the remuneration report), further guidance for remuneration committees may be useful.

There is a question as to whether nomination committees should be solely comprised of non-executive directors (in the same manner as audit and remuneration committees) rather than a majority of its members being non-executive as the Combined Code currently

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recommends. We do not believe there is a strong case for change. Indeed, we believe that executive directors have a role to play as it is they who bring the necessary detailed knowledge of the business to the nomination committee's deliberations.

The importance of nomination committees should not be understated as the key to effective non-executive directors must lie in ensuring the right individuals are appointed in the first place. Nevertheless, the nomination committee fulfils only part of the appointment process. Appointment should be a two way process. Nomination committees have a significant role to play in determining the competencies and other attributes required by non-executive directors, but similarly, candidates should carefully consider whether they have the requisite knowledge, skills and time, and only accept appointments where they can contribute effectively. It is incumbent upon candidates to perform their own due diligence and this will usually include one to one meetings with the chairman and some of the other non-executive directors.

We encourage greater transparency and disclosure about both the selection process and the criteria for used for selection.

Q20. What processes are in place for setting objectives and reviewing performance against those objectives, for the board as a whole and for individual directors?

At uncertain times such as these, it is more important than ever that boards perform professionally to the best of their abilities. Both chairman and investors need assurance that the right board members are in place and contributing to the best of their capabilities. It is important that both the potential of each director is fully understood and realised, and that concerns and anxieties are consciously addressed, discussed and dealt with.

Performance criteria for the board and individual directors facilitate the assessment of success or failure. A fair, objective, systematic and regular evaluation of the board and individual board members helps directors determine how well they are meeting their duties and ultimately contributes to improved performance.

Some boards, but by no means all, endorse the concept of self-assessment, including the assessment of each individuals contribution to board performance. By participating in their own assessment directors can 'own' a process that should belong to them. Moreover, self-evaluation by the board and by directors can send a strong signal of accountability to shareholders, while providing assurance to directors themselves that their work will not go unnoticed.

In our view, facilitated self-appraisal mechanisms, which are becoming increasingly common place in the southern hemisphere, may provide the most constructive feedback, though it is recognised that some boards may be initially be wary of such processes.

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The success of the appraisal process, however it is carried out, is dependent on a number of interrelating activities: ensuring the process is controlled by the chairman; establishing clear goals for the appraisal process and ensuring that those appraised have input into the process; establishing a tailored approach that is appropriate for the needs of the company; ensuring the evaluation takes place in an environment of confidentiality and mutual trust; regular review of the evaluation process; and transparency of the assessment procedure and criteria.

As part of our survey of non-executive directors, we asked participants how often they are formally assessed. 24% were formally assessed annually, but 56% were never formally assessed.

We also asked non-executive directors to indicate, on a scale of one to five (where one is very important and five is not at all important), the extent to which they considered formal appraisal to be beneficial. Respondents were clearly in favour of formal assessment, for executive directors. Nevertheless, there was also widespread support for the assessment of the chairman and non-executive directors. The following indicates those non-executives rating formal appraisal as either one or two):

- Chairman – 77%
- Chief executive officer – 94%
- Other executive directors – 93%
- Non-executive directors – 65%
- The board as a whole – 73%

Q21. 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?

Transparency is crucial, but it is also important that appraisals are carried out in an environment of confidentiality and mutual trust. Disclosure should be limited to a description of the process by which the performance of non-executive directors is reviewed, rather than the results of the appraisal process itself – which should be a matter for the chairman and the individual concerned.

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Q22. 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?

Ultimately this is a question of independence. It is imperative that non-executive directors can express views to the board that are different to those of the executive directors and be confident that, provided this is done in a considered way, they will not suffer.

Where problems persist, the last sanction at the non-executive director's disposal is resignation. There have been suggestions in the media that should a non-executive director resign, the reasons for their resignation should be disclosed. We do not believe that this is appropriate. Apart from the practical difficulties surrounding such a requirement, it is usually apparent that things are 'not well' when a non-executive resigns on a matter of principle. The important issue is to remove barriers that prevent non-executive directors from exercising this 'ultimate sanction' (eg, share options, financial dependency etc).

D RELATIONSHIPS WITH SHAREHOLDERS AND OTHERS

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

Q23. 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 support the unitary board and would not wish to see processes implemented that create a tension between the executive and non-executive element on the board and in doing so threaten the unitary board framework.

As a consequence, we do not believe non-executive directors should, as a matter of course, meet separately with key shareholders. Such meetings could cloud the issue of accountability and communication and be potentially divisive. Such meetings should happen only as a last resort when investors need to consult separately – for example, when there is dissatisfaction with a combined CEO / chairman or both the chairman and CEO. The senior non-executive director may have a role to play here.

Notwithstanding the above, we believe that both executive and non-executive representatives should be encouraged to meet regularly with senior representatives of key shareholders to exchange views and information on strategy, performance, board membership and quality of management. This would normally be the CEO and the non-executive chairman.

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Finally, it should not be forgotten that there is a down side to increased dialogue between directors and institutional shareholders. Close contact between directors and shareholders may lead to different shareholders receiving unequal information. In particular, directors must be cautious of revealing price-sensitive information that may deprive investors of the legal right to trade shares.

Of the non-executive directors responding to our survey, few believed interaction with shareholders to be a key part of their role or a change that would contribute to increased public confidence in the role of non-executive directors.

Q24. 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 is responsible for creating an environment in which non-executive directors can contribute effectively. They should control the tone of board meetings, keep discussions on track, encourage all members to make a contribution, and defuse personality clashes should they arise. We believe most good chairmen do this.

Board meetings should be conducted in a businesslike manner but should not be excessively formal. Here much depends on the skill and attitude of the chairman, who needs to keep proceedings moving along whilst encouraging vigorous debate and a thorough examination of the key issues. The chairman, assisted by the company secretary, should also monitor technical matters such as proper notice of meetings, punctuality, the presence of a quorum, the content of the agenda, the distribution of board papers, adherence to the company's constitution and applicable provisions of the Companies Act.

The chairman also has a key role in ensuring that non-executive directors are properly briefed. This is essential as even those non-executives who are vigorously independent, diligent and knowledgeable will prove ineffective unless they have both access to, and an understanding of, all the relevant information. Individual non-executive directors can help improve the quality of board meetings by being well prepared, by sticking to the matter under discussion and by listening carefully to other views.

Q25. 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 relationships should be candid and honest. Non-executives should have access to both the chairman and CEO at all times and be free to talk to any other member of the board or management. It is essential that the board and especially non-executive directors are

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given opportunities to meet senior management. This is beneficial for governance, succession planning, knowledge and motivation. It can also be useful for certain non-executives to mentor executive colleagues.

Non-executive directors should also have access to advisors. In the increasingly complex environment in which directors operate, occasions may arise where they need to seek legal or financial advice in the furtherance of their duties. They should always be able to consult the company's advisors, but in certain circumstances it may be appropriate for them to seek independent advice.

Agreed procedures should be laid down formally, for example in a board resolution, in the Articles, or in the directors' letter of appointment. Some companies may wish to make it part of the procedure that directors consult the Chairman, for example, before taking independent professional advice. This is acceptable, but we would recommend that there should be a choice of directors (including at least one non-executive director) who could be consulted.

Q26. How can Company Secretaries support effective performance by non-executive directors?

Company secretaries have a fundamental role in ensuring board procedures are both observed and regularly reviewed. They have prime responsibility for organising and assisting the board meeting and will be involved in:

- preparing the agenda with the chairman and CEO;
- ensuring the meeting flows effectively and providing advice to the chairman and other directors on matters of governance; and
- recording the decisions of the board.

The importance of this role should not be underestimated. All directors, and in particular the non-executive directors, should have access to the services of the company secretary, and will look to them for guidance on their duties and responsibilities and on how they should best be discharged.

It is important that company secretaries are appropriately qualified. In this regard, the Companies Act 1985 requires that directors have a duty to appoint someone who is capable of carrying out the duties which the post entails. We do not see any problems with this in practice.

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E SUPPORT

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

Q27. 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?

Even non-executive directors who are vigorously independent, diligent and knowledgeable will prove ineffective unless they have both access to, and an understanding of, all the relevant information. In performing their oversight duties, non-executive directors are only as good as the information they receive and reliance solely on what is volunteered by management is unlikely to be sufficient in all circumstances. Further enquiries may well be necessary if a particular non-executive is to carry out their duties effectively.

Trust has an important role to play. Non-executive directors fulfill an oversight function, they do not have a hands on role. Consequently, they must put a great deal of trust in their executive colleagues and auditors to tell them what they need to know. If they experience surprises (eg, material effects of a change in accounting policy come to light just before they are due to approve the financial statements), they need to start questioning their relationship with management and consider how they can ensure they get relevant and timely information.

Non-executive directors should have access to all the information that they consider necessary for them meet their obligations and to be able to understand and monitor the performance of the business. This should include all the information available to the executive directors. Such information should be relevant, reliable and robust. Consistency of application is also important and non-executive directors should be alert to changing assumptions and the reasons for such changes.

Information should also be both timely and received in a manner which enables them to quickly get to grips with the salient facts. Too much information or badly presented information can cause key bits of information to go unnoticed. By contrast, too little information will leave non-executive directors improperly briefed. The chairman has a particular responsibility to ensure that all directors are properly briefed and given adequate notice of all issues arising at board meetings.

It is important that management information is not interpreted too narrowly. In addition to financial information, non-executive directors should also have access to, and an understanding of, non-financial information relevant to the state of the companies affairs, performance, or sustainability.

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Q28. What training and development opportunities are available? Could they be improved and, if so, how?

It in light of increasing complexities in the business world, financial reporting and in shareholders' expectations, it is imperative that non-executive directors stay abreast of current developments. They must be in a position to ask the right questions and, more importantly, understand the answers they receive. Training is therefore essential.

Good directors keep up to speed by reading relevant industry and business publications, attending conferences, and conversing with legislators, financiers, business leaders, technical experts, and anyone else who might be the source of useful information. These activities provide directors with business intelligence independent of the company's management.

Nevertheless there is often a need for more formal education or training processes. Non-executive directors can, and should, be supported in their role by regular updates and appropriate training from management, internal audit, external audit and appropriate professional advisors. Training should encompass: industry related issues; financial reporting; audit issues; new developments; internal control and risk management; crisis management; and early warning signals etc.

Recognising the importance training and updating to non-executive directors, and in particular audit committees, we have recently created an Audit Committee Institute to serve and educate audit committee members and help them adapt to their changing role. Historically non-executive directors have largely been left on their own to keep pace with rapidly changing information related to governance, audit issues, accounting and financial reporting. However the Audit Committee Institute will provide complementary knowledge to audit committee members (and other non-executive directors) and act as a resource to which members can turn at any time for information or to share knowledge in such key areas as:

- the role and responsibilities of audit committees;
- corporate governance, technical and regulatory issues;
- sounding board for enhancing audit committees' processes and policies;
- surveys of trends and concerns.

Q29. Can induction for non-executive directors be improved?

The extent to which new non-executive directors undergo an induction process will depend on the organisation and the experience of the individual concerned. Some directors may not have extensive knowledge of the major businesses in which the company is engaged, others will require knowledge about the responsibilities of a non-

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executive director, including the legal and fiduciary principles applicable to directors' activities in fulfilling those responsibilities.

The purpose an induction process is to familiarise new directors with their role and responsibilities, and the company's business, operations, finances, and facilities. The process should include meetings with the chairman, directors, senior managers and other officers (eg auditors) as appropriate.

In addition to any induction organised by the company, it is incumbent on each director thinking about accepting a board appointment to consider whether:

- they are familiar with the responsibilities and obligations of a company director?
- they are aware of a director's rights and obligations under the company's constitution?
- they are comfortable about assuming a director's responsibilities and obligations?
- they are prepared to commitment sufficient time to do justice to the job?
- they can add value to the board by virtue of their personal qualities, professional skills, or industry expertise?
- there are any conflict of interest issues?
- they are familiar with the company - its operations, its performance, its values, and its aspirations?
- they have met the company's existing board, and believe they can work cooperatively and constructively with these people?
- they are you satisfied with the board's structure and composition (size, mix of executive and non-executive directors, the existence, or otherwise, of appropriate board committees, etc)?
- they have made an assessment of the abilities and integrity of the chairman and the CEO?
- appropriate controls are in place?
- earnings have not been aggressively managed?

Q30. Do non-executive directors get clear guidance on what is expected of them and do they get feedback on whether they are meeting expectations?

Institutional shareholders have some responsibility in stating what they expect of non-executive directors, and we see the recent guidance issued by the National Association of Pension Funds *Independent directors – what investors expect* as a positive step.

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More generally, non-executive directors can only be expected to perform to the best of their abilities if they know what expectations are placed upon them. This should be addressed as part of the appointment process and performance against these expectations should be regularly reviewed.

It is important that both the potential of each director is fully understood and realised, and that concerns and anxieties are consciously addressed, discussed and dealt with. The concept of self-assessment is widely endorsed, including the assessment of an individual director's contribution to board performance. Facilitated appraisal mechanisms, however, may provide the most constructive feedback.

F SMALLER LISTED COMPANIES

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

Q31. To what extent do different factors apply in the case of smaller listed companies? Is different provision necessary?

The needs of smaller listed companies are different, but this is accommodated by the flexible 'comply or explain' governance regime operated in the UK. We do not think that the Combined Code should differentiate between companies by type of business or size. The principles on which the Combined Code is based (openness, integrity and accountability) should apply to all companies, not just the very largest. A proliferation of codes for different enterprises would be confusing for directors, preparers and shareholders alike, and would be unlikely to lead to better governance. Furthermore, differentiating companies by size introduces arbitrary boundaries that are unacceptable.

Boards and investors alike should understand that what might be appropriate for a larger company may be inappropriate for a smaller company. In this regard, interpretative guidance may well be appropriate and organisations such as the Quoted Companies Alliance (QCA) should be encouraged to continue to develop guidance for smaller listed companies. However, this should support the Combined Code rather than act as an alternative set of recommendations.

G INTERNATIONAL CONTEXT

What can we learn from international experience?

Q32. What lessons can be learnt from international experience, either in terms of structures or behaviours?

It is ten years since Cadbury identified many of the key governance issues and left the UK with arguably the best governance framework in the world. UK company law also has

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had a significant role to play in protecting minority interests and the primacy of shareholders.

We support the unitary board and believe it has served the UK well. The unitary board structure has been in place for many years and it appears, where there is strong non-executive representation and a balance of power at the head of the company, to fulfil the needs of good corporate governance. There are many arguments in support of a well constructed unitary board and we remain unconvinced of the need for change.

Unitary boards provide a mixture of different skills and experience at the head of the company yet provide a clear focus for responsibility. We think it right to have a single body that is clearly responsible for the direction and supervision of the company. In addition, unitary boards are in a position to implement strategy more quickly than two-tier boards which run the danger of increasing delay through the second board reviewing the decisions of the first. This could well lead to unacceptable tensions between the boards, widening the scope for disagreements and personality clashes.

It is important to review developments in other countries, but we should be cautious of adopting practices simply because they have been adopted elsewhere. For example, though US boards generally have more non-executives than executives, they can be weak due as power is often concentrated in one individual – the combined CEO / chairman. By way of contrast, the unitary board operated in the UK allows non-executives to contribute to strategic thinking while exercising appropriate oversight. Furthermore, the presence of other executives creates balance.

Other examples of where we should be cautious of adopting US practices include the tighter definition of independence, rules regarding the composition of the audit committee, and disclosure of the audit committee charter. These may improve the public perception of UK governance in the short-term – and this is in itself very important - but they will not of themselves, create an enduring governance framework.

Q33. Do other models of corporate governance or different boardroom roles or dynamics contribute more to company performance?

We do not believe other corporate governance models offer any significant advantages. (See also question 32)

Q34. Would it be beneficial to bring UK practice more in line with that in any other countries? If so, why and how?

No. We believe that international practice may be moving towards the UK practice. We should lobby hard for other countries to adopt the UK model, not the other way around.

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