

Reponse of London Underground

REVIEW OF THE ROLE AND EFFECTIVENESS OF NON-EXECUTIVE DIRECTORS – CONSULTATION PAPER

Introduction

Consideration of the role of Non-Executive Directors cannot be undertaken in isolation; consideration also needs to be given to the role of Executive Directors, the decision making structure and the internal control mechanisms. The following paragraphs outline in general terms how we believe corporate governance should operate and, in particular how management should apply internal control to satisfy the Board and, therefore, enable non-Executive Directors to undertake their role more effectively.

Specific answers to the questions asked in the consultation document follow. The responses to the questions are based on the collective personal experience of officers within LUL, gained from a wide variety of organisations, rather than simply based on experience gained within LUL.

General Comment

Most of the recent pronouncements concerning reforming corporate governance arrangements have centred around the roles and responsibilities of the Audit Committee, Internal Audit, the External Auditors and Non-Executive Directors. Less has been said about reforming the role of management, which is surprising when most governance failures have been caused by them. The changes that are really needed though cover how management should actually design, implement and maintain effective internal controls and report on their ongoing effectiveness. Only then can the role of Non-Executive Directors take its proper place in overall governance.

The Turnbull Committee requirements include the need for a risk-based system of internal control to be in place, embedded in the culture, and for management to gain assurance on an ongoing basis that controls are operating effectively. To date though, few companies have fully implemented and are maintaining a risk-based system of internal control with an overall assurance process. Even fewer are certifying their actual effectiveness, rather they are reporting that a review of the effectiveness of controls has been undertaken.

While the summary of the U.S Sarbanes-Oxley Act talks about the principal executive officers being required to certify various matters, including their responsibilities for establishing and maintaining internal controls and evaluating their effectiveness, it does not go into, perhaps understandably, how this will be done. Set out below are some proposals on how a number of companies are starting to address this issue which could be an effective way forward.

As companies start to fully recognise their responsibilities in this area and the benefit of the work involved, they are establishing “Risk and Control” sub committees of the main board to monitor the assessment of significant risks and the design, implementation and maintenance of risk management, internal control and assurance processes by management. These

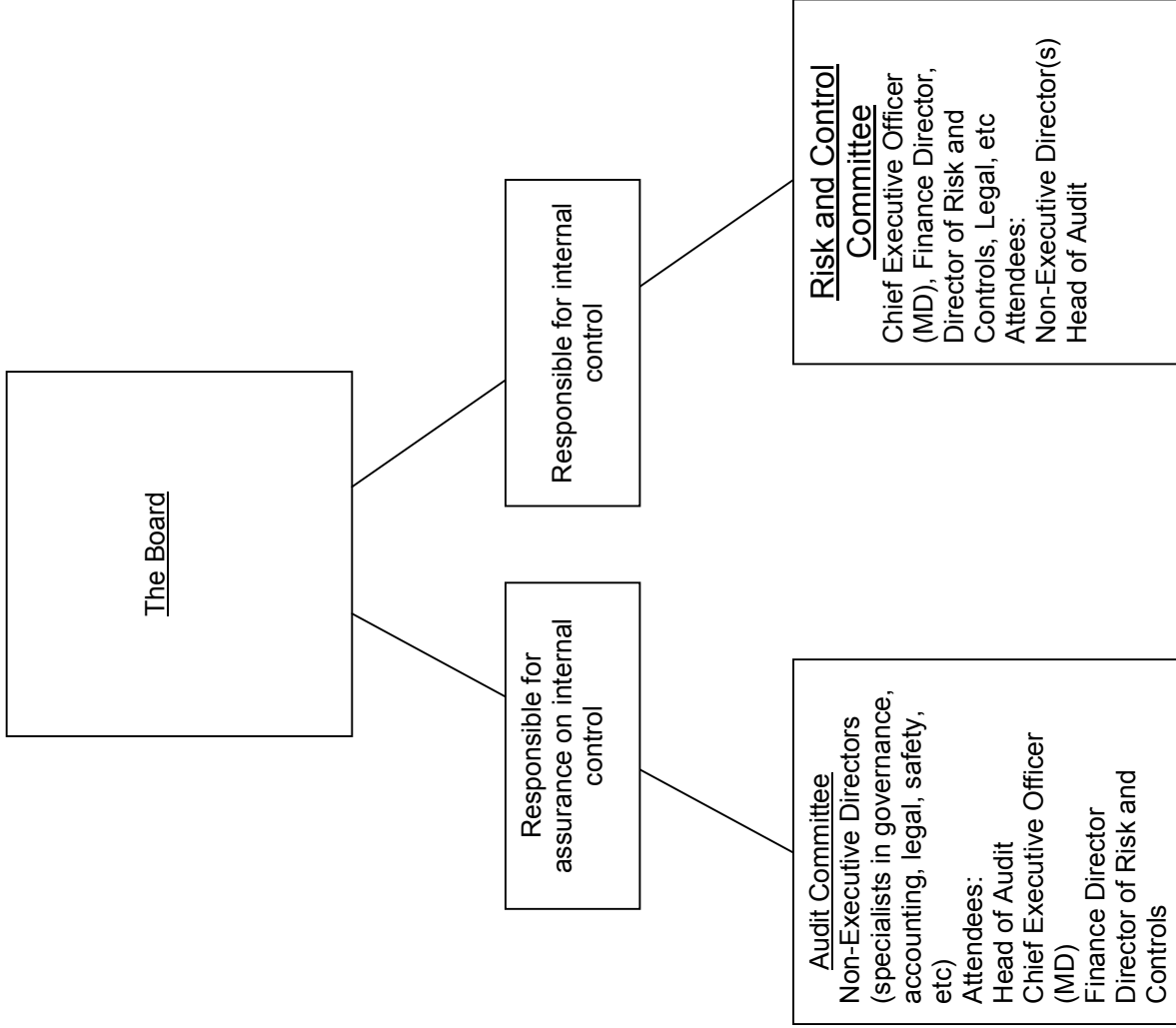
committees should become a formal requirement of company governance structures as Audit Committees did some 30 years ago. Non-Executive Directors, with the appropriate expertise, (governance, accounting, legal, etc) should be members of these committees, along with Executive Directors. These Non-Executive Directors should continue to sit on the Audit Committee to cover their continuing assurance responsibility for the Board and monitoring of the Internal and External Auditors. Terms of reference for these committees will need to be developed to describe their purpose and objectives, monitoring role and responsibilities, the activities and functions they cover, frequency of meetings, membership and reporting requirements, etc.

Equally, a few companies are appointing a Director of “Risk and Controls”, responsible for managing the risk profile and related mitigation/internal control arrangements of the company. Size and value of businesses are relevant, but where appointed, these directors should be assisted, as appropriate, by a team of “controls experts”, working alongside line management to design, implement and maintain effective risk management, internal control and assurance arrangements. They should also chair, as an alternative to the Chief Executive Officer, or certainly be members of, the “Risk and Control” Committee discussed in the previous paragraph.

Two other related proposals are, the appointment of “controls” experts to work as part of management to design, implement and maintain effective controls and assurance processes and the promotion of risk management and controls as a dedicated specialist discipline of management. This is quite separate to Internal Audit, whose responsibility is to provide independent assurance to the Audit Committee on the effectiveness of the company’s internal controls. However, both functions would require similarly skilled risk management and controls experts, but having a separate team as part of management allows Internal Audit to provide completely independent assurance on management’s controls to the Audit Committee.

These changes need to be implemented, not just to strengthen the training, understanding and implementation of effective systems of risk management and controls, but to show that management is also being reformed and a “controls” culture is actually being embedded in the corporate governance framework of companies. The Non-Executive Directors could, therefore, take responsibility for promoting these suggested reforms for management action in the continuing need for maintaining strong effective internal control by management, albeit under the overall responsibility of the Board.

To illustrate these proposals, a diagram and table of the different responsibilities of Internal Audit, External Audit and Management are attached.



Internal Audit, External Audit and Management – The Differences

Internal Audit	Management	External Audit
<p>Head of Internal Audit reports to Chairman of Audit Committee with “dotted” reporting line to CEO.</p> <p>Audit reports submitted to management and the Board, usually via the Audit Committee</p> <p>Provides independent assurance on risk management, control and governance processes</p>	<p>Chief Executive Officer (CEO) reports to Chairman, Director of Risk and Controls reports to the CEO.</p> <p>Reports to the “Risk and Control” Committee (RACC), the Board and Audit Committee</p> <p>CEO responsible for implementing and maintaining risk management, internal control and assurance processes. Director of Risk and Controls responsible for managing the risk profile of the company and providing advice and guidance on risk management, controls and assurance and reporting thereon to the RACC and Board.</p> <p>CEO undertakes annual review of effectiveness of internal control on behalf of the Board, with overall assurance thereon provided by the Director of Risk and Control, supported by reports from individual directors for their functional areas.</p>	<p>Reports to shareholders via the Audit Committee</p> <p>Provides an opinion on the financial statements and reports to shareholders if some aspects of corporate governance are not complied with</p>
<p>May be provided by the company’s employees or outsourced to a third party or a combination of both</p> <p>Its mandate and powers are determined by the Board of the company</p> <p>Operates within a framework of international <i>Standards and Code of Ethics</i> issued by the Institute of Internal Auditors</p>	<p>Provided by the company’s employees</p> <p>Its mandates and powers are determined by the Board of the company</p> <p>Operates within a framework of acts and codes of conduct</p>	<p>Provided by an independent third party appointed by shareholders. May also provide consulting services</p> <p>Its powers stem from statute/regulation</p> <p>Complies with auditing standards issued by the Auditing Practices Board and standards/code of conducts issued by their professional body</p>

Specific Answers

A. Role

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?

A: *The Board should concentrate on strategy and objective formulation, setting policy and overall control of business activities and monitoring the Chief Executive. It should ensure delegation authority, decision authority and reporting hierarchies are in place which describe these elements of control and assurance below Board level as well as specifying those reserved to the Board. It should review regular reports on achievement of performance objectives and financial position; key tasks, projects and contracts and the effectiveness of risk management and internal control.*

The Chairman is responsible for managing the business of the Board, the activities of Board members and the communication with key stakeholders, but not the management of the company, which is the responsibility of the Chief Executive. He or she is responsible for assigning functional areas and specialist activities to Non-Executive Directors, based on their expertise, and appraising their performance. He or she will set the ethical tone of the company.

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?

A: *Non-Executive Directors should challenge the received wisdom of the executives, but should support them in their management of the company.*

Non-Executive Directors should be selected for their commercial expertise and breadth of experience gained outside the company. This should be wide ranging between individual Non-Executive Directors so that the balance of expertise on the Board is as broad as possible, e.g. previous Board experience as well as either legal, engineering, accounting, safety or governance expertise, to enable them to adequately provide challenge, advice and guidance on all the activities of the company.

Q3: How does this compare to the present position?

A: *They need to provide a greater review and challenge to management's responsibility for identifying risks and maintaining an effective risk management process and system of internal control. (See General Comment).*

Q4: How independent do Non-Executive Directors need to be for the different roles?

A: *Ideally, so as not to cause any serious conflicts of interest between their responsibilities for the company and external responsibilities: they should be independent in both fact and appearance so as to provide arm's length monitoring.*

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?

A: *The main area of potential conflict is where the company has contracts with suppliers with whom the non-executive has a pecuniary/financial interest. This is a particular problem where take-overs are muted and where projects are undertaken by consortia of companies so that the interests of Non-Executive Directors can come into conflict unexpectedly. Annual or preferably even six month reviews of interests (by way of a signed declaration), with non-executives being constantly encouraged in the interim to declare any potential conflicts of interest. Most Boards have a regular item included as the first item of business on the agenda to encourage directors to do this.*

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?

A: *To answer the first part of the question – it very much depends on the company, although for a fairly large company it is not unusual for a Chairman to spend 2-3 days per week and for Non-Executive Directors to spend 2-3 days per month. Although for the proposed enhanced role (see A3) for non-executives, this time would need to be increased to at least 6-8 days per month. To answer the second part of the question – yes, particularly if they are also employed on a full time or even part time basis elsewhere, they are unlikely to be able to adequately cover more than 3 companies.*

Q7: Should there be a special role for a "senior independent" non-executive director?

A: *Yes, particularly if the Chairman is executive – a senior independent non-executive director should be appointed as Vice Chairman.*

Q8: Do you have any 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?

A: *No, as there should be no distinguishing in law between the two sets of directors, if the non-executives are to be fully committed to the enhanced role (set out in A3).*

B. Attracting and Appointing Non-Executives

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?

A: *Considerable commercial experience gained at Board level from outside the company, preferably as broad ranging as possible between members in terms of their specialisms / experience, e.g. not all Non-Executive Directors should be from an engineering background but they should have experience of legal,*

accounting and governance matters and ideally change management and major IT implementation and process re-engineering projects.

Q10: What personal qualities and attributes are needed?

A: Integrity, honesty, openness, good communicators, ability to mentor Executive directors, know when to challenge and insist on change or improvement. Not try and “second guess” executive management but provide constructive challenge, advice and guidance. Have strength to resist power of other personalities and make the tough decisions. Be aware of early warning signs of problems particularly those affecting the sustainability of the company.

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.

A: See comments above in A9 and A10, but effectiveness comes from the collective behaviours of the individuals regarding leadership, communication, motivation and mentoring between the Non-Executive and Executive Directors. An example would be encouragement given to the implementation and maintenance of risk management in a company. A spectrum of youth and experience is valuable.

Q12: How easy it is to recruit Non-Executive Directors with the right skills and attributes? Could recruitment and appointment mechanisms, including Nomination Committees, be improved?

A: Not easy to recruit the right directors but, yes, Nomination Committees would improve recruitment through bringing a wider range of skills and experience to the recruitment process. They should have precise selection criteria i.e. skills, knowledge, experience and behaviours.

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?

A: Need to involve more senior management from professional firms, banking and public sector.

Constraints – probably risk of legal action against the reward. Foreign (right experience and background) representation would no doubt help to enlarge the pool and should be possible with globalisation of business.

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?

A: Rewards probably on the low side, apart from share options – need to be increased in line with additional responsibility and time involvement indicated in A3 and A6. Interest in the company or sector may outweigh this issue.

Rewards need to match risk of legal action personally and risk profile of the company in general.

Q15: Do you have comments on the issue of risks or insurance provision for Non-Executive Directors?

A: *This should be included in officers' and directors' indemnity insurance.*

C. Structures and Accountability

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?

A: *The definition of independence is generally understood, as are the provisions on the balance between executive and Non-Executive Directors.*

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?

A: *To a degree, yes. However, Non-Executive Directors can only make a contribution normally on the basis of the information provided to them by the organisation by way of Board papers and reports. If they are not given adequate information to enable them to make informed decisions then their attendance at Corporate Governance Committee Meetings or even membership of those committees (risk and control/credit risk/insurance risk) should help to aid corporate governance.*

No comments on Board size.

Q18: Do you have any 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?

A: *The composition of the Audit Committee needs to reflect the activities of the company but must include one non-executive with corporate governance/risk management expertise and knowledge of accounting disclosure requirements and complex transactions. The Chief Executive and Finance Director should attend all meetings as well as the director responsible for risk management and control (if this position exists). They should also receive a regular report on the activities of the Risk and Control Committee and the output of their meetings, together with reports on legal compliance and propriety issues.*

The Audit Committee should, along with its existing responsibilities, receive an annual report from the External Auditors on their process for ensuring audit independence and managing conflicts of interest.

The Combined Code should be amended to reflect those requirements and also the need for a Risk and Control Committee (see General Comment) to monitor risk management and internal control.

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

A: *No comments, as little experience in practice. Composition of committees needs to reflect comments above in A2.*

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?

A: *Each year the main Board should approve key performance targets/objectives to be achieved for the following year. A report should be submitted to each meeting thereafter, on the performance in relation to each key task/objective enabling Non-Executive Directors to review performance against targets and decide what, if any, remedial action needs to be taken to ensure performance continues to meet objectives.*

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?

A: *Half-yearly appraisals of the objectives, performance and activities of Non-Executive Directors by the Chairman and Chief Executive should be undertaken. This should include comments on their role of mentoring Executive Directors, level of contribution to Board and committee meetings, specialist areas of responsibilities and any specific key tasks or review of projects they have conducted.*

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?

A: *To answer the latter part of the question - one means by which it could be made easier is if Non-Executive Directors received the minutes of executive meetings, or at least a summary of decisions taken. They could also receive specific papers on key decisions taken or key risks reported. A standing item could also be included on Board agendas 'Matters Arising from Executive Meetings', providing Non-Executive Directors with a suitable opportunity to question the rationale to key decisions made by Executive Directors/others and to probe more into the consequences and benefits of those decisions and how well the Executive Directors understand the true extent of the residual exposure.*

D. Relationships with Shareholders and others

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?

A: *With institutional shareholders there is a tendency for them to 'sit in their ivory towers' and be slightly out of touch with the issues and challenges facing the business. Additional effort needs to be put in by both parties to help shareholders really understand the issues and activities of the company.*

Attendance at Board meetings by representatives of institutional shareholders would help improve relationships and aid greater understanding. Alternatively, presentations by Chairmen and Chief Executives should help address the issues, which are most vexing to the shareholders and offer them a chance to ask questions.

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?

A: *Non-Executive Directors could attend main Board sub committees or executive meetings when performance and financial positions or corporate governance matters are reviewed.*

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?

A: *Always objective and independent, one of providing challenge, advice and guidance.*

Q26: How can Company Secretaries support effective performance by Non-Executive Directors?

A:

- *by advising on governance, ethics, probity, accountability and good practice; being the key source of advice and maintaining an ever-watchful-eye;*
- *by making directors aware of their main duties and powers and their restrictions as directors;*
- *by being the essential interface between the Board of management and its internal and external stakeholders and opinion formers;*
- *by submission of appropriate documents/papers to Board meetings so that no items of concern are overlooked at Board meetings;*
- *by providing relevant, timely and appropriate information, thereby involving Non-Executive Directors in the decision making process, rather than their being merely a 'rubber stamping' forum. In larger companies, a member of staff whose sole function is looking after Non-Executive Directors, should be considered;*
- *by ensuring regular reporting on performance in relation to key objectives, tasks, projects and contracts set by the Board and that this is set out on the agenda in a logical, clear and concise order;*
- *by ensuring that reports written for Board meetings follow an agreed, standard format (making it easier for directors to follow) and contain enough information to enable directors to make informed and balanced decisions; experts should be invited to attend Board meetings (with the consent of the chairman) to present more complex issues and be available to answer questions of members; and*
- *by ensuring that Board procedures are followed regularly and reviewed.*

E. Support

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?

A: *They should have unlimited access to information upon request. If Non-Executive Directors were sent copies of all agendas and minutes of executive meetings and supporting papers, they would at least have an idea of the types of issues upon which they would wish to know more.*

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

A: *Regular presentations should be provided by the Chief Executive, and by senior management to Non-Executive Directors.*

Q29: Can induction for Non-Executive Directors be improved?

A: *Yes, should be along the same lines as for staff, but focus more on their role and responsibilities, corporate governance, decision making structures and key issues affecting the business.*

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?

A: *Both should be applied as part of their half yearly appraisals.*

F. Smaller listed companies

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

A: *Same principles should apply but time commitment for each assignment would be less.*

G. International context

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

A: *No real up-to-date international experience – no comment.*

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

A: *None known.*

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

A: *None known.*

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