

Response of Neil Chisman

Review of the role and effectiveness of non-executive directors

Summary

- There is little wrong with the structures within which non-executives operate – indeed it may be argued that the UK leads the world in governance standards.
- The key problem is the shortage of competent non-executives.
- The key missing skill is that of shareholder value management. This is so for both executive directors and non-executives. For non-executives the emphasis is on the avoidance of value destruction particularly by vetoing poor capital expenditure projects, notably corporate acquisitions and disposals.
- Supply and competence would be greatly enhanced by a full-blown professional body for directors and requiring directors of listed companies to be qualified.
- The Institute of Directors is quite close to being such a professional body, for example its Chartered Director qualification is reasonably testing. However it would need to enhance its stringency for example by introducing disciplinary procedures and by gradually tightening its entry qualifications and examinations.

A. Role

I find that most of the discussion on the role of the non-executive director can be neatly structured around the concept of value creation. In simple terms executive directors are responsible for value creation, non-executives are mainly responsible for avoiding its destruction and to a lesser extent in assisting in its creation.

Avoiding value destruction encompasses all the normal aspects of corporate governance. In particular, the Schedule of Matters Reserved to the Board ensures that all major decisions are essentially proposed by the executive directors for approval by the non-executives. This applies most commonly to capital expenditure proposals, particularly corporate acquisitions and disposals. Non-executives can reject risky proposals or resign very publicly if outvoted. An executive director who consistently makes unacceptable proposals can be removed from the Board.

My reading of the newspapers on recent corporate disasters – not only those in the USA – suggests that almost every case is a failure of this aspect of corporate governance. If competent non-executive directors are given a proper opportunity to approve all major decisions they will be a potent safeguard against disaster.

Assistance in value creation takes many forms in most cases depending on the non-executive having had useful experience – review of strategy, review of investment proposals, contribution to debate, mentoring and coaching of executive directors, using an address book to open doors.

Small issues within this topic include:-

- The role of the Chairman is usually to act as the senior non-executive director (and so there is no need for this additional position). He has a specific responsibility to run Board meetings, a duty which should not be under-estimated. He also differs from all other directors in that, like the monarch, if normal procedures break down he has to step in and restore order.
- Non-executive independence is either a red herring or the kernel of the issue. Any non-executive who gets sucked into irrational exuberance is failing in his prime duty. He must therefore act independently – essentially being concerned about his own reputation. I cannot understand how any previous background can preclude someone from such independence – does it mean you cannot be friendly with the executive directors?
- Time commitments vary from company to company and from time to time. In an orderly company a non-executive can fulfil his duties in 12 days a year. More time will be needed if the company is very active – making many proposals requiring Board approval. More time will also be needed if the executive directors are inexperienced and require considerable coaching. There is clearly a limit to the number of non-executive directorships an individual can diligently fulfil but it is quite high – I would estimate that a competent full-time “plural” director could cope with up to 15 positions.

Nothing needs to change procedurally for this version of the role of directors to take place – the issues are to do with the will and the competence to carry it out.

B. Attracting and appointing non-executives

The main function of a non-executive director is to protect investors’ interests by rejecting proposed courses of action which would destroy value. Consequently, the main required skill is in the theory (and practice) of value creation. Unfortunately this skill is not at all widespread. But it is a skill that can be taught.

The pool of qualified candidates could be increased if *all* directors of listed (or public) companies were required to be formally qualified (including training in value creation). Executive directors would then form the pool of future non-executives. It would also seem appropriate to require Boards to have an adequate corpus of non-executives (2 plus the Chairman seems appropriate).

There is as yet no fully-fledged professional body which could provide the necessary qualifications. However the Institute of Directors is not far from it. It already offers a Chartered Director qualification and it may be that only minor changes would need to be made – such as the introduction of disciplinary procedures and review of the examination syllabus.

Under these disciplines a market would establish itself for good people and there would be no requirement to regulate remuneration. In addition, reputational risk would address the issue of independence.

C. Structures and accountability

The Combined Code is a fine piece of work that will do its job perfectly well if we have adequately qualified directors on boards. I do not believe it needs any further development. The Schedule of Matters Reserved to the Board is the most effective element of the Combined Code and should be recognised as such. In particular, it is fruitless to attempt to strengthen the definition of independence; rather the solution is to encourage independence of action by ensuring that reputational risk is real.

The duties and responsibilities of Audit and Remuneration Committees are adequately defined at present. It is possible that better director training could make them more effective.

The problem of measuring Board performance is one of definition. I believe quite strongly that performance is best measured by value creation (which automatically incorporates the requirement in the long-term to meet stakeholder concerns such as those on environmental and social responsibility). But accounting standards would have to change fairly dramatically for external reporting on this basis to become routine and the international context of the IASB precludes any early progress or unilateral UK action in this respect. There is no barrier to companies operating with this performance criterion, but there are significant barriers to external reporting on the subject – such as the Listing Authority's regulations on profit forecasts.

D. Relationships with shareholders and others

The idea that relationships between non-executives and shareholders need to be strengthened stems from the fear that executive directors are not to be trusted and that non-executives are not to be trusted to control them. And yet the whole concept of a director is that of trustee. Any attempt to strengthen relationships would be treating the symptom not the disease and would add a superfluous structure into listed company governance. The problem is lack of quality directors; the solution is to create more and to improve the quality, not to monitor more closely something that is likely to fail.

I have never detected a problem in relationships between non-executive directors and senior management although, of course, it is part of a non-executive's remit to remove incompetent executive directors. Nor have I seen problems in relationships with the company's advisers. In particular, it is normally well understood that a non-executive on enquiry has the right of access to any company advisor or to his own legal advisor.

E. Support

In my experience where non-executives are inadequately supported or informed they very rapidly demand that the deficiencies be met. When your reputation is on the line you can be very intolerant of short-term difficulties in such basic requirements. Possibly the Combined Code could more clearly spell out the right of access of all directors to all information but I have never seen a situation where this was necessary.

F. Smaller listed companies

I see no differences between large and small listed companies. Indeed I would go further and say between any public companies – except that the regulator changes for public but unlisted companies.

The main difference is with private companies. Where all the shareholders are directors there is very little external need for formal governance – even if the private company is very large.

G. International context

I have some knowledge of governance and board practices in other jurisdictions but cannot claim that it is comprehensive. I have seen structures similar to and worse than those in the UK but I have never seen better. I believe that the work done in the UK on accounting standards and on the Combined Code during the 1990s sets the standard internationally.

In particular, governance in the USA suffers from several problems that we do not have (or no longer have) in the UK. US accountants are inferior in status and influence to lawyers. As a consequence US GAAP is based on detailed rules rather than principles – and rules will always have loopholes requiring further rules to close them. A further consequence is the attitude to audit which may be typified as “show me where it says I can’t do this”. In the UK this attitude was eliminated in the 1990s by improvements to accounting standards and governance. And the USA has no direct equivalent of the Combined Code. The UK should not look to the USA for a model of governance, rather the reverse.

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