

## **Derek Higgs – Review of the role and effectiveness of non-executive directors**

*Answers to questions 1-34 in the consultation paper of 7 June 2002*

1. The principal role of the board is to lead by example in ensuring the integrity of the organisation, to agree strategy, to monitor executive execution of that strategy, to represent the interests of all stakeholders in the business, and to ensure that the resources (human and financial) for the execution of that strategy are in place. The appointment of high calibre executives, particularly the CEO, and proper succession planning, are also fundamental. The chairman leads the board in this role with the support of the other NEDs.  
In the current environment it is essential that the board as a whole regularly considers the ethics of the business and the messages that are being received by staff regarding issues such as transparency of external reporting, the policies for dealing with customers and other stakeholders, and remuneration policies, so that management are not aggressively motivated to maximise short-term shareholder returns at the expense of their broader responsibilities.
2. NEDs will bring different backgrounds and skills, which should complement each other. Not all NEDs will perform all roles, but usually they will be involved with some/all of the main board committees.
3. Generally, NEDs try to discharge their responsibilities diligently and major strides have been made in recent years in the area of corporate governance. However, there is inevitably a limit to what NEDs, operating part-time and not in an executive role, can do to detect wrongdoing or get close to the day-to-day running of the business. Therefore, the relationship with the company's internal and external auditors is critical.
4. The NEDs should be truly independent with no employment/business links to the company and no conflicts of interest.
5. We do not envisage that truly independent NEDs should have any conflicts. However, if there is any conflict of interest, the NED should stand back and remain outside the discussion.
6. Time commitments will vary by company and its needs. Based upon our experience, a non-executive Chairman would generally need to devote 1-2 days/week and NEDs (without board committee responsibilities) 1-2 days/month. Our view is that an executive director should be limited to one outside directorship and that NEDs should consider very carefully before taking on more than 1 chairmanship and two other NED positions. We would support the NAPF maximum of 5 appointments.
7. A senior independent NED is less important if the chairman is a NED, but we support a senior independent NED as being helpful as an additional point of contact for investors and to chair certain of the board committees. This will often be the deputy chairman. He/she may also be a useful counterweight to the Chairman.
8. The legal duties of all directors, executive and non-executive, should be the same. However, it should always be recognised that a NED cannot realistically know as much about the affairs of the company as an executive.
9. The key skills are for NEDs to be broadly-based business people, with excellent ability to judge people (i.e. good people skills). Financial experience is becoming increasingly important and will become more so over the next 10 years. NEDs should have the ability to challenge executives on strategy and key issues affecting the business.
10. In addition to the skills mentioned in 9. above, integrity, open-mindedness and determination are important personal qualities. Common sense may often be more helpful than the highest intellect.
11. A broad mix of different experience and attributes is important, brought about by a range of backgrounds, careers and good gender balance. It is important to encourage more women on to boards. In our particular experience, the NEDs played a considerable role in the company deciding on a demerger, where there were inevitably differing interests of executive directors.

12. Recruitment of NEDs is not always easy, as often the same pool is fished. It is difficult in the current climate, and high quality recruitment consultants need to work hard to find suitable candidates. However, it is quite possible.
13. The pool could be widened by more companies encouraging senior managers immediately below board level to become outside NEDs, particularly women . This is useful in career and personal development. Care needs to be taken not to deter potential new NEDs by making the role unreasonably burdensome by reason of legal/regulatory demands.
14. The rewards for NEDs seem generally reasonable, although they will vary according to the complexity of the company, its industry and the role being undertaken. The Chairman and the Audit and Remuneration Committee chairmen have onerous (time and complexity) roles, often with very high personal risk. Some US companies are finding it difficult to recruit AC Chairmen. There may well be pressure to pay more as NEDs come under greater pressure and scrutiny. Remuneration should be in cash (although a NED may choose to buy shares), not share options. Recent examples of excessive remuneration and corporate greed have been highly damaging to public perceptions of business.
15. In the current post-Enron climate the legal pressures on NEDs have become unrealistic and excessive. D&O insurance cover is an increasingly scarce and expensive commodity and certain risks cannot be covered. This may well deter suitable candidates from agreeing to take on NED roles.
16. Following Cadbury, Greenbury and Hampel the Combined Code works well. Though never perfect, great strides in corporate governance have been made over the last 5 years.
17. The recommended structure for board committees works well and provides an opportunity for all NEDs to participate. For board meeting procedures to work effectively is very much down to the chairman. Boards should not be overly big (6-8 directors for most companies to achieve effective contribution and involvement).
18. The Audit committee is very important. The membership should have a balance that provides financial and operational expertise. Executive management should ensure that it has appropriate resources to service its needs. There must be a strong independent internal audit function which provides the AC with a window on the risk and control environment. There should be regular private meetings between the AC and the external/internal auditors. The CEO should be invited to attend the AC meetings so that he is full aware of the committee's views on the control and risk environment and the judgmental reporting issues.
19. The Nomination Committee will generally consist of all NEDs on the board and there is no reason why the NC should not work effectively in making new board appointments. Similarly, the Remuneration Committee has a vital role to ensure that remuneration strategy is appropriate for the demands of the business. Generally, they work well. RCs should ensure that incentives reflect all the broad responsibilities of executive management and not be overly influenced by short-term shareholder return and sales growth.
20. Performance evaluation of the board and individual directors should be adequately done by self-assessment (led by the Chairman) rather than external review in most cases. Such on-going assessment is an important part of the board's role of monitoring its own performance. There should be 360 degree feedback.
21. Shareholders should be aware of which NEDs sit on which board committees and consideration should be given to reporting on regularity of board attendance and total time involvement. More detailed reporting to shareholders on the performance of NEDs is probably not practical.
22. Yes. NEDs are there constructively to question executives on strategy and key issues, and must be prepared to do so. If they are unable/unwilling, they should resign.

23. Whilst most contact will be between executives and institutional shareholders, NEDs (particularly the chairman) should make it known that he/she is available to meet major shareholders as required. However, experience shows that non-disclosure of price sensitive information can often constrain a genuine two-way dialogue, especially on trading issues.
24. It is down to individual chairmen to create the right conditions for effective NED contributions. It will often be a matter of style and personality, encouraging contributions in a participative, and not dictatorial, way.
25. The board should all be pulling the oars in the same direction for the company to move forward. Therefore, relationships between NEDs and executive directors should be harmonious and cooperative. Whilst being challenging and ensuring the fulfilment of executives' duties, NEDs should be there to support executives in the attainment of agreed objectives. Key advisers are there to advise, but only as required.
26. The company secretary has the major link with NEDs. It should be remembered that he/she has responsibilities both to the board and the executive management. However, the company secretary should be seen as an important link with management and in a position to offer impartial advice without undue influence.
27. NEDs should be forceful and thoughtful in setting the agenda for board meetings, in inviting appropriate management to present papers and in considering the quality and completeness of the information they receive. It is particularly important that the NEDs have the expertise to challenge management on strategic, financial, operational and technical areas such as IT and insurance. Summary information, with the ability to access more detail, is often the most useful.
28. All new NEDs should undergo an induction and familiarisation programme with the business, and then receive regular update training on new developments affecting them. However, the qualities to be a good NED cannot generally be taught and need to be present when NEDs are appointed.
29. Inductions are key, but are occasionally rushed or overlooked altogether. Time needs to be made available by both NEDs and the company.
30. NEDs should expect regular feedback on their performance, usually from the chairman. The chairman's own performance should also be assessed.
31. The roles and responsibilities of listed company directors should broadly be the same, irrespective of size.
32. Continental boards may generally have a greater proportion of NEDs, but the time (and real) involvement is usually much less. In most respects the UK would be perceived as being ahead of the rest of Europe in corporate governance.
33. We would not advocate other models, particularly not the supervisory board favoured in certain European countries. Works Councils and Employee Forums may often meet the need for employee consultation and communication.
34. We believe that the UK is leading in much of this work. Certainly, there would appear to be little would be gained from following the US model, which seems to be behind the UK.

In conclusion, we believe that excellent progress has been made in corporate governance in recent years, requiring disclosure and transparency. NEDs play a vital, and increasingly responsible, role and must be prepared to be demanding of executive management in a constructive, but supportive, way. Good NEDs can be found, but the pool does need widening by encouraging more senior managers to make themselves available. Care needs to be taken that the increasing, unrealistic legal and regulatory pressures on NEDs do not deter suitable candidates.

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(in consultation with **Peter Blackburn, Chairman,** and **Tony Hobson, Deputy Chairman**)

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