

Enabling Boards to Achieve Their Full Potential

Response to consultation paper from Mr Derek Higgs on the review of the role and effectiveness of non-executive directors



1. Developing world-class boards

We welcome the opportunity to comment on the Consultation Paper. The development of boards of outstanding quality in listed companies of all sizes in the United Kingdom is a critical factor in building world-class companies. We need more such companies if we are to increase productivity in the economy and remain competitive within the EU and globally. We set out below the changes to our present system that we believe are needed to enable these goals to be achieved.

If changes are to be implemented by boards with the necessary vigour and enthusiasm they must be seen to be linked to improving corporate performance as well as to strengthening corporate accountability.

2. Framework for reform - promoting sustainable wealth creation

Proposals for reform should be evaluated against the following five principles:

- the primacy of sustainable wealth creation;
- the importance of balancing entrepreneurship and risk management;
- the value of promoting responsiveness and innovation;
- the merits of a preventative approach;
- the need to ensure the benefit of any change is greater than its cost.

These proposals are discussed more fully in '*Asserting Independence: Preventing an Enron-type Crisis in British Business*', a copy of which is available on our website at www.rsmi.co.uk

In evaluating possible changes, it is necessary to keep in mind the interlocking nature of any corporate governance system. Individual changes cannot be considered in isolation: changes in one area will have an impact elsewhere in the system.

3. The unitary board - at its best, a first-class means of governance

We believe that an effective unitary board with a mixture of executive, independent and, if appropriate, other non-executive directors continues to be the best means of governance for listed companies in the United Kingdom. All directors have, and should continue to have, responsibility for making sure that the company is honestly run and achieves its full potential.

Effective unitary boards facilitate independent directors being well informed in the undertaking of their oversight role and executive directors having the benefit of external support in the running of the business. Checks and balances are, however, needed to ensure that potential conflicts of interest do not reduce the effectiveness of unitary boards.

Above all, unitary boards require a strong cadre of independent directors who are independently appointed, financially independent of the company and independently-minded.

4. The Combined Code - a solid platform on which to build progress

The Combined Code, and its predecessor Cadbury Code, has led to significant improvements in corporate governance in the United Kingdom over the past decade. It provides a solid platform on which to build necessary reform.

Compliance with The Combined Code should, however, be made mandatory for listed companies. The current situation of merely having to disclose areas of non-compliance is not adequate. The PIRC

'Corporate Governance 2001' survey reports that only 28% of companies state that they comply fully with The Combined Code. Moreover, institutional shareholders should take a more active role in encouraging companies to comply fully with its requirements.

5. Board and committee composition - getting the right board in place

Every listed company should have a separate chairman and chief executive officer. This should be a specific requirement of The Combined Code. The present wording of The Combined Code (Code Provision A.2.1) which only requires that 'a decision to combine the posts of chairman and chief executive officer in one person should be publicly justified' is not satisfactory and needs to be strengthened. Splitting the roles is the only effective way to ensure that 'no one individual has unfettered powers of discretion' (Code Principle A.2).

The distinction should be drawn in The Combined Code between independent and other directors (executive and non-executive directors who are not independent directors). Oversight roles should be exercised by independent directors through relevant board committees comprised wholly of them. The wording of the present Code is confused in its use of the terms 'independent' and 'non-executive'. In a number of instances, references to 'non-executive directors' would be more appropriately to 'independent directors'.

In addition to independent directors, it may be appropriate in certain circumstances to appoint other non-executive directors to the board for their particular skills and experience. This may, however, have the effect of increasing the overall size of the board if it is to contain the requisite proportion of independent directors.

The Combined Code should clearly identify criteria to be satisfied by non-executive directors if they are to be regarded as independent directors. This would eliminate the current confusion which exists as to which non-executive directors may be considered independent, with different organisations having varying definitions.

To avoid potential conflicts of interest, independent directors should not have any financial or other business relationship with the company other than in relation to receiving their fees from it. They should not hold share-options and a case can further be made for their not owning shares in the company. The alternative view that being paid in shares or being required to hold shares has the merit of aligning directors' interests with the company's goals needs to be balanced against the potential threat to independence this poses. The proposed restrictions would not apply to non-executive directors who were not being counted as independent directors.

In addition to being financially independent of the company, independent directors should not be members of the board for longer than 10 years or be previous executives of the company. They should also not have consultancy arrangements with the company.

In view of their close involvement in major decisions affecting the company, the chairman of the board should not be counted as an independent director, even if the position is non-executive in nature.

Boards should assess at the time of appointment whether independent and other non-executive directors are likely to have sufficient time to fulfil their responsibilities diligently and should subsequently keep this matter under review. Setting absolute limits on the number of non-executive directorships of listed companies (or equivalent

appointments in the public or voluntary sectors) any individual can hold would be arbitrary as it would not take account of the varying amounts of time required for each such appointment. It would, however, be useful to provide guidance that one would not normally expect an executive director or a chairman of a listed company to have more than two non-executive appointments, or a non-executive with a portfolio of appointments to have more than five in number. A list of all significant appointments held should be included in directors' biographies in the Annual Report.

Independent directors should comprise at least half of the membership of the board as opposed to the present minimum of just over one sixth (see Code Provision A.3.1). We accept that it may be necessary to implement this proposal in a phased fashion, perhaps requiring independent directors to make up one third of the membership of the board as an initial step.

The requirements of The Combined Code on the appointment of directors (Code Provision A.5.1) should be strengthened. Independent directors should comprise 100% of the membership of the nomination committee, at least when it makes proposals to the board for the appointment of independent directors. Independence in selection is the foundation on which all other provisions relating to independent directors rest. If the perception is that independent directors have not been chosen through a process that is genuinely independent of the executive team, the perception that they will be independent in their actions will necessarily be prejudiced.

It is hard to understand the exemption in The Combined Code from the requirement to have a nomination committee where the board is small (Code Provision A.5.1), the more so since 'small' is not defined and as a large company may have a small board. This derogation potentially allows a listed

company to circumvent a vital provision of the Code and to comply with its provisions despite executive directors having a dominant role in the selection of independent directors.

The Audit Committee should be comprised entirely of independent directors.

6. Reviewing the board's performance - making sure the board is achieving its full potential

The Combined Code should require boards to review their own performance on a regular basis. The presence of a strong group of independent directors will help make this a rigorous process.

A formal review by the board of its performance, perhaps assisted by an outside facilitator, should aim to answer the following questions:

- Does the board have the right blend of skills and experience to take the company forward? Do board members have sufficient time to discharge their responsibilities conscientiously? Is the board's committee structure appropriate?
- Are there clear objectives, a viable strategy to achieve them and a sound approach to risk management which reflects those objectives?
- Is the board paying enough attention to human resource issues and to communications with external stakeholders?
- Does the board receive and discuss financial and other key performance measures on a timely and regular basis?
- Does the board provide a challenging yet supportive environment for the executive team, with full discussion of major issues before decisions are taken?
- Is sufficient emphasis being given to providing relevant training for board members?

Board committees should also regularly review their performance. Audit Committees should, for example, ensure that they have the right blend of business, audit, accounting and governance expertise either through membership of the committee or by way of independent advice. We would expect that following such a review a number of Audit Committees would identify the need to strengthen their membership and to increase the time devoted to their duties.

Appropriate arrangements should also be in place to review the performance of individual directors, executive and non-executive including independent directors, as well as the board as a whole.

We welcome the announcement in the Interim Report of the Co-ordinating Group on Audit and Accounting Issues that the Financial Reporting Council is setting up a group to develop existing Combined Code guidance for Audit Committees. The responsibilities of the Audit Committee should include acting as the principal point of contact with the company's external auditors; agreeing in advance other services to be provided by the auditor; keeping under review the fees paid to the auditor for the audit and other services; undertaking a full scale review of whether the audit should be put out to tender at intervals not exceeding 5 years; leading in the process of selecting new auditors and ensuring the company has appropriate 'whistleblowing' arrangements in place.

7. Widening the pool from which independent directors are drawn - helping to build vibrant boards, diverse and challenging

Significant efforts should be made by companies to widen the pool from which independent directors are drawn.

The board-executive, independent and, if applicable, other non-executive directors - are collectively responsible for directing and leading the company and should command strong respect both within the company and externally. This requires the board to have regard to the impact its composition has in the marketplace.

Drawing independent directors from a wider pool will offer many boards broader challenging insights that will add to the overall quality of the board. In addition, it would allow boards better access to much needed additional expertise in areas such as social, environmental and community issues, human resource matters and global marketplace issues. These are all vital to the successful development of the corporate sector. It is also important that there should not be any glass ceilings in relation to boardroom appointments. We would stress though that all directors should be seen as part of a unified team and not on the board just to represent a particular interest.

Groups from which increased participation would be welcome would include (not in any particular order):

- those operating in the company's key international markets;
- human resource specialists;
- those with an expertise in social, environmental and community affairs;
- those in senior positions in the education sector, eg university vice-chancellors, college heads and senior members of business schools;

- other people with leading executive positions in the public, not-for-profit and voluntary sectors;
- those from ethnic minority backgrounds;
- female executives with a business background or that in one of the above groups, including those currently taking career breaks;
- younger executives just below board level in leading companies.

A wider pool would have the additional benefit of increasing the supply of non-executives which is necessary if there is to be full compliance with the present Combined Code and with our proposals for increasing the proportion of independent directors on the board.

If efforts to draw directors from a wider pool are to be successful, it is essential that the issue of how this pool can be accessed should be addressed. One way would be through advertising independent director positions in the national press and relevant specialist media, another would be through encouraging headhunters to conduct wider searches than they may have done hitherto. It would also be hoped that market solutions would emerge with new firms of specialist headhunters being formed. The HR departments of leading companies could also indicate they would be willing to consider requests to make executives just below board level available for independent appointments.

8. Training and development in the boardroom - keeping up-to-date, sharing best practice

Greater emphasis should be attached to training and development in the boardroom at the time of appointment of new directors (especially if it is their first appointment to the board of a listed company) and subsequently.

Training and development may take a variety of forms including highlighting directors' responsibilities, updates on changes in legislation or regulations affecting the company as well as a focus on general business issues, eg related to the formulation of strategy and effective risk management, and those specific to the company. Relevant training should also be provided for board committees.

Leading business schools should be encouraged to develop Boardroom Leadership Centres which could both provide executive education courses to boards and undertake research to identify and then disseminate best practice in relation to running world-class boards. There is currently a dearth of information on the functioning of boards.

9. Directors' remuneration - providing incentives for real success whilst not rewarding failure

We support Code Principle B.1 that says 'levels of remuneration should be sufficient to attract and retain the directors needed to run the company successfully, *but companies should avoid paying more than is necessary for this purpose*' (our italics).

Executive directors should, along with employees, be well rewarded for outstanding performance but the remuneration committee needs to take care to see that substantial bonuses in cash or via share options are linked to outstanding performance rather than average or even good performance. They should also guard against large payoffs in the event that executive directors leave as a result of the company's poor performance.

It is likely that independent directors will be required to be paid more as a result of the additional time that they will need to devote to the company's business in the future in a number of instances and also due to an acknowledgement of the heavy

responsibilities associated with their roles. We regard this as a small price to pay for the benefits derived from any increase in costs this will entail.

10. Disclosures - should be illuminating not boilerplate

A thorough review should be undertaken of the existing disclosure requirements to be satisfied by listed companies in relation to directors and associated governance issues. In some areas, such as those related to directors' remuneration and as to how the Statement of Principles in The Combined Code has been applied, they are often more voluminous than they are illuminating. The focus should be on the steps taken by the board to make sure the right board is in place and that it is working effectively. Consideration should also be given to what information should be provided in the Annual Report and what might better be contained in a separate filing open to public scrutiny by those who wish to access it.

11. Smaller listed companies - the merits of a common framework

We believe there should be a common framework for corporate governance for listed companies of all sizes. We do not believe it is in the interests of the markets or of smaller listed companies themselves for there to be perceived to be a two-tier approach though the way in which companies implement The Combined Code will clearly have regard to their size.

If implemented as part of a wholehearted commitment to develop a highly effective board, The Combined Code and our proposals above offer significant opportunities to increase the value of the business. The value derived by the business, not to mention by society more broadly, from having highly effective boards is likely to far outweigh any implementation costs.

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