

Response from the Review Board to the Review of the Role and Effectiveness of Non-Executive Directors

The Review Board's response consists of three parts:

1. Key issues for consideration
2. Results of attitudinal surveys
3. Supplementary comments by Review Board members

1. Key issues for consideration

There are a number of key issues which we believe you need to consider as part of your review of non-executive directors:

- If the role of audit committees is to be expanded along the lines of the recommendations in the Interim Report of the joint DTI/HTM Co-ordinating Group on Audit and Accounting Issues, consideration needs to be given to the financial literacy, common sense, experience, information availability, time availability, administrative support and training of non-executive directors.
- Should the number of non-executive directorships any individual holds be limited to, say, three or four?
- Is there a way of improving the supply of good quality non-executive directors by providing them with indemnification against liability excepting wilful negligence?
- What principles should govern non-executive directors' remuneration and tenure?
- What should be the relationship between the external auditor and the non-executives? e.g. what kind of meetings should they hold?
- How do you determine whether non-executive directors are independent, given that:
 - There are no generally-agreed definition of what constitutes "independence". Some companies adopt the guidance offered by the National Association of Pension Funds (NAPF) or the Association of British Insurers (ABI) but some of the criteria, such as length of service and age, are not universally supported?
 - There are no generally accepted procedures to ensure the independence of audit committee members although some companies carry out reviews of the effectiveness of Board members (including non-executive directors serving on the audit committee) through the Nominations Committee?

- Should all audit committee members be independent non-executive directors? Our attitudinal survey indicates that, although there is a logic for all Remuneration Committee members to be independent because of the obvious conflicts of interest that arise in this area, the case has not been made for all members of the audit committee being independent non-executive directors.

2. Attitudinal surveys

The Review Board is currently involved in a programme of work contributing to the review being undertaken by the joint DTI/HMT Co-ordinating Group on Audit and Accounting Issues.

As part of that work we have commissioned an attitudinal survey from MORI which has raised a number of issues with a sample of auditors (62), audit clients (230) and institutional shareholders (50). In addition, we have conducted lengthy face to face interviews with 30 individuals representing auditors, audit clients and institutional shareholders. Both studies have focused on the following areas:

- corporate governance
- technical competence of auditors and accountants
- auditor rotation
- non-audit services
- appointment of auditors
- auditor liability and reports

This section reflects the views expressed during the survey and interviews on the issues related to the role of non-executive directors on audit committees.

There is strong support for underpinning the role of the audit committee in company law, especially as at present there are no requirements for large public interest organisations to have audit committees. However, many believe that the Combined Code offers greater flexibility and should be used to define more clearly and fully the role and responsibilities of the audit committee.

Taking each of the questions raised in your consultation document in turn:

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

Our studies focussed more on the functions of the audit committee as opposed to non-executive directors individually, but the findings are of relevance to your review.

The face to face interviews suggested that executive directors know and understand sufficient detail to make operational decisions so that audit committees should allow management to develop recommendations on, for example, the audit appointment and the remuneration to be paid. It is for the audit committee to challenge, change if necessary, and approve these recommendations. For example:

- audit committees should appoint (and remove) auditors and set their remuneration based on the recommendations of the executive directors
- audit committees should review the audit appointment on a regular basis (every 3, 4 or 5 years) and keep the auditor's independence under critical review. This may mean re-tendering the appointment and/or ensuring that senior audit staff are rotated on a regular basis
- audit committees should communicate with the auditors, independently of executive directors, on a regular basis but should neither discourage nor prevent free and open dialogue between executive directors and the auditors

The MORI survey results showed that the vast majority of auditors, audit clients and institutional shareholders considered that the audit committee should undertake the following **review** roles:

- review of the appointments process (92% of auditors, 93% of audit clients and 76% of institutional shareholders)
- review of auditor independence (98% of auditors, 98% of audit clients and 76% of institutional shareholders)
- evaluation of audit effectiveness (87% of auditors, 93% of audit clients and 72% of institutional shareholders)

There was significant but less support for the audit committee undertaking **managerial** roles:

- appointment of auditors (77% of auditors, 85% of audit clients and 58% of institutional shareholders)
- setting of remuneration for the auditors (74% of auditors, 72% of audit clients and 62% of institutional shareholders)
- authorisation of non-audit services (50% of auditors, 48% of audit clients and 44% of institutional shareholders)

One possible scenario would be for the executive directors of the company to present their recommendations in respect of the choice of the auditors, their remuneration and the provision of non-audit services (either by the auditors or another firm of auditors) to the audit committee. The audit committee would then assess the appropriateness of these recommendations and the context in which they were made. If satisfied, the audit committee would then make their recommendations to shareholders for their approval. Such an approach would be consistent with the comments made during the face-to-face interviews where it was considered that the audit committee should not undermine the unitary board of directors or the managerial responsibilities of the executive directors.

B What knowledge, skills and attributes are needed and what can be done to attract, recruit and appoint the best people to non-executive roles?

Comments made during the face-to-face interviews suggest that there are concerns that an enhanced role for the audit committee, as described above, could make being a member of it more onerous for non-executive directors, with implications for their future availability. This is particularly relevant for high risk companies, where the potential costs of being a non-executive director, in terms of both personal liability and reputation, are so significant that few are willing to take up such positions.

It was also considered that the role of the Chairman of the audit committee was critical in terms of his involvement in the organisation's affairs (e.g. involvement in AGMs).

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

The following points were raised during the face-to-face interviews in respect of the structures and procedures adopted by audit committees:

- there should be more transparency about an audit committee's work
- audit committees should have written terms of reference, a proper work programme, regular meetings and an established timetable to coincide with key events during each year
- all audit committee decisions should be recommended to the full board for formal approval (i.e. the audit committee should continue to be a committee of the board and not be independent of it. All audit committee decisions should be formally ratified to prevent undermining the concept of the unitary board)
- audit committees should provide formal reports as part of the Annual Report and Accounts in the same way as Remuneration Committees do at present

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

The face to face interviews with institutional shareholders revealed that they are not as concerned about communicating with audit committees as one might have anticipated and that they are often unaware of the audit committee's activities. Hence, there is limited support for shareholder representatives (or someone with observer status) on audit committees.

Publishing a summary of the audit committee's terms of reference would be one way of reassuring shareholders about the extent to which they can take comfort from the audit committee's role.

The MORI survey presented a rather different picture. The vast majority of institutional shareholders (78%) considered that audit committees helped to represent their interests as shareholders. **However**, the vast majority of institutional shareholders (78%) considered that they had insufficient access to the audit committee to enable them to make informed decisions about their investments. This view was shared, albeit to a lesser extent, by auditors (47%) and audit clients (66%).

Not surprisingly, a majority of institutional shareholders (64%) considered that an independent observer within the audit committee, appointed directly by shareholders and acting solely in their interests, would improve their representation.

Some commentators have expressed concerns regarding the assumption that audit committees and non-executive directors represent the preferred model of corporate governance for the future. Our surveys tested a number of alternative models.

The first of these alternatives related to introducing a shareholder or stakeholder panel (representing employees, creditors and the general public) to represent and protect the interests of those groups in relation to the appointment and setting of the remuneration of the auditor. Both surveys found that there was little support for shareholder or stakeholder panels having responsibility for appointing and fixing the remuneration of auditors. The MORI survey found that the majority of auditors (55%) and audit clients (55%) consider that auditor independence would not be improved if auditors were appointed by a shareholder or stakeholder panel. This was largely because it was felt that the rights of shareholder governance and confidential information should not be concentrated on a small group of shareholders.

A second alternative was to set up an independent organisation to appoint the external auditor. This body could be positioned within the Financial Services Authority (FSA) and focus only on listed companies or it could be an independent body akin to the Audit Commission controlling the appointment and remuneration of all auditors. The MORI survey revealed that there was minimal support from auditors (10%) and audit clients (12%) for an independent appointments body akin to the Audit Commission or the Financial Services Authority.

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

Our discussions have revealed that many non-executive directors on audit committees do not feel that they have enough guidance or training about their role. Development of such guidance and introduction of guidelines in relation to training would help to alleviate these concerns.

It was suggested by our interviewees that the Nominations Committee of a company could be used to evaluate the qualities (including qualifications, financial numeracy, time availability and effectiveness) of non-executive directors serving on the audit committee. In relation to all of the above we need to consider the following two aspects,

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

In general, our interviewees felt that audit committees for the larger companies in the UK performed effectively but that there was much more variability with smaller companies. It was suggested that a different view of the audit committee may be necessary to cope with the circumstances of smaller companies where management and ownership are often more aligned.

Smaller companies often find difficulties in attracting suitable non-executive directors. It was suggested that a reason for this was that they were too ambitious in trying to recruit board members from large companies. Greater consideration could be given to recruiting those with management experience in large companies, but below board level, and also to those in the public sector and in academia.

G What can we learn from international experience?

The prescriptive approach adopted in the USA has been questioned in the light of the major corporate collapses there. There are also indications that they are considering moving to a more principles-based approach to corporate governance as used in the UK.

As mentioned above, there are serious reservations within the UK business community about any move away from our concept of the unitary board. Our survey and interview responses indicate that it is felt that the supervisory board model adopted in Germany and Netherlands is not conducive to effective board operation as it results in one tier of the board effectively policing the other and, therefore, destroying a facilitative working relationship between executive and non-executive directors.

3. Comments by Review Board members

Review Board members have not yet met to discuss the results of the attitudinal surveys. Some, though, have individually made the following comments in answer to the questions.

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

The National Association of Pension Funds (NAPF) guidelines on the role of independent non-executive directors are commended¹. While agreeing with the NAPF suggestion that independent directors should develop more sources of information independent of that received from the executive, it is suggested that this is no substitute for ensuring that the

¹ The NAPF guide (revised May 2002) says that, while independent directors are normally appointed to the board primarily for their contribution to the development of the company's strategy and to provide valuable expertise not otherwise available to management, the NAPF believe that such directors must accept that they have a control or monitoring function too. Institutional investors do not expect independent directors to become involved in the detail of corporate operations, but do expect them to exercise effective oversight of the executives in relation to their achievement of strategy and performance targets, as well as internal control systems, financial statements and executive remuneration.

board receives the right information. For example, a regular staff attitude survey conducted by a reputable external benchmarking organisation cannot be substituted by a handful of visits to front line or back room operations. Anecdotal information can be biased or unrepresentative and non-executives must be careful not to be pumped for insider information or used by lobbyists. If they become too close to groups or individuals in the company, this can lead to involvement in internal power plays. Independent directors should certainly accumulate impressions from customers, competitors and other external stakeholders.

B What knowledge, skills and attributes are needed and what can be done to attract, recruit and appoint the best people to non-executive roles?

The qualities of non-executive directors as set out in the NAPF guidelines for independent directors² are generally correct but there are trade-offs to be made. A non-executive director with limited time but highly relevant business knowledge may be best equipped to challenge executives on strategy and commercial decisions. It is important to recruit non-executive directors so as to form a balanced team, complementing the strengths of other non-execs and the executives. The Chairman of the Board should make clear to new non-executive directors the specific expectations of that individual within the team.

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

The detailed modus operandi of audit committees should enable them to operate de facto as well as de jure independently of management. This relates, for example, to the timetabling of meetings so that issues cannot be ‘bounced through’ these committees by management, and the ability for committees to meet in the absence of management without causing a stir. The role of the chair of the audit committee is key in striking the right balance between independence and co-operation.

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

A Review Board member expresses strong reservations about having a shareholders’ observer on the audit committee as it raises a number of questions. Will they influence decisions in which case they risk becoming a shadow director with the legal liabilities which flow from that? Will they report back to the entire shareholder body and, if so, how is that to be achieved between AGMs? If only to institutional shareholders, how are they to

² The NAPF guidelines set out eight qualities that institutional investors expect of independent directors:

- A willingness to contribute to strategy and to challenge executives on strategy and other matters, as necessary
- A readiness to challenge the company’s mergers and acquisitions policy
- An ability to contribute to financial and capitalisation issues
- Relevant experience for the needs of the company’s business
- Independence of mind
- Sufficient time to devote to the needs of the business
- Integrity and a preparedness to resign over matters of principle, should that be necessary
- A willingness to learn and continue to learn, not only about the business and its market sectors, but also about the role of the independent director

report back without breaching stock exchange rules (for example, re inside information)? Will they be bound to keep commercial confidences and, if not, will they lead to the suppression of full and frank debate? Does it already work in some other jurisdiction? If not, what reasons are there to believe that it would work in practice?

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

With so much emphasis on the role of non-executive directors looking after shareholder interests, it is essential for institutional investors to articulate their expectations more clearly than in the past. The guidelines for non-executive directors produced by the National Association of Pension Funds is a good example here. (However, it is suggested that the NAPF reflects unrealistic expectations of what non-executive directors in isolation can contribute to financial control – the best prepared and most fully prepared non-exec will not necessarily uncover any and every misdemeanour by executives engaged in cover up (see following comments on the Sarbanes-Oxley Act and whistleblowing).

G What can we learn from international experience?

Review Board members had the following comments on the Sarbanes-Oxley Act on corporate disclosure introduced in the USA in 2002:

- Support is expressed for the proposition that all audit committee members should be ‘independent’ within the definition used by Sarbanes-Oxley i.e. it focuses on absence of financial conflicts and does not import notions linked to length of service, for example³.
- Support is also expressed for the proposal that employee whistleblowers have a channel direct to the audit committee as it is unrealistic to expect a non-executive director can single-handedly identify problems that have internal control processes or which have been purposely suppressed somewhere in the management chain. Although whistleblowing procedures are sometimes resisted for fear of the scope they give to mischief makers this can be kept to manageable limits through, for example, rules which penalise the malicious raising of unfounded concerns.
- However, concern is expressed about the proposal that Boards should be required to categorise audit committee members as to whether or not they are ‘financial experts’⁴. At least one member of an audit committee should be a qualified accountant. The implications for the individual(s) designated as ‘financial experts’ must be made clear. For example, are they to bear a particular burden of expectation that they will be knowledgeable about every aspect of the company’s financial transactions and will they be held more liable than other members if something goes wrong? What does this imply for the remuneration and

³ Sarbanes-Oxley states that ‘in order to be considered independent....., a member of an audit committee of an issuer may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee (i) accept any consulting, advisory, or other compensatory fee from the issuer; or (ii) be an affiliated person of the issuer or any subsidiary thereof’.

⁴ Sarbanes-Oxley requires an issuer to disclose whether or not, and if not, the reasons therefor, the audit committee of that issuer is comprised of at least one member who is a ‘financial expert’.

risk/reward ratio facing potential non-executive recruits? It would be better to specify that all audit committee members must display a basic minimum of financial understanding, to be specified by the FSA according to the complexity of the business, with training courses, initial tests, and periodic refresher training provided.