



The Role of the Non-Executive Director:
Making Corporate Governance Work

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1 Overview

When the the Enron scandal hit the headlines in late 2001, accountants were suddenly granted the level of public scrutiny normally reserved for celebrities and politicians. As the front pages carried stories detailing the latest misdemeanours of errant chief executives, undergraduate accounting courses experienced a surge in demand. What had been widely regarded as a somewhat staid profession was generating unprecedented amounts of attention.

Enron was followed by a series of high-profile bankruptcies and a flurry of restated earnings at other American companies. It soon became difficult to argue that it was merely a case of "a few bad apples". The public's trust in capital markets seemed to crumble with every new revelation of corporate greed, folly and deceit. Thousands of ordinary employees and shareholders lost their savings and pensions, along with their unwavering conviction in the supremacy of US capitalism.

And it is still happening. In February this year, Dutch retailer Ahold announced that the profits of its US distribution company had been

overstated by around \$500 million. Immediately after the disclosure, the CEO and the CFO resigned and the value of the company's stock dropped by more than 60 per cent.

The response from the US regulators has been tough and uncompromising. The Sarbanes-Oxley Act, published in 2002, covers issues ranging from provisions about document retention to protection for whistle-blowers.

On this side of the Atlantic, many people have shrugged off the US scandals in the complacent belief that Britain's corporate governance system would have prevented "an Enron".

One survey of UK chairmen showed that only 10 per cent recognised the possibility of a corporate governance failure in their own company. The advantages of an approach based on principles as opposed to rules were rehearsed over and over again, and the Accounting Standards Board's efforts in preventing the transfer of debt off balance sheets by using a network of affiliates drew praise from all quarters.

But the UK government soon decided that the situation was too serious for the "if it ain't broke, don't fix it" approach. It launched a series of consultations under the umbrella title of



'Overall, most of the recommendations in the Higgs report are sensible, and are already implemented in many companies'

David Kappler, chief financial officer, Cadbury Schweppes

Professional viewpoint: Paul Fullagar

"Post-Enron initiatives". Chancellor Gordon Brown and Patricia Hewitt, the secretary of state for trade and industry, set up a co-ordinating group on audit and accounting issues. They gave Derek Higgs the task of examining the role and effectiveness of non-executive directors (Neds) and they called on Sir Robert Smith to lead a review of the Combined Code guidance for audit committees. As a consequence of these reviews' findings, the Combined Code is now in the process of being modified.

All this prompted a frenzy of activity among accounting bodies, institutional investors, consultancies, accountants in business, private individuals and many others. The Higgs consultation alone generated more than 250 submissions and made front-page headlines when the report was published in January 2003. It has since drawn mixed reactions (*see panels*) and the Financial Reporting Council, which will draw up the final corporate governance rules based on the Higgs plan, is now under pressure from the FTSE 100 to water them down.

Now that the reports are completed and the Combined Code is all but rewritten, it's questionable how many accountants fully grasp the implications. They may also be unaware of the wider context of corporate governance beyond that which affects them directly in their day-to-day work.

CFOs and FDs aside, accountants in business – at whom this guide is primarily aimed – are unlikely to be closely involved with the inner workings of the boardroom. But, in order to fulfil their role of providing information to the board, they do need an understanding of how that information is used. This guide provides an overview of recent corporate governance developments, as well as some pointers as to how accountants and finance professionals can contribute to the effectiveness of their boards. ■



The Higgs report is poorly constructed and will be extremely damaging to shareholder wealth, according to Paul Fullagar ACMA, a senior non-executive director at Staffware and Marlborough Stirling, both of which are techMARK 100 companies. It will even cause many firms to reconsider whether the public domain is the right place to be, he says.

"Most of the FTSE 100 will be breathing a sigh of relief, because it's not as bad as the Sarbanes-Oxley report in the US. But for many smaller companies, which have a very different dynamic, the review is madness. If Higgs had said that these rules were only for the FTSE 350, and that other firms simply had to be mindful of them – especially if they wanted to move towards the FTSE 350 – that would have been fine."

Fullagar says the report offers no evidence attributing any corporate failures (or successes) to the current structure of UK boards or the role played by Neds. And he claims it is merely supposition that the recommended revisions would make a difference. The Enron and WorldCom scandals would not have happened in the UK, because the structure of boards over here is very different, he argues.

"The review was a knee-jerk political reaction to a handful of multinational failures, principally in the US, that had no bearing on any UK companies apart, perhaps, from a few conglomerates in the FTSE 100."

Fullagar also challenges Higgs's view that governance shortcomings have contributed to stock market slumps over the past few years. It's widely accepted that this was caused when worldwide market forces chased prices up too high and then down too low again, he says. "How firms' share prices rise and fall is largely unrelated to corporate governance. You need market regulation, not internal company regulation, to change this."

Fullagar accepts that there is some sense in splitting the roles of chairman and chief executive to prevent one individual from dominating the board in larger companies, but insists the proposal that a chief executive should not become chairman of the same company is flawed. "This supposes that the benefit of the CEO's knowledge and experience in a company has little ongoing value to the shareholders, and that an 'independent' chairman with no knowledge of the organisation will perform better."

He also believes that the proposed definition of an independent Ned will decimate the level of talent in UK boardrooms. To conform to the review's proposals, non-independent Neds would surely be forced off plc boards in large numbers. "A director who has worked for the company and thoroughly understands it, or has been a director for more than six years or holds a material shareholding in the firm cannot be independent or contribute to shareholder wealth under these recommendations," he says. "But the man in the street who has no knowledge of the specific business or practical experience of running a company would fully qualify."

Fullagar describes the "comply or explain" approach as "a lovely concept", but predicts that companies which decide not to comply will suffer as a result. "The reality is that most fund managers, investment analysts and compliance officers don't accept reasonable explanations," he argues. "It is all very well saying that it won't be illegal if you don't comply, but you'd receive a large number of negative votes from these groups."

2 Corporate governance defined

Corporate governance can be simply defined as “the system by which companies are directed and controlled” (*Cadbury report*), which focuses on the “hygiene” and “housekeeping” aspects of running a business. The Organisation for Economic Co-operation and Development (OECD) extends the definition by stating that corporate governance involves “a set of relationships between a company’s management, its board, its shareholders and other stakeholders [that provides] a structure through which the objectives of the company are set and the means of attaining those objectives and monitoring performance are determined”.

An organisation can be viewed as consisting of corporate governance processes on the one hand (a so-called framework of accountability) and value-creating activities such as strategic decision-making on the other. Both elements are necessary, since focusing on performance without having adequate checks and balances is like building on sand. But recently we may have overlooked the need for firms to ensure that corporate governance does not become an end in itself – ie, a set of rules that actually constrains the value-creating activities of the business.



It has often been assumed that there is no direct causal relationship between an organisation’s corporate governance and its economic success – in the sense that the former does not guarantee the latter; it merely facilitates it. But recent research has shown that good governance can in fact create value itself, and surveys by the *McKinsey Quarterly* have found that major institutional investors are increasingly willing to pay a premium for it.

The inclusion of the word “relationships” in the OECD’s definition points to the fact that corporate governance is not simply about complying with the regulations. While there is clearly a need for structures and processes, there is no way of legislating for people’s behaviour. However strict the controls may be, there is always a danger that wilful personalities or skewed incentives can override them. Enron was a case in point. It has been described as a systemic failure of governance, despite the fact that all the right boxes had been ticked. The spirit of good governance – which must begin with directors and managers acting in the best interests of the business and its owners – simply didn’t exist. ■

‘The reinforcement of the “comply or explain” rule is to be welcomed – it recognises that one size does not fit all. On the other hand, the increasing role of the senior Ned versus that of the chairman needs careful consideration’

Philip Yea, non-executive director, Investcorp

3 The evolution of corporate governance in the UK

The UK's corporate governance system is based on a combination of voluntary codes, which have gone through a series of revisions over the past decade, and legislation on company law.

1 Cadbury committee

Reforms of UK corporate governance in response to corporate failures are nothing new: the scandals of Polly Peck, BCCI and Maxwell Communications Group in the 1980s prompted the first of such attempts to clarify the duties and responsibilities of boards. In 1992 the Cadbury committee issued a code of practice covering:

- the board's composition and appointment procedures for directors;
- the role and functions of the board;
- the qualities required of Neds;
- executive directors' pay;
- the duties of the board to present a balanced view of the company's performance and to maintain effective internal controls and relationships with auditors.

The code was aimed at listed companies in the UK, but the committee hoped that as many firms as possible would aim to meet its requirements.

2 Greenbury committee

In 1995 there was a huge public outcry over the size of the pay increases awarded to directors in newly privatised companies. This led to the establishment of the Greenbury committee, set up on the initiative of the CBI but remaining independent of it. The committee built on the work of Cadbury, adding specific guidance on boardroom pay.

Greenbury's approach was to strengthen board accountability and to encourage performance improvements through transparency, the appropriate allocation of the responsibility for setting pay and proper reporting to shareholders. Specifically, the committee felt that the task of determining executives' pay needed to be delegated by the board to a suitably knowledgeable and independent group of people – namely, non-executive directors – who would have no vested interests. They were also given the task of reporting to shareholders, providing full details of individuals' remuneration and the policies underlying pay decisions.

The final report was published in 1995 in the hope that its recommendations would improve remuneration practice in large companies. As with Cadbury, it was also hoped that smaller and non-listed firms would find the report's conclusions of merit.

3 Hampel committee

In 1996 the Hampel committee was established with a remit to:

- review the Cadbury code and how it had been implemented;
- keep under review the roles of executive and non-executive directors;
- review the recommendations of the Greenbury report;
- address the role of shareholders and auditors in corporate governance.

4 The Combined Code

In 1998 the Hampel committee produced its Combined Code, which embraced the work of the Cadbury and Greenbury committees as well as its own. The code was passed to the London Stock Exchange to sit alongside the listing rules.

In 1999 the Turnbull committee published additional guidance on principle D2 of the Combined Code, providing more advice on how to maintain a sound system of internal control to safeguard shareholders' investments and the company's assets.

The three reports – Cadbury, Greenbury and Hampel – represented the key corporate governance templates throughout the 1990s. In effect, the Combined Code was the outcome of nearly 10 years of gradual reform.



5 'Comply or explain'

Like its predecessors, the Combined Code has no statutory force. Its implementation through the listing rules requires companies to disclose in their annual reports whether or not they are complying with its provisions and, if they aren't, to explain why. The Financial Services Authority is currently responsible for checking whether such disclosures are made, but not for verifying their accuracy or quality.



This "comply or explain" regime, based on principles rather than rules, has been one of the defining features of the UK corporate governance system. It is an explicit acknowledgment that there is no one-size-fits-all solution for the governance of listed companies, and that a certain amount of flexibility needs to be built into the system. It's also an attempt to strike a balance between control and accountability on the one hand and entrepreneurial spirit and risk-taking on the other. In effect, it allows the market to determine what is acceptable for an individual company.

6 Post-Enron initiatives

The UK government's response to the US accounting scandals was swift and determined. Although it recognised the substantial differences between the two systems, it warned that it would be "dangerously complacent" to assume that this type of corporate failure was inherently less likely to happen here, and that this "relatively advantaged" position (*Higgs report*) would not

preclude the need for improvements. Instead, it wanted the regulatory regime for financial reporting and audit in the UK to continue to be effective and provide "appropriate underpinning for strong and efficient national and international capital markets".

In a speech on 30 January 2003, Patricia Hewitt said: "Structures, standards and regulations can never be a complete defence against individuals who are determined to do wrong, nor can they wholly protect us against a culture of corporate greed and loose ethics. But we owe it to savers, investors and employees, as well as the honest business people whose reputations have been tarnished by those scandals, to ensure that our defences are as robust as they need to be."

Back in February 2002, the secretary of state had announced the establishment of a body whose remit was to ensure that there was a co-ordinated programme of work by individual regulators reviewing UK's regulatory practices. The co-ordinating group on audit and accounting issues (CGAA), as it was called, became an umbrella body for the separate strands of the reform.

In April 2002 Derek Higgs, an experienced investment banker and Ned, was appointed to lead an independent review into the role and effectiveness of non-executive directors. A consultation paper was published in July and three separate research projects were commissioned at the same time. The Higgs review was finally published in January 2003. All the relevant

'Nowhere in Higgs does it say that the senior Ned would usurp the position of the chairman. The chairman has an important role in guiding the board, and this report is not diluting that responsibility'

John Wroe, director, group financial control, BT

documents, including some of the submissions, can be accessed at www.dti.gov.uk/cld/non_exec_review/

A summary of the report's main recommendations can be found in appendix 1.

At the same time, the Financial Reporting Council (FRC) was asked by the CGAA to set up an independent group to clarify the role and responsibilities of audit committees. Sir Robert Smith, chairman of the Weir Group, was given the task of leading the group. Its final report was also published in January.

A summary of its recommendations can be found in appendix 2 and the full report can be downloaded from www.frc.org.uk/publications/content/acreport.pdf

The Higgs report put forward a suggested revised code incorporating review recommendations and Smith's new code provisions on audit committees. The FRC has opened a 12-week consultation process ending on 14 April to highlight any "fatal flaws" in the proposals and comment on specific drafting matters. But it has stated that it does not intend to re-examine "the substance of the recommendations". After this consultation period closes, it will issue a revised version of the Combined Code, which will take effect on 1 July.

7 Company law review

The complementary piece of the corporate governance jigsaw in the UK is company law. While the Combined Code represents best practice, company law concerns the detailed legal rules intended to support a competitive economy. It therefore represents a wider context in which to interpret good governance. The difference between the two is highlighted in the 1999



The classic British boardroom model is superior to its US equivalent because it includes executive directors other than the CEO and CFO, according to Tony Isaac FCMA, chief executive of the BOC Group.

"You need the leaders of the main businesses as executive directors for two reasons," he says. "First, it's a good development opportunity for the individuals concerned, as it takes time to adjust to a board environment. Second, it's very good for Neds, because they can question those who are running the main parts of the business as well as the CEO and CFO."

Too big a board can also cause problems, Isaac says. "If it is to debate issues sensibly, it should have no more than 12 members, even in a large FTSE company. And having a majority of Neds enables enough of them to serve on other committees."

Isaac believes Higgs's proposals will upset the balance of the board in two key areas. "What worries me most is the relationship between the chairman and CEO," he says. "Most firms have a proven and established relationship between a non-executive chairman and the CEO. The chairman's main role is to run the board efficiently, liaise with the Neds and executives, discuss strategy and succession issues and be the main link with shareholders in presentations. If the shareholders are not happy, they can talk to the chairman. It works well, so I don't agree with Higgs's view that you need a full-time chairman – who therefore isn't independent – and that you need to strengthen the role of the senior Ned."

Isaac is also against the proposal that Neds should have separate meetings with investment institutions. He thinks this is an executive's job, with some support from the chairman. "There is no need for a senior Ned to be party to meetings with shareholders – it's not appropriate. Companies will also struggle with the practicality of having senior Neds at one-to-one briefings. It fuzzes the current relationship. If you ask the chairman to take a full-time executive role, then you are asking the senior Ned to move into the arena of the chairman and the CEO, and this will cause a lot of concern."

But Isaac acknowledges that some of Higgs's proposals have been extremely positive. "The report supports board evaluation, for example, which is totally right," he says. "Obtaining feedback on the board process, management, individuals and the effectiveness of the board is helpful and constructive."

At BOC, all board members receive a copy of the CEO's and CFO's presentations to investment institutions, the main issues that were raised and unattributable feedback from those bodies. This gives them a good view of the investors' concerns, he says. "Something along these lines in a best-practice code would be ideal."

Isaac also supports the "comply or explain" approach. "If people take the decision not to comply, they have to think through how they will explain why. If shareholders have genuine concerns about non-compliance, they can then be debated," he says.

BOC recently used the "explain" option to explain why it had re-elected Matthew Miao and Roberto Mendoza as independent Neds, despite the fact that they'd both had connections with the company that raised questions about their independence. "These two individuals are outstanding and have knowledge and experience that is essential to the board," Isaac says. "Both add value, especially in board discussions, and I have been very happy to explain this to the small number of investors who have raised the issue."

consultation document from the company law review steering group, which states that “the issues dealt with under the Combined Code were more suitable for best practice than legislation. The government would not intend to replace such best practice by legal rules, [providing that] it was seen to be working.”

The UK company law framework was set in place more than 150 years ago by William Gladstone. There was widespread recognition that this “archaic Victorian system”, as Hewitt once called it, had become too dated and complicated to meet the needs of the modern economy. As a result, the Department of Trade and Industry launched the company law review in 1998. After a period of extensive consultation, the review steering group presented its final report in 2001. The government published its response in a white paper in July 2002. The proposed changes are likely to be included in the Companies Act 2003.

The overall aim of the DTI's review has been to reassess the structure and processes of current financial reporting practices with a view to increasing “corporate responsiveness to wider interests through transparency and accountability”. It acknowledges that the information currently provided by most companies is backward-looking, providing no real indication of their future performance, and also fails to recognise different stakeholder concerns. Details of the company law review can be found at www.dti.gov.uk/cld/review.htm

8 Operating and financial review

To address the shortfalls in the current legislative approach, a key requirement of the revised company law is the mandatory operating and financial review (OFR). The OFR attempts to rectify the anomalies in the reporting rules by redefining directors' duties to take into account wider stakeholder interests (while maintaining their legal responsibility to shareholders alone).

It is a qualitative, as well as financial, evaluation of performance. Rather than prescribing detailed mandatory requirements, it demands that directors' themselves make a judgment of materiality – ie, what constitutes a relevant account of their companies' performance, both historical and forward-looking.

CIMA fully supports the OFR. We see it as a positive step in improving transparency by enhancing the quality of reporting.



9 A holistic approach to regulation

Many people believe that corporate governance reforms in the UK are based on an erroneous assumption that governance failures are to blame for the recent decline in equity markets. They argue that the movement of share prices has nothing to do with internal company regulation, but with the way the market as a whole behaves.

But if corporate governance is taken to mean a whole set of relationships with different market participants – as the OECD definition would have it – then the changes in the structure of boards and the way directors interact with shareholders, external auditors and so on will inevitably affect market operations on a larger scale.

An important feature of the reforms is precisely this holistic approach to regulation. Hewitt called them comprehensive and “mutually reinforcing” and they do in fact address what the Institute of Internal Auditors calls “the pillars of corporate governance” – namely, executives and Neds, senior managers, board committees, internal and external auditors and shareholders. ■

4 Review of the role and effectiveness of non-executive directors

Although it was warmly received on its publication, the Higgs report has since drawn criticism from several quarters. While the government is deciding whether to implement Higgs's recommendations in full or to tweak some of the most contentious points – which seems the most likely outcome at present – commentators point to the reception that greeted the Cadbury report 10 years before. After a broad initial welcome, it was branded “ill-conceived” at best and “dangerous” at worst.

The loudest voices of dissent seem to be coming from chairmen of companies in the FTSE 100 and directors of small firms. The former are concerned that the appointment of the senior Ned, as recommended by Higgs, will split the unitary board and undermine the role of the chairman. Having a Neds’ “representative”, they claim, would make the chairman a quasi-executive and create alternative power bases in the boardroom. The latter complain that the burden of compliance may prove to be too onerous and costly. They argue that they simply haven't got the resources – not only to appoint more independent Neds but also to provide an explanation of why this is the case. (This also applies to companies in the process of flotation, because they are likely to be coming to the market with a wholly or largely executive board.)

The answer to both of these concerned parties lies in the flexibility of the “comply or explain” approach, which is already at the heart of the Combined Code. At a recent discussion organised by CIMA and the Adam Smith Institute, Derek Higgs stressed that explanation was as important as compliance. The overall aim should be accountability and transparency in reporting corporate governance practices. Investors are interested in the reasons behind decisions rather than total compliance for its own sake.

This last point serves as a reminder of the role played by shareholders, especially large institutional investors. If their reaction to the proposed changes in the code ends up being what Higgs has called “the gleeful ticking of boxes” at best and indifference at worst, then many of the reforms will take a long time to become embedded in business practice. Investors have a responsibility – as Arthur Levitt, former chairman of the US Securities and Exchange Commission, writes in *Take on the Street*: “Like democracy, corporate governance works only when you exercise your right to vote.”

Although the revised Combined Code will come into effect without delay, Higgs stresses that it is not about “grinding, crunching, immediate change”, but about the evolution of corporate governance practice. It aims to initiate easily manageable, gradual improvements. Had it ended up being all things to all people, it would have meant accepting the lowest common denominator and not trying to raise standards.

The senior Ned approach should not be viewed as an opportunity for confrontation. It can serve to diffuse power across the board, and the full text of Higgs stresses the importance of the chairman's role on several occasions. For instance, the section entitled “The role of chairman” starts off by stating: “The chairman plays a pivotal role in creating the conditions for overall board effectiveness, both inside and outside the boardroom. The role differs significantly from that of other non-executive and executive directors.”

The report adds that the chairman has the responsibility of leading the board in setting the values and standards of the company, and of maintaining the relationship of trust with and between the executive and non-executive members. This hardly constitutes a

weakening of his or her position or the creation of a separate agenda for non-executives. The chairman's role may be pivotal, but it does not have to be all-powerful.

Yet it does appear that the government is likely to give ground over the recommendation that senior Neds should hold regular meetings with shareholders. The *Financial Times* predicts that ministers are likely to tighten up the wording of the proposal to make it clear that such meetings should be the exception rather than the rule.

In response to the small companies' objections, there's a strong argument to say that the benefits of having the right people on the board will outweigh all the costs of finding them. But there have been other strongly voiced challenges to Higgs besides these. For example, many have complained about the recommendation that a chief executive should not become the chairman of the same company. The new definition of independence has also been criticised as too stringent. And Higgs's suggestions for widening the pool of non-executives by attracting people from outside the commercial sector have attracted a great deal of media scrutiny.

Although all these issues need to be discussed and worked out before the Combined Code takes effect, some people are questioning whether those who defend the status quo are doing it out of concern for their company or to protect their own interest and status.

For accountants in business, many of whom will be producing work for their company's audit committee, the recommendations of Sir Robert Smith's group will be directly relevant. They may now be subject to scrutiny by a more knowledgeable audience if the Smith recommendations about the membership of audit committees are implemented in full. ■

5 Corporate governance and the finance professional

“There should be no mystique surrounding the board of directors. A board is just another committee,” says Brian Walsh, deputy chairman at the Nationwide Building Society (see *panel, opposite*). He believes we should be reminded of this fact from time to time and points out that most employees perceive boards as distant – and that most directors want to keep it that way.

Those accountants in business who are not CEOs, CFOs or FDs will probably not have a direct link into the board. Most will have no involvement in its workings and a limited understanding of how their work contributes to its effectiveness.

But the role of the finance function is crucial. A recent survey by the Economist Intelligence Unit and KPMG has revealed that financial information and the understanding (or lack of it) of financial issues are major barriers preventing the implementation of successful corporate governance policies. Nearly a quarter of the international companies in the survey cited a “lack of financial understanding on the part of senior executives and the board” as a significant stumbling block.

1 Quality information and board effectiveness

The main contribution of the finance professional to board effectiveness is the provision of relevant and timely information. Even if all the corporate governance boxes are ticked, best practice is observed and the right mix of personalities and expertise are present, the fundamental requirement of every board is access to good information.

This is especially important for Neds, who generally have less involvement in day-to-day business operations. They can only comment on, and make decisions about, those matters that have been brought to their attention. Any gaps in the information they receive will result in poor decision-making.

As the Higgs reports states: “In order for a non-executive director to be effective, adequate information of the right kind is vital. Information must be provided sufficiently in advance of meetings to enable non-executive directors to give issues thorough consideration, and it must be relevant, significant and clear.”

Robert Bittlestone, managing director of management consultancy Metapraxis, proposes the following theory about Neds:

Director’s effectiveness =
time available x personal competence
x information quality

He cites Marconi as an example of a company that failed partly because the board received untimely information: “Board members who had been relying on schedules of historic data contained within reports submitted a month or so previously (or even in the previous quarter) would clearly have had little chance of exercising their talents to save the company.” In other words, it was a case not of incompetence or flawed risk assessment, but of a simple delay in providing the right information.

Only by having timely information can the board have a common understanding of the business model. And only then will it be able to pull the right levers at the right time and in the right way.

The information provided must include the intangible value drivers of the business, which may not be expressed in financial terms. This is where the preparation of the mandatory OFR will help. This represents a qualitative evaluation of performance, trends and intentions, including corporate governance values and structures, an account of company’s key relationships, policies on environmental or social issues and so on.

But, although the predominance of financial information in assessing performance has attracted much criticism in recent years, it still represents

an essential piece of the jigsaw. If improved performance in other areas fails to translate into financial results, then the board will have to rethink its strategy and the means it has chosen to achieve it.

Of course, the information cannot simply be aggregated and presented to the board. It needs to be analysed in a timely and insightful manner if it’s to add value. Detailed financial reports will simply add to the information overload. What the board needs is an overview of the financial health of the organisation and an understanding not only of what has happened, but of where the company may be heading and how to steer it in the right direction – ie, good strategic management accounting.

This implies that accountants will have to perform activities that transcend the normal boundaries of their profession. They need to become both more creative and commercially aware, virtually acting as strategic advisers to the board. In fact, their expertise and professionalism should be used to ensure that internal reporting processes are not distorted by short-term market considerations that impose unrealistic targets on managers. By taking control of internal reporting, financial directors and finance professionals below board level can focus the board’s decision-making on long-term, sustainable value creation.

In his recent book, *Corporate Governance and Chairmanship*, Sir Adrian Cadbury writes: “The finance director stands in a special relationship to the chairman and to the chief executive, which is why the three of them often form the top team in a company. The basis of this relationship is the finance director’s professional independence. It is the duty of finance directors to give their chairmen, chief executives and boards their own best judgment on the company’s financial position. They may

Professional viewpoint: Brian Walsh

well give their boards a more cautious view of the financial state of the business than their chief executives.”

Cadbury also makes an important distinction between direction and management: the former is the task of the board and the latter is that of the executive. But, unless there is a very clear division of duties, there will be “confusion over where the power of decision lies, and over who is accountable for what decision”.

According to surveys commissioned during the Higgs review, 90 per cent of directors are happy with the amount of information they are receiving, but they are concerned about its quality and relevance. Typical comments included:

- “I don’t know what’s happening. I mean, you’re given financial information, but you never get to know what’s really going on.”
- “I’d like more information about the underlying day-to-day activity.”
- “Financial information is presented in too much detail.”

The role of finance professionals is about more than putting the right information on the boardroom table. In many cases, they will also be charged with ensuring that this information is communicated to – and understood by – the City, to ensure that their companies are more accurately valued by investors. In other words, their role is both inward- and outward-facing.

CIMA believes that there should be no radical difference between the information that’s reported internally to the board and that which is provided to external stakeholders. If the board is committed to reporting its key value drivers, then the information used to manage the business should be made available to the markets.

This framework of transparency – a continuum between internal and external reporting – should be the cornerstone of good governance. By this



Much of what happens on boards boils down to individual relationships, according to Brian Walsh FCMA, deputy chairman of the Nationwide Building Society. And that’s why there has been some negative reaction to the recommendations of the Higgs report.

“There is a huge fear of change, because everything depends on the personalities, chemistry and maturity of people in the boardroom,” he says.

The issue of the senior Ned versus the role of chairman is causing the greatest concern, he says. “This is predicated on the assumption that the chairman might have a relationship with a firm that’s not as independent as you might like.”

Walsh describes Higgs’ proposal for a senior Ned as “a bit of a smack in the face to the chairman”, but he thinks that boards should take a more considered approach to this recommendation. “They should sit back and think ‘let’s make it work’. They don’t need to be fearful that a senior Ned will take over the company – that’s immature in the business sense.”

He agrees that increasing the diversity of board membership would be helpful for shareholders. “Most boards are preoccupied with shareholder value as a concept, so all discussions tend to have an economic angle. A mixture of people from different backgrounds – not necessarily economic – is important, but most boards want to protect the status quo.”

Walsh also supports Higgs’s views on the joint role of chief executive and chairman. “If you are a chief executive, why appoint a new chief executive, move upstairs to the chairman’s role and sit there sniping at him or her and trying to limit his or her influence? Making sure that people can’t move from CEO to chairman does make sense.”

The Higgs report is all about checks and balances, he points out. “Another proposal that people have perhaps gone a bit over the top in criticising is that the chairman of the board should not chair the audit committee. I totally agree with this recommendation. I’m the chairman of an audit committee and I would not allow the chairman to come in on that. It’s common sense.”

The fact that Higgs is based on “comply or explain” grounds should satisfy most companies, he points out. “There are enough ‘outs’ that, if people want to explain themselves, they can do so – although some companies will still drive a truck through that.”

And Walsh is also somewhat sceptical about the ability of the Higgs framework to prevent an Enron-style scandal from happening in the UK. “Enron ticked every corporate governance box – it was most meticulous about that,” he says. “If there’s enough greed in the system, it’ll find a way round the rules.”

we don't mean that companies should start reporting more information; rather, that what they report should be the kind of information that's needed by the markets.

As the nature of business reporting changes, boards and the investment community will become increasingly reliant on the finance professionals to provide information about the company's performance that is relevant, timely and robust.

This might all sound straightforward, but the reality in many organisations is that the right information simply isn't available or that it takes too long to retrieve it from various different systems. It could be something as simple as asking how profitable a certain customer is on an economic profit basis: a lot of people will spend a lot of time looking for the relevant figures and then reconciling them. And the information that emerges at the end of this process will have so many caveats attached to it that it's unlikely to be worth much.

The issue clearly isn't only the time wasted trying to get the right figures. It is also the fact that the board will not be able to form an understanding of the key value drivers of the business.

Most boards comprise knowledgeable and competent individuals. But a recent (unpublished) survey from PricewaterhouseCoopers showed that, while nearly two-thirds of the companies it questioned had made at the very least a modest attempt to combine all their value drivers into a business model, only 10 per cent felt they had actually succeeded in doing this. Of course, no company is likely to admit publicly that its board doesn't know what it's doing, but there is enough anecdotal evidence to confirm that directors occasionally put forward solutions based on their understanding of isolated functional areas, rather than the business as a whole.

2 CIMA strategic enterprise management (SEM)

CIMA has been advocating SEM as a strategic management approach that allows companies to focus on creating and sustaining shareholder value through the integrated use of best-practice analysis techniques, technologies and processes in support of better decision-making.

This approach starts from the realisation that successful strategies for creating sustainable shareholder value are in most cases based on superior decision-making capability at board and senior management level. This in turn depends on the provision of high-quality information.

For further information on CIMA SEM, visit www.cimasem.com. Later this year an executive report outlining the findings of our SEM round-table discussions will be available.

3 Finance professionals as custodians of shareholder value

In an attempt to make boards more effective, improving the quality of information could constitute "most gain for least pain", as Robert Bittlestone says. Of course, there are no quick fixes and, if the culture of the board is wrong, no amount of good information can make directors ask the right questions. But there are ways of improving the finance function that can result in real gains across the business.

As an aside, it's worth mentioning that the Higgs report puts the company secretary at the heart of effective information provision in terms of "facilitation of good information flows, provision of impartial information and guidance on board procedures, legal requirements and corporate governance". Although CIMA acknowledges that such a role is indeed fundamental, we believe that the complementary role of the

finance professional, especially the CFO or the FD, could perhaps have been given more emphasis.

The report sees non-executive directors as the custodians of the governance process. In a way, management accountants act as champions of shareholder value. The external auditor checks the conforming side of the business – ie, the traditional governance structures and processes – while the finance function guards its performing side – ie, the part where value is created.

4 Financial literacy of the board

The onus for providing the right information does not lie with financial professionals alone. Directors, especially Neds who are unlikely to have detailed knowledge of the business, must request the information they need and specify any changes in its format or timing.

The Higgs report says it's important that "non-executive directors give constructive feedback on the value of the material provided and guidance on what is required. Where information is not appropriate, this should be clearly signalled through the chairman. It should be part of the annual evaluation of the board's performance to examine whether the information provided to the board meets directors' expectations and requirements."

The ability to grasp the information that's presented is another prerequisite. Without this, Neds will not be able to ask the right questions or challenge executives, especially if they suspect there is evidence of wrongdoing. A study conducted last year by KMPG found that most Neds in fact felt comfortable with their level of financial knowledge, but wanted to receive training on topics such as how to spot the early signs of business failure.

Because Neds' main channel for receiving financial and non-financial

6 The cultural and behavioural aspects of board effectiveness

performance information will be the CFO or the FD, there is always some element of risk that what is presented to them may be biased in some way. This is why Neds should strive to get to know the company and its management below board level. In fact, many of those interviewed by the Higgs review said that attending company events and visiting local offices, with the informal contact with managers this brought, had significantly improved their knowledge of their organisations. Higgs also explicitly states that opportunities “should be provided to ensure that non-executive directors see regularly, and at first hand, the performance of the senior management team”.

Audit committee members will need a more comprehensive financial knowledge. This is particularly true of the chairman. The Smith report stipulates that at least one member of the audit committee should have significant, recent and relevant financial experience – and preferably have an accounting qualification.

Knowledge of finance can also be useful in the work of the remuneration committee, because directors will need to assess the link between the complex structure and form of executive pay. ■

To those who have read the full text of the Higgs report, it's evident that the emphasis has been placed firmly on the behavioural and cultural aspects of board effectiveness. This aspect of the review has largely been overlooked in the discussions following its publication, probably because it cannot be reduced to a simple code recommendation or a controversy worthy of a headline.

The introduction to Higgs states: “Corporate governance provides an architecture of accountability – the structures and processes to ensure companies are managed in the interests of their owners. But architecture itself does not deliver good outcomes. The review therefore also focuses on the conditions and behaviours necessary for non-executive directors to be fully effective.”

In other words, governance has to be about more than complying with the regulations. People, and their relationships, are the key to attaining the desired level of individual and overall effectiveness at board level.

One way of creating conditions for the right board culture is by recruiting, inducting and training the right people to be directors. The current practice hardly constitutes a professional approach: only 4 per cent of Neds in the

Higgs review's research sample have been appointed through a formal interview, two-thirds have never received any training and three-quarters have never had a personal performance review. More than two-thirds of Neds in the FTSE 100 are over 55 and only one-tenth of Neds are women.

The Higgs report was partly an attempt to expand the pool of Neds and professionalise the relevant HR practices. Having a set of “formal, rigorous and transparent” procedures – for example, clear job specifications, recruitment interviews and performance reviews – should ensure that the people selected have the skills, expertise and personal attributes that will complement, and not clash with, those of existing board members.

There can be no simple prescriptions about how to ensure that this so-called soft side of boards is functioning effectively. But observing some relatively formal guidelines – or making an effort to explain why it isn't necessary to do so – will at least mean that the threat of failure is minimised in areas where there is established best practice. In that sense, the Higgs report is, as it states, “a counsel of best practice that can be intelligently implemented with discretion”. ■



7 A challenge for the future

As many commentators have pointed out, there are companies that already comply with most of the Higgs report's recommendations. The rest have until July to make the required changes, or to explain their reasons for not doing so.

Corporate governance is not a static subject; it has to be flexible enough to reflect the changes in the wider business environment. The notion of periodically formalising best practice (something that typically happens in the FTSE 100), while also allowing flexibility, should keep raising the bar and so lead to change that's incremental and based on what's actually happening in businesses. The new Companies Act, together with the revised Combined Code, should ensure that the UK's corporate governance system remains robust.

It bears repeating that corporate governance does not equal economic success. It may well provide the right conditions for it by taking care of the fundamentals. But it has to be complemented by superior business performance, which depends on good strategy and effective decision-making. The Higgs report, and the government's entire programme of reform, is an attempt to balance accountability with wealth creation.

The established role of finance professionals is to ensure that the board has a clear picture of the financial health of a company (later this spring CIMA will be publishing a guide on how to improve performance reporting to boards). But they should also be extending the horizons of decision-making to move boards away from their current short-termism and into sustainable value creation. Of course, accountants in business cannot do this alone – they will need help from other market participants, particularly investors. ■



The Higgs review is to be applauded, says Katherine Howard FCMA, a non-executive director and chair of the audit committee at the Council for Registered Gas Installers, because the position of Neds and their role has long needed clarification.

"Higgs gives a welcome focus to the quality and constituency of Neds," she says. "It's not always easy for us to establish exactly the right relationship with our executive directors to ensure that corporate governance is effective yet doesn't interfere with their activities."

Howard believes the report will also enhance the role of financial managers in making boards more effective. "For too long the role of finance professionals has been weighted too heavily towards providing historic and purely financial information," she says. "A desire to improve governance will allow them to contribute to board effectiveness by focusing on the strategic, long-term direction of the business; by paying attention to the flow of information to and from the board (so removing the effects of the 'marzipan layer' that hampers effective engagement between the board and employees); and by providing information, not only financial, that will enhance business performance and assure corporate responsibility."

But Howard believes that the Higgs report's recommendations look weak in some important areas – most notably, the proposal that Neds should engage with employees and other stakeholders, as well as shareholders. "Often the information coming to the board is constrained to that which enables the board to meet legal and regulatory compliance," she says. "For effective governance, Neds need to look beyond compliance and into how the business operates and its environment. I would like to have seen it explore the subject of information flows to and from the board further."

Because her company is not listed on the London Stock Exchange, it isn't obliged to follow Higgs's recommendations, but it is working towards complying with all aspects of the Combined Code. The audit committee has been assessing its own performance over the past few years and the company is aiming to introduce performance assessment that addresses the full scope of governance.

Howard acknowledges that in some businesses, including several larger members of the FTSE 100, the Higgs review will result in major upheavals. And, for smaller businesses, updating processes to meet its recommendations will be time-consuming and expensive. The reaction of these businesses hinges on how good they want their governance to be.

"Of course there are cost implications in complying with the Combined Code and any subsequent enhancements. But it depends what the company wants," she says. "If it is sincere about having good governance, it has to be prepared to invest in getting the right people and setting up appropriate processes that will deliver effective assurance and sustained value creation."

Appendix 1 Summary of the Higgs recommendations

The board

The board should be an appropriate size. At least half of the board's membership, excluding the chairman, should comprise independent non-executive directors.

The chairman

The chairman has a pivotal role in creating the conditions for individual director and board effectiveness. A chief executive should not become chairman of the same company. At the time of appointment, the chairman should meet the test of independence set out in the review.

The role of non-executive directors

Non-executive directors should meet as a group at least once a year without the chairman or executive directors, and the annual report should include a statement on whether such a meeting has occurred.

Prior to appointment, potential new non-executive directors should conduct a due diligence exercise both on the board and on the company to satisfy themselves that they have the knowledge, skills, experience and time to make a positive contribution.

The senior independent director

A senior independent director should be identified who meets the test of independence set out in this review.

The senior independent director should be available to shareholders if they have concerns that have not been resolved through the

normal channels of communication with the chairman or chief executive.

Independence

A definition of independence is proposed for incorporation into the Combined Code.

A non-executive director is considered independent when the board determines that the director is independent in character and judgment, and that there are no relationships or circumstances which could affect, or appear to affect, the director's judgment.

Such relationships or circumstances would include where the director:

- is a former employee of the company or group, until five years after employment (or any other material connection) have elapsed;
- has, or has had within the past three years, a material business relationship with the company, either directly or as a partner, shareholder, director or senior employee of an organisation that has such a relationship;
- has received or receives extra remuneration from the company (apart from a director's fee), participates in the firm's share option plan or performance-related pay scheme, or is a member of its pension scheme;
- has close family links with any of the company's advisers, directors or senior employees;
- holds cross-directorships or has significant links with other directors through involvement in other companies or bodies;

- represents a shareholder with a significant stake;
- has served on the board for more than 10 years.

Recruitment and appointment

The nomination committee should consist of a majority of independent non-executive directors. It may include the chairman of the board, but it should be chaired by an independent non-executive director. A statement should be made in the annual report setting out the composition, terms of reference and activities of the nomination committee and the process used for appointments.

Proposals are made to broaden the pool of candidates for non-executive directorships, including more non-executive directors and senior executives from other companies and directors of private firms, as well as advisers and those from other business backgrounds.

A small group of business leaders and other parties will be set up to identify how to bring to greater prominence candidates for non-executive directorships from areas other than the private sector.

Induction and professional development

A comprehensive induction programme should be provided to new non-executive directors and is the responsibility of the chairman, supported by the company secretary.

The performance of the board, its committees and its individual members

should be evaluated at least once a year. The annual report should state whether such performance reviews are taking place and how they are being conducted.

Supported by the company secretary, the chairman should assess what information is required by the board. Non-executive directors should satisfy themselves that they have appropriate information of sufficient quality to make sound judgments.

Tenure and commitment

A non-executive director should normally be expected to serve two three-year terms, although a longer tenure will be appropriate in exceptional circumstances.

A full-time executive director should not take on more than one non-executive directorship or become chairman of a major company. No individual should chair the board of more than one major company.

Remuneration

The remuneration of a non-executive director should be sufficient to attract and fairly compensate high-quality performers. It may comprise an annual fee, a meeting attendance fee and an additional fee for the chairmanship of committees. Non-executive directors should have the chance to take part of their remuneration in the form of shares.

Non-executive directors should not hold options over shares in their company. If, exceptionally, some payment is made by means of options,

shareholder approval should be sought in advance and any shares acquired through the exercising of these options should be held until one year after the non-executive director leaves the board.

Audit and remuneration committees

Sir Robert Smith's recommendations on audit committees are endorsed (see *appendix 2*).

The remuneration committee should comprise at least three members, all of whom should be independent non-executive directors. The committee should have responsibility for setting remuneration for all executive directors and the chairman. It should also set the level and structure of compensation for senior executives. The committee should be responsible for appointing remuneration consultants.

No one non-executive director should sit on all three principal board committees simultaneously.

Liability

Companies should provide appropriate directors' and officers' insurance, and supply details of their insurance cover to potential non-executive directors before they are appointed.

Relationships with shareholders

All non-executive directors, particularly chairmen of the principal board committees, should attend the annual general meeting to discuss

issues that are raised in relation to their role.

The senior independent director should attend enough of the regular meetings of management with a range of major shareholders to develop a balanced understanding of the themes, issues and concerns of shareholders. The senior independent director should communicate these views to the non-executive directors and, where appropriate, to the board as a whole.

Boards should recognise that non-executive directors may find it instructive to attend meetings with major investors from time to time, and that they should be allowed to do so if they choose. Moreover, non-executive directors should expect to attend such meetings if requested by major investors in the company.

The review endorses the government's approach to more active engagement by institutional shareholders with the companies in which they invest, and the Institutional Shareholder Committee's code of activism. Institutional investors should attend annual general meetings where practicable.

Smaller listed companies

The recommendation that no one individual should sit on all three principal committees at the same time should not apply to smaller listed firms. With this exception, there should be no differentiation in the Combined Code's provision between larger and smaller companies. ■



Appendix 2 Summary of the Smith recommendations*

Composition of the audit committee

The audit committee should include at least three members, all of whom should be independent non-executive directors.

At least one member should have significant, recent and relevant financial experience.

Audit committee roles:

- To monitor the integrity of the financial statements of the company, reviewing significant financial reporting judgments.
- To review the company's internal financial control system and, unless expressly addressed by a separate risk committee or by the board itself, risk management systems.
- To monitor and review the effectiveness of the company's internal audit function.
- To make recommendations to the board in relation to the appointment of the external auditor and to approve the remuneration and terms of engagement of the external auditor.
- To monitor and review the external auditor's independence, objectivity and effectiveness, taking into consideration relevant UK professional and regulatory requirements.
- To develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external auditor.

Reporting to shareholders

The directors' report should contain a separate section that describes the role of the committee and what action it has taken.

The chairman of the audit committee should be present at the annual general meeting to answer questions, through the chairman of the board.

Code provisions and related guidance

The recommendations above should be reflected in the revised Combined Code and amplified in the detailed guidance. ■



* Summary information extracted from the Higgs report

Appendix 3 The CGAA report's key recommendations

- Lead partner in external audit firms to be rotated every five years.
- Two-year gap before auditors can join the company they audited.
- Financial Reporting Council assumes the functions of the Accountancy Foundation (FRC).
- FRC's roles will include setting and monitoring accounting and audit standards, and overseeing professional bodies.

The Role of the Non-Executive Director: Making Corporate Governance Work

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