CIMA

Non-Executive Directors

Their Value to Management

ACKNOWLEDGEMENTS

Revised in 2001, this guide was originally produced in 1992 and updated in 1996 by a project team of the Institute's Law and Parliamentary Committee (now the Technical Committee). It has been revised to reflect developments in the corporate governance debate.

The project team's terms of reference were:

'To show how the non-executive director can add value in the management of companies and to bring together the Institute's policies on those aspects of corporate governance relating to the role of the non-executive director'

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PREFACE

Much of the debate on corporate governance centres on the responsibilities that business has and owes to the community. The two-fold role of non-executive directors as 'business advisers' and as 'watchdogs' needs to be seen in balance. This is particularly important if greater understanding is to be achieved and non-executive directors engaged throughout listed companies and in smaller companies.

While it is now widely accepted that non-executive directors have an important part to play in the proper running of boards of listed companies, it is often very difficult to define the exact role and contribution of a non-executive director. There also continues to be a lack of appreciation of the added value non-executive directors can bring to growing smaller companies, through their knowledge and experience. This is the focus of this paper.

Furthermore, the independence of non-executive directors, both in terms of their selection to the board and also their contribution to the board's deliberations, has also become an area of concern.

INTRODUCTION

It has long been recognised that, in all but the most closely held owner-managed companies, the powers delegated to the directors may enable them to serve their own interests at the expense of shareholders[1]. The corporate governance climate in the UK over the past few years has placed the non-executive director at the forefront of media and shareholder attention. The current government review of the law surrounding directors' duties and responsibilities, changing practices and a succession of working party reports, have placed growing expectations on boards to be better equipped with the requisite skills and knowledge to undertake their roles effectively.

The historical context of the corporate governance climate deserves mention. The scandals in the 1980s caused much public questioning about how effective the boards of companies such as BCCI, Polly Peck and the pension funds of the Maxwell Communications Group had been. The scandals highlighted the difficulties that non-executive directors and auditors faced in 'standing up' to dominant chairmen or chief executives. In response to this need for direction and clarity over the boards' duties and responsibilities various committees were established over the 1990s. The first, the Cadbury Committee, issued a Code of Practice in 1992 on:

- The board's role and functions.
- Its composition, and appointment procedures for directors.
- Qualities required of a non-executive director.
- Executive directors' pay, and
- Duties of the board to present a balanced view of the company's performance, and maintain effective internal controls and relationships with auditors.

The Code was directed to listed UK companies, but the Committee hoped that as many other companies as possible would aim to meet its requirements[2].

In 1995, public outcry over very large pay increases awarded to directors of newly privatised companies led to the establishment of the Greenbury Committee. This elaborated on the work of Cadbury on executive director remuneration.

The Greenbury Report

The Greenbury Committee was set up in January 1995, on the initiative of, but independent of, the Confederation of British Industry (CBI). Its terms of reference were to ascertain what was good practice in determining directors' pay, and to prepare a code of practice based on its findings. The committee was not just responding to public and shareholder concern about pay increases and accountability, but also considered the relatively neglected issue of how to appropriately reward performance.

The Committee's approach was to strengthen accountability, and encourage improved performance through transparency, the appropriate allocation of responsibilities for determining remuneration, and the proper reporting to shareholders. Specifically, it felt that determining directors' pay needed to be delegated by the board to a suitably knowledgeable and independent group, non-executive directors, who would have no vested personal interest. This group would report to shareholders, providing full disclosure of individual remuneration and the underlying policy.

1 Modern Company Law: Developing the Framework, paragraph 3.112.

2 Cadbury, paragraph 3.1.

The committee published its report in July 1995, and considered that implementation of its recommendations would improve corporate remuneration practices. Although their research focused on UK listed companies, the committee expected that non-listed and smaller companies would find their conclusions of merit.[3]

The Combined Code on Corporate Governance

In 1996, the Hampel Committee was established. Hampel's remit was to:

- Review the Cadbury Code and its implementation;
- Keep under review the role of directors (executive and non-executive);
- Review the Greenbury recommendations; and
- Address the roles of shareholders and auditors in corporate governance.

The committee produced a Combined Code, embracing Cadbury, Greenbury and its own work and passed this to the London Stock Exchange so that it could sit alongside the Listing Rules. The committee indicated that companies would be required to make a statement to show how they apply the principles and comply with the Combined Code, and to justify any significant variances. The Combined Code was published in June 1998.[4] In addition, the Turnbull committee published additional guidance on principle D2[5] of the Combined Code in September 1999.

The Hampel Committee, as part of its remit, also considered the issue of director pay. Without paying more than is necessary, the level of remuneration should be that which is necessary to recruit and retain directors of the right calibre. Some elements should be performance-related in such a way as to encourage the achievement of corporate objectives and to reward individual performance. Policy on executive remuneration should be clear, and no director should be involved in determining his/her own remuneration. Details of remuneration policy and the remuneration of each director should be stated in the annual report[6].

The Combined Code, like its predecessors, has no statutory force. The implementation, through the Listing Rules, requires listed companies to disclose in annual reports either that they comply with the provisions or why they do not. The London Stock Exchange is at present[7] responsible for checking that disclosures are made, but not their accuracy, nor their quality.

Company Law Review

On 4 March 1998 the Government announced the launch of their review of Company Law. This review has led to a number of consultation documents and will result in a White Paper in spring 2001[8]. The review is considering 'the proper relationship between company law and non-statutory standards'[9]. The government states 'there is clearly a role for codes of practice, in particular in the corporate governance field, as well as for

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3 CIMA 'Corporate Governance – History, Practice and Future' P5.

4 For more details on the work of Hampel, Greenbury and Cadbury please refer to CIMA booklet: 'Corporate Governance: History, Practice and Future, published by CIMA Task Force, ref. N14 available from CIMA Publishing Sales Tel: +44(0) 20 8849 2229.

5 Principle D2 of the code 'The board should maintain a sound system of internal control to safeguard shareholders' investments and the company's assets'.

6 Principles B1-3, Committee on Corporate Governance, Final Report January 1998.

7 But transfer of responsibility for the Listing Rules to the Financial Services Authority has been announced.

8 The current consultation document is called 'Company Law Review – Developing the Framework' at http://www.dti.gov.uk/cld/condocs.htm#company.

9 Modern Company Law for a competitive Economy, DTI 1998, para 5.2.

requirements operated through the Stock Exchange Listing Rules and elsewhere. However, the broad picture in this area requires a fresh look'[10]. The current document points out that the approach is to accept much of the Hampel conclusions but to re-examine particular areas if there is a good case for doing so. The review has raised a lot of questions of the role of non-executive directors. For example, the question has been raised as to whether the monitoring responsibilities of the board should be set out in legislation.

The Company Law Review can be explored on the DTI's web site: http://www.dti.gov.uk/cld/condocs.htm

10 Ibid, 5.4

THE EFFECTIVE NON-EXECUTIVE DIRECTOR

Few would disagree that boards of directors are likely to be more effective if they are made up of both executive and independent non-executive directors. There should be a balance between executive and non-executive directors. Ideally, non-executive directors should comprise not less than one third of the board[11]. The Company Law Review has raised the question as to whether the board should actually contain a majority of non-executive directors. The skills and experience of the non-executive should complement those of the executive team.

However, only 40 per cent of medium-sized companies in the UK employ non-executive directors. In fact, the majority of small and medium sized enterprises (SMEs) do not have a non-executive director. A recent study[12] found that most managing directors of SMEs had considered appointing a non executive director, but had felt in the end, that they were not necessary. This indicated some mistrust of the non-executive role (for example disruption of directorial team, breaches of privacy, loss of control and freedom).

Executive directors of smaller companies need to be made aware of the very real benefits to be gained from having non-executive directors. Non-executive directors can:

- Broaden the horizons and experience of existing executive directors.
- Facilitate the cross-fertilisation of ideas, particularly in terms of business strategy and planning; and
- Have a vital part to play in appraising and commenting on a company's investment/expenditure plans.

A team of executive and non-executive directors needs to be made up of people with business acumen and hands-on experience. Non-executive directors should be able to fill the gaps in expertise not available in the executive team. Lack of experience at the top can slow down the growth of young companies. In a larger company for example, the team of non-executives could comprise:

- A director well-versed in the technological side of the mainstream business; and/or
- At least one director who has had wide experience of direction and leadership ;of a company: and/or non-executive directors
- A director with sales or marketing experience; and/or
- A director with good city connections; and/or
- A qualified accountant or lawyer. CIMA believes that it is useful for at least one non-executive director to have a level of skill and experience in financial matters that is adequate to permit the asking of 'awkward' questions and to ensure that executive management provides a satisfactory response.

A non-executive director can bring essential qualities to a growing business, qualities which will stand it in good stead if it is to be successful, what ever its stage in the business lifecycle.

11 Combined Code A.3.1.

12 Research report no.63 – The role of non-executive directors in United Kingdom SMEs by Aiden Berry and Lew Perren (ISBN: 185908 323 4) commissioned by ACCA.

ADDING VALUE IN SMALLER COMPANIES

The non-executive director in a smaller company can add enormous value. An experienced independent voice can help a small or growing company to avoid pitfalls and to make better decisions that enable that company to prosper and succeed. The non-executive director should be viewed as a sensible investment decision.

During their growth smaller companies need sound, independent, business advice. Non-executive directors are well placed to provide this. As the companies develop and become more relevant to the 'public interest', the guardianship role of non-executive directors becomes more relevant.

Companies seeking entry to the Alternative Investments Market, for example, need to consider whether:

- The board needs to be strengthened. Length of service, stability and experience of directors are important considerations. The use of non-executive directors would help satisfy these.
- Directors must be able to show they have no conflict of interest. Non-executive directors would again be able to bring the required knowledge and experience to the company free from any conflict of interest.
- The management structures are of an acceptable standard. This is a mainstream contribution to be expected from non-executive directors, and
- The financial and control systems are adequate to allow the board to exercise its duty of care. Again the use of non-executive directors demonstrates greater management conviction and commitment.

The primary added value of non-executives to a smaller company will initially be business expertise and advice. As the company grows, it will also benefit from more specific support on, for example, finance, marketing and research. Financially expert non-executive directors have a contribution to make in helping smaller companies avoid potential over-trading. They can ensure that they receive adequate and timely management accounting information both to run their business and to meet legal requirements.

The role of the non-executive director in growing smaller companies can include:

Business advice based on experience and knowledge

Business realism can be injected into major decision making. A non-executive director can encourage entrepreneurial spirit and technical flair whilst channelling these into effective output. In a growing smaller company a non-executive director can bring out the best in existing personnel – something that may not always be easy in a company whose management is comprised of strong individual personalities.

Where a company is trading successfully, some of the strategic aspects of the non-executive director's role are most obvious at small companies, where the objective is business growth. Adding an experienced voice to the board can mean the difference between abortive and successful expansion.

When it is right for a company to seek a higher public profile, a non-executive director should be able to broaden the connections of executive management to this end. He or she will also be able to dampen down any overly enthusiastic embracing of greater public attention that could result in damage to the enterprise.

A non-executive director will also have time to keep a watching brief on the impact of the day-to-day pressures on executive management and the effect on the company's development plans.

Financial expertise, particularly for management purposes but also in terms of meeting statutory requirements

Non-executive directors can help, for example, to ensure that goods/services are costed and priced effectively.

A non-executive director should also be able to encourage the company to have effective credit control – particularly at the pre-sale/manufacture point – so that a customer's creditworthiness and 'reputation' can be assessed. He or she will also be able to strengthen the resolve of executive management in the event of late payment.

In statutory terms the regular returns of VAT, PAYE and NIC are as important as annual accounts. They can also have particular consequences on cash flow. Non-compliance with requirements can mean heavy penalties and by ensuring that periodic returns are planned and submitted on time, the non-executive director will help the company steer clear of these pitfalls.

Control and management practice

Dot Com start ups may have all the ingredients for success, but if they are not managed effectively, with due regard to cash flow, reporting requirements, internal controls, the start up could be doomed to fail. A non-executive director can help steer the managed growth of the company, ensuring due attention is paid to control and management issues. The more developed and the more technical the environment the more necessary this becomes. He or she should also be able to help ensure detailed procedures for complying with British and European Standards, health and safety regulations etc, are established and adhered to. CIMA is a strong proponent of the need for adequate internal control. While CIMA believes that larger companies should have an internal audit function, it accepts that this is not appropriate for smaller companies and recommends that a non-executive director can perform this internal review role.

Guardianship

The essence of a successful business is honesty and integrity. Shareholders should be confident of a sensible return on their investment. As a company grows it may be necessary to 'make-up' sacrifices made earlier in its development. Within this context the non-executive director can help ensure for example that management rewards are not at the expense of shareholders and staff. Or that profit-related pay schemes have a defined range. That staff working conditions and terms of service are of an acceptable standard and that proper arrangements for pension provision are in place. It is essential for non-executive directors to take a close interest in pensions and to guard against any non-observance of proper standards.

Unlike a business 'mentor', a non-executive director has a legally constituted position and vote on the Board. The non-executive director is therefore in a position to challenge the actions of the Board should there be disagreement over the direction it wishes to take.

SELECTION OF THE NON-EXECUTIVE DIRECTOR

Achieving a suitably balanced team of directors can prove more difficult than it appears. The appointment of a non-executive director is an important task. Recruitment of a non-executive is expensive and needs to be taken seriously.

The board must be clear about the particular skills that they want a new non-executive director to bring. Chemistry is important, as a non-executive director must be able to establish credibility with the board and be able to present views perhaps not held by the majority.

The key to any successful appointment is for the Board to be clear about what qualities they are looking for in a potential applicant. Many attributes may be desired – integrity, diplomacy, tact experience of business, good judgement and financial and commercial acumen.

The non-executive director must not depend on the appointment to supplement income. He or she should not owe any particular allegiance to any member of the Board, and should be in every way independent.

In the selection of a non-executive director, a specification should be drawn up detailing the personal and commercial qualities of the individual sought, as well as the particular skills that the board would wish the individual to bring.

Frequently small companies do not adopt a formal approach to recruiting a non-executive director. A resent research report[13] revealed that:

- SMEs are most likely to acquire a non-executive director through informal personal contacts.
- Smaller companies (less than 50 employees) rely even more heavily on family friends for finding a non-executive.
- Larger SMEs relied on their accountant or bank for help in the selection process.
- SMEs in general are more likely to listen to suggestions from trusted sources, such as family or their accountant, then from seemingly more distant sources, such as non-executive registers or Business Links.

An independent approach to selecting a suitable non-executive director would be to use an external third party, such as a specialist recruitment service or register of suitably qualified individuals.

Companies can assist in creating the pool of available people themselves by encouraging their executive directors and senior executives to take up non-executive directorships of non-competitor companies. The lowering of retirement ages also means that there are many retired or semi-retired people with the right qualifications and experience who now have the time available to devote to the office and who have the capacity to hold several non-executive directorships. Those who are employed full time in an executive capacity are unlikely to be able to take up more than two such appointments effectively.

Status related appointments need to be discouraged and avoided. Companies should also avoid appointing more than one non-executive director from any other company.

Independence is an essential attribute of the non-executive director. The combined code states that 'The majority of non-executives should be independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement. Non-executive directors considered by the board to be independent in this sense should be identified in the annual report'[14].

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13 Research report no.63 – The role of non-executive directors in United Kingdom SMEs by Aiden Berry and Lew Perren (ISBN: 185908 323 4) commissioned by ACCA

14 Combined Code A.3.2.

SUMMARY

At present, only 40 per cent of medium-sized companies in the UK employ non-executive directors. As companies get larger, they are more likely to have at least one NED. The point at which a company decides to engage a non-executive director relates more directly to the number of employees than to the turnover or the age of the company.

Yet, there are essential qualities that a non-executive can bring to the growing business, whatever its position in the business lifecycle.

Non-executive directors in an SME can add enormous value. An experienced independent voice can help a small or growing company avoid pitfalls and to enable better decisions to be made by the Board, enabling the company to prosper and grow.

The primary added value of a non-executive to a smaller company will initially be business expertise and financial acumen. As the company grows, it will also benefit from outside objectivity, structured board procedures and the broader perspective a non-executive can bring.

The appointment of a non-executive director is an effective means of broadening the vision of a company Board. A carefully selected non-executive director can bring an independent view on a range of matters, drawing on knowledge and expertise which is not otherwise available to the company.

Businesses without non-executive presence are denying themselves a great opportunity to strengthen their senior management with someone who is able to act in the best interests of the company without the complications of day to day involvement.

FURTHER READING

Executive Remuneration published by CIMA Technical Services, CIMA 2000. Available free of charge.

Modern Company Law: Developing the Framework The report is available on the Internet at
http://www.dti.gov.uk/cld/condocs.htm#company

'Directors' Remuneration Consultation Document', July 1999, DTI. This may be seen at and downloaded from the DTI's website: *http://www.dti.gov.uk/cls/*

Copies of the Greenbury, Hampel, Turnbull and Cadbury reports and the Combined Code may be obtained from Gee Publishing Ltd, 100 Avenue Road, Swiss Cottage, London NW3 3PG, or by calling the Gee Customer Service number 020 7393 7666/7

For more details on the work of Hampel, Greenbury and Cadbury please refer to CIMA summary booklet: 'Corporate Governance: History, Practice and Future, published by CIMA Technical Services, CIMA 2000, available free of charge.

The full text entitled 'Corporate Governance – History, Practice and Future' looks at:

- Developments in other countries
- Current UK requirements for listed companies
- Corporate governance in the public, not-for-profit and SME sectors
- The future of corporate governance

This is available at £15 from Publishing Sales 020 8849 2229.

'The Independent Director – The role and contribution of non-executive directors', Ernst and Young and the IoD. Price £9.95. Sales 020 7766 8766

Berry, A, and Perin, L: Research Report No.63 – the role of non-executive directors in UK SMEs (ISBN 185908 323 4) ACCA.

APPENDIX 1
CHRONOLOGY OF GUIDANCE ON CORPORATE GOVERNANCE

● Financial Services Act 1986 (major effect on regulatory role of Stock Exchange)	
● 1986 Publication of Treadway Report (USA)	Oct 1987
● SEC update listing requirements (USA)	1988
● Polly Peck £1.3 bn business empire collapses.	1990
● Establishment of CADBURY Committee on Financial Aspects of Corporate Governance	May 1991
● Regulators seize operations of BCCI	July 1991
● Discovery that £480m has disappeared from Maxwell Group Pension funds	Dec 1991
● INTERNAL CONTROL – INTEGRATED FRAMEWORK report published by the Committee of Sponsoring Organisations of the Treadway Commission (COSO)	1992
● CADBURY REPORT and CODE published	Dec 1992
● CITIZEN'S CHARTER published	1992
● UK Stock Exchange amends its Listing Rules – companies now have to show extent of compliance with CADBURY with effect from 1 July 1993	April 1993
● Publication of the South African 'Cadbury', the King Report	1994
● RUTTEMAN guidance on Internal Control and Financial Reporting published	Dec 1994
● Establishment of GREENBURY Group on Executive Remuneration	Jan 1995
● Publication of First NOLAN report	May 1995
● Publication of GREENBURY proposals	July 1995
● Publication of the French 'Cadbury' – the Viénot Report	1995
● UK Stock Exchange amends its Listing Rules – companies now have to show extent of compliance with GREENBURY	Oct 1995
● Establishment of HAMPEL Committee on Corporate Governance	Nov 1995
● Publication of Second NOLAN report	May 1996
● Publication of the Dutch 'Cadbury' – the Peters Report	1996
● Stock Exchange amends its Listing Rules in the light of GREENBURY's recommendation re phasing of share options	June 1996
● Publication of Third NOLAN report	July 1997
● Publication of Fourth NOLAN report	Nov 1997
● Publication of the HAMPEL report	Jan 1998
● Publication of the HAMPEL Combined Code	June 1998
● Publication of the TURNBULL guidance on internal control	Sept 1999
● Modern Company Law For a Competitive Economy: Developing the Framework	

Deadlines June /July 2000. White paper expected in Spring 2001.

APPENDIX 2 – BOARD COMMITTEES

Non-executive directors have a key role to play through their involvement in Board Committees.

The Audit Committee

Further on in their development, companies will reach a stage when it becomes appropriate to appoint an audit committee. CIMA has consistently promoted the value of audit committees and has encouraged their use.

The audit committee of the board should consist of at least three non-executive directors and should have written terms of reference clearly setting out its authority and duties. A properly established audit committee has a vital role in the corporate governance of the organisation, because it is able to provide independent, objective review of the corporate governance arrangements, based on reports from both internal and external audit.

It should consider the appointment of the external auditor, the nature and scope of the audit, any problems arising from the audit, the external auditor's management letter and management response, and the audit fee. It should review the half-year and annual financial statements before submission to the board. It should review the internal audit programme, ensure co-ordination between the internal and external auditors, and ensure that internal audit is adequately resourced and has appropriate standing in the company. It should consider the major findings of internal investigations and management's response[15].

The terms of reference of an audit committee must be set out in detail. There are several examples of 'best practice' in this area from which it is possible to extract common elements. The Cadbury Committee report contains specimen terms of reference for guidance only. CIMA commends these terms of reference as being a useful template. As a minimum the terms of reference of an audit committee should include the following.

1. To confirm and ensure the independence and objectivity of external auditors and review with management any areas of disagreement between management and the external auditors.
2. To review and recommend approval of or otherwise the company's major accounting policies, principles and practices.
3. To review with the external auditors the interim and final results of the company.
4. To discuss with the external auditors the scope of the external audit, the extent of their reliance on internal audit, and matters arising from the external audit.
5. Review with the chairman and chief executive the adequacy of internal control systems including the internal audit function, its professional standards, scope, resourcing, reporting arrangements, work plan and interface with the external auditors. The chief internal auditor or head of internal audit must have direct access to the audit committee.
6. To approve the external audit fee and review any non-recurring, non-audit services to be performed by the external auditors and to appraise and report on any possible conflicts of interest.
7. To review the responses of management to major recommendations made by external or internal audit.
8. To review policies and practices involving legal compliance, ethics and other such matters and ensure that these are adequate.
9. To meet with the external auditors at their request at any time they deem necessary.

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15 from '*Corporate Governance, History, Practice and Future*', CIMA (2000) p.10.

The Remuneration Committee

Cadbury, Greenbury and Hampel all agreed that the boards of listed companies should establish a remuneration committee. And that the committee should be made up wholly of independent non-executive directors. They should be responsible for determining the remuneration and other terms and conditions of service of the chairman, chief executive and senior executives. The government consulted on Directors' Remuneration in July 1999 and is likely to announce the conclusions before the end of the Company Law Review. The current consultation document states 'The government may include mandatory provisions about the composition and role of the remuneration committee and requirements about reporting on, and shareholder participation in, decisions on remuneration.'

The Nomination Committee

A majority of the members of a nomination committee should be non-executive directors and the chairman should be either the chairman of the board or a non-executive director. The current review of Company Law is considering whether Non Executives should be appointed by a nomination committee consisting entirely of independent Non Executives, as a way of reducing the influence of executive directors on the selection of NEDs.