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The Business Case for Corporate Governance

Edited by Ken Rushton

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The Business Case for Corporate Governance

This book goes beyond the 'what and how' of corporate governance to explore the impact and benefits of good governance for companies and their investors. The contributors are leading market practitioners, investors, academics and consultants who offer their own views based on a wealth of experience. Topics covered include what makes for an effective board and is the unitary board sustainable? The contribution of governance to financial performance – is the research conclusive? Managing risk and reputation – how do boards ensure they are trusted by their shareholders? The benefits of market-led standard setting – do US and EU regulatory initiatives threaten the traditional UK approach? The book looks to dispel the belief that governance is a burden on companies that adds little value by demonstrating the contribution it makes to board effectiveness and corporate performance.

KEN RUSHTON is a former Director of Listing, Financial Services Authority and Company Secretary ICI.

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Introduction

KEN RUSHTON

This book is not intended to be another handbook or primer on corporate governance. Although readers will find chapters, such as those by Charles Mayo and Stilpon Nestor, that describe recent developments in laws and regulations, the main purpose of the book is to describe corporate governance in practice from the viewpoints of the principal players, including the board of directors, the regulator and the investor. Contributors have focused on the benefits of good governance and a number have written about events and their own experiences that demonstrate governance in action: both positive and negative examples.

I hope that the book will appeal not only to lawyers but also to those working in listed companies. Those who are directors may identify with the views of Sir Geoffrey Owen and many of the Chairmen I interviewed who believe that boards are becoming more professional. The role of director, whether executive or non-executive, can no longer be considered simply as a promotion for a successful senior manager or a reward for doing a good job running another business. Being a director is a job in its own right that demands specific skills and individual qualities. Aspiring directors will gain an appreciation of the value of good governance for their business and should understand the importance of high-performance effective boards for corporate success. Colin Melvin and Hans-Christoph Hirt from Hermes Investment Management have written about the academic and professional studies that show that good governance leads to improved corporate performance.

Similarly, I hope institutional investors who read this book will understand the benefits of responsible activism. Peter Montagnon writes that the relationship between companies and their investors on governance should not be confrontational, but that the quality of the dialogue must be improved. As Melvin and Hirt contend, positive engagement with investors results in more value-creation for companies.

UK regulators, supported by Government, take the view that the public interest is best served by market-based solutions to governance issues rather than by regulation. Sir Bryan Nicholson points out that voluntary codes, reinforced by the Listing Rules, are more flexible and more aspirational than laws and regulation. Laws require compliance with minimum standards while codes focus on raising standards. Sir Bryan, and other contributors, compare the UK principles-based approach favourably with the US rules-based approach and criticise the knee-jerk reaction of US legislators following Enron, World Com *et al*. Although it is easy to criticise the Sarbanes-Oxley Act, it has helped to restore investor confidence in the US. Furthermore, it is arguable, as the chapter by Keith Johnstone and Will Chalk suggests, that corporate scandals on the scale of Enron in the UK would place enormous pressure on government to pursue a legislative response rather than continuing to rely on a voluntary code enforced by the market. The Government was sensible, following Enron, to call in regulators and market professionals to review what steps should be taken to reduce the risks of a similar scandal occurring in the UK. This review resulted in worthwhile measures for improving the effectiveness of oversight of audit and accounting.

What is corporate governance?

The classic definition was provided by Sir Adrian Cadbury in 1992: 'Corporate governance is the system by which companies are directed and controlled.' Although this definition focuses usefully on the board of directors, it is a somewhat narrow and mechanistic view of governance. Ira Millstein, the US lawyer whose views on corporate governance command international respect, defined corporate governance in 2003 as:

> that blend of law, regulation and . . . voluntary private sector practices which enables the corporation to attract financial and human capital, perform efficiently . . . generating long-term economic value for its shareholders while respecting the interests of stakeholders and society as a whole.

Millstein recognises that good governance requires both regulation and voluntary measures, and he draws attention to the benefits for companies of good governance practices. This was also reflected in the 1998 Hampel Review in the UK which emphasised the importance of corporate governance for its contribution to business prosperity as well as to accountability. Millstein's work has influenced the OECD and when they published their revised Principles of Corporate Governance in 2004 they defined corporate governance as follows:

> Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set and the means of attaining those objectives and monitoring performance are determined.

In this last sentence, we find the link between governance and performance clearly expressed. It is this positive aspirational definition that is more likely to capture the enthusiasm of directors and managers as opposed to a definition calling for structures and processes that appear to be designed solely to police bad behaviour by boards of directors.

Sir Adrian Cadbury himself moved somewhat in this direction when he redefined corporate governance in 2003:

> In its broadest sense, corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources.

Corporate responsibility and ethics

Sir Adrian Cadbury refers to ‘holding the balance between economic and social goals’ while Millstein mentions ‘respecting the interest of stakeholders and society as a whole’. Although the Company Law Review rejected the stakeholder model for a company when considering directors’ duties in favour of the ‘enlightened shareholder value’ model, as discussed by Charles Mayo, it is notable that the formulation of the legal duty to promote the success of the organisation in effect requires directors to ‘hold the balance between economic and social goals’. The enhanced Business Review, also discussed by Mayo and others, then requires directors to report annually on how they have fulfilled their responsibilities towards stakeholders.

When the OECD Principles referred to corporate governance involving a set of relationships between management, the directors, shareholders and other stakeholders, they articulated four basic principles to govern those relationships:

- accountability – to shareholders
- responsibility – to stakeholders
- transparency – in all actions
- fairness – in treatment of shareholders.

Follow these principles, the argument goes, and companies will be rewarded by a lower cost of capital as they will be seen to be less risky. Their performance will benefit from better information flows and more rigorous decision-making. Investors will have more confidence in companies that respect their rights and produce fewer bad surprises. In essence, the proposition is that well-governed companies offer investors better returns on their investments. In addition, good governance produces superior operational performance through more considered allocation of resources creating more wealth.

I am delighted that a number of contributors (including Owen, Montagnon, Johnstone and Chalk, and Melvin and Hirt) have chosen to emphasise how corporate (social) responsibility is now a key component of corporate governance and reputation management. In conversations with business leaders about good governance, the word ‘integrity’ is often mentioned. I agree with Murray Steele when he picks out good judgement and integrity as essential qualities for directors. I have always thought of corporate governance and corporate responsibility as sub-sets of business ethics. My interest in all these areas stems from my passion for business. From my days at university, I bought into the argument that business creates much of the wealth the country needs to provide public services and high living standards. I continue to be dismayed that business generally has a poor image and I have always felt that the media give business a raw deal.

Looking back, it seems that companies were slow to appreciate that competitive advantage could be gained by articulating strong values and insisting these values are lived up to and that high ethical standards are maintained by those working in the organisation, especially by those at the top of the organisation. Words like ‘values’ and ‘ethics’ were not often heard in boardrooms and might have been regarded as ‘soft’ issues only fit for Personnel or Communications departments to worry about.

Readers may not like the idea of linking values and ethical standards with competitive advantage. While I have never doubted that most business leaders have high integrity, I found in my short time at the Institute of Business Ethics that it was easier to command their attention if I used the language of business rather than the language of academic ethics which is rooted in philosophy.

Increasingly, talented people who can choose for whom they want to work, and thoughtful consumers who elect to choose from whom they will purchase goods and services, are adopting ethical criteria to inform their decisions. We are also seeing some institutional investors taking ethical considerations into their investment decisions. So companies should seek to gain a reputation for ethical and responsible behaviour because they appreciate it makes good business sense. Companies need to appreciate, however, that this is a high-risk area, as fine words and glossy communications, though helpful, are not sufficient if the leadership ignores reputation risks when making business decisions, or if those at the top of the organisation put self-interest ahead of the interests of shareholders and other stakeholders. The old adage ‘actions speak louder than words’ is never more true than when it comes to defending corporate reputation. To my mind, the disciplines of corporate governance, as captured in this book, should help a business leadership that is committed to ethical behaviour and reputation risk management.

Role of the board

Although corporate governance is sometimes criticised for being obsessed with structures and processes while it is understood that people and their behaviour are usually the cause of scandals, if those structures and processes are effective they can go a long way to ensuring that employees do act in the best interests of the company and comply with corporate policies.

I appreciate this is making corporate governance appear to be no more than a monitoring tool, and those responsible for the stewardship of corporate governance are often referred to as watchdogs or corporate policemen. A number of the contributors to this book discuss whether the role of the board is to monitor compliance with the law and recognised standards, such as the Combined Code, or whether it is rather to raise the performance of the business while supervising management. The answer, surely, must be that the board is responsible for both. I agree, however, that boards who perceive corporate governance merely as another compliance obligation are missing the point that good governance is good business. David Jackson, as a Company Secretary, sees his role as assisting his Chairman and the non-executive directors to use the corporate governance framework as a means of getting more effective performance and more value from the board. Jackson points out with delight that the focus on corporate governance has promoted the Company Secretary from being a mere servant of the board to being chief of the Chairman's staff.

As the authors have shown, board evaluation has become commonplace since Sir Derek Higgs reported. It would be valuable, as Sir Geoffrey Owen suggests, if there was a better way of measuring the performance and contribution of the board. The German Society of Investment Analysis and Asset Management in 2000 developed a corporate governance scorecard based mainly on the German corporate governance code. Although the scorecard was intended to be used mainly by investors, it can also be used by boards to evaluate the quality of their own governance frameworks. It would be interesting to see if such scorecards could be developed for UK companies to use as part of their board evaluation process.

Is corporate governance working?

The evidence from the reviews of the Combined Code carried out in recent years by the Financial Reporting Council is encouraging. Many countries use the UK as their model for developing corporate governance regimes, as the US is no longer seen as the gold standard. The absence of a developed institutional shareholder base may mean that other countries look for tougher enforcement mechanisms. Simon Lowe points out in chapter 11 that only 10 per cent of the FTSE 350 companies comply in full with the Combined Code. However, the Code is promoted on the basis of comply-or-explain and is not intended to be applied as a one size fits all set of rules.

A greater concern has been that companies could be defaulting to compliance with the provisions of the Code rather than risk having to justify deviations to their investors or other critics. Companies criticise box-ticking by proxy voting agencies and others whom they accuse of having little interest in finding out the reasons why boards might choose not to implement certain Code provisions. However, some companies regrettably choose to adopt a box-ticking approach themselves when implementing the Code and when describing their corporate governance arrangements in their annual reports. Those that do choose to explain why they are not complying with a provision often use boilerplate, me-too language rather than providing a customised explanation appropriate to the circumstances of the company.

I would like to see more companies use the corporate governance statement to investors to describe how they have applied the principles of the Combined Code. This is currently a Listing Rule requirement, and I suggest that if investors had a better understanding of a board's strategy for implementing corporate governance requirements, this would improve the quality of the dialogue between companies and their investors around departures from Code provisions. Peter Montagnon accepts that the quality of this dialogue is sometimes deficient and he lays the blame on the way both companies and investors tend to compartmentalise their communications. I agree there are situations which can be defused by earlier contacts between Chairmen or senior independent directors and Chief Investment Officers rather than leaving the corporate governance specialists to conduct the engagement for too long. As Montagnon recognises, there is still a weakness in that the governance and investment processes in institutions are insufficiently joined up. This results in board members often seeking to bypass the governance specialists. Also, in smaller companies it is often the case that governance is regarded mainly as a compliance activity to be managed by a senior official such as the Company Secretary rather than a board responsibility.

Contribution of non-executive directors

Another hallmark for governance is to assess the effectiveness of non-executive directors. This is not easy as one has to rely on anecdotal evidence. It is certainly true that boards are taking more trouble to appoint suitable non-executive directors. The nomination committee has assumed far more importance and the process for recruitment and appointment has become more sophisticated. It is remarkable that the pool of talented candidates for non-executive director appointments remains so deep given the risk–reward ratio and the time commitment to do the job properly. Murray Steele considers that many investors are slow to challenge companies with weak performance and rely instead on non-executive directors to provide challenge to the 'acceptable under-performance' mindsets of their executive colleagues. I recall one highly regarded US activist investor saying at a conference that there were certain eminent non-executive directors in the UK whom he felt confident would do a good job in looking after shareholder interests, and if he saw their names on a board he was more relaxed.

My own experience confirms that a conscientious non-executive director can really make a valuable contribution both to fulfilling the board's monitoring responsibilities and to the quality of its decision-making. Much will depend on his level of commitment to understanding the business and his willingness to ask the awkward questions, as well as on his individual skills and experience. It worries me, however, that commentators and some investors have unrealistic expectations of what non-executive directors can achieve, following the Higgs review. Their limitations were dramatically exposed in the Equitable Life and Northern Rock collapses, which demonstrated that it remains true that it is the Chief Executive and his management who run the business.

I am also concerned that a number of UK boards are moving towards the US model of having a minority of executive directors and appointing more non-executive directors. Although I welcome the trend for smaller boards, I have always believed that a balanced board comprising roughly equal numbers of executive and non-executive directors is desirable. The Chief Executive should be supported by a few executives who share responsibility for board decisions. This serves as a useful check on the powers of the Chief Executive who might otherwise be tempted to be selective in the information he shares with the board, and also gives the board a close-up view of potential successors to the Chief Executive. Choosing the Chief Executive is, arguably, the most important decision a board will make; firing a failed Chief Executive runs it a close second.

Sanctions

The topic of sanctions is well covered by Keith Johnstone and Will Chalk who have introduced the interesting concept of the Virtuous Circle. It will be fascinating to see how the population in the Circle might change over time. One sanction which I consider to have been underdeveloped is the power to disqualify errant directors for serious breaches. I am pleased that Johnstone and Chalk appear to support my view. When I was Head of the UK Listing Authority, I failed to persuade the then DTI that such a power would be a helpful addition to our armoury. I am not convinced that the sanction of a fine, even though unlimited, is a sufficient deterrent for Chief Executives or Chief Financial Officers who are determined to mislead investors, possibly for their own personal gain. Such serious breaches of the Listing Rules demonstrate that the individual directors concerned lack integrity and are not fit for office. An alternative is to introduce a licensing system for directors of listed companies on the lines of the ‘approved persons’ regime for financial services organisations. I believe that the disqualification power is a preferable option. It is not easy to convince enforcement authorities that are not courts or tribunals to bring actions against individuals in breaches of Listing Rules cases. The hurdles are set high and I believe the alternative of seeking a disqualification order from the Companies Court should be explored again. Given the choice, I believe the market would prefer to see proceedings brought against a reckless director rather than punishing the shareholders (possibly for a second time) by pursuing the company for a fine in respect of the behaviour of one or more of its directors.

The future of corporate governance

Stilpon Nestor describes regulatory trends in the US and the EU in his chapter. A number of influential commentators in the US are calling for principles-based regulation and comparing the approach of US regulators, such as the SEC and the New York Stock Exchange, unfavourably with our own. UK companies that remain listed in New York (and a number have delisted in recent years) face the costs and complexities of compliance with the Sarbanes-Oxley Act, though some of the burdens have been lifted for foreign registrants.

In the EU, the Company Law Action Plan at one time appeared to threaten our market-based approach to corporate governance. Our Government have so far done well in Brussels in influencing the implementation of the Action Plan so that, by and large, the UK approach to corporate governance has not been impaired. We have been helped by the philosophy of Commissioner McCreevy, a strong believer in better regulation, which means the need to demonstrate market failure that can only be remedied by regulation before going down the road of legislation. While his approach should be applauded, it remains to be seen whether it will be maintained when there is a change of Commissioner.

The EU Commission would like to see greater convergence of national corporate governance codes, though it no longer talks of an EU-wide code. Although convergence would be consistent with a single market, the differences in national laws and structures of companies and their ownership make such an outcome unlikely.

In the UK, it is generally agreed that we have a code that is fit for purpose. It is regularly reviewed and minor changes are made, often to suit the needs of smaller companies. The Financial Reporting Council is rightly focused on how well the Code is being implemented by companies and shareholders alike. There are concerns that the effectiveness of comply-or-explain would be damaged if both companies and shareholders lapsed into a box-ticking approach to compliance. Contributors to this book urge companies to provide more thoughtful corporate governance statements in their annual reports, particularly when they are explaining why they have departed from the Code's provisions. Similarly, investors need to be more active in their engagement activities with companies if the comply-or-explain approach is to be sustained. The benefits of responsible constructive activism are demonstrated by the success of focus funds, as described by Melvin and Hirt. As Montagnon relates, the UK Government supported the market-based approach rather than regulation of corporate governance because it saw shareholder power being more business friendly, but it still requires shareholders to use their powers sensibly. Melvin and Hirt provide an interesting case study in Premier Oil which shows how a thoughtful, long-term engagement between investors and the most senior board members helped to turn a company round. It is also a good example of how a company Chairman can influence his board by listening to his investors.

One direction which corporate governance could take is to lay down more rules regarding the responsibilities of institutional shareholders. I think it is unlikely that the Financial Reporting Council will wish to pursue this line. There is already some criticism that Section 2 of the Combined Code, which deals with institutional investors in terms of their voting responsibilities, the role of activism and the need for careful evaluation of company disclosures, sits uneasily in a Code that is aimed at the behaviour of companies. As implementation of the Code relies on policing by shareholders, when it comes to the responsibilities of shareholders themselves one has to ask 'quis ipsos custodiet?' (who guards the guards?). It is commendable that shareholder bodies such as the Institutional Shareholders Committee and the International Corporate Governance Network have published statements of shareholder responsibilities. It is perhaps now time for these bodies to consider how compliance with these policies should be monitored and whether sanctions are necessary for non-compliance.

Challenges

Sir Bryan Nicholson and Peter Montagnon highlight further challenges to corporate governance, including:

- The growing influence of hedge funds, many with short-term interests in ownership compared with institutional investors and therefore less interest in governance.
- The increase in ownership of UK companies by foreign investors who have different experiences and expectations of good governance.
- The possibility that institutional investors, when they see that their influence over boards is diminishing, will become apathetic about engagement, which might also result in companies taking even less care with their governance disclosures.
- Boards of directors may become confused about their role and the unitary board itself could be threatened. It may become more difficult to find strong Chairmen and effective non-executive directors who are willing to give the time to challenge underperformance and weak internal controls.
- Small companies may find the burden of corporate governance so great that they desert the main market and find refuge on AIM or other markets. But that begs the question of how long those markets can continue without raising their standards of corporate governance.

1

The role of the board

SIR GEOFFREY OWEN

Introduction

Since the early 1990s we have seen three important changes in the composition and behaviour of boards of directors in UK public companies: first, the decision by most though not all large firms to separate the posts of Chairman and Chief Executive and to appoint to the chairmanship an outsider, that is, someone who is not, and has not previously been, an employee of the company; second, the increase in the number and influence of independent or non-executive directors, who now occupy at least half and usually a majority of board seats, and dominate board committees; and, third, the greater emphasis on the monitoring function of the board, both in evaluating the performance of the executive team and in ensuring that the company complies with what has become an increasingly onerous set of corporate governance guidelines or rules.

These three changes, taken together, represent a distinctively British approach to corporate governance. In the US, most companies combine the roles of Chairman and Chief Executive Officer in a single person, although there is some pressure from corporate governance reformers for separating them.[1] US public company boards usually contain no more than one or at most two executive members (the Chief Executive and the Chief Financial Officer), whereas the executive component of the typical British board is larger, often including heads of major divisions and/or managers with functional responsibilities. In France, power in most large companies continues to be concentrated in the hands of the Président-Directeur Général, although the status and influence of non-executive directors appear to be increasing. Germany remains committed to its two-tier board structure, whereby the tasks of the supervisory board are separated from those of the managing board. While there is dissatisfaction within the German business community over some aspects of this system (for example, the fact that the co-determination arrangements exclude non-German employees from seats on the supervisory board), the prospects for radical reform to bring German corporate governance into line with Anglo-American practice are remote.

[1] See, for example, Paul W. McAvoy and Ira M. Millstein, *The Recurrent Crisis in Corporate Governance*, New York: Palgrave, 2003. For a defence of the combined Chairman/CEO role see James A. Brickley, Jeffrey L. Coles and Gregg Jarrell, 'Leadership Structure: Separating the CEO and Chairman of the Board', *Journal of Corporate Finance* 3 (1997), 189–220.

How well is the British system working? Part of the rationale behind the proposals contained in the Cadbury Report, published in 1992, was the perceived need to restrain overpowerful Chief Executives. Several corporate scandals at the end of the preceding decade had highlighted the apparent inability or unwillingness of some boards of directors to prevent dominant leaders from riding roughshod over the interests of shareholders in pursuit of their private ambitions. This restraining role has been an important strand in the subsequent evolution of corporate governance in the UK, but it has been subsumed within the broader objective of making the board an effective instrument for improving the quality of decision-making and bringing about better financial performance.

How well boards achieve these goals is hard to measure, since board composition is only one of a large number of factors which affect how a company performs. Some companies have done outstandingly well over a long period, despite having board structures which are not in accord with approved corporate governance principles. Critics of recent corporate governance reforms use such cases to question the value of what they see as unnecessary constraints on enterprise, driven largely by political correctness.[2] Nevertheless, most Chairmen, most directors and probably most investors believe that a well-organised board, with an appropriate mix of skill and experience, can make a positive contribution to the success of the business.

It is certainly true that a vast improvement has taken place in the professionalism of British boards since Cadbury reported. This applies most obviously to the non-executive directors, who take the job more seriously than in the past and devote more time and effort to it. The days when a director might be seen opening his board papers as he walks into the board meeting, remarking to the Chairman ‘I have to be away by 12’, are long since over, as is the tendency for companies to fill their boards with ‘the great and the good’ – people who might add lustre to the company by virtue of their distinction in other fields, but have little to contribute to the business. The process by which potential non-executive directors are identified and selected is more rigorous than it used to be. Companies are looking for people whose skills are relevant to the business, and who have demonstrated the strength of character and independence of mind that are necessary to do the job well.

Yet these changes do not in themselves ensure that boards perform better than they did before the changes were introduced. Building an effective, British-style unitary board that genuinely adds value to the business calls for much more than simply adhering to the new corporate governance requirements. Nor should one ignore the persistent lack of clarity, both among directors and in the outside world, about what boards are for. There are ambiguities in the role of

[2] An early critic of the Cadbury approach was Sir Owen Green, former chairman of BTR. See his Pall Mall Lecture to the Institute of Directors, ‘Corporate Governance, Great Expectations’, 24 February 1994.

non-executive directors which, even if they cannot be removed, should at least be openly recognised. Moreover, while most boards now submit themselves to some form of annual self-examination, the improvements that result from these exercises generally relate to style rather than substance. A better approach needs to be developed whereby boards can set realistic goals for themselves and measure how well they have been achieved.

The Chairman's role

The practical problems start with the Chairman. It is his job to manage the board and, assuming that the post is not combined with that of Chief Executive, a great deal depends on how he handles two potentially awkward relationships: with the Chief Executive and with the other non-executive directors.

On the first, a clear division of responsibilities is essential, written down, agreed by the two individuals and approved by the board as a whole. But an agreed document is only the beginning. What matters even more is that the Chairman and Chief Executive should complement each other – in skills, knowledge and experience, and preferably also in personality and style. There has to be mutual respect between the two individuals, and a recognition by the Chief Executive that his hold on the job depends in the last resort on how well the Chairman, advised by the other directors, thinks he is doing it. There is plenty of anecdotal evidence to suggest that the relationship between these two people can easily become dysfunctional, either because the Chairman stands back too far or because he interferes too much, or simply because the two individuals have been unable to develop a constructive working relationship. There is a further discussion on this relationship in the chapter on the role of the Chairman (chapter 2).

Given that the Chairman is normally inevitably closer to the Chief Executive, and spends more time with him, than he is to the non-executive directors, there is a danger that proposals will come to the board 'pre-cooked', agreed in advance between the Chairman and the Chief Executive. In these circumstances, the other directors may be reluctant to express a contrary view, and the board serves merely to rubber stamp what has already been decided. The most effective Chairmen are those who involve the non-executive directors in major decisions at the earliest possible stage, so that they have the opportunity to debate them from every angle and to ensure that any reservations are fully aired. Involvement can be increased by developing a secure website for use by board members, so that non-executive directors can be kept fully abreast of developments between formal board meetings.

The executive/non-executive relationship

A second set of relationships which can be problematic is that between the executive and non-executive members. Many companies encourage non-executive directors to supplement their attendance at board meetings with visits to the businesses and discussions with functional heads and line managers. In one large retailing group, for example, directors are assigned to particular stores, which they are encouraged to visit on a regular basis. In some cases directors may be selected for their specific skills – in brand management, for example, or in the human resources field – which are put to use in mentoring the relevant executives within the company. The danger here is that such close relationships may blur the distinction between executive and non-executive roles; the outside director may lose his objectivity and become a spokesman for the part of the company with which he is most closely linked.

Outside directors, most Chairmen agree, should be regarded not as consultants, but rather as broadly based individuals who can take an intelligent and objective view of the company as a whole; there are other ways for the company to access specialist expertise than by appointing specialists to the board. If the specific skills of directors are to be used, it is better to use them on issues that cut across divisional or functional responsibilities, rather than attaching them to a particular department.

The ideal is for the board to act as a cohesive group of well-informed and active participants who know enough about the business to make a full contribution to the discussion. That knowledge cannot be obtained purely by attending monthly board meetings. But how much knowledge is needed? This question highlights one of the ambiguities in the role of non-executive directors on a unitary board. How can they be both independent of the business and sufficiently well informed about it to contribute intelligently to decision-making?

As two American commentators have pointed out, most part-time independent directors are busy with other activities, and they find it hard to acquire more than a rudimentary knowledge of their companies' affairs; it may take several years before they begin to understand the business, and in the meantime they are almost entirely dependent for information on the Chief Executive and his senior colleagues.[3] They may supplement this source by talking to industry experts and analysts, but a little knowledge is a dangerous thing, and directors have to resist the temptation to second-guess the executives in areas where their expertise is superficial at best.

It is true that, if they want to be more than remote monitors, directors do need to get to know the company, and that involves more interaction with management than is possible at formal board meetings. But their value depends not so much on how much they know about the company and its industry, as on their ability to identify and focus on the small number of key issues on which the success of the business depends. How well they do so depends to a considerable extent on the direction they get from the Chairman. For more discussion on the role of the non-executive director, read Murray Steele in chapter 3.

[3] Colin B. Carter and Jay W. Lorsch, *Back to the Drawing Board*, Cambridge, MA: Harvard Business School Press, 2004, p. 45.

The board agenda and the number of meetings

Since the outside director has only a limited amount of time to devote to the company, that time must be used constructively. A crucial task for the Chairman is to structure the agendas of board meetings in a way which ensures that the board focuses on important issues and has the opportunity to engage with the executives on policy.

In one large company, the Chairman has ruled that each board meeting should allocate an appropriate amount of time to the following topics:

- a report on operational and financial performance against plan
- an update on markets, competitors, customers and investors
- progress on strategic issues
- developments on important people issues
- a review in depth of one key strategic issue
- a short presentation from one senior or high-potential leader.

Other topics, for example the strength of the brand, succession plans and longer-term scenario development, are dealt with on a periodic basis. In this company, the Chairman also ensures that at the end of the meeting at least five minutes are set aside for an assessment of how well the board has handled the agenda and how useful the discussion has been. This is a good discipline since many board meetings tend to overrun their allotted time span, leading to hurried treatment of the last few items on the agenda. The Chairman has to steer a path between sticking rigidly to a specific time slot for each item and allowing a free-flowing discussion. As the size of the agenda tends to expand, partly because of the growing importance of corporate governance issues, many companies are finding that a morning meeting followed by lunch is no longer enough; an all-day meeting is becoming common practice, often followed or preceded by an informal dinner.

The Chairman's ability to manage board meetings efficiently depends to a considerable extent on the support he receives from the Company Secretary. This is a role which has become more central to good corporate governance. Apart from the responsibility for organising and distributing the board papers (preferably at least a week before the meeting), for taking the minutes and for providing a full record of the discussions, the Company Secretary has to keep the Chairman and the board abreast of new developments in corporate governance, and to ensure that all statutory requirements are fulfilled.

What can sometimes seem to be pedantic interventions on the Company Secretary's part can irritate directors who want to get on to what they regard as more interesting topics, but scrupulous attention to detail is an essential ingredient in the board's deliberations. The importance of the Company Secretary's role is reflected in the decision by British Petroleum to detach the post from the

Chief Executive and make it part of the Chairman's office. Under this arrangement, the Company Secretary is not part of the executive management. He reports to the Chairman and 'provides support to all the non-executive directors, ensuring that board and board committee processes are demonstrably independent of the executive management of the group'.[4] More on this can be found in David Jackson's chapter on the role of the Company Secretary (chapter 4). While this system may not be appropriate for smaller firms, it underlines the need to provide the Chairman and the outside directors with adequate administrative support.

As for the number of board meetings, most companies have eight or nine regular meetings per year, usually supplemented by a two-day strategy discussion away from the head office. Such a schedule can cause problems for companies with extensive international operations and with several directors based outside the UK; having fewer meetings with 100 per cent attendance is clearly preferable to having more meetings with irregular attendance. Moreover, there is a danger with too many meetings that the discussion takes on a routine character, with the directors spending most of their time in passive mode, listening to reviews of the previous month's results.

Board committees

The time commitment of non-executive directors has been increased by the additional duties that have been given to board committees, principally the audit committee, the remuneration committee and the nomination committee.

The audit committee is responsible for ensuring the adequacy of the company's financial controls and the robustness of its external and internal audit arrangements. At least one member of the audit committee is required by the Combined Code to have recent and relevant financial experience. The other members need to be knowledgeable enough to understand the accounts and the financial reporting rules that have to be followed. Following the Enron affair and the passing of the Sarbanes-Oxley Act, British boards, whether or not their company's shares are listed in the US, have become much more aware of their responsibilities in the area of financial control. This has meant, among other things, a closer relationship between the audit committee and the external auditors. The auditors increasingly regard the chairman of the audit committee as their boss (and paymaster), rather than the company's Chief Financial Officer. Audit committees are also looking more closely at the balance between the auditing firm's audit and non-audit fees, and seeking to ensure that the latter are not so large as to jeopardise the auditor's independence.

[4] *BP Annual Review 2003*, p. 39.

Membership of the remuneration committee has also become more demanding. Members have to wrestle with the increasing complexity of executive remuneration packages and with the knowledge that their decisions will be scrutinised critically by institutional investors and the press. Most companies now offer their senior executives a range of incentive schemes tied to the achievement of specific performance targets. Remuneration committee members rely on consultants to advise on the incentive effects of these schemes and on how they compare with those offered by other companies. Whether the complexity of these schemes is justified by their impact on executive performance is open to question, but the fact remains that setting remuneration packages has become a difficult and time-consuming process, calling for sensitivity on the part of committee members, both to the wishes of investors and to the effect of their decisions on morale within the company.

Inevitably the largest burden falls on the chairmen of these two committees, and this is reflected in the size of their fees, but it is important to ensure that other members play more than a minor role. They need to be fully engaged in the reviewing and decision-making process and, again, this means devoting more time to the meetings of the committee and to preparations for them.

The nomination committee, concerned with identifying and selecting new non-executive directors, meets less frequently than the audit and remuneration committees. Its task is to ensure that the board has an appropriate mix of skills and experience and that succession plans for retiring directors are organised well in advance. A tricky issue is the degree of influence that should be wielded by the Chief Executive in the appointment of new directors. The Combined Code states that new directors should be independent, having no previous business connection with other members of the board, and most companies go to great lengths to avoid any hint of cronyism in their appointments. Yet there is still a tendency to go for candidates who will fit in with the established culture of the board, and to steer clear of people who may be thought to be too aggressive or in some sense too awkward in their approach.

The Chief Executive has every right to object to nominees who, in his view, are unlikely to work constructively as part of a team, but this should not preclude the appointment of strong-minded individuals who are capable of challenging the Chief Executive's proposals. Hence it is important that the nomination process is not dominated by the Chairman and the Chief Executive; other board members must be fully involved. That a new Chairman should be compatible with the current Chief Executive goes without saying; whether the Chief Executive should have the right of veto, as is the case in some companies, is another matter.

The nomination committee is sometimes also given responsibility for corporate governance, in the sense of monitoring on the board's behalf any new corporate governance rules or guidelines, keeping abreast of the corporate governance debate and ensuring that the board is alerted to significant developments.

Size and composition of the board

Taking into account the responsibilities which now fall on non-executive directors, how many of them should there be? What is the optimum size of the board, and what is the appropriate mix of executive and non-executive members?

Most Chairmen agree that, as a minimum, the Chief Executive and the Chief Financial Officer should be on the board. Whereas in the US that is generally regarded as a maximum, many British companies take the view that other senior managers such as the Chief Operating Officer, if there is such a post, or functional directors like the heads of R & D or human resources, or the heads of major divisions should also be considered for board membership.

Some Chairmen believe that managers who are answerable to the Chief Executive should be not be members of the board since they are placed in an impossible position. As managers, they cannot express views which might imply lack of confidence in the Chief Executive; yet as directors they are required to take an objective view of what is in the best interests of shareholders. Others believe that the presence on the board of two or three executives in addition to the Chief Executive and the Chief Financial Officer strengthens the sense of a balanced team at the top of the company, working together to drive the business forward. Such an arrangement, according to this view, gives the non-executive directors greater exposure to potential successors to the current Chief Executive, and the executive directors are obliged to think more broadly about the company as a whole. This is particularly relevant in international companies where several divisions are based outside the UK; the divisional heads may be central to the success of the business, but if they are not on the board they may have little contact with the head office and little understanding of the pressures to which the directors are exposed.

As one Chairman has put it:

> to have a meaningful executive representation you have to have the heads of the key divisions there, not to talk narrowly about their own operations, but to be involved in broader issues of strategy, and in such matters as dividends, share buy-backs, feedback from shareholders. Divisional executives learn a great deal about governance, which is a good preparation for becoming Chief Executive, and their contribution goes way beyond their divisional responsibilities.[5]

The balance between executive and non-executive director membership has implications for the size of the board. The tendency over the past fifteen years has been for boards to get smaller, and for the executive component to go down. According to a study by Deloitte, the average FTSE 350 board had ten members in 2005/6, comprising six non-executive directors (including the

[5] Quoted in Geoffrey Owen and Tom Kirchmaier, *The Changing Role of the Chairman*, London: Chairmen's Forum, 2006, p. 25.