# Improving corporate governance

Company direction is now far removed from the Gentlemen's Club mentality which prevailed in Britain for much of the 20th Century. One view is that the law has taken a step too far, certainly at the level of the smallest businesses, where less onerous obligations on directors might be justified. Here, we examine the changing role of non-executive directors and assess their benefits to companies.

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A re-appraisal of the role of directors started in the Seventies. This process has been continued through a succession of Companies Acts, Reviews and Codes of Practice.

# Do **non-executive directors** play a **useful role** in the companies they serve?

Agreeing to become a director comes complete with a health warning about the personal and financial risks involved. We consider the case for non-executive directors prepared to take up that challenge.

How will history remember Jeremy Thorpe? Probably as the leader of a Liberal Party with a Commons presence small enough in 1970 to hold its meetings in the back of a London taxi cab. Or as the MP who was tried and acquitted on a charge of conspiracy to murder back in 1979. And there might well be a paragraph or two on his directorship of a bank which collapsed spectacularly in 1973.

In terms of its impact on the way that the role of company directors was to change forever, that last episode – a relative footnote to the larger appraisal – would be Thorpe's unintentional legacy to the management and control of UK businesses.

Notwithstanding the allegations of fraud at the institution - in which Mr Thorpe was not involved - The London and County Securities Bank had been typical of the way in which public company boards were run in the '60s and '70s. A core of senior executives was enhanced by what can best be described as 'personality' directors prepared to lend their name and reputation to the letterhead of public companies for a not ungenerous annual fee.

A scale had evolved over the years, with ex-Cabinet Ministers at the top of the pile, and senior military men vying with Earls and Viscounts for their seat further along the gravy train. Knights came in for proportionately smaller rewards but were convenient make-weights. Whatever the pay grade of these celebrity directors, few were involved in the conduct of the Boards they joined: even fewer attended meetings apart from the shareholder-facing AGM.

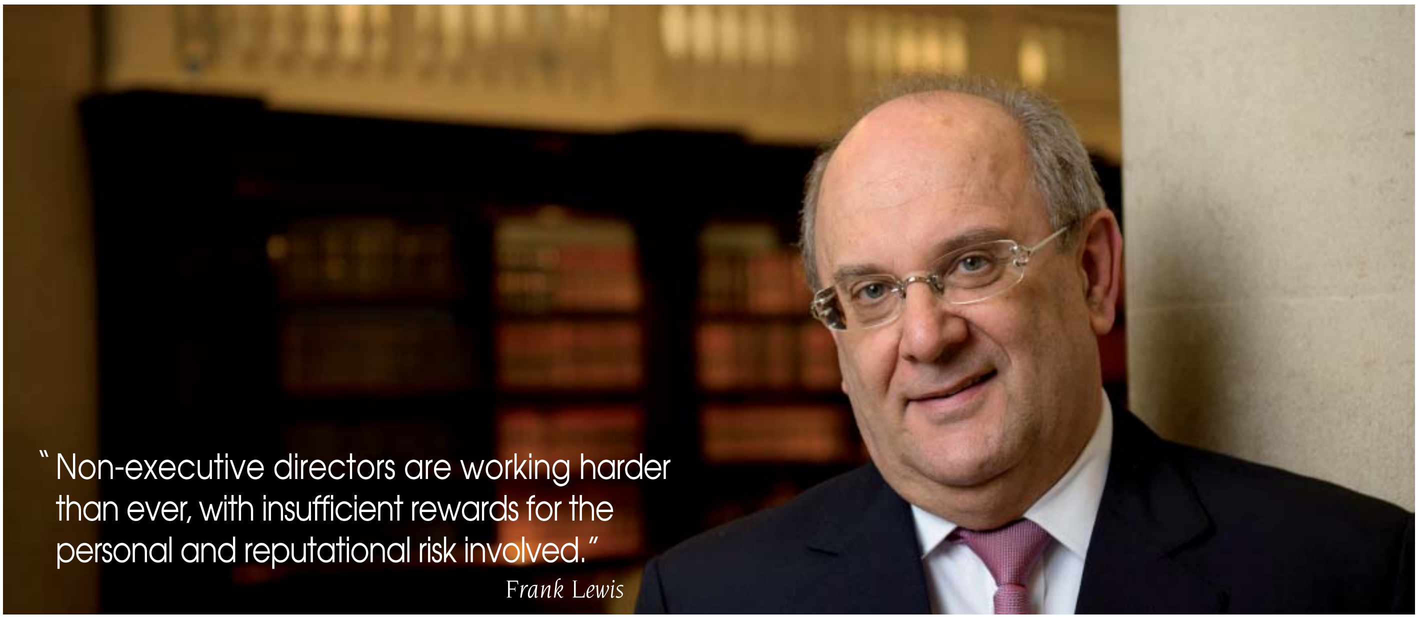
The enquiry into the collapse of London & County highlighted the problem and triggered a complete re-think of the responsibilities of all company directors.

This process, which is continuing almost four decades later, has been implemented through a succession of Companies Acts, state promoted Reviews and Codes of Practice. The framework for responsible directorship has permeated right down from the FTSE 100 elite to the smallest private company.

## New breed of non-executives

The moment a company raises its head above the parapet and seeks a listing for its securities on any of the UK's trading platforms, non-executive directors (NEDs) become *de rigueur*. A whole industry has developed to lend authenticity to company direction at this level. 'Corporate governance' is a subject in which fee-charging consultants can revel:

**There is a burgeoning role for a generation of 'professional' non-executive directors who can move easily across multiple board rooms to rent out their wares of knowledge and experience.**




there is an implied PR benefit if a board can demonstrate to the City and its shareholders that it has paid to have all its boxes ticked and has jumped through the right hoops on schedule.

And there is a burgeoning role for 'professional' NEDs who can move across multiple board rooms to rent their wares of knowledge and experience. Jeremy Thorpe has a lot to answer for.

## Drawing on expertise

Given the importance to companies and their executive directors of getting it right under today's corporate regime, we raised concerns about company direction with Frank Lewis who has served – indeed, still serves – as chairman, executive director and non-executive director of companies in the UK and overseas.

He has particular experience working with SMEs quoted on the Alternative Investment Market; a sector of the traded market usually characterised by rapid growth.

Where better to start than with the definition of a non-executive director? Michael Grade is on record saying that "NEDs are like bidets – not sure what they are there for, but they add a bit of class!"

Frank Lewis does not accept this view of non-execs. They are working harder than ever, he believes, with insufficient rewards for the personal and reputational risk involved. "The role of the NED has become more onerous in the wake of the 2009 Walker Report into Corporate Governance, which focused on the banking sector."

## Tolerating dissent

While he would not describe many boards as delicate flowers, Lewis argues that they are not tolerant enough of challenge: anyone asking too many questions will be branded a member of the 'awkward squad'.

As he noted, "The ability to stand up to executive management is more important than any qualifications that NEDs might hold.When the company involved is an SME, there must be a temptation for NEDs to 'get their hands dirty' and assume management responsibilities."

According to Frank Lewis, this is to be avoided at all cost: "My definition of a good non-executive director is one who ensures that the business is well run but who does not run the business.

"Indeed, the two skill sets are generally different. Taking integrity and commercial awareness as read, NEDs must possess good interpersonal skills and an ability to manage conflict should it arise.

"The sound judgment required of any director will be followed through with the clear communication skills to influence decisions.

"But they also require the conviction to say things that they believe need saying. And, as a last resort, they need the willingness to vote with their feet and leave the board."

As players who should not become entangled in the day-to-day operations of the business, non-execs can look at the company as a whole; a 'helicopter view', as Lewis describes it.

## Flexible approach

The Walker Report in 2009 noted that, while a complete overhaul of the contents of the Combined Code [on corporate governance] was not required, there remained parts which needed further review.

Accordingly, the Market's view could be seen to be that the flexible 'soft law' approach remained the most appropriate way of raising standards of corporate governance.

**When the company engaging the services of non-executive directors is an SME, there must be a real temptation for them to 'get their hands dirty' and assume management responsibilities.**

Under the Companies Act 2006, all directors are obliged to promote the success of the company for the benefit of all of its members. The NED needs to make a meaningful contribution on several fronts.

# What is in the **Non-Executive's terms of reference**?

## Challenge key players

By asking apparently simple questions about the business, the NED can greatly help an executive team to refocus on the important rather than the urgent. Also to challenge commercial ideas such as "We have always done it that way".

## Knowledge & insight

General business wisdom and experience gained from a variety of environments has huge value as business people often learn best from the experience of others.

The moment a company raises its head above the parapet and seeks a listing for its securities, non-executive directors become essential. A whole industry has developed to promote corporate governance. There is an implied PR benefit if a board can demonstrate that it has ticked all its boxes and has jumped through the right hoops on schedule.

## Raising governance

A good NED should help to raise the standards of corporate governance within a company. This helps to ensure that executives understand their obligations in this respect and thereby comply with the Code.

## Advise on strategy

A business without a strategy is a business without a sense of direction or purpose. NEDs can assist the executive team in articulating the strategy. NEDs must therefore have good interpersonal skills and sound judgment.

## Challenge business plans

Executives can often produce business plans where their goals are comfortable rather than stretching. NEDS can push, interrogate and raise the performance bar. They can also challenge where they believe ambitions are simply unrealistic. They provide a commercial reality check.

## Mentor

One of the most important roles of a NED, especially for SMEs, is to act as a mentor to the executive board and coaching of directors in governance, people management etc.

## Sounding board

NEDs have an invaluable role to play when a company is considering decisions such as acquisitions and disposals of businesses.

## Statutory duties

These roles have to be read in the context of any NED's statutory duty to promote the success of the company for the benefit of its members as a whole under the Companies Act 2006. This is an obligation shared with co-directors.

But the NED can act as the impartial 'honest broker', helping to make well thought out decisions where the heart wants to rule the head in some cases.

# The increasing risk of fraud while the economy is under pressure imposes additional pressure on the non-executives.

NEDs should ensure greater transparency with the executives, timely financial information and knowledge that control procedures are continually being reviewed.

The UK Corporate Governance Code implemented in 2010 introduced changes designed to improve effectiveness. The headline points of the code are . . .

- The entire board of FTSE 350 companies should stand for annual re-election.
- There should be a balance of skills, experience and knowledge on the board.
- The chairman should hold regular development reviews with each director and there should be an external evaluation of the board of FTSE 350 companies at least every 3 years. It is likely that this will apply to AIM and lower FTSE companies in the near future.

What are the implications of the Code, and whatever may be formulated for businesses outside the present 'frame'? Mr Lewis believes that the importance of the chairman and the NEDs in providing leadership and constructive debate is brought to the forefront of the Code. "It is necessary to ensure that the board has a clear line of sight. If the directors cannot see what is happening inside the business, and are therefore not receiving the necessary information, they will not know what questions to ask.

"Indeed, if the risk management processes are not organised in a clear and methodical way, then a small number of part-time executives do not stand much chance of overseeing them. These two variables – boardroom behaviour and connectedness to the organisation – are necessarily inter-dependent. There will therefore be no real challenge for the boardroom unless the company makes it possible."

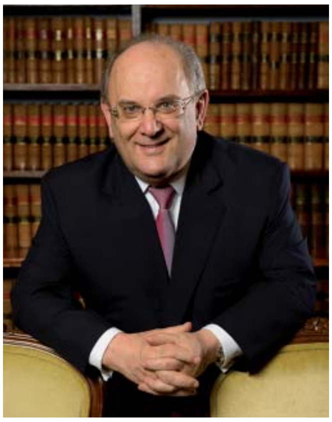
## Board conduct

Lewis maintains that how executive managers conduct themselves is central to the way in which the Code is applied and companies conduct their affairs. . . .

- Further, discussion should be tough, testing and stretching, but conducted in an adult, grown-up way.
- Challenge needs to be focused and informed, not aggressive or hostile.
- The whole board needs to come together or it risks becoming dysfunctional. "Having prima donnas is neither helpful nor constructive", Lewis believes.

In the present difficult economic times and market conditions, there are more frequent reports of fraudulent actions by companies and their executives.

Price-sensitive information may be hidden from shareholders and prospective investors. "For this reason, NEDs should ensure more transparency with the executives, timely financial information, and that internal control procedures are continually being reviewed."



**If the non-executive directors cannot see what is happening inside the business, they are not receiving the information they require, and will not know what questions to ask of the rest of the board.**

The 2006 Companies Act ratcheted up the threat of legal action. The NED sits around the table with the same onerous obligations as those who run the company full-time.

# What can non-executive directors bring to the table in the 26½ days that they spend with a company each year?

NEDs in the boardroom face an increasingly tough and challenging job. New legislation under the 2006 Companies Act, for example, has ratcheted up the threat of legal action. The NED sits around the table on an equal footing with - and has the same legal obligations as - those who run the company on a full-time basis.

Activist shareholders and are all too ready to put NEDs under fire. This has made the role of the NED even more crucial and onerous.

## Influencing NED role

How do these factors influence the role of the NEDs? According to Lewis, their focus should be on the spectrum of risks facing the business. "There should be an emphasis on factors as diverse as internal controls, cash management and receivables, balance sheet gearing, and ensuring that bank covenants are not breached. All the way along, they have to retain customers and protect markets."

But there are non-financial risks which also have to be reviewed. These include retaining key personnel, litigation, environmental factors, and Health & Safety.

And then there is the Bribery Act 2010; widely regarded as the most draconian – and unnecessary – piece of legislation introduced in the past decade.

As Lewis noted, "The non-execs should ensure that the executive team fully understands the issues of the day and that they are complying with the board's decision at all times. Hopefully, however, one can seek to impart one's experience of difficult times to the management teams."

## Boardroom police force?

How far does Lewis believe that non-execs should act as a 'boardroom police force'? That role can only be taken so far, it appears. "NEDs can add value in so many ways but investigative policemen they are not. In my opinion there should be a balance between ensuring that there is good corporate governance and adding commercial value to the enterprise.

They need to be more vigilant and clearly understand their fiduciary duties and the requirement to identify clearly the major risks to the company on whose board they serve."

It is clear that a non-executive cannot know everything about a company in the 26½ days spent with it on average by a single director each year.

The issue must surely be how these independent additions to the board can accelerate both industry and company knowledge. Several aspects of a company's activities may prove to be trigger points which need monitoring by the non-executive directors . . .

- Geographic diversity and cultural differences.
- Technology and security risks.
- Reputation risk – given that NEDs have to rely on others in the company and its control mechanisms, to keep matters under review, the fear of what is not known is an issue.
- Legal proceedings against directors can result in reputational damage that can, in many cases, be irreparable. Lewis recommends that a legal representative at board level should advise all directors on issues as they arise.
- Non-execs who are members of the audit committee have to get to grips with the challenges of risk assessment.

There are non-financial risks which also have to be reviewed by all of a company's directors. These include retaining key personnel, litigation, environmental factors, and Health & Safety. And then there is the Bribery Act 2010; widely regarded as the most draconian – and unnecessary – piece of legislation introduced in the past decade.

"What I find works is that I speak with my companies at least weekly, get copied in on all relevant email correspondence, receive monthly management accounts, have monthly board meetings and ensure that accurate board minutes are produced when appropriate. It is not enough simply to get company directors to sign that they understand their ongoing obligations."

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## Additional considerations

These principles should apply, as appropriate, to any corporate entity, but there are additional concerns when a business decides to seek funding through an IPO or have its securities listed. . .

- To ensure the ongoing implementation of corporate governance policies which have been put in place at the IPO.
- NEDs should not be removed or replaced other than in exceptional circumstances within 12 months of an IPO.
- Any changes at any time to the NEDs should be approved by the Corporate Advisor to the company. (For the AIM section of the London Stock Exchange, this is the Nominated Advisor, or Nomad. These advisors should also play a major part in the education of the companies they are helping to bring to the market.

Having served in many boardrooms over the years, Mr Lewis is well placed to position the relationship between the non-exec and the company. "My objective over the years has been to build an open and transparent relationship with the executive directors.

"I believe that the more one communicates, the better the chance of building a relationship of trust and transparency with the executive members of the board.

Communication, therefore, plays a major role in attempting to achieve this objective, which becomes more difficult when dealing with international companies due to the cultural and language differences involved.

Frank Lewis again: "It is part of the learning process for executive directors of companies to understand their obligations and to build a sound relationship with their NEDs. These non-execs can also be of help with general business advice, mentoring and representing the company in the City.

"What I find works for me, for example, is that I speak with my companies at least weekly, get copied in on all relevant email correspondence, receive monthly management accounts, have monthly board meetings and ensure that accurate board minutes are produced when appropriate.

"It is not enough simply to get company directors to sign that they understand their ongoing obligations."

## Guiding principles

According to Mr Lewis, the guiding principles which should govern the relationship of the company with its non-executive directors would be:

- NEDs must be invited to attend all board meetings well in advance of the meeting and be provided with board papers.
- The executive directors of the company must be willing to engage in full dialogue with the NEDs and respond fully to their requests for information.
- Prior to an IPO, the entire board should attend a meeting with the company's corporate and legal advisors to review the board's overall responsibilities and duties including corporate governance.
- Admission to a trading platform will take up significant management resources. The NEDs must ensure that the company remains well-managed.
- The board should meet its first year forecast. Failure to do so would lead to a rapid deterioration in the share price and ability to raise further equity in the markets, as well as impacting on the credibility of the company's management with investors.
- Appoint non-execs as soon as possible in the IPO process to begin to build a trusting relationship with the executive directors. Their experience can benefit the company.

The world of company direction is now far removed from the Gentlemen's Club mentality which prevailed in Britain for much of the 20th Century. One view is that the process has taken a step too far; certainly at the level of the smallest businesses, where directors are constantly having to look over their shoulder at the financial and legal sanctions that can be imposed; way out of proportion to the scale of business they are running.

Far from creating a safe environment for investors, has corporate governance joined the Bribery Act and the Money Laundering Regulations to stifle the true entrepreneurial spirit? §

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