Non-executive directors have come in for significant criticism in recent months – largely due to the perception that they are failing in their duties to companies. Kevin Eddy asks if accusations of negligence are justified.

They are overpaid. They are largely men of a certain age and social class, appointed by similar men of a similar profile through an exclusive ‘old boys’ network. They are more concerned with garnering large numbers of lucrative positions than engaging with the companies they are supposed to be responsible for. They are, at least in part, responsible for the financial crisis that proved to be the catalyst for a global recession. They are the non-executive directors of the UK’s largest companies.

At least, that’s the caricature of the professionals who are charged by the Combined Code on Corporate Governance to, amongst other things, ‘constructively challenge and help develop proposals on strategy’, to ‘satisfy themselves on the integrity of financial information, and that financial controls and systems of risk management are robust and defensible’, and to be ‘responsible for determining appropriate levels of remuneration of executive directors’.

The Code’s description of the role of non-execs reads like a charge sheet of recent corporate governance failings – especially in the banking sector. Are NEDs really that disengaged that they are failing companies – or is it companies that are failing, by not giving them the information they need to carry out their duties? Are there other underlying issues that mean NEDs are unable to do their jobs? And if so, does that mean there is a ticking timebomb lurking under the surface of British business, just waiting to go off?

Responsibilities

The first and most significant criticism of non-executives is that they have not challenged executive teams sufficiently – either through a lack of interest, a lack of knowledge or because of sheer intimidation.

Philip Wright, chairman of PricewaterCoopers’ non-executive director programme, suggests that the problem lies in the boardroom environment.

‘On one level, non-executives are intelligent, diligent people,’ he argues. ‘However, from our experience there is an element of naivety around some NEDs – at a basic human level. For example, there can be a reluctance to challenge, for example, the honour and integrity of the chief financial officer, or to raise issues of concern in a company that on the surface looks successful. It takes courage to rock the boat in those circumstances, but that’s when you should be a rebel.’
Graham Durgan, Chairman of the Non-Executive Directors’ Association (NEDA), thinks at least some of the problems in the boardroom might be down to a simple lack of understanding of the key responsibilities of a NED:

“You need a thorough understanding of your corporate governance responsibilities: I’m not sure enough NEDs have that understanding,” argues Graham. “After all, it’s not typically tested or measured – hence, one of the things that NEDA is looking at introducing is a very simple knowledge and understanding test for directors.

‘Of course, you must also consider the application of that knowledge. Typically, those who may have sat on boards before, will largely have been concerned with running the business. By becoming non-executives, they’re moving into an oversight role, which is very different. I’d question whether their prior experience is sufficient, or whether they need more support and training to help them perform that role.’

Bryan Foss and John Sheath are two non-executives who took extra training seriously, by studying for the Institute of Directors (IoD)’s Chartered Director qualification. They both insist that this has been invaluable, and John reckons that even executives with vast experience can benefit from some training – even if it is not as indepth as the IoD qualification:

‘Even if you’ve been a director for 18 years, it doesn’t necessarily mean that you’ll automatically make a good non-exec,’ he argues. ‘In fact, there’s a danger that it can make you more complacent. It doesn’t help that many board induction processes assume that non-executives automatically know what their responsibilities and liabilities are: that’s not necessarily the case.

‘To some extent, it’s down to the chairman, the company secretary and the chief executive to ensure that the board’s skills are kept up to date – but directors have to take responsibility for their own development too. After all, there’s inevitably going to be more emphasis on how qualified directors are to perform that role in the wake of the financial crisis, and what it means to be a non-executive director.’

Knowledge of governance, responsibilities and liabilities isn’t enough, though: a good NED should also really know and understand the business they’re acting for. That, stresses Bryan Foss, can only be achieved by looking beyond the boardroom.

‘A non-executive must engage with all the stakeholders of the company – external and internal,’ he says. ‘You need to be able to immerse yourself in the company – it’s simply not enough to just turn up at board meetings. It’s essential that, for example, you’re approachable to employees, so that issues can be raised with you between meetings if necessary. It’s certainly been my experience that serious problems have been averted at an early stage through employees seeking advice from NEDs outside of the context of the formal meeting.’

Philip Wright acknowledges that some NEDs may be hesitant to get too involved in a company.

‘You have to weigh up spending time with the company to make sure that you can carry out your duties against spending so much time involved that you become some kind of quasi-executive director,’ he warns. ‘However, the risks and responsibilities involved in being a NED are stacking up: I’d argue that they should be spending more time with companies, even if it is just to be on the safe side.’

A numbers game

Being able to immerse yourself in the details of how a company operates inevitably requires one thing: a significant time commitment. Another often-heard criticism of non-executives – particularly of the largest companies – is that they’re taking on too many roles, and are therefore unable to spend sufficient time with the companies for which they are legally responsible.

Is this criticism justified? In some circumstances, yes, says Bryan Foss.

‘Some non-execs do take on too many appointments,’ he comments. ‘I know of people with high single-figure and double-figure numbers of roles, and their whole year already scheduled out. My question is, how much can you really know about an individual organisation in that situation? Plus, how can you
Lesley Stephenson, from recruitment and information website The Non-Executive Director, argues that part of the problem relates to the estimates about how much time positions involve.

‘You seriously need to think about the amount of time that a role like this might take. The typical estimate – two days a month – is just not realistic. You might be able to get away with that if the company is cantering along with no problems, but it becomes very different when, for example, a major corporate transaction happens. That’s when NEDs need to devote plenty of time to a company, and if they hold too many positions, they just won’t have the time to do that job properly.’

So, what is the solution? Should the number of roles one can hold be limited, as some commentators have suggested? Bryan is in favour of some kind of limit:

‘I don’t think that anyone should hold more than a small handful of substantial positions – probably less than five. If you’re a portfolio director, there are plenty of things you can do in between – advisory roles, for example, or working with innovative SMEs.’

Graham Durgan, meanwhile, is reluctant to impose a ceiling – pointing out that a lot depends on the type of companies that an individual is involved in.

‘If you are the chief executive of a FTSE company and have a lot of non-exec positions, I would question whether you can do any of those roles effectively. Whereas, if you are the chief executive of a small business and have a few non-executive positions with smaller companies and maybe charities, then I would suggest that could be manageable.’

Graham suggests that industry might impose its own limits.

‘We might begin to see companies hiring non-executives on the understanding that they only hold a certain number of NED positions. That can be done contractually. There’s nothing to stop firms saying, well, if you want a position here, then you can only take on one or two others. At the moment that doesn’t happen, but there’s no reason why it shouldn’t.’

John Sheath, who is based in the Isle of Man, advocates a third solution.

‘I’m aware of one person who holds 26 non-executive roles. Now, I don’t think I would be able to do that, but he seems to be able to manage perfectly well. So, I’d argue that it has to be a personal decision – but there must be transparency.

‘The way the Isle of Man manages multiple directorships is not through a statutory ceiling, but by requiring anyone holding over ten non-executive positions to be licensed. So, that doesn’t stop individuals holding multiple roles if they wish, but it does put a safety net in place, and highlights the fact that the regulators are watching.’

Another argument that regularly comes up when discussing NEDs and the time that they spend with companies relates to how much and in what way they are rewarded. So, how does the remuneration of NEDs stack up against what they do?

Pay and reward needs to be reassessed, insists Graham Durgan.

‘People argue that £30,000 a year for the average NED is perfectly adequate: I don’t think it is. True, by reference to a normal person’s earnings, NEDs are extremely well paid. But these are not people who were previously earning normal wages.

‘One has to see what the alternatives are. Other income sources include, for example, private equity – either as an adviser to a company with little or no liability or being actively involved in the running of a company. Therefore, in order to attract talented people, the public arena has to at least match the rewards available elsewhere.

‘Ultimately, remuneration hinges on the risk involved,’ concludes Graham. ‘In the past, the risk involved in being a NED has been fairly minimal, and therefore the
Widening the gene pool

Of course, one of the most common arguments rolled out to defend multiple directorships is that there simply aren’t enough qualified people to take on NED roles, hence those that are qualified have no choice but to take on more positions. Graham Durgan disagrees.

‘Part of the reason NEDA was established in the first place was because we believe there is a pool of over 300,000 people who are capable of doing non-executive roles, who just don’t have access to them: for example, people who have been in the public services at a senior level, people who have been involved in the not-for-profit sector, people who have run divisions of major public companies – which can be bigger than some listed companies or AIM stocks – and partners of law practices. There’s a lot of very talented people who simply don’t get the opportunity to get to NED positions.’

Why have they been denied this opportunity?

‘I think it is, to a large extent, because the old boys’ club still exists,’ replies Graham. ‘Although, in my belief, a veneer of independence has been brought to the recruitment side of things, in practice people are still tending to recruit people like themselves, and from similar positions – chief executive, chairman and so on. The danger with that is that you can get groupthink; because everyone is coming from the same background, they’ll think the same way.

‘There’s nothing wrong with recruiting someone you know, of course – provided that other people have been considered,’ he continues. ‘After all, you don’t know what someone might be able to offer if you don’t give them the chance.’

As someone who had not previously held a position on a UK board – although he was a member of a global industry board at IBM for several years – Bryan has first-hand experience of how difficult it can be to get a NED role.

‘It is undoubtedly easier to get a non-executive position if you have been a UK board CEO or CFO,’ he comments. ‘However, that formula creates boards that are very similar. In my experience, companies can also be far too concerned about experience than relevant skills, too. For example, if you’re a vending machine company, do you really want someone who has 20 years’ industry experience, who’s steeped in the industry and might only bring more of the same? Wouldn’t it be more valuable to hire someone who can bring a new perspective – yet is also able to immerse themselves quickly?’

It all sounds well and good in theory, but industry has been aware of these issues since 2002’s Higgs Report – and evidently little progress has been made in the intervening seven years. How exactly should the pool of non-executives be widened while still ensuring adequate oversight – especially in the current risk-averse environment?

Lesley Stephenson reckons that the private sector can learn some lessons from the public sector.

‘If you look at the way the public sector recruits, it’s a far more open process. Appointment policies are more transparent, every position is advertised as widely as possible, and they are willing to look at the broadest range of people. Going through that process also has the benefit of focusing the board’s collective mind on what they are looking for – it makes the whole process more professional.’

Graham, meanwhile, believes making just a few key changes to the NED recruitment process could revolutionise it.

‘First, every director role, be it executive or non-executive should be advertised – and properly advertised, not just placed with a headhunter. That would give a broader range of people the opportunity to apply – and also help people realise that those roles are out there.

‘Second, I think there should be a requirement for diversity imposed on company boards – say, for example, that 30 per cent of boards should be made up of
women within three years. If you put that sort of requirement in, boards would need to look outside their 'comfort zone' – and that would lead to massive change. Yes, there will be accusations of tokenism to begin with, but that sort of positive discrimination can lead to real diversity – which would ultimately benefit the companies in question.

‘Third, AIM businesses should have more corporate governance rules placed on them – principally, that they should be required to have a majority of non-execs on the board. Not only would that help protect shareholders’ stakes in those companies, but it would offer a career path for non-executives. There is undoubtedly a shortage of people qualified to be non-execs of a FTSE 100 board – but one of the reasons for that is that there is no career progression for a NED,’ he comments.

‘You just don’t get NEDs who start with a private company, work their way up through AIM-listed firms and eventually take on a role at a main list firm. Instead, the people you get taking on the roles are generally operating at a very senior level and it’s a closed shop. By requiring AIM companies to hire more NEDs, you may catch people at an earlier stage of their career and widen the gene pool that way.

‘Combine those measures with greater support and training for NEDs, and the aforementioned simple test on NEDs’ understanding of governance, and the pool of potential non-executives should increase while ensuring that the roles are still being carried out effectively.’

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While there is consensus on the governance failings involving non-executive directors, there is far less agreement on the measures that would help address them.

To some extent, it’s a balancing act – where one must balance creating a wide, diverse pool of NEDs while ensuring quality of oversight; where directors must weigh up immersing themselves in a business with still retaining a critical eye; and where the relationship between risk and reward must be carefully – and fairly – calibrated.

However, if there is one key thread which all those canvassed agree upon, it is the independence of non-executive directors – and that non-execs should ensure they remain independent regardless of any other considerations.

‘The independence of non-executive directors is sacrosanct,’ insists John Sheath. ‘The whole purpose of the non-executive director is that they are independent – if that is compromised, then everyone loses.’

‘If non-executives aren’t getting the right information, or are unable to engage with the executive, they must raise this with the chairman or company secretary,’ adds Lesley Stephenson. ‘NEDs must be proactive – after all, they are a legal director of the company, with the same liabilities as an executive director. It is a responsible role, and they have to take on that responsibility.

‘Most good NEDs are already doing that, and are vocal about how much they enjoy the role,’ she continues. ‘Being a non-executive requires bravery and integrity – they must be prepared to put their head above the parapet, to ask the stupid question, and to add value to the business. If they’re not doing that, then you have to ask yourself why they are there in the first place.’

Kevin Eddy is Editor of Chartered Secretary.