

Non-executive directors' survey 2002/3

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Foreword

From Cadbury to the Combined Code, the corporate governance reforms of the last decade have systematically formalised and extended the role of the non-executive director. Many might argue that the jury is still out as to how effective such reforms have been. Nevertheless, the current spate of restated financial statements, missed earnings projections, and high profile corporate failures have caused the spotlight to fall once again on the role of the non-executive director and a brisk current of change appears set to sweep through UK boardrooms.

There have been calls to tighten the UK governance regime, and in particular, extend the audit committee's role to include a specific duty to recommend the appointment of the external auditor and to approve non-audit services. Also there are demands for a tighter definition of independence, widening the pool of non-executive talent, and a restriction on the number of directorships an individual may hold.

Against this background, we have surveyed the views of non-executive directors on a number of issues: roles and responsibilities; knowledge, skills and attributes; widening the pool of non-executive directors and improving public confidence in non-executive directors. Generally we have found that non-executive directors are resistant to the imposition of a tighter governance regime – preferring instead a self-regulatory framework. Concerns about an over emphasis on checks and balances to the expense of wealth creation are apparent. However, there is recognition that change is required. In particular, calls for transparent appointment procedures, improved training and access to better information are recurrent themes.

Good non-executive directors are a vital element of the UK governance framework, however, they cannot be expected to provide meaningful protection for shareholders unless they are *independent* of mind, *diligent*, *knowledgeable* and in possession of relevant and reliable *information*. They must be able to challenge management and draw sufficient attention to dubious practices – even in apparently successful companies. They must ask tough questions and make sure they fully understand the answers. Non-executive directors are in effect the ‘corporate conscience’ particularly on remuneration and audit issues. This is not an easy role and the expectations are high.

Finally, we welcome Derek Higgs’ recent review into the role and effectiveness of non-executive directors and believe his recommendations will strengthen the role of the non-executive director, and help ensure there is renewed focus on the recruitment, training and time requirements to perform this important role. A number of boards in the UK will not currently be fully compliant with the recommendations and it will be important to help ensure the quality of boards over a period of change. Beyond this, we believe the recommendations will improve overall corporate governance through the increased knowledge and authority of non-executive directors.

Sir Adrian Cadbury chaired a committee that produced a report on the financial aspects of corporate governance in 1992.

The Combined Code contains both principles and detailed provisions relating to UK corporate governance.

Derek Higgs, an experienced City investment banker and non-executive director, was asked by the government to lead a review into the role and effectiveness of non-executive directors. He published his report on 20 January 2003.

1. Highlights

Relative importance of the non-executive directors' (NEDs) role

The following areas are considered particularly important:

- reviewing strategy (98%); reviewing business risks (97%); reviewing business plans, budgets projections (89%); reviewing financial information against plans (86%); and reviewing the scope of internal and external audit (81%).

The following areas are considered much less important:

- providing specialist technical advice (17%); communicating with other stakeholders such as bankers, analysts, and lobbyists (15%); and communicating with key shareholders (28%).

(Percentages refer to those considering this a important or very important aspect of the NED role.)

Factors which prevent NEDs from taking on new non-executive directorships

The following factors prevent non-executives from taking on new appointments:

- lack of available time (69%); reputational risk too high (69%); lack of adequate reward (54%); existing executives perceived as being too dominant (50%).

The following factors do not prevent non-executives taking on new appointments:

- lack of adequate training (7%); lack of adequate dialogue with key investors (9%); and lack of formal appraisal mechanisms (15%).

(Percentages refer to those considering this a significant or very significant impediment.)

NEDs' perception of their own knowledge

The areas respondents considered themselves most knowledgeable in were:

- financial performance and indicators (94%); cash flow analysis and projections (89%); and the system of internal control and its effectiveness (76%).

The areas respondents considered themselves least knowledgeable in were:

- external benchmarking and competitor analysis (44%) and non-financial performance indicators (60%).

(Percentages refer to those considering they have sufficient knowledge of an area.)

NEDs training

Most NEDs receive training in the following areas and feel it is beneficial:

- corporate governance issues (78%); and financial literacy (68%).

Most NEDs do not receive training in early warning signals and crisis management, yet most respondents considered that such training would be beneficial.

All charts, data and percentages referred to in this publication are derived from a survey of Non-Executive Directors conducted by KPMG in the UK in late 2002. Further information regarding this survey is provided in section 2.

Formal assessment

Over 50% of NEDs are never formally assessed. Just under one quarter of NEDs are formally assessed annually.

Changes to increase the pool of NEDs

The following would increase the pool of people willing to put themselves forward as non-executive directors:

- capping or otherwise limiting the liability of non-executive directors (69%); greater financial rewards (69%); Focus on strategy not controls (64%); and greater clarification of the role and responsibilities of non-executive directors (46%).

The following would have little impact on the pool of people willing to put themselves forward as non-executive directors:

- fees based on hours worked (18%) and fees paid in share options (36%).

(Percentages refer to those agreeing or strongly agreeing with proposal.)

Increasing public confidence in the role of non-executive directors

Respondents considered that the following initiatives would increase public confidence in the role of non-executive directors:

- report in accounts from audit committee on auditor independence (65%); disclosure of non-audit fees to be disclosed by type in the annual report (63%); formal independence criteria included in the Combined Code (50%); Code of Best Practice for non-executives to be developed and incorporated into the Combined Code (51%); and imposing a cap on the number of directorships non-executives could hold (53%).

Respondents considered that the following initiatives would have little effect on public confidence in the role of non-executive directors:

- minimum training requirement (37%); cap on number of years NEDs can serve (33%); and disclosure of training and appraisal mechanisms (21%).

(Percentages refer to those agreeing or strongly agreeing with proposal.)

Board committee structure

Overwhelming support for the board committees recommended by the Combined Code (92%). Only 15% saw a need to strengthen the existing Code recommendations on audit committees.

2. Background and methodology

2.1 Background

The role of the non-executive director has always been challenging. However, following the recent spate of corporate failures the non-executive's role and effectiveness in contributing to both business prosperity and accountability is under more scrutiny than ever before.

Those directors who have taken part in our non-executive director programme will know the pride we take in it and how keen KPMG is to help individual non-executive directors and business in general rise to the challenges they face. This may mean new ways of working and new priorities.

In order to improve our understanding of the impact of these challenges, KPMG in the UK undertook a survey of non-executive directors to explore their views on a number of issues including:

- roles and responsibilities.
- knowledge, skills and attributes of non-executive directors.

- training and assessment.
- issues preventing non-executive directors taking on more non-executive directorships.
- widening the pool of non-executive directors.
- improving public confidence in non-executive directors.
- corporate governance structures.

Our enhanced understanding of the issues and concerns facing non-executive directors will help enable us to contribute more widely to business and to restoring public confidence in the capital markets during this challenging period.

2.2 Methodology

The research was conducted during late 2002, using a postal questionnaire. By the cut-off date, 160 questionnaires were received.

In addition, a small number of semi-structured interviews have been carried out in order to deepen our understanding on a number of the issues arising from the survey.

This report summarises the most significant findings from the survey and includes a brief interpretation and discussion.

2.3 Demographics

The sample was made up of non-executive directors drawn from FTSE 350 companies. However, as Figure 1 illustrates, many respondents held non-executive directorships at a number of organisations including smaller listed, and private, companies.

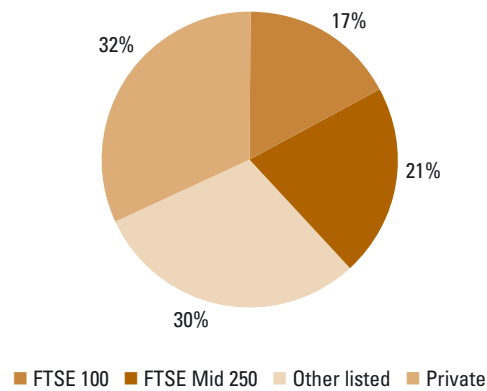
In terms of respondents' principal non-executive role, the spread of respondents by industry was dominated by: financial, which accounted for 26% of respondents; services (23% of respondents); general industrials (21% of respondents); and consumer goods (14% of respondents).

Of the total number of respondents, 92 fulfilled a principal role as chairman; 128 were members of an audit committee and 125 were members of a remuneration committee.

The age profile was as one might expect: 1% of respondents were aged under 45; 12% aged between 45 and 54; 62% between 55 and 64 and the remaining 25% aged 65 or over. This is consistent with the last survey of non-executive directors conducted by KPMG in the UK in 1999.

The gender profile remains predominantly male (92%), hardly changed from three years ago (94%).

Figure 1: Non-executive directorships by company type



Source: KPMG survey

3. Main findings

3.1 Roles and responsibilities of non-executive directors

Perceived importance of aspects of the role

Respondents were asked to what extent they considered various aspects of their roles as non-executive directors to be important. Responses were given on a five point scale running from 'Very important' (one) to 'Not at all important' (five). The results are shown in Figure 2 – responses awarded a one or two are classified as 'Important'.

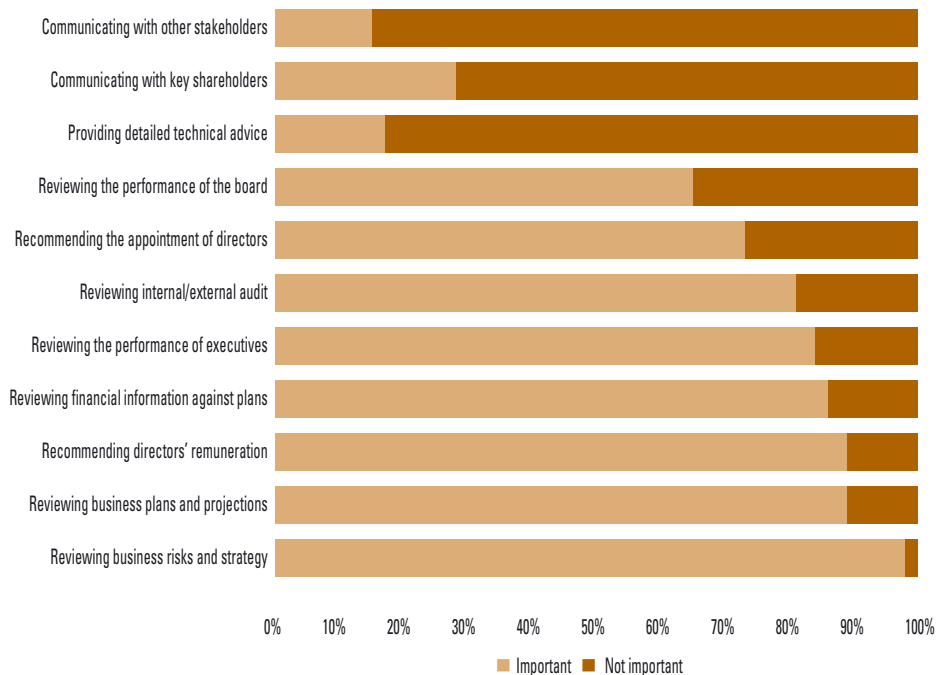
Reviewing strategy; business risks; business plans, budgets and projections; and financial information are all seen as key aspects of the role by non-executive directors. Conversely, communication with shareholders and other

stakeholders, and acting as a specialist technical adviser in specific functional areas are not regarded as important by the majority of respondents.

Considering the broad divisions of the role into strategic, governance, operational and communication aspects then, on balance, it is the strategic aspects of the role which assume the greatest importance, with communication and operational aspects being seen as the least important. This is broadly consistent with the last survey of non-executive directors conducted by KPMG in the UK in 1999.

The importance of the strategic issues is refreshing as the true value of non-executive directors must lie in both their contribution to business prosperity and to accountability. In the current environment, it is all too easy to forget the former, but it is important that undue concentration on aspects of accountability do not destroy entrepreneurship and ultimately value.

Figure 2: Importance of various aspects of the role of NEDs



Source: KPMG survey

In the light of recent recommendations, it is perhaps surprising that few respondents consider ‘communicating with key shareholders’ and ‘communicating with other stakeholders such as bankers, analysts, etc’ as an important part of their role.

Many respondents were of the view that non-executive directors should not, as a matter of course, meet separately with shareholders as such meetings cloud the issue of accountability and could be potentially divisive. It was widely held that this is an area for the chairman and chief executive and that it would be wrong for non-executives to take a lead other than on specific governance points. For example, the chairman of the audit committee might address shareholders in the context of the quality of the accounts and the chairman of the remuneration committee on remuneration.

Of the aspects of the non-executive’s role not specifically addressed by our questionnaire, many respondents considered site visits and meeting non-board personnel to be crucial to effective performance. Others emphasised the coaching/mentoring aspect of the role.

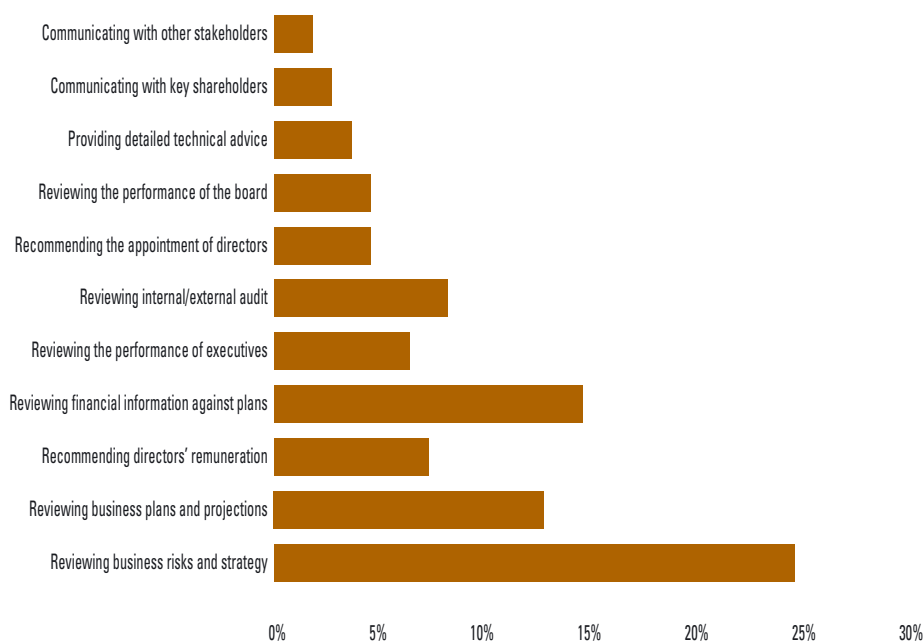
Time spent on aspects of the role

As a follow-up question to the perceived importance of various aspects of their roles, non-executive directors were asked what percentage of time they spend on these same aspects of their role. The breakdown of the time spent on the various aspects of the non-executive role is detailed in Figure 3.

There is some correlation between the time spent on various aspects of the non-executive role and respondent’s views of the relative importance of each aspect.

Again, reviewing strategy; business risks; business plans, budgets and projections; and financial information are the areas where non-executives spend most of their time (nearly 60%) while little time is spent communicating with shareholders and other stakeholders (around 5%).

Figure 3: Time spent on the various aspects of the non-executive role



Source: KPMG survey

3.2 Factors preventing non-executive directors taking on further directorships

We asked respondents to consider a list of factors and determine which, in their view, could be a deterrent against non-executive directors taking on more non-executive directorships. The results are detailed in Figure 4.

Amongst the listed factors preventing non-executive directors from taking on further positions, reputational risk is jointly rated the most important reason with 69% of respondents believing this to be a significant factor. This is perhaps not surprising given the personal risk involved in being a public company non-executive director in the current environment.

One non-executive commented *“Liability is the most important reason as you are so dependent on the honesty of the executive.”*

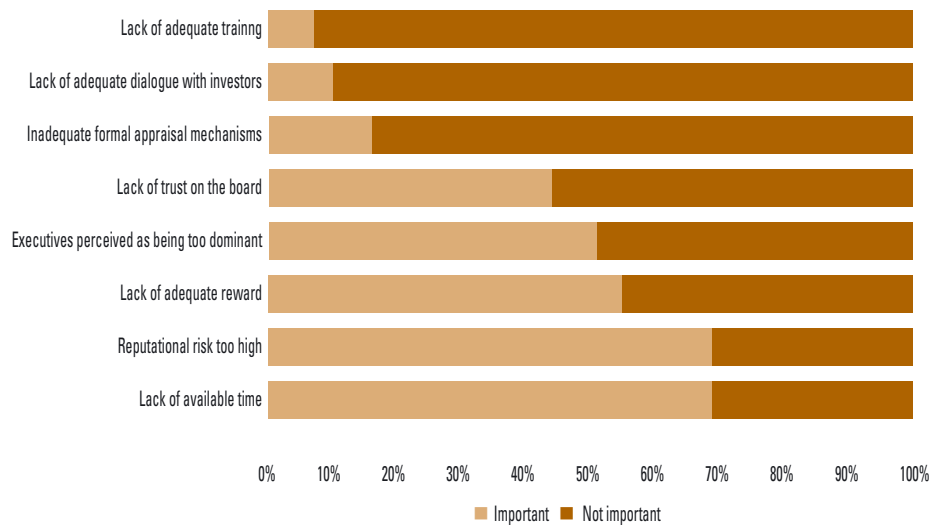
The survey revealed clear evidence that many non-executive directors believe there is a wide gap between the stress and risk of executive and non executive directors. Several suggest somehow restricting the liability of non-executive directors while maintaining the unitary board concept. Others suggest developing guidelines on what can reasonably be expected of non-executives – this could act as a judicial defence to claims of negligence. The standard of reasonableness would be less onerous than for an executive director.

Even within the executive there may be distinctions according to the particular issue. For example, a failure in treasury might be seen as the primary responsibility of the finance director which would make him more culpable under a reasonableness test than the CEO, let alone the non-executives.

Along with reputational risk, ‘lack of available time’ is the other significant deterrent recognised by respondents. Many respondents believed that non-executive directors should spend more time with each organisation and achieve a better understanding of senior employees (i.e., beyond the executive directors).

Nevertheless, there is sensitivity around this area as some executives may consider it going beyond becoming better informed to assuming executive responsibilities. One non-executive commented, *“the current time allocation may need to increase to four or five days a month in order to achieve the appropriate depth of business understanding.”* Others considered that non-executive directors should be able to explain how they can operate effectively with the number of posts they hold.

Figure 4: Factors deterring non-executive directors taking on further directorships



Source: KPMG survey

Some of those responding to our survey felt that widening the pool of available talent would help though there was clear support for recruiting individuals who are best qualified for the job. Rather than defining any particular class or group of individuals who currently rarely sit on boards, the debate should focus on setting open and transparent appointment criteria. One respondent commented that *“the appointment process is often too opaque.”*

There was widespread support for large organisations encouraging top management (the so-called ‘marzipan’ layer) to take on non-executive positions in other organisations. Not only would this grow the pool of talented non-executive directors, but also would enhance the abilities and therefore contribution of the individuals concerned.

Just under half of those responding consider a lack of trust on the board to be a significant factor in preventing them taking on some directorships. Some also feel the perceived dominance of some executives to be a deterring factor. One non-executive director commented that *“poor internal controls and lack of adherence to corporate governance principles”* are significant

deterrents. This serves to remind us that appointment should be a two-way process – nomination committees have a significant role to play in ascertaining the competencies and other attributes required by non-executive directors, but similarly, candidates should carefully consider whether they have the requisite knowledge, skills and time, and only accept appointments where they can contribute effectively. It is incumbent upon candidates to perform their own due diligence and this will usually include one-to-one meetings with the chairman and some executive and non-executive directors.

There is some concern about the degree of bureaucratic regulation and that non-executive directors are increasingly expected to “tick boxes” rather than bring in outside experience and knowledge to help the company. Several non-executives considered that, in recent years, the pendulum has swung too far towards statute and regulation and that effective non-executive directors cannot be conjured up out of thin air simply by ticking the right boxes. Lack of *“job satisfaction”* and *“no fun just being a policeman”* is how one respondent put it. Another questioned

management’s attitude to non-executive directors, *“we are only appointed because the City says it won’t float or invest unless we have non-executive directors.”*

Finally, one non-executive director summed up the issue as *“more and more responsibility for very little reward and huge time commitment in an environment which is antagonistic.”*

3.3 Knowledge

Non-executive directors were asked if they had sufficient knowledge in a number of specified areas. Respondents were also asked if they felt that other knowledge, skills and attributes are needed by non-executive directors which were not covered in the question. The results are summarised below in Figure 5.

Financial performance and indicators

An overwhelming 94% of respondents considered non-executive directors to have sufficient knowledge of financial performance and indicators. Those few respondents that consider non-executive directors to have insufficient knowledge in this area, perhaps recognise that, in an age of ‘smoke and mirrors’ where both financial transactions and accounting standards are becoming increasingly elaborate, it is no longer possible for those non-executive audit committee members to operate effectively with only a passing knowledge of finance.

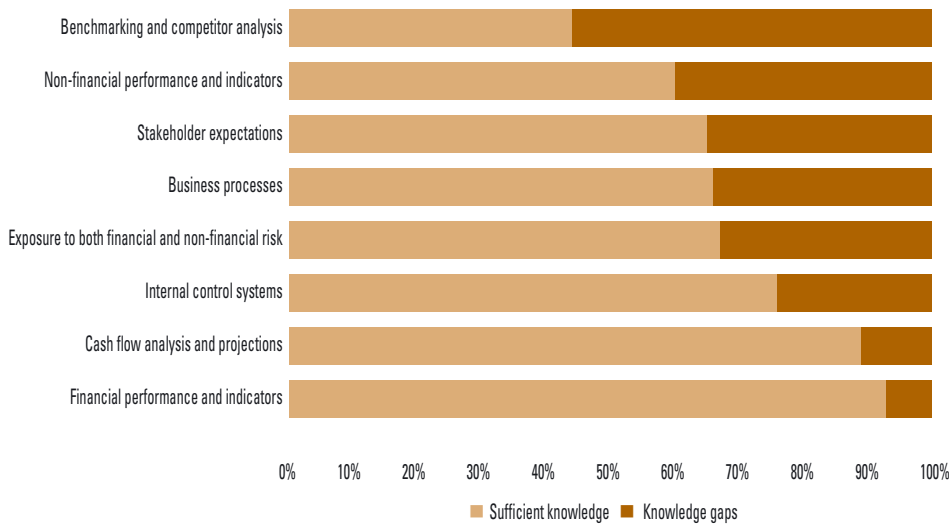
They must have expertise, that goes beyond familiarity with financial statements. They must understand the principles that underpin the preparation of financial statements, why critical accounting policies are chosen, how they are applied, and satisfy themselves that they are applied consistently and that the end result fairly reflects their understanding.

Non-financial performance and indicators

In contrast to financial performance and indicators, only 60% of respondents considered non-executive directors to have sufficient knowledge of non-financial performance and indicators. It is difficult to understand how business performance can be fully understood without an appreciation of non-financial critical success factors and key performance indicators.

The main reasons given for this ‘worrying’ deficiency are “*lack of industry knowledge*” and that the “*information provided by executives is mainly financial.*” Some non-executive directors appear to blame executives for not providing this sort of information. Trust has an important role to play as non-executive directors naturally must put a great deal of trust in their executive colleagues to tell them what they need to know. Nevertheless, they should not rely solely on what is put before them. They should ask the right questions and, perhaps more importantly, understand the answers they receive.

Figure 5: Knowledge sufficiency of non-executive directors



Source: KPMG survey

Business process, how value is added and customer satisfaction

One-third of those responding considered non-executive directors to lack sufficient knowledge of the business process, how value is added and customer satisfaction. The main reason cited is the lack of time and knowledge of the underlying business although most agree that this is an important area. Others suggested that this type of information is often not gathered, or not provided by management – perhaps this is because certain key performance indicators (KPIs) are only reported by exception.

Cash flow analysis and projections

Although a vast majority (89%) indicated that they have sufficient knowledge in this clearly fundamental area, some respondents believed that non-executive directors lacked adequate training on, and awareness of, the importance of cash flow projections. Lack of appropriate reporting by management on cash flow information/projections was also reported.

System of internal financial and financial controls and its effectiveness

One-quarter of those responding felt non-executive directors lack sufficient knowledge here. This is surprising in the post Turnbull environment and may reflect that non-executive directors are now much more conscious of risk and control and the

role they are expected to play. Again, lack of time and/or insufficient information provided by management are cited as the main reasons for knowledge deficiencies.

Exposure to financial and non-financial risk

Notwithstanding the fact that 97% of those responding considered reviewing business risk to be an important part of the non-executive role, over 30% considered non-executive directors to lack sufficient knowledge of exposure to financial and non-financial risk.

Once again, lack of time, information and training are cited as the main reasons. Many reported that financial risk is better understood than non-financial risk (mirroring their knowledge of financial and non-financial performance and indicators). It appears that non-executive directors often lack the tools or skills to understand and assess this properly. Again this may reflect their greater expectations in the post Turnbull environment.

External benchmarking/competitor analysis

Over half of the respondents believed non-executive directors lack sufficient knowledge of competitors. Respondents generally cited the main reasons for this lack of knowledge as “*information just not provided to non-executive directors*” and “*information is selective and from the eyes of the executive.*”

Again, while there should be trust on the board, it is also incumbent on non-executive directors to not rely solely on what is put before them, but seek out the information they require. Internal audit has a role to play in providing assurance on all the information received by all board members.

Stakeholder expectations

While only 15% consider communicating with stakeholders (other than shareholders) to be an important part of their role, over 30% believe that generally non-executive directors do not have sufficient knowledge of the expectations of such stakeholders.

Some cited “*lack of access to quality stakeholders*” as a key reason, as they only have a “*restricted view.*” Others suggest that “*stakeholder relations is an executive function.*” Either way, it would appear that there is often insufficient oversight by non-executive directors in this key area of reputational risk and shareholder value management.

In 1999, Nigel Turnbull, then a director of Rank Group Plc, chaired the working party that produced guidance for directors on the internal control aspects of the Combined Code.

Other knowledge, skills or attributes needed by non-executive directors

Respondents were invited to comment on what they feel are the most important skills, knowledge or attributes that are needed by non-executive directors. The responses can be broadly summarised in the following categories.

Industry processes and company knowledge –

Without a clear insight into current issues facing the business, it is difficult for non-executive directors to assess potential risks and contribute more generally to corporate strategy. It is perhaps surprising that a number of respondents feel non-executive directors lack knowledge in this area.

Tenacity – The “ability to stick to your guns” is an important attribute in dealing with overly-assertive chief executives. Skills in “constructive challenge” as one non-executive director puts it. Related attributes are independence of mind and integrity. Being able to objectively assess the executive team, especially the chief executive, is described by one non-executive director as important. Other important personal skills cited are: a probing mind, good listener, common sense.

Ability to stand back – This skill is cited by several respondents as important. One non-executive director responded “anything can be achieved if you do not care who gets the credit”. For some former executives, this may not be an easy transition.

Big picture – The ability to distinguish the “wood from the trees” and only become “involved in detail when they sense a problem looming” is how one non-executive director describes the non-executive director role. Of course, this is much more than simply doing nothing until things go wrong.

Effective relationships – Getting “the right chemistry” and being able to work with executives and other non-executives is important. It is also important to transcend the popularist view the non-executive is a policeman – “non-executives must also be committed to the company’s growth and success.”

Corporate governance – Keeping up to date with corporate governance developments is described by one non-executive director as being important. However, another respondent warns “there must be a limit to what can be expected of non-executive directors.” This is why many respondents believe some sort of guidance or code for non-executive directors would be helpful.

3.4 Training

In light of an increasingly dynamic business environment, complexities in financial reporting and changes in shareholders’ expectations related to financial disclosures, it is imperative that non-executive directors stay abreast of current developments. They must be in a position to ask the right questions and, more importantly, understand the answers they receive.

They can keep up to speed by reading relevant industry and business publications, attending conferences, and entering into a dialogue with legislators, financiers, business leaders, technical experts, and anyone else who might be the source of useful information. Nevertheless there may well be a need for a more formal education or training processes.

Non-executives were asked if they have received any formal training in a number of areas. We also asked to what extent they believe that training or guidance in those areas would be of benefit to non-executive directors in fulfilling their duties. The results are summarised in Figure 6.

It is apparent that many non-executive directors have not received formal training in a number of areas. What is perhaps even more surprising is that in nearly all the areas looked at, more respondents believed training was beneficial than those who had actually received formal training.

The only exception was corporate governance issues where 78% had received formal training while only 73% thought such training was beneficial. Perhaps this reflects the growth of formal ‘governance training’ in the wake of successive UK corporate governance reports.

At the other extreme, 78% of respondents believed training in early warning signals would be beneficial while only 32% had actually received some kind of formal training. This demonstrates the lack of formal training available for non-executive directors despite recognition of the importance of these matters – especially since the high profile corporate collapses at the beginning of the year.

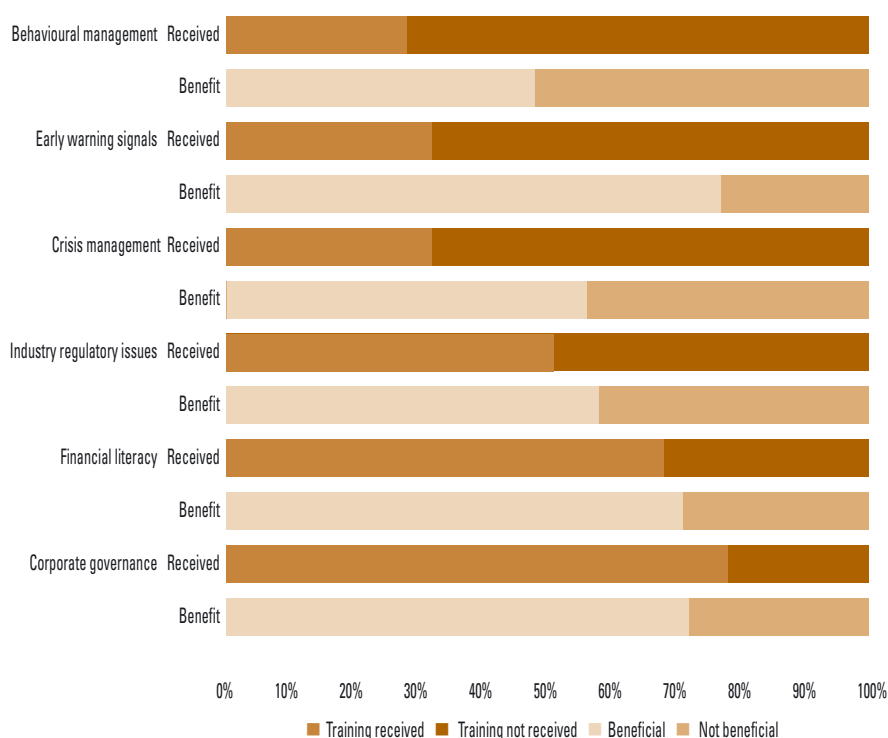
Many respondents were concerned by the burden and complexity of regulations and the difficulties in keeping up to speed with rapid change. One commented that *“commercial knowledge and experience will no longer be enough to equip an individual to be a non-executive director”* – how do they keep their knowledge of regulation up to speed? Previously this was done on an informal basis, but it is likely that this will become more formal. The need for a qualification in ‘directorship’ and compulsory post-qualification experience was raised by some respondents, but rejected in favour of a responsible approach to self-learning and attending high quality courses.

3.5 Assessment

At uncertain times such as these, it is more important than ever that boards perform professionally to the best of their abilities. Both chairman and investors need assurance that the right board members are in place and contributing to the best of their capabilities. It is important that both the potential of each director is fully understood and realised, and that concerns and anxieties are consciously addressed, discussed and dealt with.

Clearly-articulated objectives for both the board and individual directors facilitate the assessment of performance. Also, lessons can be learnt from achievement, or non-achievement, of set goals.

Figure 6: Formal training – received and benefits



Source: KPMG survey

A fair, objective, systematic and regular evaluation of the board and individual board members helps directors determine how well they are doing and ultimately contributes to improved performance.

Some respondents, but by no means all, endorse the concept of self-assessment, including the assessment of each individual's contribution to board performance. By participating in their own assessment directors can 'own' a process that should belong to them. Moreover, self-evaluation by the board and by directors can send a strong signal of accountability to shareholders, while providing assurance to directors themselves that their work will not go unnoticed.

Both 360° feedback and facilitated self-appraisal mechanisms should be considered, though it is recognised that some boards may initially be wary of such processes.

The success of the appraisal process, however it is carried out, is dependent on a number of interrelating activities: ensuring the process is controlled by the chairman; establishing clear goals for the appraisal process and ensuring that those appraised have input into the process; establishing a tailored approach that is appropriate for the needs of the company; ensuring the evaluation takes place in an environment of confidentiality and mutual trust; regular

review of the evaluation process; and transparency of the assessment procedure and criteria.

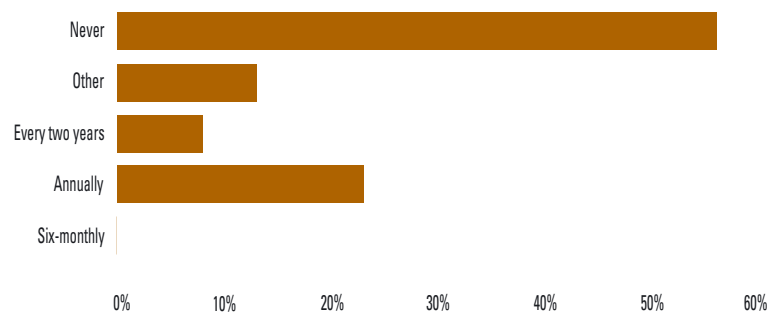
As part of our survey of non-executive directors, we asked participants how often they were formally assessed. The results are summarised in Figure 7 below.

It is apparent that the formal appraisal of non-executive directors is not yet common practice. Over half of the respondents were never formally assessed, and less than a quarter are assessed annually.

We also asked non-executive directors to indicate the extent to which they considered formal appraisal to be beneficial. The results are summarised in Figure 8 opposite. Respondents were

clearly in favour of formal assessment for executive directors with over 90% of respondents considering appraisal beneficial. Nevertheless, there was also considerable support for the assessment of the chairman (77%) and the other non-executive directors (63%). Interestingly, 73% of respondents considered appraisal of the board to be beneficial, yet only 65% considered it an important part of non-executive directors' role. Similarly, the number of non-executives being formally assessed (44%) in practice compares unfavourably with the 63% of respondents who consider appraisal of non-executives to be beneficial. Clearly there is a gap here and non-executive directors should proactively work to close it.

Figure 7: Frequency of formal assessment



Source: KPMG survey

One respondent mused that there is a need for open and honest communication about performance across the board and this is very frequently swept under the carpet. Most respondents commenting on this area were in favour of a formal process, but there were differing views as to whether this should be undertaken directly by the chairman, or whether an independent facilitator should act as an honest broker giving anonymity over effectively 360° feedback. Most believed that feedback should be both at individual and collective level on board performance.

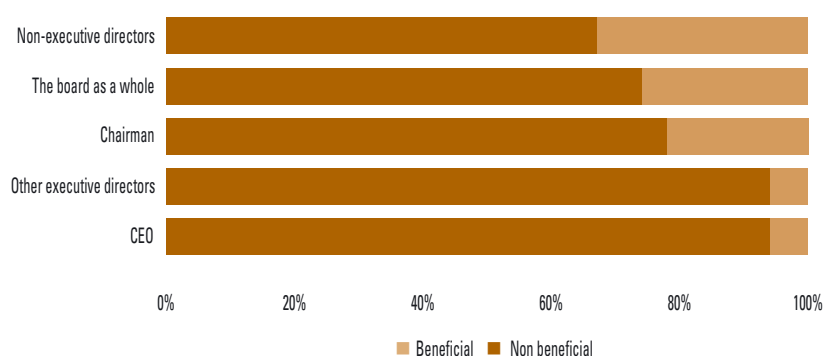
Finally, there was some criticism of non-attendance at board meetings – though previous KPMG studies have shown that UK board meetings are better attended than elsewhere in Europe. One respondent believed that non-attendance should be policed and serial offenders should ultimately be dismissed from the board. Others supported disclosure in the annual report and accounts of the number of board and committee meetings, and the attendance record of each director.

3.6 How to increase the pool of potential non-executive directors

Recruitment is a major issue as there is anecdotal evidence to suggest that headhunters are having increasing difficulty in persuading people to sit on boards and particularly on audit committees. Studies in the U.S. also suggest that fewer individuals want to take on the responsibility or commit the time required to be effective audit committee members.

It is imperative that the supply of good non-executive directors is not cut off. There have been calls, not least from the Trades Union Congress, for non-executive directors to be recruited from a larger pool of candidates. There might be merit in this, nevertheless, we believe that boards should recruit individuals who are best qualified for the job – and this may, or may not, include representatives from overseas, academia, the public sector and not-for-profit organisations. The debate should focus on setting open and transparent appointment criteria, not defining any particular category or group of individuals.

Figure 8: Is formal appraisal beneficial?



Source: KPMG survey

As part of our survey, we asked whether a number of suggested changes would increase the pool of people willing to put themselves forward as non-executive directors. The results are summarised in Figure 9.

It is clear from the above that the majority agreed that capping or otherwise limiting the liability of non-executive directors (69%) and greater financial rewards (69%) would increase the pool of non-executive directors. The personal risk involved in being a non-executive director is clearly a deterrent – especially in the current environment.

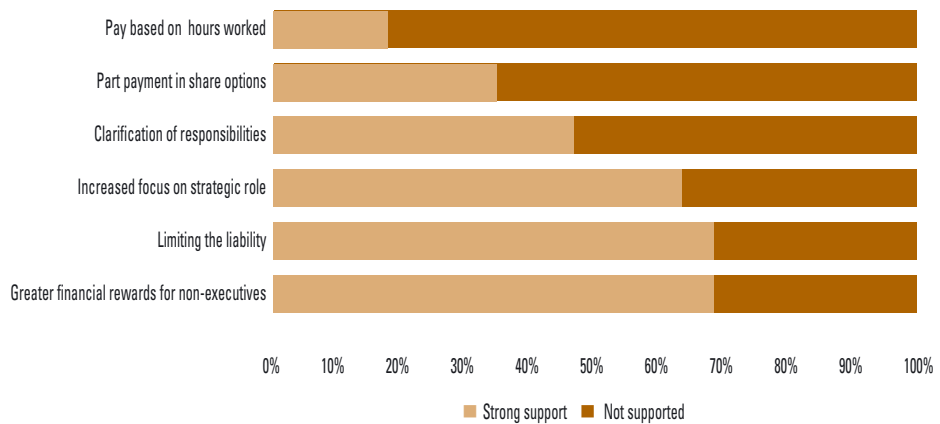
Respondents also cited greater clarification of the non-executive role (46%) and an increased emphasis on the strategic aspects of the role (64%) as initiatives that would increase the pool of available talent. It is to be hoped that the ‘Higgs’ guidance on the role of the non-executive director will have a positive impact in this regard.

By contrast, few respondents believed that fees based on hours worked, a proportion of executive remuneration, or share options would increase the pool of available talent. Nevertheless, many did believe that greater financial rewards for non-executive directors

would help, albeit one dissenting voice considered non-executives to be adequately paid at present. *“Individuals take on non-executive directorships for status and to gain experience, not for money. Paying more will not make any difference to their quality or quantity.”*

Of course, while many are quite rightly looking at how the pool of potential non-executive directors can be widened, several respondents raised concerns that the appointment of an ‘inappropriate’ board member can make a board ineffective.

Figure 9: Increasing the pool of non-executive directors



Source: KPMG survey

Other respondents suggested that nomination committees, and the recruitment consultants they engage, should be encouraged to go further down organisations to find talent. In particular, large organisations could encourage top management (the ‘marzipan’ layer) to take on non-executive positions in other organisations. Not only would this grow the pool of talented non-executive directors, but also would enhance the abilities and therefore contribution of the individuals concerned.

3.7 Market confidence

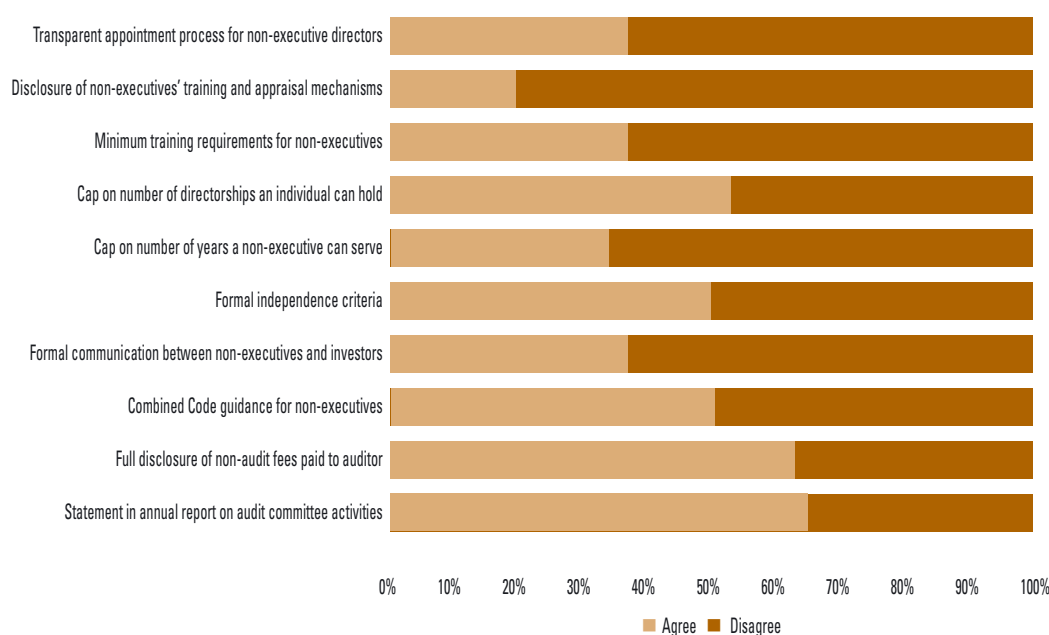
In response to recent interest in the effectiveness of non-executive directors, not least of which is Derek Higgs’ enquiry into their role and effectiveness, we asked participants whether they agreed or disagreed with a number of suggestions aimed at increasing public confidence in the role of non-executive directors. The results are summarised in Figure 10 below.

Perhaps reflecting the spotlight placed upon the independence of auditors, many respondents consider that the following would greatly increase public confidence:

- audit committee statements regarding the steps they have undertaken to review the independence of the external auditors; and
- disclosure of non audit fees paid to auditors in greater detail than that already required by the Companies Act 1985.

Over 50% of those responding agree that a cap on the number of directorships will help improve public confidence, but only 33% think that capping the number of years a non-executive director can serve in each company will help. Notwithstanding the perceived impact on public confidence, many respondents were wary about prescribing strict rules governing the number of non-executive appointments a individual may have. Several commented that the minimum time input is impossible to quantify and will vary with the role being undertaken. Other respondents highlighted the differing time demands on (say) audit committee members over those that have no committee duties. Likewise, it was noted that “*some non-executive directors hold executive positions while others do not.*” Even those who no longer have executive positions may have “*other commitments that take up large amounts of time.*” Each individual has different commitments and each organisation is different – though a practical constraint is the number of days in each month to read papers and attend board meetings.

Figure 10: Increasing public confidence in non-executive directors



Source: KPMG survey

Respondents did not indicate that disclosure of training and appraisal mechanisms would be particularly successful in improving public confidence. However, this should not be interpreted, *per se*, as a lack of appetite for training and appraisal.

Many respondents were of the view that non-executive directors should not, as a matter of course, meet separately with shareholders as such meetings cloud the issue of accountability and could be potentially divisive. It was widely held that this is an area for the chairman and chief executive and that it would be wrong for non-executives to take a lead other than on specific governance points. For example, the chairman of the audit committee might address shareholders in the context of the quality of the accounts and the chairman of the remuneration committee on remuneration.

Respondents were also asked to suggest other initiatives which might increase public confidence in their role. Some more notable suggestions were:

Clarifying role of non-executive director

Some non-executive directors are of the view that there needs to be *“much greater emphasis on the fact that both executive*

and non-executive directors have the same primary duty – to create value for shareholders.” Other respondents feel that having non-executive directors as a majority on the board would help. One person suggested that *“a formal definition of the non-executive role might be problematic given that the role can vary significantly as circumstances vary both within a company or between different companies.”*

More disclosure

Some non-executive directors are of the view that a report by the non-executive directors, within the annual report and accounts, might help to explain their work to the shareholders. However, it is not clear whether such a report would lend support to the unitary board concept, or be divisive.

Better transparency in recruitment process

Greater transparency and disclosure about the selection process and criteria were highlighted as an area for improvement. It was suggested that steps should be taken to increase transparency by openly advertising NED appointments in the public domain. Soliciting interest from a wide population coupled with a more rigorous and transparently objective approach to non-executive recruitment would robustly

confront the current, and often incorrect, perception that such appointments are unduly subjective.

More access to executives below board level

There appears to be widespread support for non-executive directors spending more time on company visits, meeting with divisional management and generally having a better understanding of the business.

No more legislation

In general, non-executive directors feel that increased legislation is not a solution to the current fall in investor confidence. Some non-executive directors question whether the public, fueled by media reports, is not overreacting. Others suggest that leaving the whole matter to market forces is perhaps the answer.

Meeting without executives

There is support for non-executive directors meeting amongst themselves to discuss issues and, in particular, the performance of the executive directors. Again, other respondents questioned whether such meetings threatened the unitary board concept – for which there was widespread support amongst respondents.

3.8 Effectiveness of governance processes

Participants were asked to indicate the extent to which they believe a number of governance processes and procedures are effective. The results are summarised in Figure 11.

It is surprising that in each of the four areas investigated, no more than two-thirds of respondents believed the stated governance processes to be effective – though a significant number were non-committal. In particular, three years after the Turnbull guidance emphasised the role of the whole board role in reviewing the system of internal control and risk management, it is perhaps disappointing that so many non-executive directors are unsatisfied with their systems.

The dissatisfaction with procedures for assessing the link between executive pay and performance is also disappointing. However, it should be remembered that this is a difficult area and establishing a robust link that provides an appropriate incentive in all circumstances is a complicated business.

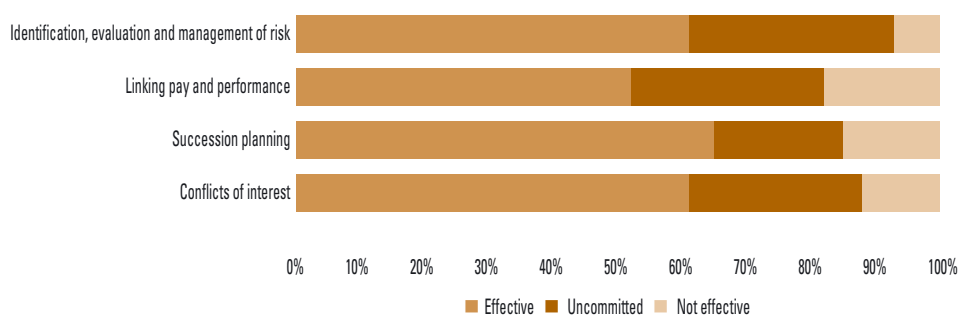
Finally, it can be argued that the selection, development and retention of the right CEO is the single most important responsibility of the board of directors. It is disappointing therefore that non-executive directors show such little faith in the procedures for planning for the succession of the CEO and other key executives – they should be responsible for helping ensure the right procedures are in place.

3.9 The Combined Code

Participants were asked if the structures for board committees recommended by the Combined Code facilitated good corporate governance and the effective contribution of non-executive directors.

The overwhelming majority of the respondents (92%) supported the current Combined Code arrangements and there was widespread resistance to imposed legislation. Indeed some non-executive directors felt that the current Combined Code arrangements were already too prescriptive and further guidance (or regulation) would merely increase the administrative burden on non-executives and may even lessen their effectiveness.

Figure 11: The effectiveness of governance procedures



Source: KPMG survey

One non-executive director controversially commented that *“too many non-executive directors have no real interest in board committee work”*. Others thought that the effectiveness of board committees depends to a large extent on the committee chairman. Specific training for committee members – and in particular committee chairmen – was advocated by many.

3.10 Audit committees

Participants were asked if they have any comments on the composition and duties of audit committees, and whether the existing Combined Code provisions for audit committees needed strengthening.

Most respondents (85%) did not believe the existing Combined Code provisions needed strengthening and several commented that the existing guidance was already comprehensive. Notwithstanding this resistance to change, the Financial Reporting Council’s group, under the chairmanship of Sir Robert Smith, has developed the existing guidance for audit committees contained in the Combined Code.

Respondents showed widespread support for having at least one experienced accountant on the audit committee (often the chairman). This is no doubt a sensible suggestion. However, consideration has to be given as to what this means in practice. What level of expertise? How recent should the experience be? Should all audit committees be treated the same?

While Sarbanes-Oxley has gone some way to defining the appropriate level of expertise for audit committee members, respondents were not supportive of the regulatory approach taken in the U.S. Instead, many believed that the debate should focus on the qualities required by audit committee members and the procedures that encourage those qualities.

Some respondents were wary of increasing the audit committee’s powers such that they become solely responsible for recommending the appointment of auditors to shareholders as this may not always be in shareholders’ best interests. They argue that an audit committee with untrammelled authority is inclined to be too cautious and restrictive. It is the balance of non-executives and executives that makes a unitary board work effectively and best protects the interests of shareholders. Too cautious a view will not provide the right balance between risk and reward for shareholders.

The Financial Reporting Council with its subsidiaries, the Accounting Standards Board and the Financial Reporting Review Panel together make up an organisation whose purpose is to promote and secure good financial reporting in the UK.



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Non-executors' survey 2002/3

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