



 **ERNST & YOUNG**

Quality In Everything We Do

Board Performance

Non-Executive Directors and
Their Contribution to Business Performance

Introduction



Gerald Russell
Senior Partner – London
Chairman – Non-Executive
Director Programme

One year on from November 2003, when the major part of the Higgs Review¹ (the Review) was incorporated into the Combined Code, it is valuable to research any changes in the perception of board performance by those most under the spotlight – Non-Executive Directors (Non-Executives). The Review focused on the contribution of Non-Executives and aimed to balance board effectiveness and performance on the one hand and appropriate risk management on the other.

In a recent interview Patricia Hewitt, Secretary of State for Trade and Industry, said, “*Derek Higgs’ Review was never meant to be set in stone. It was intended to start a debate.*”² This report contributes to the debate by exploring the personal perceptions of Non-Executives regarding the extent of their contribution to business performance. Given recent interest by investors in the performance of boards, this report is particularly timely.

As every week goes by, comments or surveys suggest that boards of directors, and particularly Non-Executives, are having their time directed to dealing with compliance matters emanating from regulators the world over.

So is the impact of the Combined Code and the march of regulation limiting the effectiveness of Non-Executives operating as part of a unitary board? Is conformance impacting performance?

Difficult questions. This research gives some interesting pointers as to how Non-Executives see their role and their contribution to their companies’ performance. It is good to learn from the research that most Non-Executives are far from being discouraged. Indeed, whilst there are real concerns about the potential for an over-regulated environment, Non-Executives see their primary role as enhancing business effectiveness.

This is good news as increasing the effectiveness of Non-Executives is an issue that Ernst & Young has been addressing over the last few years. Our activities include the Independent Director Initiative, our joint venture with the Institute of Directors; the Ernst & Young Non-Executive Director Workshop Programme on issues of topical interest; and our investment in an online service dedicated to Non-Executives at www.non-execs.com.

I am pleased that Ernst & Young can contribute to the ongoing debate through this thought-provoking report.

Overview

Background and Methodology

There is an ever-expanding body of academic research on boards and Non-Executives but the findings are contradictory and typically use secondary sources to develop statistical models of performance. We expected that by taking a different approach, conducting face-to-face interviews with a representative sample of Non-Executives, we would be able to bring new insights into the impact that Non-Executives have on business performance and how this impact is made.

By guaranteeing our participants anonymity we were able to elicit candid and refreshing perspectives on a Non-Executive's ability to contribute to business performance. This ranged from one participant suggesting that some Non-Executives still suffer from "the mushroom syndrome" – they are put in a dark cupboard and the light is only flashed on them now and again to check they are still there – to concerns about how Non-Executives and boards will cope in an over-regulated environment.

This report was developed from independent research commissioned at the University of Bath School of Management and the Oxford University Saïd Business School, advised and guided by exec-appointments.com.

The Bath study comprised face-to-face interviews with 18 Non-Executives and part-time Chairmen who worked for companies either listed on the London Stock Exchange or the Alternative Investment Market. These Non-Executives represented 43 different boards and a wide variety of industries. Their ages ranged from 44 to 70 and the male/female ratio was 78%/22%. Sir Derek Higgs was also interviewed.

The Oxford study used two different methods: face-to-face interviews with FTSE 100 and other Non-Executives, and an online survey of 65 FTSE 100 and other Non-Executives provided through the database of *The Non-Executive Director* at www.non-execs.com.

This research was designed to go beyond the Review and develop insight into how Non-Executives are contributing to business performance. While it was inevitable that the participants would comment specifically on the Review, this report has implications in new areas that have not previously benefited from a structured research approach.

We had several objectives:

- to establish if Non-Executives believe they make a vital contribution to "wealth creation" and their own view of their effectiveness;
- to establish how Non-Executives make such a contribution;
- to identify which crucial activities have the greatest impact on business performance;
- to establish what factors might constrain the Non-Executive from making the best contribution; and
- to determine whether or not they have achieved the right emphasis between the conformance and performance aspects of their roles.

From this investigation we have made suggestions which will enable Non-Executives and their boards to enhance their contribution to business performance. Topics include whether or not formal qualifications for Non-Executives are required or desired, the impact of tenure, and how selection, deployment and evaluation of Non-Executives may be approached.

Overall, the consensus amongst Non-Executives appeared to be that the Review's recommendations were useful in clarifying the requirements of the Combined Code, although they raised some notes of caution with regard to the possible constraining effect of further governance regulation.

One particularly salient quote from the online survey was:

"There have undoubtedly been changes since Higgs, although the extent to which these can be attributed to his report is unclear. It was perhaps a timely catalyst in encouraging City institutions and companies to think a little more deeply about the role and potential contribution

The Higgs Review

In the “Review of the Role and Effectiveness of Non-Executive Directors”, Sir Derek Higgs recommended that by ensuring sufficient emphasis on both the conformance and performance aspects of their role, Non-Executives can make a contribution to “wealth creation”.

The primary objectives of the Review were to re-invigorate the role of the Non-Executive according to the needs of UK boards; to provide further clarity on Non-Executives’ responsibilities; and to suggest what boards could do to strengthen the quality, independence and effectiveness of Non-Executives.

In the Review Higgs outlined four primary tasks for Non-Executives:

- **Strategy:** constructively challenge and contribute to the development of strategy.
- **Risk:** satisfy themselves that financial information is accurate and that financial controls and systems of risk management are robust and defensible.
- **People:** responsibility for determining appropriate levels of remuneration for Executive Directors and have a prime role in appointing, and where necessary removing, senior management.
- **Performance:** scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance.

of Non-Executives. For good or bad, Non-Executives are now expected to make a more formal contribution to corporate governance than hitherto. They are also being expected by some companies to contribute dramatic new ideas and insights. It is this climate of expectation that, more than anything, could help bring about change.”

Several themes emerged from the research:

- the confidence of the participants in their ability to contribute positively to business performance, although the magnitude of perceived impact varied considerably;
- the overarching importance of the Non-Executive’s strategy role and how relevant industry experience and perspective are indispensable;
- the unwillingness of Non-Executives to sacrifice time spent on performance activity to conformance activity, resulting in a rapidly increasing overall time commitment to deal with the escalating burden of national, European and international regulation;
- the criticality of the role of the Chairman in creating the board and company culture, selecting and motivating the Non-Executives and driving all types of business performance;
- the discovery that while the Review recommended a maximum of two three-year terms for Non-Executives to remain independent, tenure appears to make no difference to the impact of their contribution;
- the implication that industry experience is the foremost requirement for selection and that previous experience as a Non-Executive is not necessarily important;
- the view that a uniform qualification for Non-Executives is unrealistic and impractical;
- the recognition that the selection criteria for Non-Executives are changing significantly although the selection process still relies heavily on personal networks to deliver candidates; and
- the importance of the total board’s contribution to business performance, rather than by any single Non-Executive, and how team working is believed to enhance performance.

Research Findings

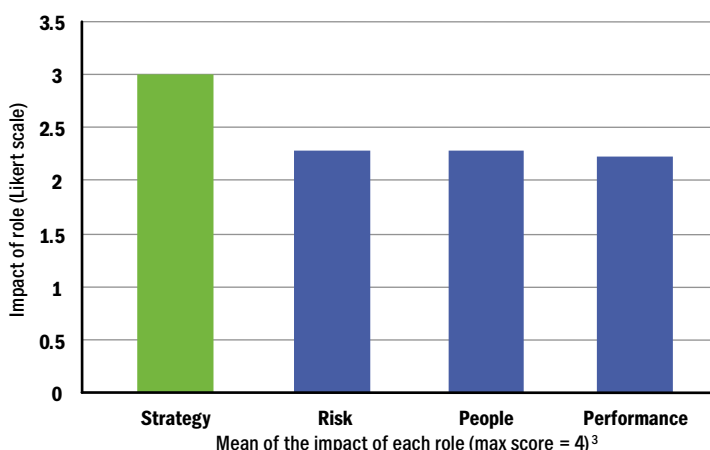
The research findings have been distilled into four areas.

1. How do Non-Executives contribute to business performance?

The participants were unanimous in believing that they made a vital contribution to business performance although there was significant individual variation. Almost all also believed that they had found the right emphasis between conformance and performance, despite apportioning their time across the roles very differently. Factors determining each Non-Executive's focus were their deployment on the board and the pressures and opportunities facing their companies.

We set out to understand *how* they make this contribution.

The value of teamwork, co-operation and good working relationships were key factors in enabling Non-Executives to contribute to business performance and were consistent themes in the interviews, as was the pivotal role of the Chairman.



When interviewed about their contribution to business performance via their four roles, the overwhelming conclusion was that the strategy role was perceived to have the greatest impact. Indeed, the mean impact of the Non-Executives' perceived contribution via their strategy role, on a scale of 0 to 4, was 3 compared to both risk and people where the impact was 2.28 and performance was 2.22.

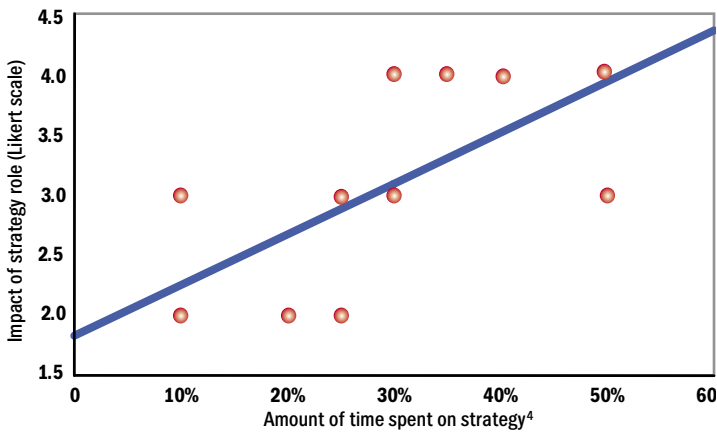
Interview Perspectives

In our interview Sir Derek Higgs said that he felt the Review threw a "good deal of daylight" onto the role of the Non-Executive, helping them to be more aware of how to maximise their contribution and helping Chairmen to deploy Non-Executives to best effect. He said:

"The challenge we have in the UK is to raise performance by encouraging rigorous behaviour and judgement and effective decision-making at the top of companies by boards who are acting as stewards for the shareholders. One way boards can be effective is to make sure there is not too much risk but more importantly another is to make sure that they are doing the right things in creating wealth."

Although the participants represented a wide range of industries and experience they were remarkably consistent in their views of their ability to contribute to business performance. They were also broadly consistent in their practical perspectives, interest and dedication to their respective companies, and commitment to their fellow board members.

One particularly relevant comment from a FTSE Chairman was that Non-Executives can only contribute to performance "if two absolutely key things happen: first that he/she receives timely and accurate information and secondly that the Executive Directors are prepared to communicate with the Non-Executives."



In our interview Sir Derek Higgs emphasised the challenging aspect of the Non-Executive’s contribution, saying, “The one fundamental right and obligation of the Non-Executive is to keep asking questions until they get an acceptable answer.”

Several participants considered a key omission by the Review was the contribution the Non-Executive makes in the creation of the corporate culture. Establishing a culture of openness and transparency is essential for promoting integrity and ethics in the company. Thus the influence of Non-Executives, and specifically the Chairman, is felt beyond the boundaries of the board.

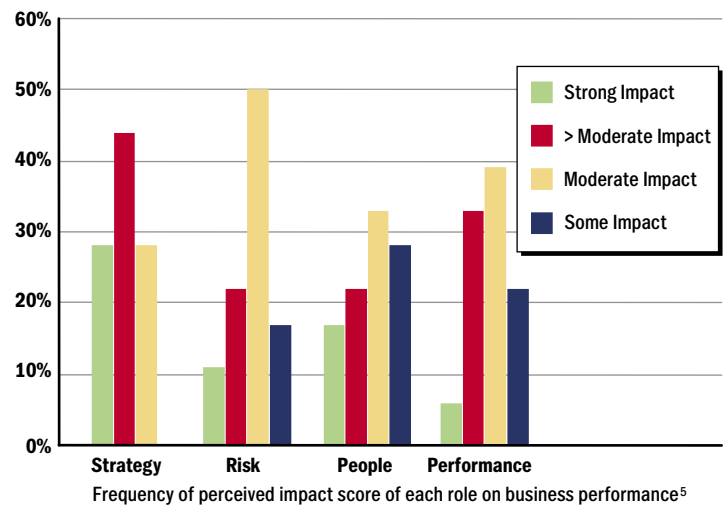
Further analysis of the data endorses the importance of the strategy role. There is a strong positive correlation between the time a Non-Executive spends on their strategy role and the perceived level of impact their contribution has on business performance. Interestingly, for the other three roles there was no such positive correlation, implying that more time spent on these roles does not necessarily reap performance dividends.

All of the participants were actively involved in their respective companies’ strategic planning and decision-making processes and saw it as a natural, expected, desired and essential aspect of their role. The traditional image of the Non-Executive, constrained from being able to participate in organisational decision-making or employed only to carry out a governance function is, therefore, not borne out by our research.

The majority believed that their contribution via their other three roles was also important and needed to be balanced with strategy. Non-Executives are responsible for selecting, replacing, and monitoring the performance of management. It is clear the participants recognised that without their focus and capability in these areas the business may be at risk of underperforming. The pendulum should not swing too far towards a ‘fashionable’ focus on strategy.

Participants identified additional approaches through which they believe Non-Executives have an impact on business performance:

- providing objective advice;
- bringing specialist consultancy advice;
- working as a board team;
- constructively challenging management; and
- contributing to the organisational culture.



Implications for Management

- The balancing act required to address adequately each of the four roles, combined with increasing corporate governance and regulatory demands, means that FTSE Non-Executives should expect to commit *at least* 3 days a month.
- The Non-Executives with the most relevant strategy skills will bring an industry perspective such as from a competitor, customer or regulator.
- Directors and shareholders are right to demand that the Chairman be effective. One participant summed up the importance of the Chairman in creating a high-performance environment, “The culture on the board depends entirely on the Chairman and many people like me will only work for companies where there is a good one.”

2. How can Non-Executive contribution to business performance be assessed?

Non-Executives do not believe that their impact on business performance can be measured by changes in high-level financial indicators. The participants argued that it was difficult to segregate the effect of individual factors because company financial performance is subject to a variety of macro-economic, sector-specific and company-specific influences. However, two methods to assess the impact of their contributions were suggested:

- subjective self-examination of their individual performance, combined with board appraisal; and
- evaluation of their impact retrospectively over a long-term period (for example, against strategic decisions such as acquisitions and divestments).

The participants were keen to place the exploration of how a Non-Executive individually contributes to performance into the broader context of all the directors on the board. Higgs also told us, *“You can’t only talk about Non-Executives because they are only one part of the unitary board unless you throw out the unitary system. I wouldn’t do that and nobody in the consultation period for the Review was in favour of that either.”*

The importance placed on board appraisal indicates the support of participants for the Review’s recommendation that appraisals are undertaken. However, several of the boards represented have only just initiated board assessment in response to the Review.

Implications for Management

- Boards that do not address the assessment process pro-actively will undoubtedly have it forced upon them by shareholders.
- There is an inherent conflict between how the Non-Executives believe their impact can be measured (on long-term performance) and how shareholders want to measure them (on short-term performance).
- The board working as a team was considered an essential ingredient in enabling it to make a vital contribution to business performance. How to measure the success of this aspect of board performance will be a challenge for most companies.

3. How do Non-Executive tenure and qualification influence contribution to business performance?

The Review recommended that six years is the maximum appropriate tenure for a Non-Executive to remain independent. But does tenure affect contribution to business performance? The research findings suggest that comparing Non-Executives who have served on the board of a single company for more than six years with those who have served for less than six years shows no difference in their perceived level of impact on business performance. There is also no difference in perceived level of impact that their contribution has in their strategy role.

There are two possible reasons for these results. Firstly, the ability to make an impact may be influenced more by individual skills and knowledge than by longevity. Secondly, new Non-Executives may be willing to expend greater time and effort in discharging responsibilities to be fully effective. This was the case for participants who had worked for their companies for less than a year. They spent an average of five days a month on their role, in comparison to the overall average time of three days.

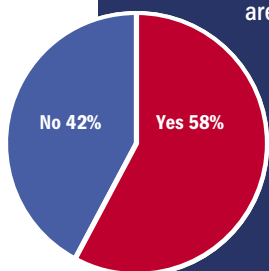
Related to tenure is whether a formal Non-Executive qualification is required to raise the standards of Non-Executive contribution to business performance. The comments from the online survey indicated that trying to force a standardised qualification on Non-Executives might make it difficult for boards to acquire the different skills required to respond to dynamic market situations.

Implications for Management

- The length of time a Non-Executive has served on a single board does not appear to affect their impact on business performance.
- One qualification to cover all the possible permutations of the Non-Executive’s role is likely to satisfy only the policy makers. As one Chairman noted, *“The reality is that, particularly in a fast-changing world, people come with partial skills and we have a limited supply of them. There are quite tough demands in terms of time and effort and we have set the bar for our expectations of Non-Executives very high.”*

Qualification – An Emotive Subject

The online survey provides insight into the current mood of Non-Executives on a standard qualification. Three areas were of particular interest.



1. Should there be a standard-setting body in the UK to qualify potential FTSE350 Non-Executive Director candidates before they take up their roles?

Although the majority said there should be a standard-setting body, the comments on this question were particularly negative and interesting.

"I believe the role justifies specific training but I cannot at present foresee a formal qualification which would be of universal application and benefit."

"I have real difficulty with qualification. It is too simplistic and won't prevent the things it is supposed to or guarantee the things we'd like."

"To add a meaningless qualification layer on top would be a very bad move; stifling creativity in appointments and creating a cadre of the 'golden circle' would make it become even more of a closed shop."

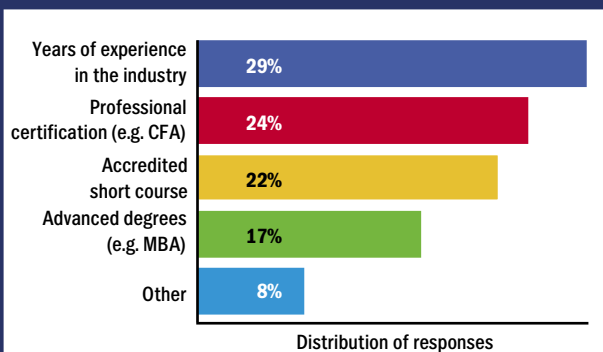
2. When asked which organisations represent a suitable governing body, the Government was the least popular.

"Why is there this tremendous need to interfere from a regulatory standpoint in every area of corporate life?"

"Keep the Government well away from it!"

"The difference between the UK and continental Europe is the UK is trying too hard to be politically correct."

3. If qualification was not practical, what could be used as a substitute to qualification?



4. What constrains Non-Executives from contributing to business performance?

The participants' comments on possible constraints upon their ability to contribute to business performance were remarkably similar. The three key areas and suggestions for removing the constraints are:

Board structure and process – receiving the right company information at the right time.

Board behaviour and relationships – a cooperative attitude from the Executive Directors; and an able Chairman who is not only effective but also encourages the right team dynamic.

Personal input to the role – devoting enough days per month to relieve pressures on time for complying with corporate governance regulation; and obtaining sufficient industry knowledge.

Implications for Management

- Additional Non-Executive compliance activities do not appear to be undertaken at the expense of other activities. Instead the time commitment, and hence remuneration, is increasing and in many cases doubling from as little as two years ago.
- Current industry knowledge is key if the Non-Executive is to make a relevant and efficient contribution to business performance.
- Any new corporate governance regulation may not be well received. If the Government is intent on expanding regulation (and prosecution) there is a reasonable expectation that the best Non-Executives will opt-out of listed company roles. The online survey revealed that the number one reason why Non-Executives would refuse a role was because of risk to their personal reputation.
- The impact of a poor-performing Chairman on overall business performance can be disproportionately negative.

Practical Actions

Qualification

Respondents to the online survey suggested training, in the form of personalised coaching or publicly available courses, as a suitable alternative for raising the quality of Non-Executives. The comments suggest there is a clear need for education for Non-Executives but there were concerns about the quality, affordability and relevance of available programmes. Attempts by the Government to regulate qualification are likely to be vociferously opposed.

Specification and Selection

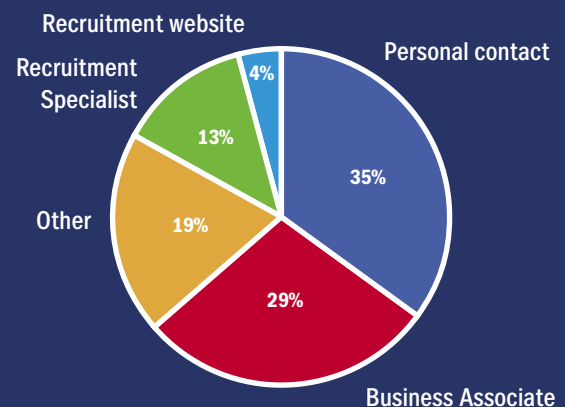
Before setting out to select new Non-Executives the Chairman should have a clear and objective assessment of board attributes, strengths and weaknesses as well as the needs of the company. Developing the Non-Executive specification will enable the board as a whole to agree the characteristics they believe will enhance board contribution to business performance.

Irrespective of the process used for final selection, boards that value high performance will devote sufficient resource to specifying adequately their Non-Executive requirements.

When selecting the best Non-Executive director candidates for a board it should be considered whether their attributes, knowledge and experience have the potential to increase board performance, while providing balance with the rest of the board. One Chairman noted, *“You would be mad not to recognise that you are surrounded by a patchwork quilt of talents and that contribution in some areas will be informed and definitive but in other areas it will be a point of view.”*

Has the Higgs Review had an impact on Non-Executive selection?

The online survey asked, *“Through which channel did the company at which you hold (or will hold) your most recent Non-Executive position, identify you?”*



“The Review has led to greater recognition and appreciation of the Non-Executive role. However, there has been little movement towards more open competition and little evidence of new blood being sought.”

“Networking and word-of-mouth are the most important sources for identifying Non-Executive positions. There may have been some change in making the recruitment process more transparent and professional but it does not yet appear to have yielded markedly different results.”

Source: Online survey

In addition, candidates should:

- be equipped to contribute to business performance across all four roles, with strategic ability being most important;
- bring relevant specialist skills that complement the rest of the board and meet anticipated changing company demands;
- interact well with him/her; and
- be a team player with other board members.

An interesting finding of the research is that the period of time the individual has been a Non-Executive appears to make little difference to their perceived impact on business performance. This suggests that when selecting new board members the individual's skill set is more important than their prior experience as a Non-Executive.

Thus the idea that the pool of candidates for Non-Executive directorships should be widened has support.

Consistent with other recent reports there appears to be little change in how Non-Executives find new opportunities. While the Review was clear in its prescription for finding new Non-Executives, the majority still rely on personal networks. The practical reality is that the selection process only appears to come into question when a board is failing.

Deployment

Deploying Non-Executives to enhance business performance is an art, not a science, and very dependent on the Chairman's style and experience. It is also important that Non-Executive deployment is not a one-off exercise but monitored on a regular basis. We have discussed various ways Non-Executives contribute to business performance, both in terms of their roles and how they approach their work (team working behaviours).

It appears to be important and desirable that every Non-Executive contributes to all four roles, albeit with a specialist focus. Artificial segregation of the conformance/performance roles – as some commentators suggest – is likely to be unhelpful.

Maintaining an effective team tackles some of the major constraints on the Non-Executives' ability to contribute to business performance. Combined with an effective

Chairman, team working is perhaps a necessary, but not necessarily sufficient, condition for impacting business performance positively.

Board Appraisal

Consistent with Higgs' recommendation in the Review, the research findings suggest that boards should have a robust board and director appraisal process. The Review did not, however, provide any explicit recommendations on how to carry out this process.

In accordance with the participants' suggestions that it is possible to assess value-adding activities by measuring them against expected results, we recommend that boards:

- identify specific decisions/initiatives deemed to be vital to the board's success in contributing to business performance;
- identify expected behaviours necessary to maintain constructive teamwork and sufficient balance between control and collaboration;
- set target Key Performance Indicators (KPIs);
- measure both the individual director's (both Non-Executives and Executives) performance and the team's performance and progress against KPIs; and
- feedback progress and the results of assessment to ensure learning and improvement.

The appraisal of individual directors must be carried out with sufficient sensitivity not to undermine board camaraderie. Given the importance of the Chairman in instilling the right board culture for effective Non-Executive contribution, providing constructive feedback to him/her is also of critical importance.

As a result of clearly defined performance expectations and distinct metrics, we propose that an effective board and director appraisal process:

- increases focus on delivery of business performance;
- provides a way of measuring individual Non-Executive and Executive Director contribution to business performance as well as that of the board as a whole;
- highlights any underperforming directors; and
- enables the board to face external criticism objectively.

Authors

		
Ernst & Young LLP	exec-appointments.com and <i>The Non-Executive Director</i>	Claire Usher
Gerald Russell Senior Partner- London Chairman – Non-Executive Director Programme	Betty Thayer Chief Executive	
Tel +44 (0) 207 951 3434 Fax +44 (0) 207 922 1485	Tel +44 (0) 845 458 9850 Fax +44 (0) 845 458 9840	Tel +44 (0) 7952 009163
neds@uk.ey.com www.ey.com/uk	director@exec-appointments.com www.exec-appointments.com www.non-execs.com	claireusher@fsmail.net

Acknowledgements

The authors wish to thank:

Dr Philip Cooper
School of Management
University of Bath
Claverton Down
Bath BA2 7AY

Tel +44 (0)1225 386544
Fax +44 (0)1225 386473
p.cooper@bath.ac.uk
www.bath.ac.uk

Agnes Cheung, Javier Licea, Rachel Roberts and Alan Tam
Saïd Business School
Oxford University
Park End Street
Oxford OX1 1HP

Tel +44 (0) 1865 288847
Fax +44 (0) 1865 288805
enquiries@sbs.ox.ac.uk
www.sbs.ox.ac.uk

Footnotes

- 1 Higgs, Derek. 'Review of the role and effectiveness of non-executive directors'. January 2003.
- 2 Clawson, T. 'Squaring the Circle' Profile of Patricia Hewitt. *PLC Director*. July/August 2003.
- 3 Each interviewee selected an impact score for each of four categories. For strategy, 44% ranked this a 3 and 28% a 4.
- 4 A Spearman Rank test was used to measure the strength of correlation. The correlation coefficient was .743 with a two-tailed p-value of <0.05.
- 5 Where Some Impact = 1; Moderate Impact = 2; >Moderate Impact = 3; and Strong Impact = 4.

Ernst & Young LLP

www.ey.com/uk

© Ernst & Young LLP 2004. Published in the UK. All rights reserved.

1 More London Place, London SE1 2AF

The UK firm Ernst & Young LLP is a limited liability partnership registered in England and Wales with registered number OC300001 and is a member practice of Ernst & Young Global.

Information in this publication is intended to provide only a general outline of the subjects covered. It should neither be regarded as comprehensive nor sufficient for making decisions, nor should it be used in place of professional advice. Ernst & Young LLP accepts no responsibility for any loss arising from any action taken or not taken by anyone using this material.

2272.indd 11/2004 Produced by Ernst & Young Creative Services.