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David Young and Lawrence Reed, Senior Advisors, Independent Audit Ltd

Ethics, risk and governance

'Many boards acknowledge the importance of a healthy corporate culture, both because of the role this plays in mitigating risk and because of the value to their franchise of a sound reputation. A healthy culture also reduces politics inside the company and makes for more engaged employees. Yet there is often a temptation to see embedding culture as largely a compliance exercise, whereas values actually go to the heart of what a business is and how it works.'

Peter Montagnon, Associate Director, Institute of Business Ethics

Content

International 3 **Russian boards survey**

Global News 4 **Corporate governance in South Africa**

Diversity deadline approaches in India

Investing in IT governance

Features 6 **NAS: the new nightmare**

David Young and **Lawrence Reed** look at the implications of the recent EU regulations on Non-Audit Services (NAS) which companies and their auditors need to have regard to well before the regulations come into force

8 **Ethics, risk and governance**

In an extract from a recent Institute of Business Ethics board briefing paper, **Peter Montagnon** argues that the role of the board in instilling a healthy corporate culture goes far beyond mere compliance

10 **Evaluation and development of 'non-PLC' boards**

David Archer argues that other boards can now benefit from the wealth of experience that exists on how to conduct effective PLC board evaluations and to get real change from the results

Essential, Authoritative Analysis and Opinion for Board Directors, Senior Executives, Investment Professionals and Advisers

Editorial Board

International

Russian boards survey

'Technological breakthroughs and the shift in the global economic balance of power are the focus of Russian boards', according to PwC's third annual Russian boards survey. The focus of the survey, *Russian boards survey 2014*, was identifying how corporate board members view various megatrends, how they perceive these trends in the context of their company's operations and how their companies can adapt and prosper in an environment of ongoing global change.

Over the next five to ten years the following global megatrends will have an impact on business:

- Technological breakthroughs
- Shift in global economic power
- Demographic shifts
- Accelerating urbanisation
- Climate change and resource scarcity.

The megatrends reflect key factors in contemporary global development and though a fairly equal number of directors saw the megatrends bringing either risk or opportunity (or both) their answers also revealed two big insecurities: how to mitigate the risks and how to seize the opportunities.

Few respondents to the survey described themselves as 'very comfortable' with their board's understanding of risks related to the megatrends.

Boards are changing their behaviour to address insecurities around risk and opportunity: 86 per cent want to devote greater time to technological breakthroughs when considering strategy and 69 per cent want to take a closer look at the likely impacts of shifts in global economic power.

Sixty-five per cent of respondents believe global trends have a significant impact on their corporate operations and only seven per cent are confident that megatrends will have no impact on their company's business.

Although climate change and resource scarcity is globally the leading concern, they do not currently rate as hot topics for most Russian boards. Fifty-two per cent of Russian corporate directors do not believe that these trends will have a significant impact on how their company's business is organised or how it operates.

Directors want their boards to dedicate more time and focus on assessing risk and opportunities presented by megatrends and their potential impact on company strategy, 28 per cent seeing new opportunities in these trends for their companies.

Technological breakthroughs and the on-going shift in global economic power were perceived by Russian directors as being the most influential of the megatrends.

Boards must better understand megatrends by taking a sustainable approach and put in place systems to monitor changing conditions and related risks and seek the best ways to address them.

Boards continue to prioritise executive oversight and compensation. Ensuring succession planning and bringing executive motivation in line with a company's strategic objectives and long-term performance are absolutely crucial.

Whilst only 17 per cent of boards study surveys on megatrends and discuss related risks and opportunities on a regular basis, most boards do consider certain strategies to respond to relevant megatrends. Responses were ranked as follows: 62 per cent consider strategies of penetrating new markets; 52 per cent consider strategies of diversifying products/ services; 48 per cent consider innovation strategies; 41 per cent consider sustainability and corporate social responsibility strategies; and 34 per cent consider anti-crisis plans. Only seven per cent of respondents say that their boards do not respond to megatrends in some way.

Boardroom trends and priorities

Current trends in Russian boardrooms include: directors' time commitment is on the rise; directors want board meetings to be less formal and to include more open discussions; board evaluations are on track to move from form to substance; boards continue facing a shortage of skilled directors; and sitting on a board is not about money, but about finding an interesting and dynamic environment.

In terms of priorities, seven hot topics for Russian boards in 2014 were ranked as follows:

1. Strategic planning.
2. Executive succession planning.
3. Crisis management and planning (factoring in megatrends-related risks).
4. Developing human capital (including analysis of megatrends such as demographic change and rapid urbanisation).
5. Overseeing strategic use of technology and related risks.
6. Review of executive performance and compensation.
7. Risk management.

It is clear that boards must better understand and respond to megatrends. Board meetings should have more discussion of key business issues and there should be engagement with a wider range of stakeholders to identify trends and be more responsive. A sustainable approach should be taken by putting in place systems to monitor changing conditions and related risks and seeking the best ways to address them. Perhaps most importantly, Russian boards do seem willing to change and adapt, whether by seeking additional expertise or changing the composition of their board committee.

The full report can be found at: http://www.pwc.ru/en/governance-risk-compliance/board-survey-2014.jhtml

Global News

Corporate governance in South Africa

'Organisations in South Africa are becoming less effective at corporate governance', according to a recent report published by the Institute of Internal Auditors South Africa. The report, *The Corporate Governance Index – an Internal Audit Perspective*, aims to advance understanding of strengths and weaknesses of corporate governance in South Africa and offers a valuable perspective on how well South Africa is performing in ensuring that organisations in all sectors of the economy are applying good governance principles and meeting their objectives in an ethical, competent and sustainable manner. It also provides management, boards and audit committees with a perspective on emerging corporate governance trends in South Africa. Views of Chief Audit Executives regarding the state of governance in their organisations were sought as well as what they regarded as their key priorities in the near future.

There is a growing perception that organisations are struggling to achieve effective corporate governance: the most challenging areas being performance and risk management. South African organisations are strongest at setting the right ethical tone for the execution of good corporate governance but struggle most at identifying external risks, although they seem to do better at operational or internal risk management. Only 51 per cent of respondents strongly believe that their organisations comply with relevant legislation, regulations and standards.

Chief Audit Executives at non-profit companies were most positive about the organisation's overall corporate governance culture and performance, followed by publicly-held companies.

Compared with results in 2013, respondents are slightly less impressed with the quality of leadership, only 37 per cent believing that organisational leaders are 'functioning optimally in delivering strategy'. Respondents feel that their leadership's understanding of the role and value of internal audit is slightly lower than in the previous year.

The two weakest areas in terms of the overall Performance Index are Human Resource management and Information Communications Technology (ICT) governance.

In terms of industry sector, Tourism/Hospitality/Food and Beverage/Recreation are the top performers according to respondents working in those sectors, with the Health and Pharmaceuticals industry a close second. Public service respondents gave their sector the poorest rating.

The top five areas of focus over the next few years are, in order of priority: Human Resources; ICT; Compliance; Ethics and Leadership; and Fraud and Corruption.

For the full survey results go to: www.iiasa.org.za/?page=CGRI

Diversity deadline approaches in India

With just one month left to comply with the Securities and Exchange Board of India (SEBI) corporate governance guidelines, more than half of the 1,469 Indian companies listed on the National Stock Exchange of India (NSE) are yet to appoint a woman director onto their boards. Corporate governance norms, issued by SEBI in February this year and coming into force from 1 October, mandate all listed companies should have at least one woman director on the board. According to data provided by www.Indianboards.com, a joint initiative of Prime Database and NSE, as at 31 August as many as 755 (51 per cent) companies out of a total 1,469 NSE-listed firms are yet to appoint a woman director on their respective boards.

According to the data, in over six months since SEBI issued the new norms, 264 women have been appointed to 274 directorship positions in 264 NSE-listed companies. Of these companies, 244 firms have complied with the requirement since the SEBI guidelines were issued, whilst 20 firms already had woman on their boards and following the new norms had hired a second female director. The data further revealed that of these firms, 242 women have been appointed to 251 directorship positions.

Interestingly, at least 45 of these 251 directorship positions have been filled by appointing women belonging to the promoter group of the company. These firms include Reliance Industries, JK Tyre & Industries, JK Cement, Edelweiss Financial Services, Asian Paints, Just Dial and Godfrey Phillips India.

A further 69 of the 251 positions are non-independent, thus leaving only 137 positions that are apparently independent. Two-hundred and twenty women hired on the boards of listed firms are first time directors of a listed company, however, of these, 42 women (holding 44 directorship positions) are from the promoter group and a further 65 women (holding 65 directorship positions) are non-independent, leaving only 113 who are independent.

Across all 1,496 NSE-listed companies, there are still only 696 women (7.1 per cent) occupying 830 directorship positions, 428 holding 463 non-independent directorships, and only 290 collectively occupying 367 independent directorship positions. Only 34 companies have a woman chairperson or co-chairperson, only one of which is independent.

For updates to this data and other board-related statistics go to: http://indianboards.com/pages/index.aspx

Investing in IT governance

'Australian organisations are seriously under-investing in IT governance particularly at a time when they are highly dependent on technology systems across all operations', according to a research paper – *Perceptions and practices of the corporate governance of information technology* – conducted by Monash University and Deakin University, in conjunction with CIO Australia. The survey was carried out amongst 143 senior executives – predominantly Chief Information Officers (CIOs), IT Directors and Operations Managers – working at large corporates and small and medium businesses.

Nearly one-fifth (19 per cent) of respondents said that the proportion of annual turnover devoted to corporate governance of information technology (CGIT) was zero; only seven per cent indicated it was ten per cent or higher; and a further 17 per cent indicated that they did not know how much their organisation spent on CGIT. The investment, expressed as a proportion of turnover, can be seen as an indicator of resource commitment, reflecting the perceived importance of this aspect of governance and could suggest that most Australian organisations are seriously under-investing in this critical area, all the more concerning given the increasing dependence that organisations have on IT systems across all operations.

In terms of IT governance frameworks and managements systems, more than half (59 per cent) of the respondents had implemented the ITIL (Information Technology Infrastructure Library) management framework. Fifty-three per cent had implemented Prince 2, 20 per cent had implemented COBIT (Control Objectives for Information and Related Technology), 15 per cent CMMI (Capability Maturity Model Integration), and 15 per cent Risk IT.

Only 29 per cent of respondents had a written, stand-alone policy on CGIT, and 22 per cent had a written policy as a component of a corporate governance policy. Twelve per cent had a written policy under development and 38 per cent did not have one or did not know if one existed.

More than half of the respondents said the CIO was primarily responsible for updating and implementing CGIT policies (55 and 52 per cent respectively), which was to be expected.

The two top benefits experienced by organisations with a written policy on CGIT were the alignment of IT with business needs (61 per cent had largely or extensively achieved that), and clarity of responsibility amongst staff (59 per cent).

For more on IT governance and to hear what two prominent Australian CIOs have to say about why IT governance is so important, go to: http://www.cio.com.au/article/552595/getting_it_governance_right/

Feature

NAS: the new nightmare

David Young and **Lawrence Reed** look at the implications of the recent EU regulations on Non-Audit Services (NAS) which companies and their auditors need to have regard to well before the regulations come into force.

The publication in May 2014 of the new EU Audit Regulation[1] allowed the EU to wrest final control of the audit from National Governments. The headline provisions concerning mandatory auditor rotation are not binding until 2016 with some further transitional rules. So companies in the UK are in danger of taking their eyes off the ball because the Regulation imposed restrictions on non-audit services that companies need to consider now. This is made more complex as National Governments have some limited, locally determined options and implementation decisions. The UK Government appears minded to allow the maximum permitted flexibility, but will not consult until later this year.

There are broadly two types of restrictions which will be introduced from 17 June 2016:

1. A cap on the level of non-audit fees that the statutory auditor of a public-interest entity can earn.

2. The introduction of a prohibited list of non-audit services that the auditor can never provide.

Why is it vital for companies and their auditors and potential new auditors to understand these complex rules in detail? Because a breach of the regulation will require the auditor to resign the audit and the company to appoint another auditor, although local competent authorities (likely to be the FRC in the UK) can be given the power to exempt breaches 'on an exceptional basis'. What companies do in the next two years could impact on the whole of their procurement of both audit and non-audit services after 2016. Put simply, who a company uses now for a professional service in a subsidiary may affect who may audit them in, say, 2018.

The new Regulation applies to the audits of all EU Public Interest Entities (PIE)[2]. All companies listed on an EU regulated stock exchange are PIEs, as are insurance companies and credit institutions such as banks. The PIE definition applies even where a company is part of a group listed outside Europe. EU subsidiaries of US groups, for example, are caught if they have securities listed on an EU regulated exchange, an EU banking licence, or if they are insurers. The impacts of both the cap and the non-audit service restrictions on an EU PIE which is part of a group are different from those where the PIE is the holding company, as is the case with most UK-listed companies. In this article we will only address the rules for a typical UK-listed PIE.

So how is the cap on NAS calculated? Firstly, it only applies where the auditor has provided NAS for three or more consecutive financial years, so the calculation only needs to be performed in year three of an audit relationship. Then the maximum non-audit fees that the auditor of a PIE can bill in any one year is set at 70 per cent of the average of the audit fees billed over the last three-year period. In this calculation:

Audit fees include the statutory audit fees for the PIE, its parent and its subsidiaries. Audit fees for fellow subsidiaries of a common parent are excluded (though if they are themselves PIEs, they may have their own cap).

Non-audit fees include those fees billed by the auditor of the PIE to the PIE and its parent and subsidiaries. They do not include fees billed by other firms within the auditor's network, so fees payable to 'Big 4 US office' are excluded.

Fees for audited-related services such as opinions on regulatory returns or interim reports are excluded from the calculation of audit fees, but they may also be excluded from non-audit fees provided they are required by national or EU regulation. Certificates required by banks or loan documentation are unlikely to be caught by this definition.

It will be apparent from this that the calculation of the cap is highly complex and current disclosures will not allow investors and market commentators to calculate the cap precisely. Some companies are buying more time in 'resetting the clock' by planning to change their auditors in 2015 or 2016, but for most FTSE 100 companies, this cap is not a problem. For smaller companies (and, unlike the UK Governance Code audit tendering provisions, these rules apply to all listed companies and not just the FTSE 350), major changes to their service providers may be required.

The potentially bigger problem is that the Regulation introduces a list of services which cannot be provided by the auditor from 17 June 2016, included within which are many forms of tax advice and compliance. Some of these are already discouraged either by best practice or by firms' professional ethics. However, Member States have some flexibility in including additional or excluding certain services. Crucially, Member States may interpret some of the ambiguous text of the Regulation differently, which could create real problems for UK groups which include a number of PIEs in different European States such as many insurance and banking groups or dually-listed structures.

The list of prohibited services applies to all EU member firms of an audit network, when they are providing NAS to a PIE, its EU parent and subsidiaries within the EU. It is important for companies to realise that this is different from the cap calculation. To add to the complexity, where NAS are provided to non-EU subsidiaries, there is a shorter list of prohibited services and others where the auditor must assess whether independence has been threatened. We have deliberately not covered the exact nature of prohibited services in this article as too many issues are not yet clear.

EU legislation is often much shorter than its UK equivalent and this leaves many questions for BIS and/or the FRC to which companies will need answers. For starters:

- How does the 'entry into force' at 17 June 2016 affect the cap calculation where it is in the middle of a financial year?
- Does a subsidiary of a PIE which is itself a PIE need to make its own calculation of the 70 per cent NAS cap?
- When does the cap apply to an entity which becomes a PIE during an accounting period eg through an IPO?
- How will the FRC respond to requests for exemption in the event the cap is breached, will it consult with shareholders before ruling and how will it publicise its rulings?
- Where will the UK exercise Member State options?
- How are certain prohibited NAS, such as tax advice exactly defined?

… and there are many more.

The expectation is that legislation will be introduced in the UK following the election next year and the FRC will produce guidance for audit committees at the same time. Our strong advice to companies, however, is do not wait for the guidance. Take action now to start collecting information and assessing the impact of the Regulation on any new NAS contracts. Large UK groups are complex and, for instance, may have more than one PIE in the group. Charts of accounts may have to be expanded to create various categories of NAS and allow proper monitoring. The large audit firms are going to require much greater co-ordination between their offices, particularly where they are not currently the auditors but non-UK offices are providing prohibited NAS which might disqualify the UK firm from tendering.

NAS contracts can be let on a multi-year basis, so a three-year internal audit outsourcing or expat tax agreement or a long-term systems implementation contract may affect whether that firm can take over as auditor when the time comes to tender. In some cases, it may make sense for NAS contracts for prohibited services to end at the same time as an audit contract, but finance and procurement departments will need to be made aware and plan for a series of contracts ending at the same time.

Information needs to be collected on a worldwide basis on any audit firm who might realistically be asked to tender when the time comes, particularly on which firms provide prohibited NAS to the group. Remember also, that some specialist services are not necessarily provided under the same brand name as the audit firm, though they are part of the firm – for instance Makinson Cowell, used by many well-known names in the UK and Europe for investor consultancy is part of KPMG. Company secretarial departments are going to have to monitor developments in any European countries in which they operate.

Not addressing NAS now may well restrict companies' choice of auditor, particularly those planning to change after 2016 that have had the same auditor for more than three years, who may be tendering in 2015. Audit committees in the FTSE 350 have had to deal with audit tendering rules for the past year, but the Regulation applies to all UK listed companies. The detail is so complex and some of the rules so uncertain, we fear embarrassing mistakes will be made. As audit committee chairs are firmly in the spotlight for the audit relationship, they and their committees should be taking a lead.

[1] Regulation 2014/537/EU.

[2] The definition of a PIE can be found in Directive 2006/43/EC, though there is limited ability for Member States to exempt or add to the entities covered.

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Feature

Ethics, risk and governance

In an extract from a recent Institute of Business Ethics board briefing paper, **Peter Montagnon** argues that the role of the board in instilling a healthy corporate culture goes far beyond mere compliance.

'We want to be proud of Enron and know that it enjoys a reputation for fairness and honesty and that it is respected.' So wrote Chairman Kenneth Lay in the forward to the final edition of the company's Code of Ethics, published in July 2000 less than 18 months before it collapsed. Lay was later found guilty of ten counts of fraud.

Building on the experience of Enron and others, this paper sets out why directors need to be actively involved in setting and maintaining a company's ethical values. It suggests some ways to approach this. Many boards acknowledge the importance of a healthy corporate culture, both because of the role this plays in mitigating risk and because of the value to their franchise of a sound reputation. A healthy culture also reduces politics inside the company and makes for more engaged employees. Yet there is often a temptation to see embedding culture as largely a compliance exercise, whereas values actually go to the heart of what a business is and how it works.

There are two reasons why this is important. One is that a series of corporate scandals, not just at banks, has eroded public trust. A recent survey for the *Financial Times* showed half of those who would vote Conservative – traditionally seen as the most business friendly party – wanted the government to crack down on big business.[1] Companies need public trust if they are to secure their franchise for the long term. It is no longer enough to justify their existence as being merely to maximise shareholder value in the shortest possible time. The other reason is that no one can run a business without having a business model, and all business models reflect the conscious or unconscious values of those who designed them. Having sound values is more likely to lead to a robust and sustainable business model.

Values are thus a primary task for boards, and an integral part of their governance role. The UK Corporate Governance Code acknowledges this when it says: 'The board should set the company's values and standards and ensure that its obligations to its shareholders and others are understood and met.'[2] There are three parts to this task.

1. Boards have to set appropriate values and ensure they are embedded.

2. They need to understand how to influence behaviour throughout the company so that employees will make good decisions. This is a complex task. It is different and many ways more difficult than the simple setting of values. Yet it is critical. Many companies proclaim their values, but what distinguishes the outstanding ones is the way in which this translates into actual behaviour. A focus on what drives behaviour within the company is a key task for boards.

3. Boards need to understand where their oversight role begins and ends and what the operational role of the management is. It is therefore important to clarify the contribution that boards can make.

This paper aims to shed light on these three issues and help directors define their contribution to the maintenance of sound values and culture. This is also an issue which could usefully be picked up in the board evaluation process.

The business model is core. A sound business model aims to generate returns by delivering value to customers in the form of products which they want and which are reliable and affordable. Essentially it puts the customer first. But not all models operate in this way. Some are flawed at the outset, and some become contaminated because executives become preoccupied with exploiting opportunities to extract value for themselves. This is perhaps epitomised by the behaviour of US mortgage bankers in the run up to the financial crisis when they were falsifying their clients' income statements in order to earn bonuses for themselves by selling mortgages their customers could not afford.

Incentives and targets play a large part in determining behaviour, but so does a corporate values system that discourages cheating and encourages fairness, transparency and respect. Boards need to understand both how the business model delivers value and whether it is operating in the way it is supposed to. It is not always easy to see when standards slip or when a product like payment protection insurance, which at the outset, appeared to have a useful social purpose has suddenly become toxic.

A flawed or poorly operating model is not sustainable. It invites rebellion by customers and retaliation by regulators. Worse, it signals to employees that it is all right to behave badly. Companies that are particularly vulnerable are those whose business involves complex products, complex pricing and/or weak competition. Another example is the British energy utility sector which was criticised for its opaque pricing policy and for not returning cash balances promptly to customers who switched suppliers. That left a regulated industry friendless at a politically sensitive time. The experience shows that boards need to be continuously aware of the way values operate in their company.

None of this is to negate the central importance of profit, which is a legitimate reward for bearing risk and delivering value to customers. Nor is it intended to imply weak moral fibre on the part of directors. Most do take seriously the standards they set for themselves as individuals and want their companies to do likewise. Yet companies are collectives. They have a life of their own and sound values do not come naturally. Without a conscious effort by corporate leaders to define and embed them, there can be a sense of drift.

The required effort goes beyond mere compliance with the law. For many companies with operations in the US, the concern with ethics is driven by a legal motivation to ensure their operation remains within the bounds set by US Federal Sentencing Guidelines. These set rules which, if followed, will reduce the sanctions imposed on companies if an offence is committed. The guidelines have determined the US approach to compliance. They have led to the appointment of ethics and compliances and shaped their role. In the UK, companies have now similarly to contend with the requirements of the Bribery Act.

This paper argues, however, that issues facing companies are more subtle and go beyond mere compliance with guidelines or specific legislation. The pressures which arise through the way people interact in work groups affect them differently from those which face them in their personal lives. Boards need to feel comfortable that employees will make the right decision under pressure, when they must make choices in situations not specifically covered by the law, regulation or formal company rules. Empty mission statements and formulaic codes of practice will not work. Values need to be genuine and embedded throughout the company. They should cover both business objectives such as service, excellence and innovation and ethical purpose such as integrity, respect and openness. What matters is not only what the company does but how it does it.

Much of the work of embedding culture is the task of management. Boards, however, have a critical role. They must work with the chief executive and the management team to define the desired culture and hold management to account for delivering what has been agreed. Directors can steer this process, by defining the culture they want, setting an example at the top and monitoring to see whether the message is getting through. The character of the chief executive is crucial because of his or her operational reach across the company. Boards should take this into account in succession planning, and, if they find themselves saddled with a chief executive who does not reflect the desired values, they may have no alternative but to remove him or her.

A critical need is to find a way of checking to see whether the workforce's perception of culture and the way they interpret corporate values actually reflects that which the management believes to be the case. Important indicators include customer complaints, staff turnover, the content of exit interviews and whistle-blowing or speaking up.

As mentioned above, boards also need to be alert to the way incentives operate through the company. They may think that they have been clear about the importance of health and safety, but sometimes the subliminal signals are strong. If employees are under pressure on deadlines and costs, then health and safety considerations are likely to recede as teams on the ground concentrate on the task in hand. The payment protection insurance scandal has been expensive for British banks. It would have been less so if sales teams had been under less pressure to meet unrealistic targets, themselves often designed to deliver bonuses to senior executives. While one task for boards is to ensure that companies meet financial and operational targets, another is therefore to ensure that those targets are clear and reasonable in the first place. Those which are too stretching or involve reward that is too enticing may well lead to trouble.

Finally, values are not just about ensuring good behaviour by employees. They are also an important support in decision-making. Boards frequently have to make difficult decisions and address problems to which there is no absolutely right answer. A clearly articulated and consistently applied set of values will at least help find answers that command respect. Similarly, directors need also to have a clear policy on managing conflicts of interest, which covers, among other things, the company's approach to financial reporting and, where relevant, its dealings with related parties.

All of this requires time and effort by boards. Some directors will object that they are, already weighed down by compliance burdens that squeeze out strategic discussion. Yet values are integral to the definition and development of the business model. They are not a distraction. They are central to the company's success.

[1] *Financial Times*, 7 May 2014 'Voters turn against big business culture, claims Populus survey'.

[2] UK Corporate Governance Code, Supporting Principle A.1. www.frc.org.uk

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Ethics, Risk & Governance: a board briefing paper is published by the Institute of Business Ethics and available from http://www.ibe.org.uk/list-of-publications/67/47#pub2154

Feature

Evaluation and development of 'non-PLC' boards

David Archer argues that other boards can now benefit from the wealth of experience that exists on how to conduct effective PLC board evaluations and to get real change from the results.

There was a time when the language of the boardroom and board governance was a rarefied thing spoken by distant people who ran banks or other major corporations somewhere in the City. But today boards are all around us and more are being set up every week as new organisations are being created to deliver public services away from direct Whitehall control. Francis Maude has recently said that he wants to see one million public service workers being employed in Public Service Mutuals or other employee-owned organisations by 2015 and all of these require boards to govern their operations and to hold their management teams accountable to stakeholders. Then there are the Foundation Schools, Hospitals, Housing Associations which again need a well-functioning board to be effective. Charities have somewhat different governance rules, but a trustee of a charity that is delivering significant operational services to the public has many of the same responsibilities and concerns of a non-executive director (non-exec).

In this scenario, understanding what makes a board work well, how to measure board effectiveness and how to develop board performance becomes a necessity for large areas of our public service delivery landscape.

In a previous edition of *Governance*, my colleague Alex Cameron wrote about a framework for PLC board evaluation (based on the UK Corporate Governance Code) and how to get beyond a tick box approach in order to give board members real insight into what drives effective collaboration in the boardroom. In this article I want to look at what lessons this Code and its application might have for the evaluation and development of other boards.

Being 'not-for-profit' doesn't make you immune from boardroom problems

Failures of governance can happen in any organisation. The headlines over the last few months about the failings of the Co-op Group have posed many questions about the experience and capability of the chairman and members of that board. In a very different sector the so called 'Trojan Horse' report[1] into Birmingham schools talks of 'behaviours by governors and governing bodies that do not appear to be in the best interests of the schools which they should serve' and says 'there is still an issue of competence' for governors. It's easy to pin the blame for failure on a lack of individual competence and there has been lots of good retrospective analysis of fatal flaws in board structures[2] but the question has to be asked – why weren't stakeholders and indeed members aware of these failings long before.

These failures may ultimately point to a failure of external regulators to hold the boards of these institutions to account – but also to underlying failure of internal mechanisms for board self-assessment and improvement. And in much less extreme cases than these, how do members of a board know where their strengths and weaknesses lie – and how do the public to whom they are delivering their services know what plans the board has in place to address those issues?

How can the FRC governance code help?

Other frameworks exist for board evaluation, the NVCO produces a board self-appraisal toolkit[3] and the Charity Commission has some useful guidance on what makes an effective trustee board. But studying the FRC Code can bring some additional benefits. This Code has been honed over many years and its principles have evolved from painful lessons of past failures of PLC governance. Whilst this might not seem an auspicious place to start I think other boards can now benefit from the wealth of experience that exists on how to conduct effective PLC board evaluations and to get real change from the results.

At the heart of the FRC Code are the concepts of '*Comply or Explain*' and of *transparent external evaluation*. A board needn't follow the detail of each provision to the letter – but if it doesn't *comply* it must *explain* to its external evaluators and through them to its stakeholders how it meets the principle behind that provision in some other way. The board then needs to go through an external evaluation process on a three-year cycle and these explanations, along with board development priorities, are publicised to shareholders and customers via the annual report.

The discipline of regular and repeated external evaluation against a consistent framework is a benefit to any group that wants to improve its performance – and that applies to boards across charities, mutuals, and public bodies as much as it does to PLCs.

The principles of the FRC Code as applied to non-PLC boards

Leadership

- *The role of the board* – every board needs to be clear about its collective purpose, the leadership it brings and its responsibility for the long-term success of the organisation.
- *Division of responsibilities (Chair & CEO)* – there should be a clear division of responsibilities between the Chair's responsibility for the running of the board and the CEO's responsibility for the running of the organisation's business. No one individual should have unfettered powers of decision.
- *Non-executive members* – as members of a unitary board, non-execs should constructively challenge and help develop proposals on strategy. But the development of strategy is a collaborative effort between all members, executive and non-executive.

Effectiveness

- *Board composition and appointments* – there should be a formal, rigorous and transparent procedure for the appointment of new members of a board based on an analysis of the appropriate balance of skills, experience, independence and knowledge required for the board to carry out its duties. All board members should be subject to a regular reappointment process and maximum terms should be clearly defined.
- *Commitment* – all board members must be able to allocate sufficient time to discharge their responsibilities effectively.
- *Development and support* – all board members should receive induction training and should regularly update their skills and knowledge. And the board should be supplied in a timely manner with information in a format and style that members can understand.
- *Evaluation* – all boards should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual members. The result of this should feed in to a development plan which is available for stakeholders to view.

Accountability

- *Financial and operational reporting* – a board should present a balanced and understandable assessment of the organisation's current position and future plans.
- *Risk management and internal control* – a board is collectively responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives.

Remuneration

- *Executive remuneration* – there should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. A board is responsible for determining levels of remuneration sufficient to attract, retain and motivate executives of the quality required to run the organisation successfully.

Relations with stakeholders

- *Dialogue with stakeholders* – the board as a whole has responsibility for ensuring that a satisfactory dialogue with stakeholders takes place. And the board should use the AGM and annual report to communicate formally with stakeholders including details of the board's own evaluation and development plans.

The different challenges of 'non-PLC' boards

Although I've argued that there are a lot of similarities in the governance challenges faced by PLC and non-PLC boards and therefore the type of evaluation that would benefit them – there are some significant differences too.

- *Lack of clear accountabilities between board and executive team* – this is a complaint of many not-for-profit board members, particularly when it comes to accountability for the definition of strategy. The standard way PLC's have developed to deal with this dilemma (in the UK at least) is the unitary board structure with effective non-executive and executive membership – and an environment that encourages robust debate and collaboration across the boardroom.
- *Board members acting as representatives of different interests* – in a PLC board the members are united in a joint responsibility to safeguard all shareholders' interests. In other boards, members may not have such a clear common purpose. And in many public sector and Public Service Mutual boards there are members who are specifically elected to represent the interests of specific constituencies such as staff or parents on a board of school governors. This feeling of being a representative can block effective collaboration in the boardroom and reduce the collective decision-making capacity of a board.
- *Many non-financial targets* – this is one of the biggest differences in the priorities of these other boards compared to a PLC. Of course PLC's have to hit many competing targets but they can trade-off under performance in one area with over performance in another and as long as the sum comes out with a good profit the shareholders and the board are probably going to be happy. Collaborative leaders on not-for-profit boards have to juggle resources and strategy to satisfy a range of stakeholders each with different objectives and desires. It's a struggle to trade one target off against another without a common currency to compute the relative benefits.
- *Shortages of skills and resources* – the UK Code talks at length about the importance of getting the right skills on a board and right resources to support it. But for other boards outside the PLC arena getting the necessary skills and resources can be a major barrier to effective functioning particularly if this involves unpaid non-exec posts.

Continued on page 12

Continued from page 11

Conclusion

The explosion in the number of boards tasked with overseeing the delivery of large components of public services calls for a new focus on board appraisal and development across these organisations. The principles within the Code can help provide a basis for this. The principles are well known to those with experience of PLC boards and with many of these individuals also serving on not-for-profit boards this gives a sound knowledge base to work from. A Code designed for PLC's can't be applied blindly to other organisations, but by explicitly addressing any differences from the PLC world (like those four points outlined in the previous section) and writing them into a terms of reference, the Code and its provision for external evaluation can be a very valuable development tool for any organisation.

[1] Report into allegations concerning Birmingham schools arising from the 'Trojan Horse' letter
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/340526/HC_576_accessible_-.pdf

[2] Report of the Independent Governance Review of the Coop Group
http://www.co-operative.coop/PageFiles/989348879/Report_of_the_Independent_Governance_Review.pdf

[3] http://knowhownonprofit.org/studyzone/board-appraisal-toolkit

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Index

Organisations

IIASA 4

Institute of Business Ethics 8

SEBI 4

People

David Archer 10

Peter Montagnon 8

Lawrence Reed 6

David Young 6

Companies

PwC 3

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