

(1.6 M Circulation)



Directors who ask the right questions

By Prue Leith, FT.com site; Dec 17, 2002

Recent failures of corporate governance at companies such as Enron and WorldCom in the US and Marconi in the UK have led to pressure for a change in the role of non-executive directors. There have been calls for the appointment to company boards of more accountants and lawyers capable of monitoring and overseeing the executive directors.

I doubt whether, in practice, such professionals are any more able than the rest of us to prevent corporate catastrophe. It is hard for anyone to spot fraud and non-executives can contribute most by helping to develop the right strategy, ethos, aims and ambitions for the company.

Sure, the non-executives should have a steadying hand - but not a regulator's deadly grip. Non-executives are not there simply to police the rest of the board. Their real job is to help build a successful company - not always the same thing as helping to make the company's directors rich.

Derek Higgs is now reviewing the role of non-executives on behalf of the government. I hope he concludes non-executives should not act like policemen. The executives will tend to keep them in the dark when the going gets tough. Non-executives need to retain the trust and confidence of executives, so when an executive needs a sounding-board, he or she will ask for help rather than hiding the problem.

We also need to preserve a rich non-executive mix: entrepreneurs, marketing people, strategists, as well as the City men. There is a place for accountants and lawyers. But they should not be on the audit committee to second-guess auditors, crawl over reams of risk analysis and play detective. They should simply satisfy themselves that the auditors will draw attention to anything untoward. I hope Mr Higgs will endorse Warren Buffett's belief that non-executives simply have to ask three questions: if they were the chief executive, would they have presented these figures; if they were the internal auditors unfettered by management, would the accounts be as they are; and if they were shareholders, would they have the information they need to judge the company?

The ideal board of directors is small and close. I should say that between 10 and 12 people is right: small enough not to be unwieldy but big enough to fill the appropriate sub-committees. Proper time must be spent discussing issues that may seem minor but could have important consequences for the company's reputation.

I recall taking part in several examples of such discussions. Should Whitbread promote Alcopops? (No); should Woolworths sell fireworks? (Yes - but responsibly); should Halifax pay its sales force commissions? (Yes - but not enormous ones); should Safeway stock genetically modified foods? (Yes, now reversed to No).

Time must also be allowed for non-execs to understand the company and to get to know the management below the board. Mark Goyder of the Centre for Tomorrow's Company argues that directors and auditors need to know the true culture of the company, rather than the picture painted in the annual report. The best way to minimise the risk of failure is to understand the internal pressures to massage results. In a company scoring poorly on ethics, communications, openness and team-working, management information is unlikely to be reliable. How can employees be expected not to cover things up if they are terrified of admitting mistakes? Of course they will massage figures if they are not allowed to have a bad quarter.

In short, we should spend more time measuring the underlying culture of the company and doing something about it and less time analysing past financial performance. We should consider what is driving behaviour. If the only concern is the share price, it is time to worry. Double-digit growth and a soaring share price are great if you can get them. But demanding them encourages executives to use dubious ways to boost earnings.

Executive directors often blame the City for being put under such pressures. I blame us, the non-executives. How often does a non-executive ask at a board meeting: "What evidence do we have that this merger is going to make money? You do know, don't you, that less than 30 per cent of mergers and acquisitions lead to increased profits for the combined company after two years?" How often does a non-executive question whether it is possible to achieve 15 per cent earnings growth indefinitely? Asking those sorts of questions is the true job of the non-executive director.

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