NEDs – Monitors to Partners

The need to shift the focus of non-executive directors from risk mitigation to promoting long-term success

tomorrow's company

About Tomorrow's Company

Tomorrow's Company is an independent non-profit think tank that exists to inspire and enable companies to be a force for good. It believes business can create more value for shareholders and society by adopting an approach that focuses on purpose, values, relationships and the long term. It succeeds in its goal by convening business leaders, investors, policymakers and NGOs to develop practical solutions. Tomorrow's Company was founded in 1995 following the RSA inquiry into the role of business in a changing world.

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Executive summary

Twenty-five years after Cadbury, there is much to celebrate within UK corporate governance. However, it may also be time to rethink some of our underlying assumptions. Corporate governance has become an industry in itself. The focus is too often on how to comply with an overly prescriptive list, rather than choose the structure and processes that help create long-term value.

This report has been prepared in collaboration with chairmen, non-executive directors (NEDs) and executives. In its conversations with them, Tomorrow's Company has come to some clear conclusions about the shortcomings of our current approach to the role of NEDs and to corporate governance generally.

This paper argues that a new direction of travel is needed that supports innovation in governance structures, greater alignment between NEDs and executives, and a focus on long-term investment with appropriate risk-taking. The primary focus is to provide this critique, and then to pose some questions and actions for how this could be put into practice by boards, investors, policymakers and regulators.

"The length of board packs, board agendas and the background of many NEDs in finance, legal and compliance contribute to NEDs too often seeing their role as ensuring good corporate governance and risk mitigation. This focus is at the expense of contributing to building a successful and sustainable company."

Mike Wilson CBE, Joint Founder & Life President, St James's Place

1. Need for change

The current approach is not improving outcomes – Despite continual reforms and refinements, there is limited evidence that what is defined as 'good governance' improves outcomes – the number of listed companies is in decline, academic evidence is weak, investment is low, public trust is low, and corporate scandals continue to occur.

The current focus is on risk mitigation rather than opportunity – Too often reforms have followed scandals, adding to the governance burden and emphasising a focus on risk aversion rather than supporting entrepreneurial leadership and long-term investment. The danger is that upcoming reforms may compound this problem. The solution to low public trust and productivity, is not more rules adding to the caution and compliance burden of boards, but the opposite – encouraging boards to invest in tackling societal problems.

2. A focus on form over substance

While the intent of the UK Corporate Governance Code is flexibility, the way it has become interpreted and applied in practice has become too formulaic. In general, this is reducing board effectiveness for the following interrelated reasons.

1. The increasing governance burden leaves a **shortage of time** for boards to discuss the topics that drive long-term value.
2. Rising expectations in excess of time and resources have also ignored the difficult decisions NEDs face in how they spend their time. This has created a **lack of clarity on the role of NEDs.**
3. Reforms have focused on the role of the NED acting as a **monitor, rather than a partner** or advisor to executives.
4. In turn, this exacerbates a focus on **backward-looking financial information**, rather than the topics core to long-term success, such as, stakeholders, culture, strategy and disruptive technology.
5. All these problems are accentuated by a restrictive approach that has led to **too little variation** in the role of non-executive directors.

Too often governance codes and best practice have sought to define a single view of good governance. In reality, the right approach is different for each company and should change through time. All NEDs have a different balance in focus between monitoring, advising and partnering with executives – we should encourage companies to make an active decision on what mix of roles and focus for each individual is most suitable for them. In short, governance should be more about encouraging mindful variation, rather than enforcing conformity. This should enable a shift in focus of NEDs from acting as a monitor to a partner.

3. Actions and questions to consider

This critique of our current governance approach has important implications for those who work on and with boards, as well as policymakers, regulators and investors. Section 3 puts forward some key questions and suggested actions to help individuals think about these issues.

For boards:
Each individual has a different role in pursuing these actions. The chairman is pivotal in leading these decisions. Company secretaries can help manage the flow of information, and support and advice NEDs. NEDs can shift their focus to partnering, and executives can reciprocate this by bringing issues to be discussed, rather than solutions to be approved.

- **Clarity of purpose and success** – What is the board's shared understanding of the company's purpose, values, key stakeholder relationships and risk appetite? Whom does the board serve? And how does it define success? Tomorrow's Company has previously developed a framework to help boards achieve this – *The Case for the 'Board Mandate'*.
- **Clarity on each NED's role and value** – Following from above, what is the role of each NED in contributing to achieve the agreed purpose and strategy? Do NEDs each know why they are on the board and what is expected of them? Do the other Board members?
- **Monitor vs partner** – Within the above, are NEDs aware of the different roles they have and when each is most effective or appropriate (i.e. acting as a partner and advisor to executives, as well as a monitor of performance and compliance?) Is this best achieved by each NED having an appropriate balance between the different roles, or some NEDs with a focus on partnering and others with a focus on monitoring?
- **Time allocation** – How much time do NEDs need to spend to be effective in this role and for which topics? Is sufficient time devoted to the long-term drivers of value, including stakeholder engagement and site visits, in addition to process and compliance?
- **Information** – What information do NEDs need in terms of breadth and independence to be effective in these topics? Is this provided in a concise and digestible form? Is there sufficient focus on forward-looking topics, in addition to backward-looking financials?
- **Diversity of voices** – How could we encourage constructive challenge by increasing the diversity in experience and networks of NEDs, as well as fostering effective conversations? A framework to help boards with the latter can be found here – *Improving the quality of boardroom conversations*.
- **Alignment** – How can all board members help build greater trust and shared purpose between NEDs and the executives?

For investors:
- Are sufficient resources devoted to stewardship in order to have a thoughtful discussion of the appropriate governance structures for each company, rather than if they have complied with a list?
- How much engagement has there been with NEDs, in addition to the chairman and executives?

Regulators and policymakers:
- How could we shift the focus from preventing scandals to encouraging long-term investment? Tomorrow's Company has put forward detailed policies to achieve this in the following report – *Promoting long-term wealth*. This advocates increasing the emphasis on principles in the Governance Code, encouraging a greater diversity in governance structures and supporting investor stewardship.

Perspectives

"This paper provides a helpful catalyst to allow Boards to challenge themselves, step back and decide what they are there to do and how they add value. This isn't just more process. It reflects the reality that Boards will have a different focus at different points in the life cycle of a company. The work of the Board will also reflect the capabilities of the Executive team and the dynamic between Chairman/NEDs and CEO. No two companies are alike and governance must address the reality of each individual company. So this paper brings a welcome focus on the dynamic of governance and on form over substance."
Robert Swannell, Chairman, Marks & Spencer

"The length of board packs, board agendas and the background of many NEDs in finance, legal and compliance contribute to NEDs too often seeing their role as ensuring good corporate governance and risk mitigation.

This focus is at the expense of contributing to building a successful and sustainable company. The fact that executives are financially incentivised to do this and NEDs are not, whilst putting their personal reputation on the line doesn't help the situation.

The most constructive and enjoyable board meetings I have attended have been for non-quoted companies or advisory board meetings. The agendas and discussions have focused on strategy, the future, competition and culture where the board members have been able to bring their experience to the table having built or run successful companies themselves.

Perhaps the potential benefits of advisory boards for quoted companies should be considered (pros and cons) with NEDs sought with different backgrounds to those for typical quoted company boards."
Mike Wilson CBE, Joint Founder & Life President, St James's Place

"Bertrand Russell once said: 'As soon as we abandon our own reason and are content to rely upon authority, there is no end to our troubles.' Rather than blind compliance with the Code, this is surely the spirit in which boards should develop their model of governance.

"On the role of information, no matter how capable the Directors around your boardroom table, in the absence of the right information they are blindfolded. And these days Boards are just as likely to be blinded by too much information, as they are by too little."

Information drives the conversation in the boardroom. To stimulate a strategic and forward-looking conversation, take a fresh look at what you are serving up to your Board and ask yourself: is it helping or is it getting in the way? If your Board receives papers that are heavily backward-looking and operational, you can expect the same from the conversation."
Jennifer Sundberg, Co-Chief Executive, Board Intelligence

"We applaud this report from Tomorrow's Company. Corporate Governance has shifted too much to a 'form over function' model and indeed an industry unto itself. This is a reminder that a key – and important – role of the Board is ensuring the appropriate focus on the long-term interest of the company."
Dominic Barton, Global Managing Partner, McKinsey & Company

"The NED role has become less of facilitator of corporate success, more of a monitor of process. For people who are business-builders, that's a dull mandate and restricts the likely appetite of many who might otherwise be attracted to the NED role."
Alex Scott, Chairman, Sandaire

"Tomorrow's Company has again issued a challenging and thought-provoking report. For me, the key role for NEDs is to assist the Company in creating value for its shareholders over the medium and long term. They should be focusing on entrepreneurial leadership. Of course, there is a major role too for NEDs in monitoring risk and checking the controls. But this role should never come at the expense of value creation. This report focuses the attention of the reader on how to find a better balance."
David Tyler, Chairman, Sainsbury's

"Tomorrow's Company is provoking a much needed debate. There is a grave danger that good corporate governance is being defined too simplistically by measures such as the proportion of 'independent' non-executives on the Board and the level of gender diversity of the Board and by seeking to define a single, uniform role for non-executives. Equally importantly, good corporate governance is never going to be secured if a single model is imposed without regards to the needs of particular companies. A more nuanced and multi-dimensional approach is required and Tomorrow's Company's suggestions point the way forward."
Richard Godden, Corporate Partner, Linklaters

"I firmly believe that the Company Secretary has an important role to play in ensuring that NEDs, and the Board as whole, spend quality time on managing and directing the business, without being overly consumed with governance or compliance issues. The Company Secretary should minimise and manage the major burden of compliance activities, to allow NEDs to focus on running the business for all of its stakeholders. Much of this should be the Company Secretary's day job, and should be considered during the formal planning for Board meetings and agendas throughout the year. Clearly, there are times during the year when Boards/NEDs do need to focus on compliance, and in these cases, the papers and materials should be concise, well-written, and informative. In my experience, much of the Board's time, and in particular, NED's time, is wasted through having to digest poorly written papers. NED time should be spent supporting, advising, and where necessary, challenging management on key issues relating to the longer-term success of the business."
Paul Moore, Group Company Secretary, Kingfisher

"Cadbury was a landmark but for a different world. In a future of infinite competition mediated by technology, we do business with businesses that share our values and in whom we trust. Governance shifts from compliance to a source of competitive advantage. Guardians of governance become central actors, not supporting roles. More of the same looks unwise as we see large-scale political rebellion against those seeking self-interest and business has the opportunity to lead society. While seizing the opportunity, any leader of change also knows that we change during the process and maybe the traditional NED is dead. A new framework is needed that embraces flexibility and diversity, that allows time for a new type of fearless NED eager for change who is integral to the ensemble in creating purpose, shaping culture, delivering advantage, adding value to the brand and building tomorrow's business."
Dr Kevan Williams, University of East Anglia

"The current prevailing attitude of investors to the role of NEDs in UK companies appears to be that their purpose is (a) to ensure the executive directors are carrying out the company's publicised strategy and (b) to limit the risks for the company in carrying out that strategy. I'd like to see us move into an era when NEDs actively contribute alongside the executive directors in the setting of corporate strategy and challenge whether that strategy needs to be altered in the future to cater for changed circumstances."
Julian Henwood, Partner, Gowling WLG

Comply or explain: A new paradigm is needed

Guy Jubb is an Honorary Professor at the University of Edinburgh Business School and the former Global Head of Governance & Stewardship at Standard Life Investments.

If there is one thing that boards and shareholders will agree on, it is that principles are better than rules. But the reality masks this consensus. The UK Corporate Governance Code has morphed from being a set of ‘comply or explain’ principles with the purpose of encouraging and supporting good governance to be followed by companies in the light of their own particular circumstances, as advocated by the Cadbury Committee. It has become a set of principles that are more akin to rules that are followed by companies, irrespective of their circumstances.

The distinction between principles and rules has become too subtle for comfort. The current approach to the Code’s principles arguably presents more of a barrier and deterrent to entrepreneurial leadership than a pragmatic framework of checks and balances to deliver the long-term corporate success for the benefit of shareholders and stakeholders that they are designed for.

Non-compliance with the Code is perceived by too many companies as a risk that is not worth taking. Shareholders are become increasingly sceptical, voting agencies often struggle to understand the context, and the media tends to show no mercy. Code compliance has become the line of least resistance and, consequently, the norm for most companies.

This state of affairs is neither in the best interests of companies or its shareholders – or society. The time is ripe to address the root causes and develop a new paradigm for ‘comply or explain’. Attitudes must change, and this demands leadership and courage by regulators, boards and investors. They all have a part to play. They must recognise and accept that, when it comes to corporate governance, there is no monopoly on wisdom. Meeting the spirit of the Code is – and always was and always will be - far more important than complying with its form.

Directors are stewards

Mark Goyder, Founder, Tomorrow's Company

It was December 1992 when the Cadbury Committee reported on the Financial Aspects of Corporate Governance. 'Why only the financial aspects?' people used to ask Sir Adrian Cadbury. His answer was always the same. 'If you want to explore the wider aspects go and talk to Mark Goyder at the RSA. They are organising an inquiry into the role of business.'

The final report of that business-led RSA Tomorrow's Company inquiry put purpose, values, relationships and the licence to operate at the heart of business success. Directors owed their duty to the company, not, as too many directors appeared to think, to shareholders.

Directors – all of them, executive and non-executives – are therefore stewards, entrusted by the shareholder with the oversight of the company's leadership and operations, with an obligation to hand the business on in better condition. They are elected by and accountable to shareholders. They are informally accountable to stakeholders upon whom the company depends and has impacts.

Directors need to be clear about their mandate. In a family or state-owned business, there is a dominant owner setting the mandate. In a listed company with multiple shareholders, the vacuum has to be filled by the directors. They need to set out the purpose, values, strategy, risk appetite and time horizon of the business and then seek out investors who are aligned with this mandate.

To preserve the entrepreneurial nature of the company, it is vital that the directors are proactive, not reactive. The same applies to corporate governance codes. Sir Adrian Cadbury never intended 'comply or explain' to impose a heavy burden. It was intended to liberate boards by letting them explain when they had gone their own way. The road to hell is paved with good intentions. After twenty years of 'comply or explain', we in the UK have unintentionally distracted companies and their boards from the true business of what Adrian Cadbury used to describe as 'driving their business forward'. Comply or explain has degenerated into 'comply or else' or just 'comply and complain'.

The best-governed companies do not allow 'compliance victim syndrome' to take hold. They stick to the spirit, not the letter, of codes. In South Africa, the formidable Mervyn King has focused minds on principles that should guide them. He asks them to 'apply and explain'. Apply the principles and explain how you have done so.

To me, the four Tomorrow's Company Stewardship principles say it all. First, clarity. Why are we here? Who put us here? What are our key relationships? How are we engaged with each and what are we learning? Second, continuous improvement. Are we learning and improving? Who is doing better than us? Third, are we sensing and where appropriate shaping the landscape around us? How good is our radar? Are we anticipating the next generation of public concern and acting accordingly, sometime with our competitors? And finally, planting for the future. Short-term pressures are real and important. How are we balancing this with our focus on tomorrow – tomorrow's talent, R&D, thinking the unthinkable about emerging risks?

What are the problems that boards should address?

Jo Iwasaki, Head of Corporate Governance, Professional Insights, ACCA

This discussion is especially relevant today as policymakers, particularly elected representatives, are sensitive to the views of the public – not just corporate governance experts. Recent activities in this area have highlighted corporate governance as a key area of focus, as we have seen in the former Business, Innovation, and Skills Select Committee's Corporate Governance Inquiry and the subsequent green paper on corporate governance reform.

At first sight, these discussions are focusing on matters that have been deliberated for decades. However, it would be a mistake to believe the answers to similar concerns in the past are likely to resolve the problems we face today. For example, the issue of executive pay has been on the agenda for over twenty years. In 1995, the Confederation of British Industry published the Greenbury report on good practice in determining directors' remuneration. It has since been incorporated within the Corporate Governance Code, but executive pay has continued to be contentious regardless. This is because corporate governance, as a whole, has increased in its complexities and, furthermore, is increasingly interrelated.

Corporate governance is a means of supporting companies to achieve their long-term success. To this end, the Financial Reporting Council's Corporate Governance Code principles are built on examples of companies that have performed well for a sustained period. Many of these examples are tried and tested, but they are not, and will never be, fail-proof.

ACCA believes we must refocus on the purpose of corporate governance and what we hope to achieve by its practice. An increase in regulations is partially a response to the fact the mechanical application of a codified corporate governance process is insufficient.

ACCA proposes looking beyond the surface of current corporate governance issues. For example, engagement of employees and stakeholders is about connecting them with company values and the business model. Companies that are integrated internally and supported by external stakeholders will excel at identifying opportunities and risks, and therefore could take swift actions.

Diversity in the boardroom and workforce is both an aim and outcome of companies maximising the resource pool and increasing their knowledge and experience base to its advantage.

Establishing appropriate executive pay is about thinking through what the company considers as its value creation model and the role of executives in achieving it. This cannot be independent of pay and employment conditions for the rest of the workforce.

Underpinning all of these areas is the notion of corporate culture, which is ill-defined to many. It is partly conceptual (e.g. group norms and peer pressure). Other important elements consist of processes and procedures – from recruitment, promotional opportunities, pay structure, decision-making style to internal communication. The board and executives have an overall steer on these matters.

Companies must consider their approaches to these fundamental propositions, then their unique solutions reflecting their business purpose would start to emerge. Heightened interest in corporate governance presents company boards with an ideal opportunity to dig deeper into these issues and propose appropriate solutions, which must withstand public scrutiny as well as the test of time.

1. The need for change

Despite continual improvements to corporate governance, it is not clear if it is improving outcomes for shareholders, stakeholders or society. The danger is that governance is reinforcing a risk-averse approach, compounded by rising external pressure.

It isn't clear whether the current governance approach is improving outcomes

Despite 25 years of corporate governance reforms, there is limited evidence that this has led to an improvement in outcomes. There are enough warning signs to question if the current approach is working. Many of these points are expanded on in *UK Business: What's wrong? What's next?*.

- The UK is viewed as a global leader in corporate governance, but has been relatively unsuccessful in developing world-champion companies.
- Links between what is deemed 'good corporate governance' and strong company performance are far from clear. For example, in *'Seven Myths of Boards of Directors'*, David Larcker, Professor at Stanford Law School, argued: "Companies are expected to adhere to common best practices in board structure, composition, and procedure. …While some common practices contribute to board effectiveness, others have been shown to have no or a negative bearing on governance quality."[1]
- Listed companies are in decline, with the total number falling and the total of dividends paid being far in excess of the primary capital raised by IPOs.[2]
- Despite the increasing sophistication of governance, corporate scandals continue to occur. There appears to be have been limited reduction in the regularity and severity of scandals.
- Listed companies on many measures appear to have become risk averse with low levels of investment and innovation increasingly coming from outside the listed sector.
- Public trust in business has declined to a low level.
- UK productivity is low, leading to the stagnation of real-wage growth.

This is not to ignore the significant progress made over the past few decades – boardrooms have become more professional, NEDs commit more time, and boards consider wider issues beyond the financial. The argument in this report is that the push to define a single description of 'good governance' has placed unrealistic and unclear expectations on NEDs. With each scandal, a new responsibility has been placed on NEDs, who have limited time and access to information.

The danger is that the upcoming reforms may introduce more of the same, even though it is unclear if this approach has worked in the past. The solution to low public trust and productivity is unlikely to be more rules, but instead how to encourage and support companies to invest in tackling societal problems.

A focus on risk mitigation rather than opportunity

A further warning sign and a key cause of poor outcomes is a risk-averse approach in many boardrooms. The UK Corporate Governance Code starts by emphasising the need for entrepreneurialism: "*The purpose of corporate governance is to facilitate effective, entrepreneurial and prudent management that can deliver the long-term success of the company."* However, too often more focus is placed on risk mitigation, than gaining the confidence to take the risks needed to embrace opportunities.

Risk aversion has many causes, from economic uncertainty to shareholder pressure, and regulatory scrutiny. In addition, the increasing burden of governance and unrealistic expectations on NEDs is a contributing factor. To invest in long-term risky projects, boards need the time to discuss and gather the information to gain the necessary confidence. The burden of governance reduces the time devoted to strategy. Faced with uncertainty, shareholder pressure and regulatory scrutiny, many boards recede into taking decisions that feel safe.

The issue of risk aversion is captured by Sir Martin Sorrell, writing in the 2015 WPP annual report: *"If political leaders are wary of risk-taking, the appetite for it in the corporate world is smaller still. Since the collapse of Lehman Brothers in 2008 and the economic crisis and recession that followed, boardrooms have become ultra-conservative in their decision-making. In a world of zero-based budgeting, activist investors and ubiquitous disruption by tech start-ups, there is little encouragement to be bold. This is a regrettable, if understandable, fact of contemporary corporate life.....Calculated risks are necessary for the long-term health of a business, because without them innovation, development and renewal are impossible."*

Evidence that large listed companies are not investing long-term:

- Dividends are at record highs. The Capita Dividend Monitor reported UK listed company dividends in 2016 of £85bn up from £54bn in 2007, with buybacks in addition.[3] Total dividends paid by UK non-financial companies as a percentage of non-financial corporation Gross Value Added (GVA) has risen from 8–9% in the early 1990s to 12–13% currently.[4]
- Investment is low. Investment in fixed assets (ex-construction) has fallen from 11% in 1997 to 8% in 2014, versus 12% for the USA in 2014.[5] Investment in R&D was 1.6% of GDP in 2012, versus the Euro Area of 2.1% and USA 2.8%.[6]
- Innovation is increasingly coming from outside the listed sector.
- Symbolic of this is that listed companies use investment hurdle rates that are far in excess of the cost of capital. A recent report by the Bank of England found that the average hurdle rate for UK companies was 12% compared to a cost of capital of 6.5% and cost of debt of 3%.[7] Furthermore, hurdle rates may be higher in listed companies. For example, a survey of the S&P500 in 2014 found an average hurdle rate of 18%.[8]
- A further sign is anecdotal evidence that some individuals are now choosing to sit on the boards of private equity owned companies, rather than listed companies. These individuals often cite the burden of compliance, governance and process being the reason.

Compounded by rising external pressure

The focus on risk mitigation has been exacerbated by increasing external pressure from the combination of competition, regulation, financial markets and societal expectations. The monitoring of executives is in essence being increasingly conducted by wider stakeholder groups, rather than only the board. As a result, the danger to our corporate system is no longer that an all-powerful CEO makes bad decisions, but rather that our companies make decisions based on short-term external pressures, where entrepreneurialism is replaced with caution and risk mitigation. In this context, the key challenge facing boards may be how to support executives in taking tough decisions in the face of increased external pressure, rather than monitoring and overseeing executives.

Rising external pressure:

- Competition in many markets has steadily increased with globalisation.
- With the pervasive influence of social media there is increasing transparency across all company activity, from customers to employees, to the supply chain.
- The news cycle is shortening: reputational storms can develop in hours.
- Societal expectations are rising – this is leading to more pressure from advocacy groups, and employees and customers are starting to take into account a company's wider social impact before they buy a product or accepting a job.
- The risk of an opportunistic takeover has continued to increase.
- Shareholder engagement is increasing with stewardship across the market, and activist funds targeting underperforming companies.
- Lastly, regulation has in general continued to increase.

2. A focus on form over substance

This section offers a critique of our current governance approach as an explanation for why the connection to improved outcomes is not stronger and why boards have become risk averse.

While the intent of the UK Corporate Governance Code (referred to from here as the Code) is flexibility, the way it has become interpreted and applied in practice has become too prescriptive and purely focused on compliance with a list of provisions. With each scandal, the quantity of codes and best practice guides has risen, placing an increasing burden on boards and NEDs, which has been further increased by rising societal expectations.

Evidence of a rising governance burden and focus on form over substance:

- In the Financial Reporting Council's (FRC) collection of essays in 2012 *Comply or Explain – 20th Anniversary of the UK Corporate Governance Code* a theme was that too often 'comply or explain' has become 'comply or else'.
- Grant Thornton's 2016 survey found 90% of companies in the FTSE350 were complying with at least 52 of the 53 provisions in the Code, while 62% complied with all provisions.[9]
- Despite the FRC publishing a report called *Cutting Clutter – Combating clutter in annual reports* in 2011, the length of annual reports has continued to rise.[10] The average length of annual reports for companies with an LSE premium listing has risen from 59 pages in 1996, to 113 pages in 2011, to 135 pages in 2015.[11]
- Reviews of corporate governance reporting in annual reports generally find that reporting is still quite generic and focused on compliance with the Code. For example, the EY review of 2015 annual reports stated that, *"The governance report is the section that contains the most boilerplate information. This seems largely due to the requirement under the Listing Rules for disclosure of how the company has applied the Main Principles of the UK Corporate Governance Code (the Code), in a manner that would enable shareholders to evaluate how the principles have been applied".*
- A further example of the increasing compliance burden is the length of compliance and regulatory updates sent to company secretaries by legal and advisory firms. For example, a recent new year update was 31 pages long.
- A whole industry has developed around corporate governance that is too often simply focused on compliance with the Code. Some reports even talk of 'governance performance'.
- Executive remuneration is a prime example of the focus on form over substance. Remuneration has become ever more complex with a whole industry of advisors. It has also taken up an increasing amount of boardroom and investor time. Despite this, the evidence is that remuneration has increased far in excess of company performance, and remains a key issue reducing public trust.
- The issue of clutter is also shown by the length of board packs. A survey by Board Intelligence found the average length is now 288 pages and takes 9 hours to read, and yet most NEDs only spend 3 hours reading it.[12] Furthermore, a survey in 2014 found that 92% of NEDs expect the time in board meetings dedicated to discussing company governance and risk to increase over the next 3–5 years.[13]
- A further sign of clutter is that many board agendas have 15–25 items on them, leaving only a short amount of time to discuss each item.
- The burden of information is exacerbated by regulatory pressure leading managers to report all information up to the board. Similarly, with the Senior Managers Regime, which puts the onus on the individual to take responsible steps to do the right thing, directors cannot say they 'did not know', so they end up asking for more information. The result is a board pack that is often too long.

Nonetheless, it is possible for an effective board with a strong chairman and company secretary to manage this burden and maintain a sufficient focus on long-term issues. Indeed, there is a significant minority of company secretaries, NEDs and chairmen who do not see the burden of governance as an issue. This group agree that the burden has increased, but that it can be managed effectively. It is the practices used by these individuals that this report seeks to support. This is what we describe as mindful variation.

Acknowledging these caveats, the increasing burden of governance codes, regulations and standard practice is having a range of negative consequences on board effectiveness, for the following interrelated reasons:

1. Shortage of time for the topics that drive long-term value
2. Unrealistic expectations have created a lack of clarity on the role of NEDs
3. A focus on acting as a monitor rather than a partner or advisor
4. A focus on backward-looking financial information
5. Too little variation in the role of non-executive directors

1) Shortage of time for the topics that drive long-term value

Expectations of NEDs have increased in excess of their time and resources, despite a steady increase in their time commitment. This limits their ability to go beyond the board pack to explore additional sources of information. The result is that NEDs tend to be overly reliant on information provided by the executives.

One constraint causing this is a restrictive view of independence, which is not caused by the Code, but by how it has become applied in practice. It is generally assumed that increased time commitment, contact with the company and industry knowledge reduce independence. The opposite is often the case. Time spent reading and meeting individuals throughout the company can improve the effectiveness of NEDs in providing constructive challenge.

Evidence on the shortage of time:

- In 1991, the average amount of time a NED dedicated to a company each year was 17 days, barely encompassing more than attending board and committee meetings.[14] This increased to 30 days in the early 2000s from where it has increased modestly.[15]
- This is also seen in a McKinsey Global Survey of corporate boards.[16] The survey found the average time commitment of a NED had increased from 28 days in 2011 to 33 days in 2015, while the number of days NEDs would like to spend per company remained constant at 38.
- A survey in by PwC in 2011 found that on average, 35% of NED time was spent in board meetings, 20% in committee meetings, while only 7% was in site visits and 3% meeting external stakeholders, including shareholders.[17] The survey also found that the three biggest issues hindering NEDs in their ability to be effective was the lack of time to debate issues, volume of paperwork and regulatory requirements.
- The Walker Review addressed this issue, recommending that for listed banks and life assurance companies there should be several NEDs each with a minimum expected time commitment of 30 to 36 days.[18] Indeed, many NEDs on the boards of financial services companies now spend well in excess of this time commitment to discharge their increased responsibilities. This shows how the time commitment of NEDs needs to vary with the complexity of a business.

2) Unrealistic expectations have created a lack of clarity on the role of NEDs

As the expectations of NEDs have risen in excess of time and information, this has resulted in a lack of clarity around their role. Section 174 of the Companies Act does recognise that the duty of directors is proportional to the knowledge, skill and experience of a director fulfilling the same role. However, the general approach of codes and guidance gives too little recognition of the information and time constraints facing NEDs and how these can be resolved.

NEDs have difficult choices on where they place their focus, and this is not always within their control, as the rhythm of board engagement is set by the chairman in conjunction with the CEO. Boardroom effectiveness would benefit from greater acknowledgement and discussion of these choices.

Examples of unrealistic expectations:

- This is especially true in the financial services sector where the expectations on NEDs around monitoring and oversight have significantly increased. The Senior Manager Regime is one example of this, since it is requiring NEDs to have a detailed knowledge of operations, with a consequently increased time commitment.
- The lack of realistic expectations is also seen in the FRC's guidance on writing the strategic report. The guide states, *"The strategic report should reflect the collective view of the company's directors"* and that *"The overriding objective of the strategic report is to provide information for shareholders that will enable them to assess how the directors have performed their duty to promote the success of the company".* However, the FRC's 60-page guide on how to write a strategic report has no acknowledgement that it is not the NEDs who write the report, but rather the internal team. The guide is written as if the non-executive directors have far more time and expertise than is realistic. Similarly, there is no mention of how the shareholders can assess the level of director involvement in writing the strategic report.
- Further evidence of the unrealistic role that is expected of NEDs is the lists of characteristics that recruiters publish for the ideal NED. These lists are long and sometimes contradictory, and this is often acknowledged by recruiters. This is captured in a report by Korn Ferry in 2012 called *What Makes an Exceptional Independent Non Executive Director?*, which said, "*Today's NEDs must be more engaged, more numerate and more technically competent than ever before if they are to be equipped to succeed in a role that has become much more demanding than was the case even seven years ago*". Since then, expectations on NEDs have increased further.

3) A focus on acting as a monitor rather than a partner or advisor

Non-executive directors act as both the monitor, advisor and partner of executives. The problem is that the increasing burden of process and compliance has over-emphasised the focus on monitoring. The focus of governance codes and guidelines is predominantly on issues such as audit, remuneration, nominations and risk management, rather than how a board can help support and foster the entrepreneurial leadership that leads to success in private companies.

The focus on risk mitigation rather than value creation is further reinforced by incentive structures. NEDs have limited financial exposure to the success of the company, yes face damage to their personal reputation if something goes wrong. This asymmetry in incentives is in stark contrast to the incentives of executives.

4) A focus on backward-looking financial information

The combination of the shortage of time and emphasis on monitoring has contributed to boards placing too much focus on backward-looking financial information, process and compliance. By focusing on the past, it emphasises the monitoring role. The focus on financial information ignores the important range of information on stakeholder relationships that are critical to long-term success, as outlined in the report *Tomorrow's Relationships: Unlocking value*. The combination reinforces a focus on risk mitigation and short-term performance. In contrast, NEDs could spend more time meeting stakeholders and spending time in the business. This could help shift the focus to opportunities for innovation and the drivers of long-term success.

5) Too little variation in the role of non-executive directors

The role of board directors has continually evolved since the first companies were created. In the nineteenth century company boards were formed of the principal shareholders. Then as ownership fragmented, boards became dominated by executives in the 1950s and 60s. Then starting in the 1970s, and crystallised by Cadbury in 1992, the emphasis shifted to independent non-executive directors.

Through these transitions there have been continual debates around the balance of knowledge versus independence; the tension between monitoring and advising; the relationship with shareholders; the balance of rules versus freedom; and the recent focus on the role of stakeholders.

Too often governance codes and best practice have sought to define a single answer to these questions. In reality, the correct balance is different for each company and should change through time. Governance structures should reflect the great variety of challenges companies face. Some business models are very complex, when others are less so. Some companies are in a high-growth mode where risks need to be taken, while others are highly regulated and operating in mature markets and industries. Some are heavily reliant on external stakeholder relationships, while others only interact externally through wholesale markets.

Companies would benefit from a different balance of independence, knowledge, time and sources of information in accordance with their unique circumstances. In short, governance should be more about encouraging mindful variation, rather than enforcing conformity.

3. Actions and questions to consider

Based on the above critique, what actions can individuals take? This section sets out some key questions for individuals who work on or for boards to consider, and in addition sets out recommendations for policymakers, regulators and investors.

These questions aim to help individuals think about why a board should be different, rather than how it can conform. This is just a starting point and Tomorrow's Company will continue to build on this work with its community.

For boards:

Each individual on or supporting a board has a different role in overcoming the problems outlined in sections 1 and 2 above.

- **The chairman** has a crucial role in leading the discussion and decisions on what mix of roles and focus is most suitable for the NEDs of their board. Indeed, many chairmen thoughtfully encourage variation in the contribution of NEDs, even though this is not a focus of codes or guidance. Further guidance on the role of chairman can be found in *Tomorrow's Chairman* – a publication by Tomorrow's Company in which the chairman's different stakeholders, from Senior Independent Director (SID) to Finance Director, set out their expectations.
- **The company secretary** is also pivotal in helping reduce the burden of governance and compliance filling up the agenda, and providing NEDs with a sufficiently broad and independent flow of information.
- **Executives** can help NEDs shift their focus from monitoring to partnering by coming to the board with a problem to discuss, rather than a solution to be approved. This can help build greater trust between NEDs and executives.
- **NEDs** can use the questions below to challenge themselves on how they add value to a board and company.

In addition, a key means for a board to discuss these issues should be the board evaluation. The evaluation should ideally cover the questions outlined below, and so prompt a board discussion on the specific role and value that each NED brings to the board. Further detail on best practice in board evaluations is outlined in the report *Improving board evaluation for greater board effectiveness*.

1) What is the board's shared understanding of the company's purpose, values, key stakeholder relationships and risk appetite?
The starting point should be the board reaching a shared understanding of the company's purpose, strategy and key stakeholder relationships. Whom does the board serve? And how does it measure performance? Only by having clarity on this can a board discuss in what ways it should be different to other boards. This can enable the board to prioritise the agenda in order to reduce clutter, decide the skills and roles that are needed on the board, and discuss the appropriate balance of monitoring versus advice and partnering.

Tomorrow's Company has previously published a framework to help boards reach this understanding, called *The Case for the 'Board Mandate'*.

2) What is the role of the board and role for each NED in achieving this?
The board then needs to be clear on its role, and the role of each NED, in contributing to achieving the agreed purpose and strategy.

The way NEDs add value can vary significantly both in the topics covered, and their role in achieving this. Topics range from strategy to operational performance, M&A, capital allocation, culture, talent, executive succession, stakeholder relations, remuneration, nominations and many more. The appropriate role for each topic can range from advising to monitoring, networking, providing experience and challenging, or a mix of all.

The table below provides a high-level framing for some topics.

Topic	Role of the NED
Purpose	Collectively agree the purpose of the company.
Strategy	Help set the strategy, and then review and challenge whether the strategy is still appropriate. This role should be driven by NEDs bringing new ideas and challenges to the board proactively, in addition to reacting to information provided by management.
Stakeholder relationships	Constantly monitor the relationships with stakeholders; this requires quality information to be provided to each board meeting, supplemented with frequent site visits.
Culture	NEDs have a role deciding the desired values and culture, and then subsequently monitoring this through site visits and employee surveys. A framework to help boards lead on culture can be found here – *Governing Culture: Risk & Opportunity?*.
Compliance, regulations, audit, remuneration and nomination	For process topics, the directors perform a vital monitoring function, scrutinising that regulations and procedures are being adhered to.
Investor relations	NEDs generally have little contact with shareholders, though some are starting to attend the occasional management roadshow.

Questions for boards:

- Given the company's current phase of development, what mix of monitoring, advising or partnering would most effectively support the company's long-term success?
- Is this mix best achieved by each NED having an even balance of focus between monitoring, advising or partnering? Or would the board benefit from some NEDs that focus on each role?
- Imagine there were no NEDs and it was a board of executives. In comparison with this, what are the topics where the NEDs add the most value? How has company performance been improved by the intervention of NEDs?
- For each of these topics, do NEDs add value by operating in partnership with the executives, or by holding them to account? Do they bring detailed knowledge or a wider perspective?

3) How much time do NEDs need to spend to be effective in this role and for which topics?
Boards have a constant battle to allocate sufficient time to discuss long-term strategic issues. Agendas inevitably become filled with the clutter of process, regulations and backward-looking financial information. Boardrooms often find it hard to dedicate sufficient time to the topics that drive long-term value, such as strategy, investment, culture and stakeholder relationships.

The following options have been suggested to help NEDs make the best use of time:

- Shorten board papers
- Strengthen delegation to board sub-committees, especially to handle time-consuming issues that are not critical to risk, innovation or long-term success
- Shift the focus of board papers to forward-looking issues, rather than historical financial performance
- Take some board papers as read
- Send regular informal updates in-between board meetings
- Have some NEDs commit more time, thereby creating a mix of NEDs with a varying balance between knowledge and independence

Questions for boards:

- For the topics and role where the NEDs can add the most value, do they have sufficient time to be effective?
- How should the time and responsibilities be allocated between the main board and sub-committees?
- Is the board doing everything it can to reduce the clutter on the agenda?

4) What information do NEDs need in terms of breadth and independence to be effective on these topics?

NEDs are still overly reliant on information provided by the executives. This can hamper independence and can be too focused on financial data, which can make it harder for NEDs to be effective, especially on topics that are difficult to externally assess such as culture, innovation and supplier relations.

To deal with this, some of the following methods were put forward in the course of the research for this report:

- Many boards are seeking to address this by organising more site visits for NEDs, but finding the time can be difficult. Furthermore, to be effective site visits need to be relatively informal, rather than a 'royal visit' where the whole board turns up to be shown one site that has had weeks to prepare.
- Another suggestion is for the office of the chairman to also act as an office of the NEDs. This can help provide the NEDs with the resources of a staffed office that is independent of the executives. The success of this approach depends on the support of a strong chairman.
- A further theme was to improve the quality of board packs, making them more concise and broadening the information beyond historical financials.

Questions for boards:

- Do NEDs have sufficient contact with and knowledge of the company to help advise and support the executives?
- How do NEDs assess the strength of stakeholder relationships?
- Are NEDs empowered to request additional information when they need it? For example, do they ask for advice from third parties or request individual site visits?
- On what topics are non-executive directors expected to react to information provided by management, and which topics to proactively bring new challenges and ideas?
- Does the board have sufficient diversity in backgrounds and time for free discussion to identify upcoming disruptive changes in the industry?

5) How does the board encourage a diversity of voices and perspective on critical board decisions? And in the selection of NEDs?

The effectiveness of a board is ultimately determined by the quality of the conversation between board members. This cannot be created by codes or structures, it comes from the values and behaviours of the individuals on the board. Tomorrow's Company has previously published a framework to help boards improve the quality of conversations, and thereby to benefit from a diversity of voices – *Tomorrow's Corporate Governance – Improving the quality of boardroom conversations*.

In addition, a greater variation in the role of NEDs would be supported by increased diversity in backgrounds. This needs to go beyond gender and ethnicity, to include background and true cognitive diversity. The board does not need experts on topics, as that is the role of advisors. Nonetheless, a certain level of knowledge does allow a NED to constructively challenge by asking the right questions. Also, having some NEDs who are complete outsiders to a topic can help in asking the awkward questions, and avoiding 'groupthink'.

Questions for boards:

- Does board composition create a diversity in thinking? Are there individuals from outside of the listed company world?
- Do NEDs know why they were appointed? What role and specialism are they expected to bring to the board?
- How is the boardroom hearing challenging voices from outside the boardroom? How often are external speakers invited? Is there a role for a stakeholder advisory panel? (See *Bringing employee voice into the boardroom*)

6) What is the right level of alignment between executives and non-executives?

Executives sometimes voice frustration that NEDs are not aligned with the long-term success of the company, instead taking a short-term risk-averse approach. This could be because NEDs have little upside if the company succeeds, and risk to their reputation if it fails. This creates skewed incentives to the downside. Similarly, sometimes executives approach the board as an obstacle, rather than a group that can add value. Too often topics need to 'get passed by the board'.

Questions for boards:

- Do executives use the board as a supporting mechanism to discuss issues, or do executives present decisions for approval?
- How much alignment between executives and non-executive directors does the board want?
- Should NEDs have greater financial incentives if the company succeeds?

For investors:

The need for greater variation in the role of NEDs has important implications for the way that governance is assessed and monitored. This relates to three issues.

- The ongoing resource constraints for stewardship within asset management inevitably reduces the investor focus on governance to compliance with a list. Having a more detailed and nuanced conversation about a different approach within a specific company would require significantly more resources for stewardship and a more principles-based approach to assessing good governance.
- Additionally, the division between the governance and investment team emphasises governance as an end in itself, rather than a means to long-term success.
- In addition, while NEDs are elected by shareholders, they have relatively little contact with them. Shareholders are also frequently blamed by boards and executives for placing a damaging short-term pressure on the company. While the lack of contact with shareholders is recognised in the UK Corporate Governance Code, there remains a disconnect between NEDs and shareholders: "*Whilst recognising that most shareholder contact is with the chief executive and finance director, the chairman should ensure that all directors are made aware of their major shareholders' issues and concerns."* Generally, NEDs are kept informed of shareholder views by an update from investor relations, though some NEDs go on occasional investor roadshows. Overall, the degree of NED engagement and contact with shareholders is an area with relatively unclear expectations.

Questions for investors:

- How much time do stewardship and governance teams need to consider why a board should be different, rather than if it complies with a list of 'good governance' characteristics?
- How can greater alignment and collaboration be achieved between the stewardship team and investment teams?
- Have there been some meetings with NEDs, in addition to the executives and chairman?

For regulators and policymakers:

Policymakers and regulators need to move away from adding more regulations as the automatic response to each scandal, and instead shift the focus to supporting and encouraging companies to invest. Tomorrow's Company has previously published detailed policy recommendations in its report *Promoting long-term wealth* under three key areas – increasing the pools of patient capital to act as stewardship investors, increasing the voice of stakeholders and shifting towards a more principles-based governance regime.

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