Response to UK Corporate Governance Consultation Paper 2018

Dear Sir or Madam,

The consultation paper concerning the thorough revision of the UK Corporate Governance Code suggests the FRC has already reached quite firm conclusions about what is needed to bring the code up to date. Much of that is sensible and some is overdue. But the recent collapse of Carillion should serve as a reminder that compliance with the code is not enough. In the company’s final annual report (2016), the chairman Philip Green proudly proclaimed: “the Company complied fully with the requirements of the UK Corporate Governance Code”.

Because your views about the shape and substance of the code are well developed, we restrict our comments to two aspects of the proposed changes; – (Question 6) the call to extend the recommendation concerning board evaluations to all listed companies, rather than just the larger ones; and (Question 7) asking whether independence for non-executive directors and chairs is lost after a nine-year tenure.

Response to Question 6:

Board evaluation has beyond doubt contributed to greater reflection by directors on their roles. While academic and industry research on the practice is limited, survey data suggests that compliance with the recommendation has grown since its introduction with the 2010 code (Grant Thornton, 2016). But compliance is not enough. Carillion’s final annual report detailed that it not only undertook annual board evaluations, but it had done so in 2016 using a reputable outside consultancy that specialises in precisely this activity (p. 56). It concluded that the “Board remained highly effective with its performance having further improved during the year”.

The board had undertaken the exercise through an anonymous online survey of the “Board as a whole and each of its Committees”, presumably including its “Integrity Committee”, a mechanism that went beyond the Code’s requirements of good governance. This use of anonymous online survey may raise warning flags for investigation and correction if used correctly, but – as the case of Carillion demonstrates – it may easily fail to do so as surveys may not reflect the actual performance of board and its members.

This incident demonstrates that board evaluation, as other provisions of the code, is not a panacea or even a reasonable guarantee against catastrophic failure. A decision to extend the practice to all listed, while welcome, risks adding to the burden of box-ticking and deflecting attention from the underlying goal of the practice: improving board effectiveness.

Despite the difficulties involved in board research, there seems to be wide acceptance of the view in Forbes and Milliken (1999) that effectiveness requires a board to navigate tricky currents that any map of routine board evaluation may fail to identify: the tension between constructive challenge – “cognitive conflict” in academic writing – and cohesiveness in boards.

1 http://annualreport2016.carillionplc.com
The role that board evaluation needs to play – and particularly the role that external evaluators can play – is that of being on board as the board navigates these waters. Our research with directors of listed companies who have undergone both internal evaluation and ones led by outside consultants, suggests that directors have found the process valuable (Booth & Nordberg, 2017). That research is still tentative, but it highlights the value of having someone in the room who is sensitive to the company’s issues and to the dynamics of the interactions of directors, who can warn when challenge veers towards dysfunction or cohesiveness towards cosiness.

As respondents to previous code consultations have said (Nordberg, 2017), and as the FRC (2016) has recently taken to heart, the ethos of a board, its culture, is crucial to how it works. Evaluating culture requires sensitivity to that ethos, the ability to detect the cultural intelligence of directors themselves (Charas, 2015; Earley & Mosakowski, 2004). It requires attention to not just the skills and knowledge of directors, the effort they put into their work, but also to the relationships between them in action (Nordberg & Booth, 2017).

The profession of the company secretary, as voiced by ICSA: The Governance Institute, is one that increasingly aspires to be an independent adviser to directors. We are tempted to say it seeks to be the conscience of the board, a persistent if quiet reminder of the duties of directors to be accountable to each other (Roberts, 2001), a duty to navigate the tricky currents, and not just to shareholders or others with deemed to have a stake in the business. Therefore, the extension of the board evaluation to include the company secretary, which is at present informally included in many external board evaluations, could be a consideration for future code amendments.

To conclude, we favour extension of the board evaluation facilitated by a professional evaluator to small companies, utilising emerging profession of board evaluation (ABExcellence, 2014; Pitcher, 2014), and the widening of the practice that the FRC’s new draft code mandates. The proliferation of the practice requires professionalisation and potentially standardisation. This may need encouragement from the FRC not just for professionalisation of practice, but also for experimentation to discover what works, in what circumstances, and to what extent. As a route to suggesting standards, the FRC might need as well to commission research into what such experiments yield.

Response to Question 7:

It appears that the FRC is undecided as to whether a tenure for independent non-executive directors should be set at nine years or whether this rule should not be implemented and it should be the shareholders who decide at annual re-elections as to whether the effectiveness of the non-executive director is relevant for the board to which they are appointed.

The independence of a non-executive director is a valid response to ensure effectiveness at board level. In 2014 published research into the composition of boards in 117 corporation failures in the UK found that a greater number of independent directors reduced the likelihood of failure (Hsu & Wu, 2014).

For shareholders to determine the effectiveness and independence of a director they need to first be presented with information to determine this. At present the annual report provides limited information to be able to consider all aspects of a director’s ability to make an effective contribution. There are currently three areas of reporting available, those being: number of listed company appointments for each director to determine if over-boarding exists; attendance at board meetings to determine commitment; and biographies for each director to determine knowledge and skills.
In our opinion shareholders will not be able to determine the contribution of the non-executive directors such as effective challenging of perceived norms and emotional intelligence to ensure effective contribution. Our research into the effectiveness of non-executive directors and the boards on which they are appointed shows that the board dynamics and the attributes of the directors which contributes to firm performance are not made available to shareholders, as shown in this model:

![Board Effectiveness Model](Nordberg & Booth, 2017)

We note that the proposed independence limit of nine years is in line with the tenure period for auditor rotation. The basis for this rotation being a fresh perspective; however, it also provides for a poor knowledge of the company (Lu & Sivaramakrishnan, 2009). This is the trade-off of rotation, but does lead to the perception of independence albeit that the rotation itself provides this and not the length of service (Daniels & Booker, 2011). In applying this to boards, whilst succession planning and independence are important, fixed tenure can lead to removal of effective non-executive directors who become non-independent after nine years with little consideration for their contribution.

In our view it is not possible for an outsider with no access to internal information to be able to judge the independence of a non-executive director. It is recognised that cognitive independence is required to avoid groupthink and other behavioural dynamics which can be considered to be destructive to board effectiveness however it may not in itself be determined by length of service. Further investigation is required to determine whether the implementation of three-year external board evaluations for all companies can be used as a tool to determine non-executive director independence rather than a fixed tenure of nine years.

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References


