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EFFECTIVE BOARDS

I am taking part in this Conference as chairman of the Committee on the Financial Aspects of Corporate Governance. However, today's discussion of the role of boards in the NHS goes wider than the remit of our Committee, so I will be drawing on my experience as a company chairman as well.

We addressed our report primarily to public companies quoted on the London Stock Exchange. Thus many of our recommendations are directed at companies whose continued existence depends on their profitability. All our recommendations, however, are based on the principles of good corporate governance, which will apply both to commercial companies and, for example, to the different NHS boards.

We say in the report that we would encourage all companies to aim at meeting our recommendations.

Report Context

You do need, however, to keep two points in mind in considering the relevance of our recommendations to the working of the particular NHS boards with which you are concerned.

First, we addressed the financial aspects of corporate governance and not corporate governance as a whole. The Code of Best Practice, we have put forward, needs to be read in that context.

We defined corporate governance as the system by which companies are directed and controlled.

Second, shareholders have a fundamental place in the framework of the report and in the implementation of our recommendations. They were one of the main audiences to whom our report was addressed, because it is to shareholders that boards of public companies are accountable. Bodies other than public companies, including NHS boards, are equally held accountable but in different ways.

With those two emphases in mind, let me say something about what lay behind our report in order to put it into context.

Formation of Committee

The Committee was established in May 1991 by the Financial Reporting Council, the LSE and the accountancy profession. Our sponsors were concerned at the lack of confidence in financial reporting and in the value of audits. These concerns were heightened by some well-publicised failures of prominent companies, whose financial statements appeared to give no warning of the real state of their affairs.

What none of us anticipated was the degree of general interest which our apparently rather narrow, technical enquiry would arose. This interest was fuelled by episodes like the collapse of the BCCI bank, the Maxwell affair and the continuing controversy over directors' pay.

We had a wide and encouraging response to our request for comments on our draft report and we published it in its final form last December. At its heart is the Code of Best Practice which applies to the boards of Stock Exchange listed companies registered in the UK.

The Code of Best Practice

The Code of Best Practice has been admirably summarised by NAHAT and so I will not deal with individual points arising from it, though happy to discuss them. I do, however, want to say something about the basis on which the Code was drawn up, because that will help you to interpret it, to meet your individual needs.

The Code is based on the need, if boards are to discharge their duties effectively, for adequate disclosure and for appropriate checks and balances within the governance structure. Both are relevant to NHS boards.

<u>Disclosure</u> ensures that all those with a legitimate interest in a company or organisation have the information which they need to exercise their rights and responsibilities towards it. In addition, openness is the basis of public confidence in any corporate system.

<u>Checks and balances</u> within the structure of a company, especially at board level, ensure that the duty of the directors to act solely in the interests of the company is always respected. They also guard against undue concentrations of power.

Boards of all kinds, if they are to discharge their duties effectively, need to have regard for a proper degree of disclosure and for appropriate checks and balances within their structure of governance.

We found considerable confusion over exactly where the responsibilities for financial reporting and control lay. In particular, there was widespread uncertainty about the respective roles of directors and of auditors in the matter.

Again I would suggest that the precise allocation of responsibilities for financial control is a matter which every effective board should keep under review.

My final point on the way in which the Code should be read and understood is that it is based on general principles, not on prescription. It sets out the aims and objectives which boards should meet in setting their standards for financial accountability and control. It does <u>not</u> lay down precisely what structures and processes they should establish to this end.

In sum, the Code provides a check-list for all kinds of boards to assess their standing and an agenda for shareholders and others to whom boards may be accountable.

Principles not Prescription

The reason why we did not lay down a specific set of governance regulations is that every board, every chairman and every organisation is different and we were conscious of the need to meet the diversity of board situations. It was also a way of encouraging compliance with the spirit of the Code and not simply with its letter.

In the event, it has meant that the Code recommendations can be applied more widely than just to public companies for whom it was drawn up. This deliberate avoidance of prescription is exemplified by two of our recommendations.

First, the Code does not specifically require the posts of chairman and of chief executive to be separated, although we make it clear in the body of the report that in principle they should be. What we do recommend is that there should be a clearly accepted division of responsibilities at the head of a company, such that no one individual has unfettered powers of decision.

How boards bring that about is up to them and those to whom they are accountable.

Second, and equally important, non-executive directors. We refer to the calibre and number of ned's being such that their views carry significant weight in the board's decisions. We do not say that there should be a specific ratio of outsiders to insiders. It is the quality of the ned's which counts not simply their number.

Judgements, therefore, have to be made in applying our recommendations in each individual board situation.

Control and Accountability

Control and accountability are two of the hallmarks of an effective board. By adherence to the Code, companies strengthen their control over their businesses and their public accountability. So the findings of our Committee relate directly to the title of this talk - effective boards.

The control and reporting items on a board's agenda do not, however, represent the sum of its activities and we need to widen the discussion beyond the limits of our Committee and discuss other key characteristics of an effective board.

Board Effectiveness

The test I used as a company chairman was what value we, as board members, were adding to the company. To earn our keep, our usefulness to those managing the business had to be greater than our cost and that judgement had to be theirs not ours!. The simple point is that an effective board contributes to the aims of the organisation for which it is responsible and is seen to do so.

Determination of Purpose

The first task of an effective board is to determine the purpose of the body for which it is responsible. This is not usually quite as simple as it might sound. Company chairmen, for example, often say that the purpose of their business is to make a profit, when that is the outcome of their achieving their purpose, not the purpose itself.

The purpose of a medical unit might be just as much to prevent people becoming ill, as their efficient treatment when they had become ill, or some judicious balance between the two, between prevention and cure.

The purpose of most institutions rarely remains precisely the same. It is the job of the board to be alert to the changing scene, because it is easier to spot the signs and direction of change if you are not immersed in the day-to-day management of an enterprise. It should have been the job of the boards of Swiss watch companies to appreciate that watches and clocks did not necessarily need hands, before so much of their market had been lost to their digital competitors.

Sir John Harvey-Jones in his excellent book, **Making It Happen,** writes:-

"If the board is not taking the company purposefully into the future, who is? It is because of boards' failure to create tomorrow's companies out of today's that so many famous names in industry continue to disappear."

The <u>effective</u> board is crystal clear as to the present purpose of its enterprise and watchfully monitors its continuing relevance. You are responsible both for your enterprise of today and for guiding it towards that of tomorrow.

Vision

The board defines the purpose of the enterprise, it also has the task of ensuring that everyone in the organisation shares that same sense of purpose and understands how their particular job contributes to the overall goal. The way the purpose is expressed, therefore, matters. Effective boards need to communicate not only direction and aims, but the vision that lies behind them.

A shared vision and sense of purpose are what inspire members of an organisation to feel that its aims are theirs and that those common aims are worth striving for. Vision is what makes you want to get out of bed and off to work in the morning!

Setting Goals

Two further brief comments on the board's responsibility for setting the goals of the enterprise - first, hammering out what the enterprise exists to achieve, and reviewing its continued relevance, is a true <u>team</u> task.

Every member of the board can and should contribute to it, because it does not require specialist knowledge, but a willingness to question accepted ideas and an openness to a continually changing environment. The outside members of a board, the NED's, have an especially valuable role to play in this regard, because they stand further back from the enterprise than the insiders. Thus the determination of purpose is not only critical in its own right, but is also a means of pulling the board together as a team.

Second, it is only by establishing clear aims that the board can measure its achievements. This definition of purpose is not only central to ensuring that an organisation applies itself to the right tasks, but it provides the benchmark against which it measures its progress.

Values

Vision and purpose, however, on their own are not enough. An effective board also has a responsibility for the values of its organisation. Values cannot simply be established by board resolutions, they are embedded in the actions of everybody in the organisation. All organisations have their own particular character, which is passed on to newcomers as "the way we do things here".

But boards can influence values, first by setting an example, by being seen to uphold those values which they believe to be important. They can also make clear which values the organisation should be aiming to attain, by reinforcing those that are already established and encouraging those that need nurturing. In my experience, statements of values and codes of conduct , hard though they are to draw up, are widely welcomed because most people want to know what is expected of them. I see the effective board as the guardian of the values of the enterprise.

Purpose into Action

The board's next task is to ensure that the necessary management structures and policies are in place to translate purpose into action. This is where the board has to draw the boundary between its responsibilities and those of the management. In my former company, it was not the board's job to become involved in how chocolate was made or soft drinks bottled, but we did need to know that the production, distribution and managerial resources were there to meet the needs of our customers and to maintain our standards of quality.

An effective board, therefore, should agree operating plans and targets, without interfering with the way in which they are implemented. The dividing line, between providing managers with the planning and policy guidance which they need in order to do their job and becoming involved with how they do it, is a narrow one. It is a line which has to be firmly held if boards are not to be diverted from the tasks which they alone can do.

Delegation

The test of an effective board is that it confines its activities to those which it alone can discharge. The great European principle, if you like, of subsidiarity! The question it must ask is whether any given issue can be appropriately dealt with below board level. The fact that the board delegates the carrying out of the strategy which it has determined does not dilute its responsibility for the outcome. Delegation does not mean abdication. The board is ultimately responsible for all that is done in its name.

The board discharges its responsibilities by ensuring the commitment and competence of its management staff and the adequacy of the framework within which they are working. I would, therefore, expect an effective board to be concerned with the appointment and training of key managers.

Holding the Balance

Up to this point, I have been concentrating on the relationship between directors and managers. I have been looking inwards at the mechanics, if you like, of the running of an enterprise.

The board, however, also has to look outwards at the customers or communities which it exists to serve. The board is the link between the outside world and the enterprise itself. An effective board is one which consciously aims to hold an appropriate balance between the interests of the organisation and of those of the people it serves.

Quite naturally and understandably any institution organises its affairs to suit its own needs as far as possible - as railway and aircraft passengers will know to their cost! This is why commercial organisations need to be as concerned with customer satisfaction as with strictly financial indicators, and it leads on to the question of accountability.

Accountability

In looking outwards, effective boards are continually alert to the issue of their accountability. It is for the board to determine to whom their organisation is accountable, both in the strict sense of to whom does it render an account of its stewardship and in the more general sense of to whom does it have some form of responsibility.

The board of a publicly quoted company is answerable to its shareholders in general meeting and has a statutory duty to take account of the interests of its employees. In addition, it regards its responsibilities to its customers as of paramount importance if it is to remain in business. Equally, it has to recognise that it has responsibilities towards lenders, suppliers and the community at large.

The issue which only the board can answer is precisely what weight to give to these different responsibilities. What action should a Company board take when there is a downturn in its ~~company's~~ trade? The interests of the shareholders might argue for redundancy, to reduce the numbers employed. On the other hand, the interests of the employees might seem to be best served by a reduction in working hours.

This balancing of claims on the organisation can only be done by the board, because the board alone is in a position to look at the situation as a whole and over a sufficient time horizon to decide where the best long-term interests of the enterprise lie. An effective board holds the balance between the variety of claims which are made on it, from within and without.

Short and Long Term

The board is responsible for holding another kind of balance as well and that is the balance between the demands of today and the needs of tomorrow. How far should funds be spent on the present and how far should they be invested in the future? Training for example has an immediate cost, but a longer-term pay-off.

Balancing short and long term needs is one of the most difficult of all judgements, and one which can only be made by the board.

I will finish with brief comments on four aspects of board working, which are particularly relevant to effectiveness,
- the board as a team, the part played by non-executive, or outside, directors, the role of the chairman and the need for boards to review their own progress.

The Board as a Team

The effectiveness of a board is a reflection of how well the members work together as a team, so the composition of the board is important. Chairmen are looking for a balance between inside knowledge and outside experience, and between personalities, skills and age.

Equally, when vacancies occur on a board, board members need to think through what skills and experience would best complement those already present The search should start with a description of the kind of person the board is looking for and not, as it far too often does, with names.

Boards like other teams need to be made up of people with different attributes. Without that mix there would be insufficient debate and challenge. Board members, however, have to strike a balance between standing up for their individual opinions and standing behind the views of the rest of the board team.

Boards should not become too cosy or club-like - you need a degree of tension. But there is no place on an effective board for the intransigent or for passengers - nor is there for directors, who see their role as representing some particular set of interests. The duty of all directors is solely to the institution for which they are responsible.

Chairmen should. therefore, have everyone's support in bringing about whatever changes are necessary to the board team to promote effectiveness.

What should hold members of the board team together is their belief in a common cause. If they are dedicated to the same task, they should be able to strike the right balance between individuality and collegiality.

The Role of Outside Directors

This leads on to the role which outside directors play on a board. I prefer the title outside director to non-executive director, because it is a more accurate description of their position. Outside directors bring their own outlook and experience to the board, which will be different from those of the inside or executive directors. In addition, they have the advantage of standing further back from the day-to-day working of the body which they are directing and thus are freer to exercise their independence of judgement.

Because they do not hold executive posts within the organisation, outside directors are in a position to review the performance of those that do. Equally, they are well-placed to take the lead over issues where the interests of the executive management and of the institution could diverge, for example over top management succession or over executive pay, because their interests are less directly affected.

The contribution of outside directors to the business of a board is to a great extent dependent on the information which they receive and the use which they make of it. There can never be equality of information between those working in an organisation and those outside it. But it is up to the chairman and the board secretary to ensure that board members are given sufficiently relevant and timely information to arrive at considered judgements on the issues before them.

The Chairman

The chairman is crucial to board effectiveness. I do not think that the degree to which board effectiveness depends on the skill and competence of the chairman is sufficiently appreciated. It is because the job of the chairman of a public company is so demanding that, all other reasons apart, I would not make it harder by combining it with that of the chief executive.

To obtain full value from a board meeting is a difficult task. While thoughtful preparation beforehand by the chairman is essential, there is no way of knowing in advance just how a meeting will develop. We are talking about a collective process and a dynamic one. All board members are equally responsible for the board's work and chairmen need to encourage them to contribute on an equal footing. The job of the chairman is to stimulate board members to give of their individual best in a co-operative cause.

Self-assessment

The hardest part of a board's job is that of assessing its own performance. Here it is normally for chairmen to take the lead, but it is up to each board member to contribute to the review. Boards can only improve their effectiveness, if directors are open with each other and with their chairmen as to ways in which they could be of more value.

Boards have to make time to review their own methods of working, as without a determined effort this chance for collective learning will be crowded out by all the urgent issues of the day. New board members need to consider how they can best prepare themselves for the considerable responsibilities which they are taking on and all board members need to determine how best they can continue to develop their directorial skills.

Conclusion

I have discussed the principles behind our Committee's proposals and some of our recommendations

While they centre on the financial aspects of corporate governance in the commercial world, I hope that you will be able to draw on them, when you put into action the thoughts which you will be taking away from today's Conference.

NHS boards are responsible internally for the effectiveness of their service and accountable externally for their activities.

Your watchwords need to be " effectiveness" and "accountability". Boards which keep those two aims continually in mind will serve the NHS and their constituencies well.

Adrian Cadbury

16/9/93.