

Corporate governance and the role of non-executive directors in SMEs

A Guest Article by Frank Lewis
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Findings of the Walker Review

Much has been written in recent times regarding the proposals of the Walker Review to strengthen governance in the banks and financial institutions and the role of the non-executive director (NED) in representing a rigorous challenge in the boardroom and to encourage institutional shareholders to play a more active role as owners.

Worryingly, however, there has been too little debate – written or otherwise – regarding corporate governance and the role of the NED of companies not included in financial services, and, in particular, in small and medium-sized enterprises (SMEs).

Why should this be the case? Investors will continue to expect a company coming to the market to have a board comprising executive and non-executive directors, who will apply the corporate governance guidelines as applicable to those companies.

“Soft law” approach to raising standards

The Walker Review notes that while a complete overhaul of the contents of the Combined Code on Corporate Governance is not required, there remain parts that may need further review. Accordingly, the market’s view can be seen to be that the flexible, “soft law” approach remains the most appropriate way of raising standards of corporate governance.

The continued creditability of this approach, however, depends on there being a consensus that the contents of the Combined Code are conducive to best practice; to boards disclosing their governance procedures in an open and transparent way; and to investors interpreting governance disclosures in an enlightened and objective manner.

Further, it is of critical importance that there are both sufficient institutional investors willing and able to engage actively with the companies in which they invest and companies willing to seek an informed external perspective on their performance from their shareholders.

The above should apply to SMEs and other listed companies as well as to banks and other financial institutions.

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Issues that still need clarification

The Walker Review specifically highlights issues such as the responsibilities of the chairman and the non-executive directors.

- Would it be helpful to further clarify – in the Combined Code or in non-binding guidance – the role, key responsibilities, and expected behaviour of the chairman, senior independent directors and non-executive directors?
- Would it be helpful to provide further guidance on the time commitment expected of the chairman or non-executive directors?

These questions can also apply and are relevant to SMEs.

There are other issues, such as board balance and composition; frequency of director re-election; board evaluation; risk management and internal control. These are all topics and issues that can be debated and fine-tuned if required.

The following are also issues relevant to SMEs:

The Combined Code on Corporate Governance sets out standards of good practice in relation to matters such as:

- board composition
- remuneration
- accountability
- relations with shareholders

and is recognised globally as the most effective corporate governance model. Indeed, the problem is not with the substantive contents of the Combined Code, but with the way they are applied. This has been confirmed, in my opinion, by the recent Walker Review.

The essence of good governance

Good governance is a complex mix, but its essence can be distilled into two factors. The first is boardroom behaviour: are the difficult questions being asked? Moreover, is there effective challenge, or simply an over-dependence on the management's view?

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The second is ensuring that the board has a clear line of sight. If the directors cannot see what is happening inside the business, and are thus not receiving the necessary information, they will not know what questions to ask.

Indeed, if the risk management processes are not organised in a clear and methodical way, then a small number of part-time executives do not stand much chance of overseeing them.

These two variables – boardroom behaviour and connectedness to the organisation – are necessarily interdependent. Therefore, there will be no real challenge for the boardroom unless the company makes it possible, which means that the management needs to want it to happen.

I believe that this represents the vital point that has been missed by Walker, in that executive management and the way they conduct themselves is central both to how the Combined Code is applied and to how companies conduct themselves.

Practical aspects of being an NED of an SME

My definition of a good NED is one who ensures that the business is well run but does not run the business.

The qualities that a good NED needs are:

- good interpersonal skills and the ability to manage conflict
- sound judgment
- the ability to influence through clear communication
- integrity
- the conviction to say things that need saying and, as a last resort, to vote with your feet
- to be commercially aware.

There are two other key points:

- NEDs should look at the company as a whole – take a “helicopter view”.
- NEDs should not get entangled in the day-to-day operations.

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The roles of the non-executive director

Challenging the MD and executive board

By asking apparently simple questions about the business, the NED can greatly help an executive team to refocus on the important rather than the urgent, and also to challenge commercial ideas such as "We have always done it that way".

Providing knowledge, insight and experience

General business wisdom and experience gained from a variety of environments has huge value, as business people often learn best from the experience of others.

Raising standards of governance

A good NED should help to raise the standards of corporate governance within a company. This helps to ensure that executives understand their obligations in this respect and thus comply with the Combined Code.

Advising on strategy

A business without a strategy is a business without a sense of direction or purpose. NEDs can assist the executive team in articulating the strategy. Therefore, NEDs must have good interpersonal skills and sound judgment.

Challenging business plans

Executives can often produce business plans with goals that are comfortable rather than stretching. NEDs can push, interrogate and raise the performance bar. They can also challenge ambitions that they believe are simply unrealistic. They provide a commercial reality check.

Mentoring

One of the most important roles of an NED, especially for SMEs, is to act as a mentor to the executive board and to coach directors in governance, people management and so on.

Acting as a sounding board

NEDs have an invaluable role to play when a company is considering decisions such as acquisitions and disposals of businesses.

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These roles do of course have to be considered in the context of any NED's statutory duty – which he shares with his co-directors – to promote the success of the company for the benefit of its members as a whole under the Companies Act 2006.

In addition, however, the NED can act as the impartial "honest broker", helping to make well-thought-out decisions – sometimes in cases where, otherwise, the heart would rule the head.

Frank Lewis

Independent non-executive director and chairman

If you would like more information on any of the points covered in this Guest Article, please contact **TCii** on **020 7099 2621**.