Role of non-executive directors

Non-executive directors govern together with the other directors in an organisation on behalf of shareholders or members by whom they are elected. A non-executive director is one who is not employed by the organisation in an executive capacity. All directors, whether executive or non-executive, must comply with basic legal requirements under the *Corporations Act 2001*[1].

Non-executive directors go by a number of names. In Australia and the UK, they are sometimes referred to as "independent directors". This is not strictly correct and will be discussed shortly in this information guide. In the US they are also referred to as "outside directors" because they come from outside the organisation, i.e. they are not executive directors who are also part of the senior management team.

The UK's Higgs Review[2] describes non-executive directors as "custodians of the governance process". In Australia it is considered good practice from a governance perspective for a majority of directors on a board to be non-executive and independent, especially in listed companies[3]. Proxy advisers are increasingly rating companies on the independence of the board as a sign of their adherence to principles of good governance.

What does the role entail?

A non-executive director's responsibilities will normally be outlined in the corporate governance charter and may also be touched on in a director's letter of appointment. Specific terms will vary from organisation to organisation, but will usually cover a director's responsibility in relation to:

- Effective governance of the organisation
- Formulation of the organisation's strategic direction
- Recruitment and performance of the CEO
- Reviewing, approving and monitoring the business plan and annual budget
- Contribution to the development of board and organisational policies
- Compliance with the legal requirements of being a director
- Compliance with legal and regulatory requirements of running a business
- Monitoring risks facing the organisation
- Involvement with a board sub-committee.
- Identifying skills required by the board and potential candidates
- Commonly, filling the role of chair of the board

The charter might also refer to minimum standards of behaviour expected of a non-executive director. AICD's Code of Conduct provides guidance on this.

How does a non-executive director add value to a board?

The perceived advantage of non-executive directors is their independence and objectivity – their ability to act in the best interests of the company is not compromised. Other ways in which non-executive directors add value include:

- Bringing an independent and fresh perspective to decision-making
- Demonstrating relevant competency, experience and ethical behaviour
- Challenging, questioning and monitoring the CEO and senior management

[1] For more information, refer to the FAQ General duties and responsibilities of directors.
[2] Higgs, D. *Review of the role and effectiveness of non-executive directors*, London: Department of Trade and Industry, 2003
[3] For example, see ASX Corporate Governance Council, *Corporate governance principles and recommendations*, 2nd ed., Sydney, 2007.
[

- Supporting and mentoring the CEO.

It should be noted that having a majority of non-executive directors is no guarantee against corporate failure. Also, there are studies which question whether the presence of independent directors really improves company performance and board effectiveness.

Are non-executive directors also independent directors?

Current good practice recommends that a majority of directors on a board be independent. An independent director is one without existing relationships with an organisation that might materially interfere with his or her ability to work in the best interests of the organisation, such as being an employee, contractor, professional adviser, supplier, customer, substantial shareholder, stakeholder, holder of other commercial interests.

A non-executive director is a director who is not also employed by the organisation on whose board they serve. A non executive director may have a range of relationships, as described above, with the organisation that reduces their independence or the perception of their independence. Note that all such relationships must be declared to the board to fulfil a director's duty to avoid conflicts of interest.

So, although the terms 'non-executive director' and 'independent director' are often used interchangeably, this is not strictly accurate. However it is possible to be an independent non-executive director.

Rather than define independence in terms of commercial or stakeholder interests, AICD and some notable commentators such as Sir Adrian Cadbury[4] believe that it is more helpful to base independence on behaviour and mindset. This requires a board culture where intelligent inquiry and independent opinion are encouraged and where the views of experts on the board or dominant board members are not automatically deferred to without investigation. The ASX Corporate Governance Council takes the view that no director who is a former employee of a listed company is considered "independent" until 5 years after their employment ended.

What information does a non-executive director need?

The greater the proportion of independent directors on a board, the greater their reliance on management for information about what is happening in the organisation and the issues arising. It is the board's responsibility to ensure it receives all necessary information to fulfil their delegations and it is management's responsibility to bring important issues to the board's attention.

An important distinction between a non-executive director's role and a manager's role is that the board is responsible for governance and oversight while executives manage the organisation. Typical shortcomings in information presented to directors include it being too detailed, operationally-focused, silo-based rather than whole-of-business-based. Information that non-executive directors need to allow them to properly discharge their duties should be governance-, risk- or issues-based, related to decision making, with major performance information to enable the board to monitor and evaluate success.

Should a director's number of directorships be limited?

Some investor groups have called for a limit to the number of non-executive directorships that can be held by one person. AICD has responded to this in a 2005 submission and in a CEO Report in *Company Director* magazine.

Generally each organisation and individual will vary in their needs and abilities. This highlights the importance of using evaluations of both boards and individual directors to measure performance. AICD has published a useful guide on this topic "Evaluating Board Performance: a guide for Company

[4] Cadbury, A *Report of the Committee on the financial aspects of corporate governance*, London: The Committee, 1992, paragraph 5.26.

Directors" Sydney, 2007.

An increasing commitment and personal liability?

A non-executive director in Australia is currently a part time role with a time commitment of less than that of a senior management position. Directors' responsibilities, personal liability and exposure to a presumption of guilt has been increased by legislation and case law and this has had an inevitable impact on the time required and the remuneration demanded. It has also altered the balance the non-executive role more towards that of an executive one as non-executive directors attempt to meet their growing responsibilities.

There are presently a number of reviews underway by government relating to director liability.

This increasing time commitment is consistent with the position under the *Corporations Act* that prima facie there is no distinction between non-executive director and executive directors in the application of director duties. As a result, non-executive directors must largely rely upon the business judgement rule and reliance and delegation defences set out in the *Corporations Act* in leaving the day to day management of the company to the company's executives but a real time commitment from a non-executive director is nonetheless required.

AICD believes that there is a need to extend the business judgement rule.

Sources

Cadbury, *A Report of the Committee on the financial aspects of corporate governance*, London: The Committee, 1992

Corporate governance principles and recommendations, 2nd ed., Sydney: ASX Corporate Governance Council, 2007

Evaluating board performance: a guide for company directors, Sydney: Australian Institute of Company Directors, 2007

Higgs, D *Review of the role and effectiveness of non-executive directors*, London: Department of Trade and Industry, 20

Cowley B "Protecting Your Position ... laws imposing personal liability on directors" Minter Ellison Lawyers August 2007

Further information
FAQs
Role of non- executive directors
General duties and responsibilities of directors
Selecting a new director
Key competencies for directors
Succession planning

Bookshop
Law
Corporate governance

Education
Available courses

Disclaimer

It has been prepared as a general overview for information purposes only and do not constitute legal, accounting or other professional advice. While all reasonable care has been taken in its preparation, the Australian Institute of Company Directors (AICD) makes no representation or warranty of any kind, express or implied, as to accuracy, completeness, reliability or accuracy of the information. It should not be used or relied upon as a substitute for proper professional advice or as a basis for formulating business decisions. Information is subject to change without notice.

AICD will not be liable for any damages of any kind to any person who acts or relies upon the information provided.

Links to third party websites are provided for convenience only and do not represent endorsement, sponsorship or approval of products or service offered.

Legal advice

AICD regrets that it is unable to provide legal advice to members. Accredited legal specialists can be found through your state Law Society.