

Boardroom behaviour and the QCA Corporate Governance Code

Observations from the QCA/YouGov Small & Mid-Cap Sentiment Index in the context of the QCA Code

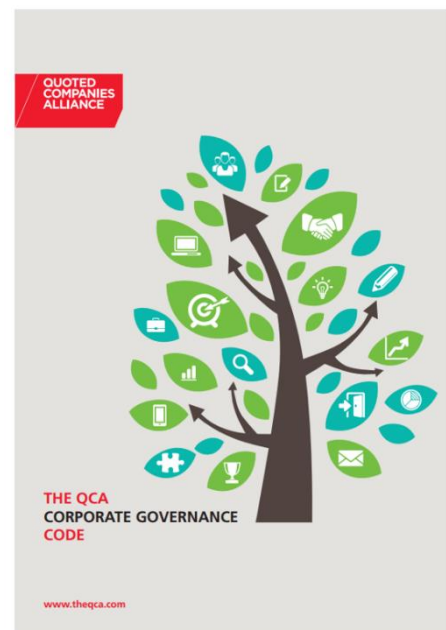
The *QCA Corporate Governance Code* states that the board of a company is responsible for setting the vision and strategy for the company to deliver value to its shareholders. But how do small and mid-sized companies and their advisors think boards and directors are performing in relation to this in the real world?

A recent *QCA/YouGov Small & Mid-Cap Sentiment Index* presented an opportunity to explore the role of NEDs and examine board effectiveness from the viewpoint of small and mid-size companies and advisory firms.

The *Sentiment Index* has taken place twice a year since 2011 with regularly recurring questions, and some rotating topical questions. Questions relating to non-executive directors (NEDs) and board effectiveness have been asked every two years since 2013, enabling us to make points of comparison over time and to spot the trends and developments which are examined in this paper.

The 2018 release of the updated *QCA Corporate Governance Code* positions NEDs as one of the cornerstones of good governance and expectations have become both higher and wider. The question is have we reached a crossroads where we have good people trying to do an impossible task which is doomed to fail?

The QCA Code presents 10 principles for companies to adopt to follow good governance practices and a number of these are especially relevant for the role of the NED. In this paper, we take four of the 10 QCA Code principles and use the data from the *Sentiment Index* to explore them from the viewpoint of the NED, with input and insight from the Non-Executive Directors' Association ('NEDA').



Contents

The QCA Code principles and the views of companies and advisors explored in this paper are:

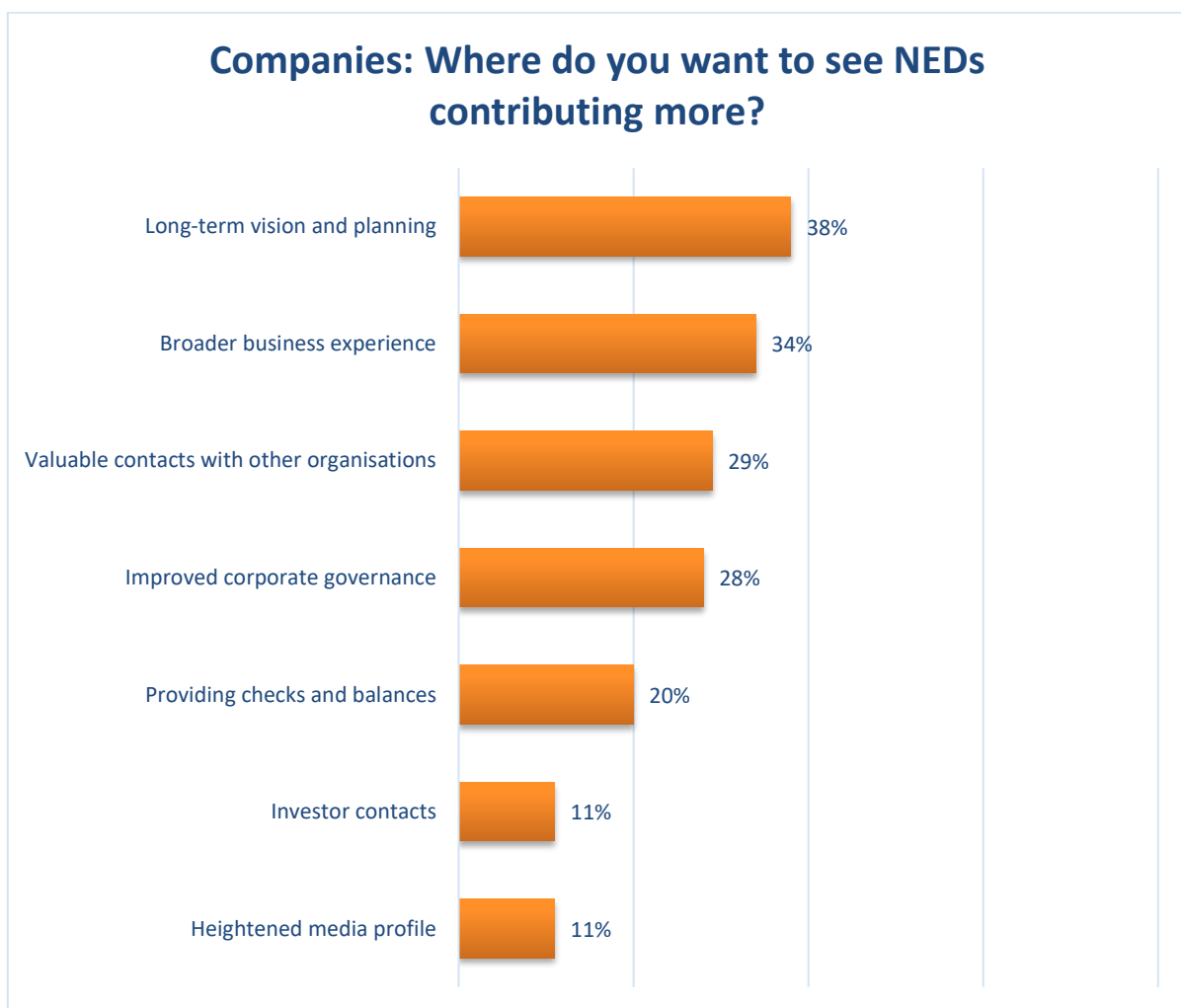
Chapter	Questions covered
1. Establish a strategy and business model which promote long-term value for shareholders (Principle 1)	<i>How should NEDs contribute to the business strategy and business model?</i>
2. Maintain the board as a well-functioning, balanced team led by the Chair (Principle 5)	<i>What skills do boards lack and what do NEDs bring? How do companies recruit directors?</i>
3. Ensure that between them the directors have the necessary up-to-date experience, skills and capabilities (Principle 6)	<i>How independent are NEDs? How gender diverse are small & mid-cap boards?</i>
4. Evaluate board performance based on clear and relevant objectives, seeking continuous improvement (Principle 7)	<i>How should you evaluate board effectiveness?</i>
5. NED remuneration, working hours, and number of board positions	<i>What should NEDs expect in terms of remuneration, working hours, and number of board positions?</i>
6. Looking forward	<i>Five questions for NEDs to ask themselves</i>

1. Establish a strategy and business model which promote long-term value for shareholders (QCA Code Principle 1)

The first principle of the QCA Code relates to company strategy and shareholder value. What is the role that companies and advisors see NEDs playing in this, and what would they like to see more of?

How should NEDs contribute to the business strategy and business model?

Both companies and advisors agree that NEDs need to be contributing more in terms of long-term vision and planning, which ties into one of the main areas of expected NED activity, based on supporting the development and implementation of strategy.

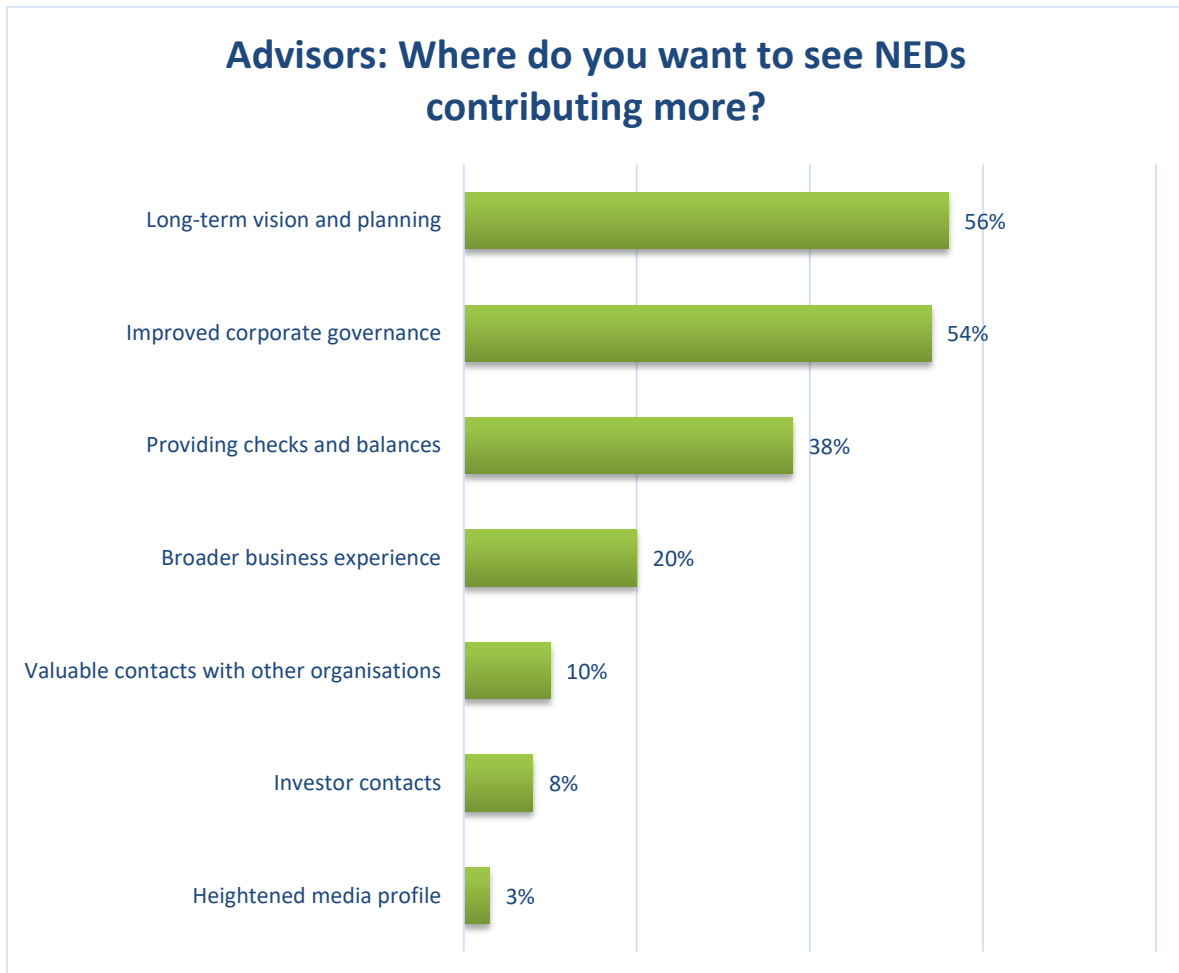


Notably the desire for NEDs to bring broader business experience has increased significantly over the years – from 17% in 2013, 24% in 2015, to 34% in 2017.¹

¹ Question to companies and advisors: “Which of these, if any, would you like to see non-executive directors contributing more of?”

Those companies wanting to see NEDs contribute to improved corporate governance has increased from 11% in 2015 to 28% in 2017.

When advisors are asked the same question, there is a much more marked desire to see NEDs bringing long-term vision and planning over broader business experience. It is also notable that they regard NEDs' contribution to improve corporate governance as significantly more important than in previous years, with 54% seeing this as a priority in 2017, as opposed to 44% in 2015.



NEDs are appointed on the basis of bringing a wealth of practical experience drawn from their own executive and NED career to date. The executive team should take responsibility for developing and delivering the strategy within an agreed business model. NEDs help to shape the strategy, whilst not writing it, and base their input on their knowledge of what works well and what does not work so well. The NED's ability to benchmark and challenge in a positive way can help the board chart the right course, whilst also monitoring progress against agreed performance targets.

Question 1 for NEDs

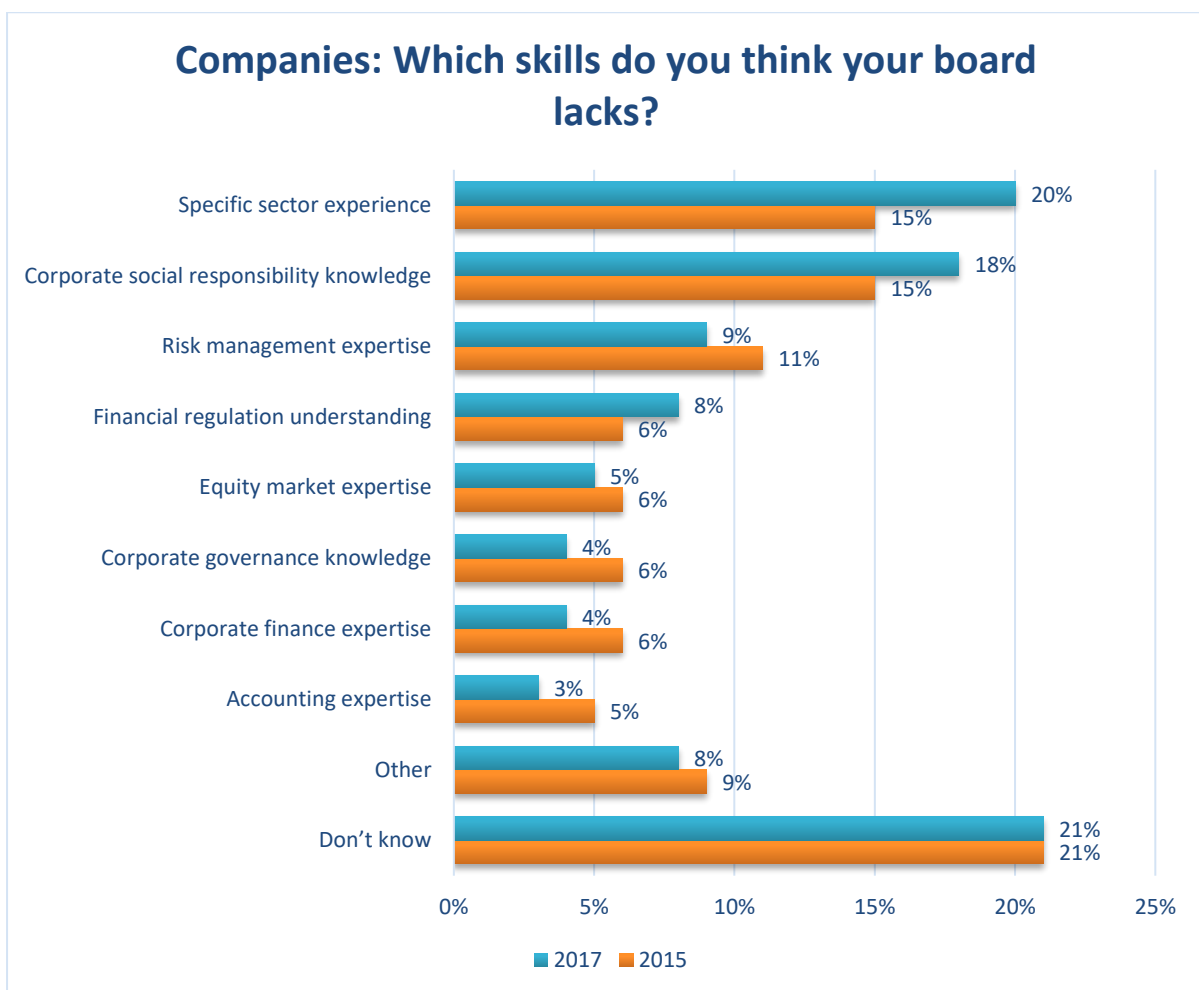
Can you explain to an investor your company's business model in 30 seconds?

2. Maintain the board as a well-functioning, balanced team led by the Chair (QCA Code Principle 5)

The fifth principle of the QCA Code relates to company boards working well as teams. What skills and experience do companies and advisors see NEDs bringing to their boards and how are they going about recruiting directors?

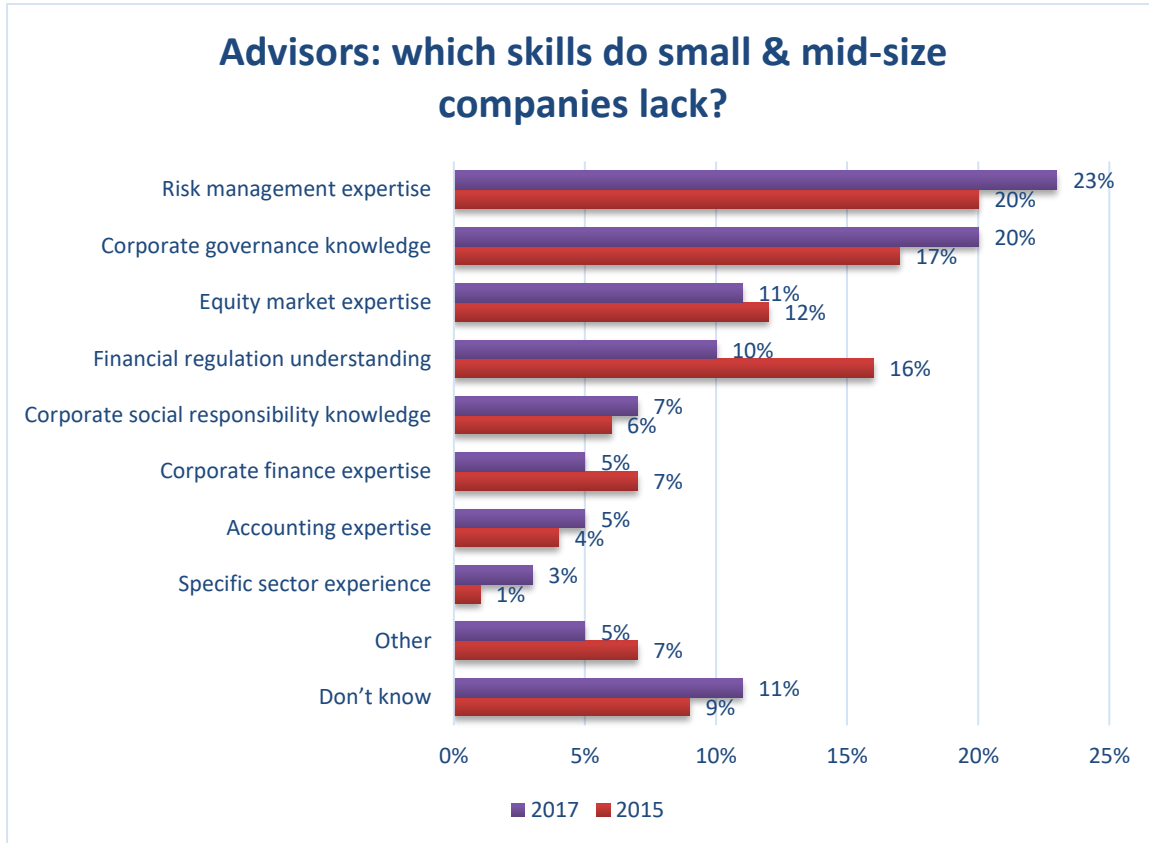
Boards lack sector-specific experience and CSR knowledge

Companies most commonly believe that their boards lack experience that is specific to their sector and knowledge on corporate social responsibility ('CSR'). These were also seen as the most common skills lacked in 2015.²



Advisers see risk management and corporate governance as the main areas to improve, which reflects the current broader focus of corporate activity based on new risk guidance (ICO31000) and corporate governance codes. Only a small percentage agree with the company perspective that they lack sector-specific experience.

² Question to companies and advisors: "Which one of the following skills, if any, do you most think your company's board / small and mid-cap companies' boards lacks?"



Companies are more positive than their advisors with regards to what NEDs bring

Companies, and NEDs themselves, are more positive than their advisors with regards to the NED role – especially where NEDs bring most value, which is typically viewed as being around providing broader business experience.³

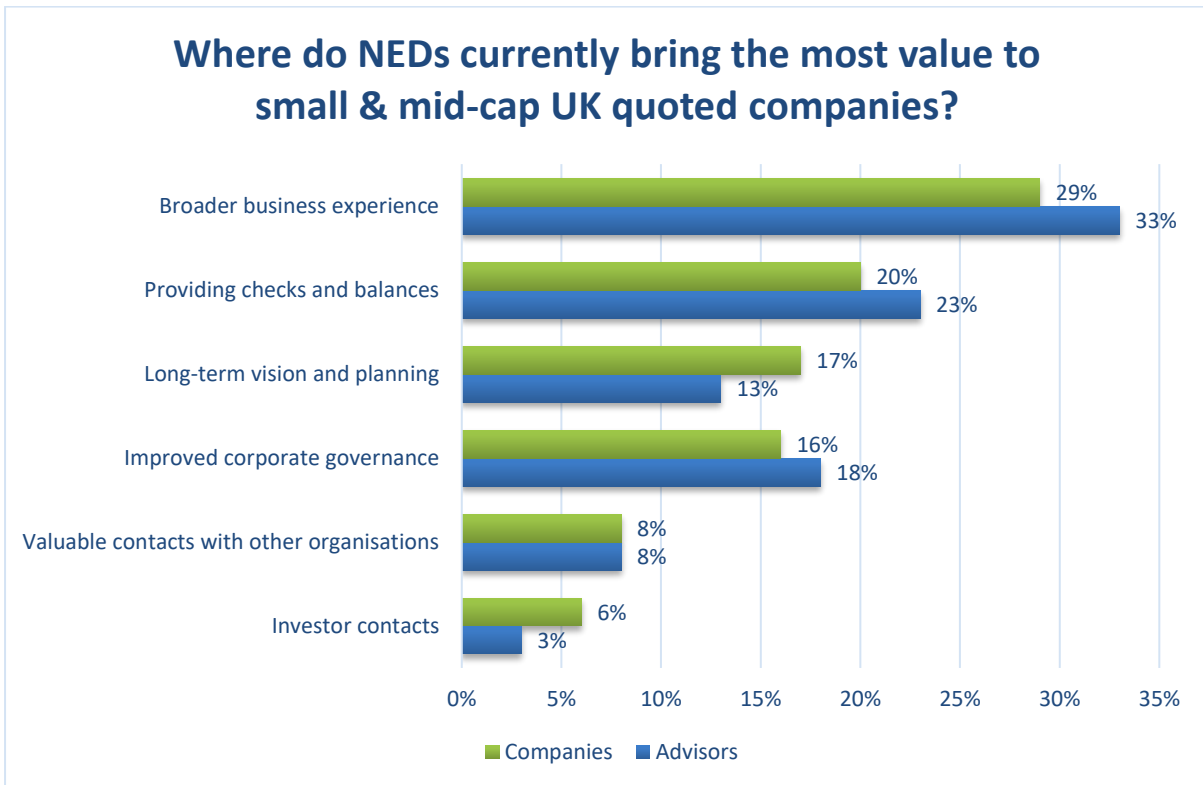
As demonstrated by the survey, there is an increasing expectation that NEDs bring more specialist knowledge and experience to the boardroom table. Indeed NEDs should be appointed based on the needs and expectations of the company – the company should have a clear ‘brief’ when seeking new NEDs. What are the specific skills and experience needed? Should these be sector specific or more generalist?

NEDs themselves will need a bank of experience that shows they have covered areas such as:

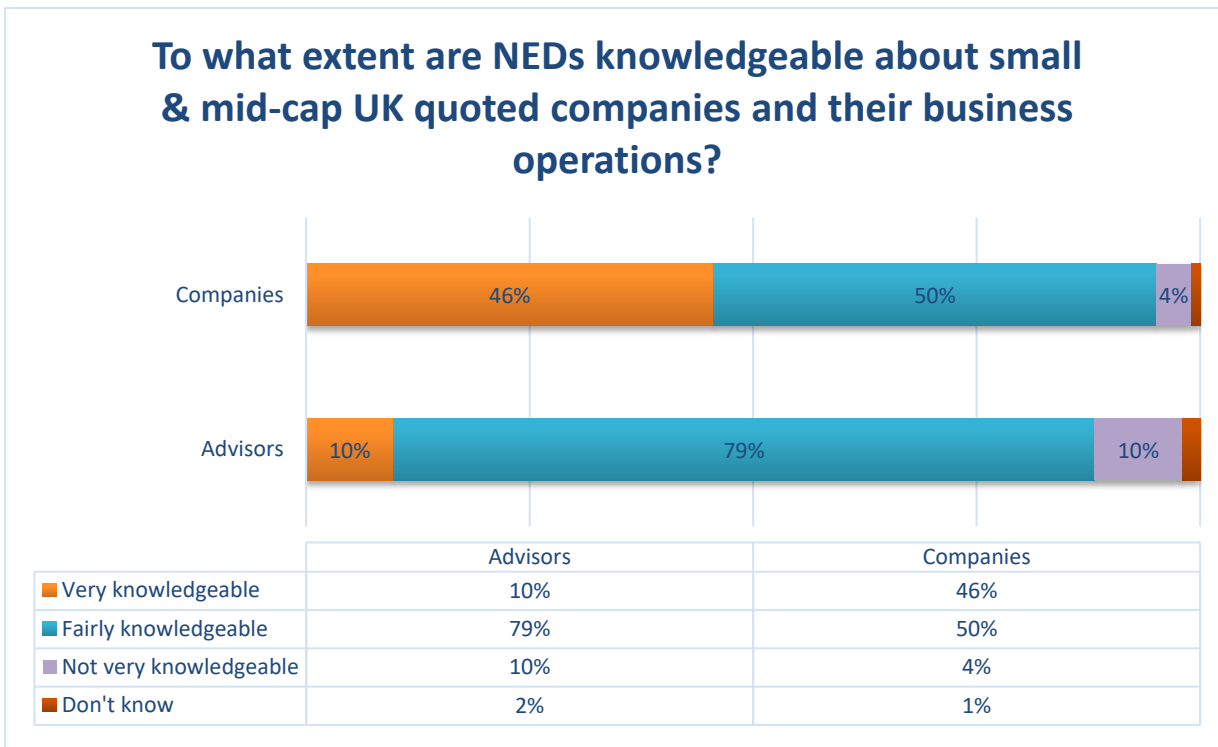
- Governance
- Strategy
- Risk
- Business change

As part of the board performance evaluation and succession planning process any gaps or areas of significance should be highlighted. The demand for ‘broader business experience’ enhances the general role of the NED.

³ Question to companies and advisors: “Where do non-executive directors currently bring the most value to a small and mid-cap UK quoted company?”



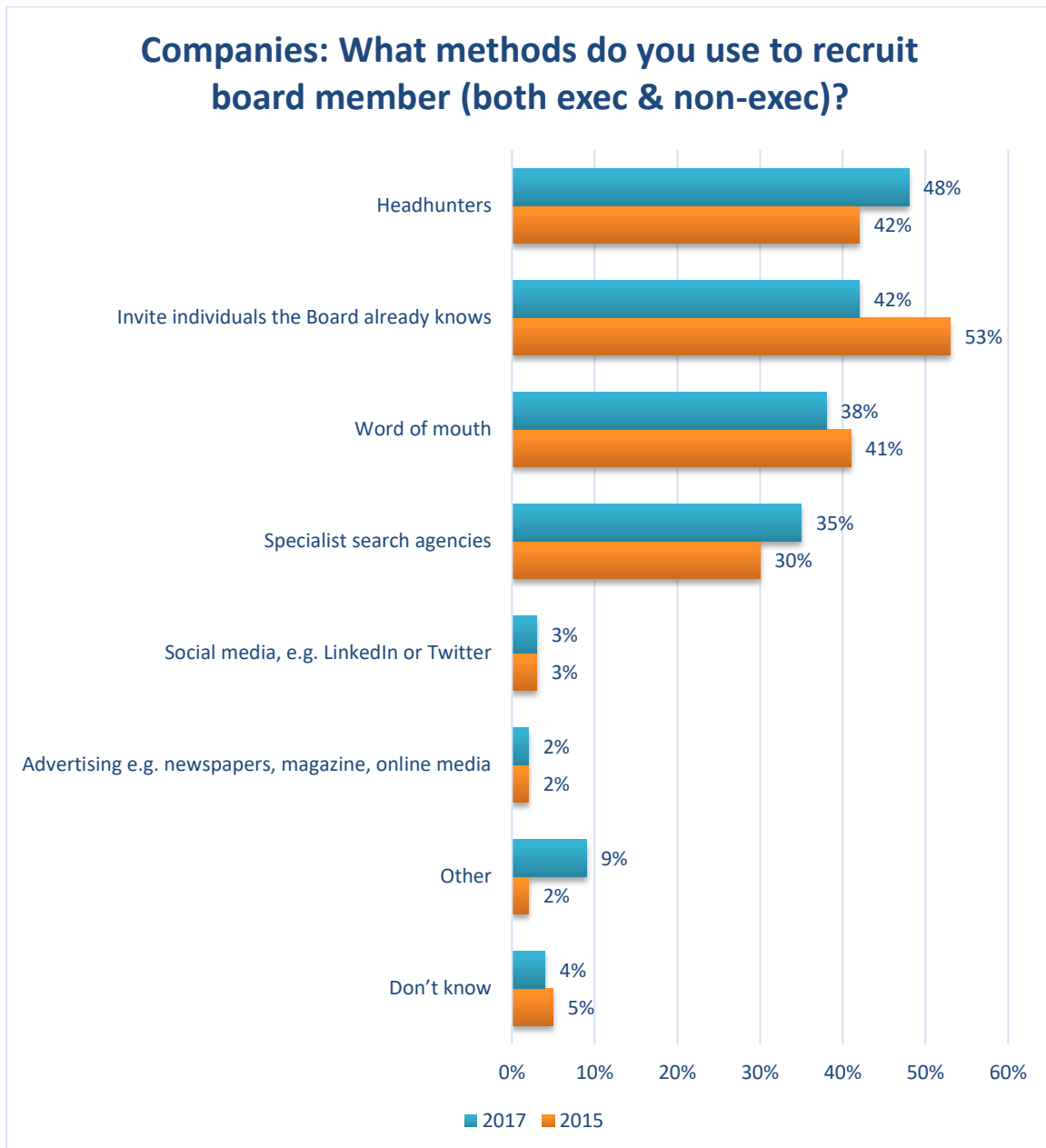
When asked about the knowledge of NEDs, companies are notably more positive than advisors. Only 10% of advisors rate them as 'very knowledgeable' in comparison to nearly half of companies.⁴



⁴ Question to companies and advisors: "To what extent are companies' non-executive directors knowledgeable about small and mid-cap UK quoted companies and their business operations?"

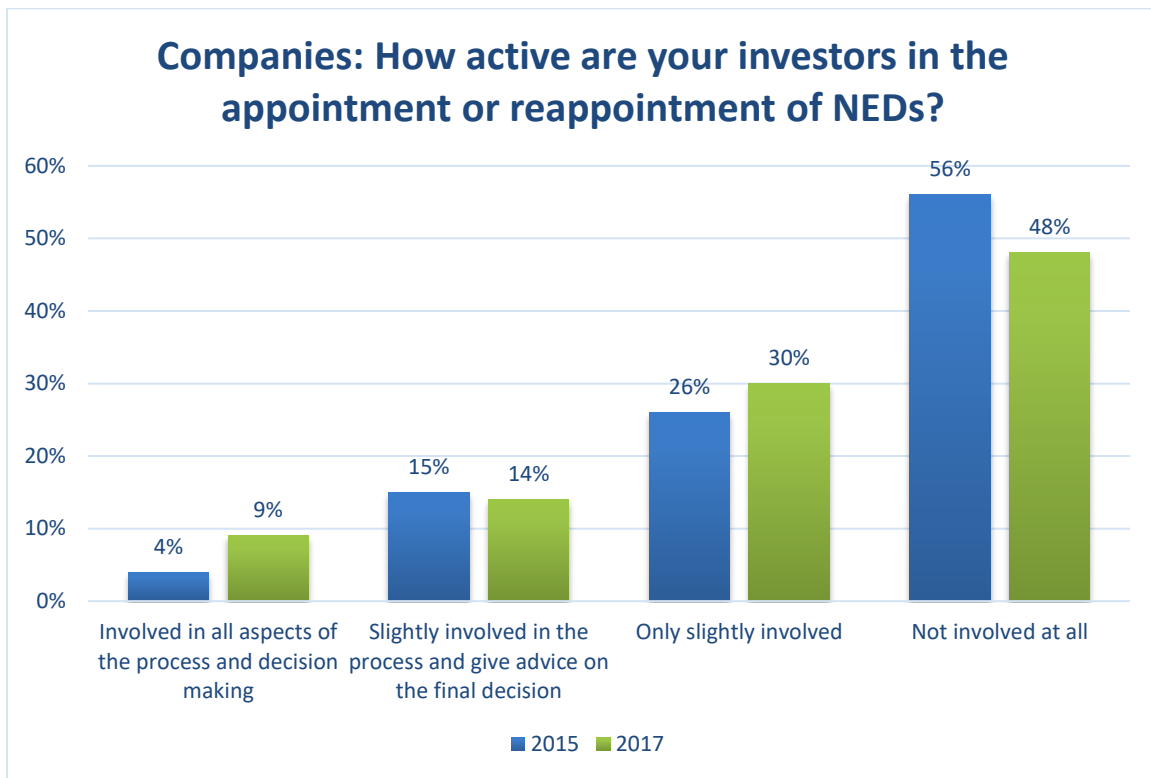
Companies moving away from recruiting individuals the board already know and increasingly using head hunters

When recruiting new NEDs there seems to be a move away from the usual suspects (individuals known to the company or Chair) with more use made of specialist head hunters and executive search firms. The concern here will be a further potential restriction on diversity, in its broadest sense, as recruiters may tend to favour their trusted candidates rather than use transparent approaches to bring new blood into the boardroom.⁵



⁵ Question to companies: “What methods does your company use to recruit board directors (both executive and non-executive)?”

It is interesting to note that investors are involved in board recruitment to some degree in at least half of the appointments of NEDs.⁶



The survey results support the positive move away from the use of the “old boys’ network” which has typically supported a NED community that is predominantly: male, retired and with a numbers/financial background.

New blood is required, but the question remains how best to tap into the increasing pool of capable, professional candidates. The use of head-hunters or executive search firms is one approach but this can often lead to a lack of transparency and, as noted, potentially a narrow field to choose from. More needs to be done to help the new aspirant NED.

Question 2 for NEDs

Can you explain to an investor the skills that you bring to your company’s board and where you could improve your skills and knowledge to help your performance?

⁶ Question to companies: “How active are your investors in the appointment or reappointment of non-executive directors?”

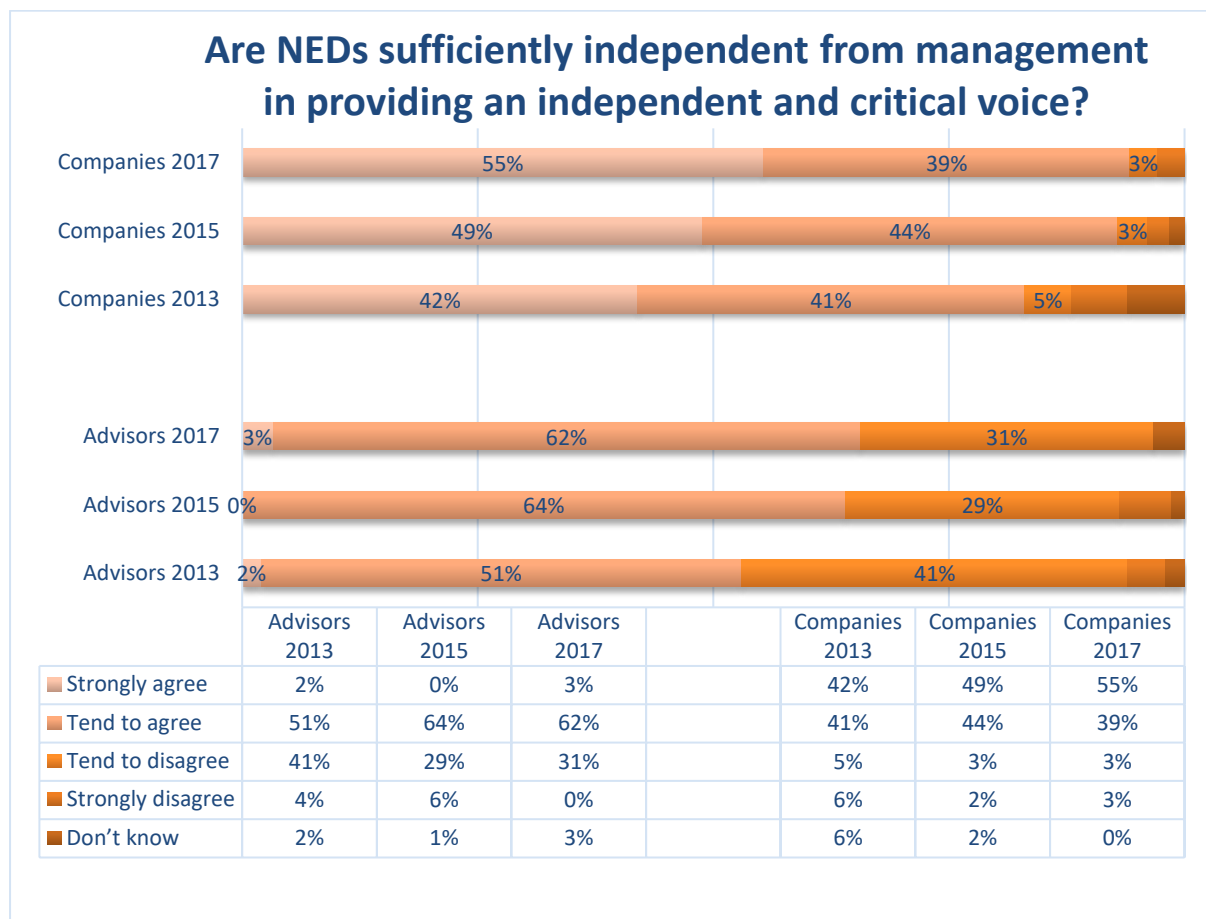
3. Ensure that between them the directors have the necessary up-to-date experience, skills and capabilities (QCA Code Principle 6)

The QCA Code's sixth principle advises that company boards need to have the right skills and experience, and for NEDs, a big part of this is independence. How independent are NEDs in practical terms and are small & mid-cap boards sufficiently gender diverse?

Belief in the independence of NEDs has increased

Historically for this survey, companies have shown themselves to be much more positive about the independence of NEDs than advisory firms: 94% of companies either tend to agree or strongly agree that NEDs are sufficiently independent in 2017. This has increased from 83% in 2013.⁷

Only a very small percentage of advisors strongly agree that NEDs are "sufficiently independent", with nearly one-third disagreeing. However, this has improved over the years, with negative sentiment in this area decreasing from advisors.



⁷ Question to companies: "In general, non-executive directors in my company are sufficiently independent from management to provide an independent and critical voice to the running of their companies."; Question to advisors: "In general, non-executive directors of small and mid-cap UK quoted companies are sufficiently independent from management to provide an independent and critical voice to the running of their companies."

Companies are increasingly seeking out female candidates for board roles

Among quoted companies that recruited for board positions in 2017, 40% explicitly sought out female candidates for their long list, compared to 36% in 2015. 67% also included female candidates on their short lists which was up from 59% in 2015.

This study supports anecdotal evidence that businesses are undergoing a change in behaviour as they look for a more diverse team in their boardrooms. This was also confirmed outside the boardroom, where 33% of hiring companies (of an albeit smaller sample of 27 companies) appointed a female candidate to a senior management position.

As indicated by the focus on independence and on gender board diversity it is important to get the right balance of skills and attributes. The NED role will typically demand an element of independent thought and action – very much holding the executive to account. The survey also supports the drive for more female representation on boards, but this should not be at the expense of finding the best person. The trend is positive but the concern is the slow speed of change.

Question 3 for NEDs

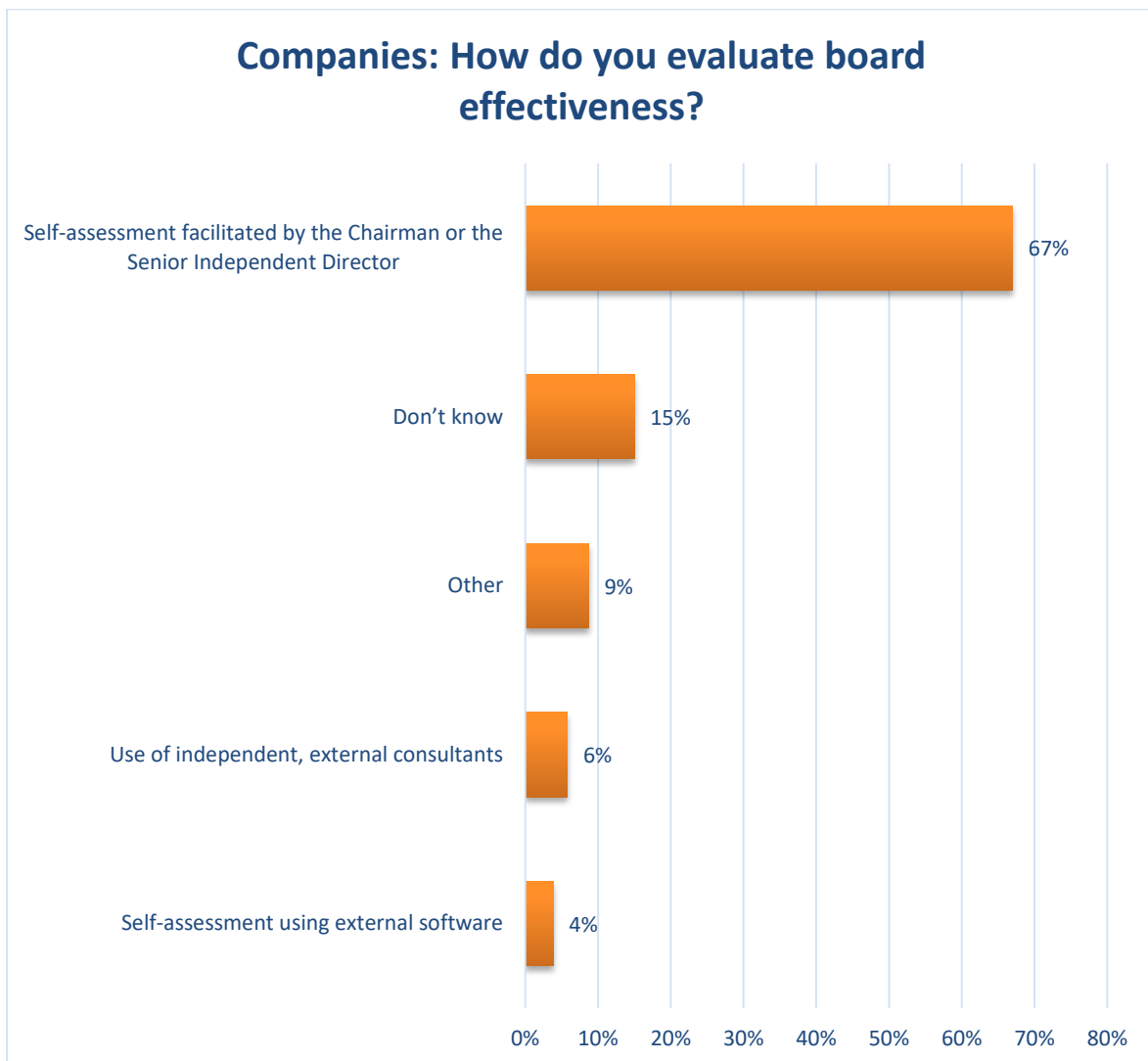
Can you explain to an investor how you are sufficiently independent from company management?

4. Evaluate board performance based on clear and relevant objectives, seeking continuous improvement (QCA Code Principle 7)

The seventh principle of the QCA Code relates to board evaluations. How do companies go about this and what do advisors think they need to do?

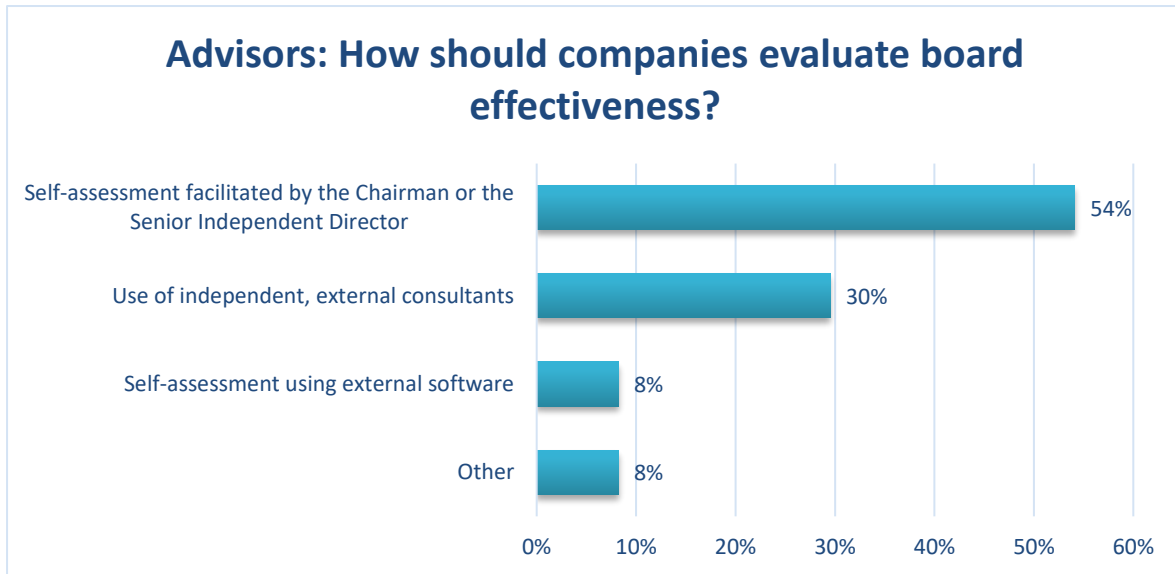
Advisors increasingly think that companies should be using independent, external consultants to evaluate board effectiveness

The majority of companies evaluate the effectiveness of their board via a self-assessment facilitated by the chairman or the senior independent director.⁸



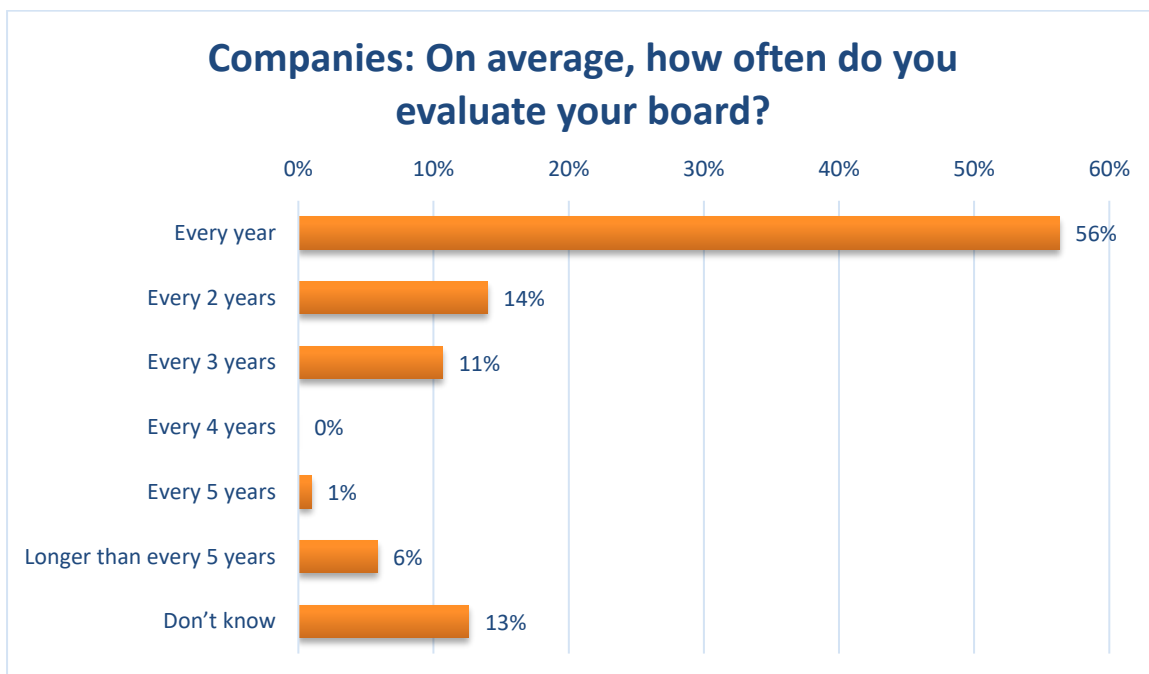
⁸ Question to companies: "How do you evaluate the effectiveness of your board?"

Just over half of investors agree that this is the way to go, an increasing amount believe that companies should be using independent, external consultants to evaluate board effectiveness. This has gone up from 13% in 2015 to 30% in 2017.⁹



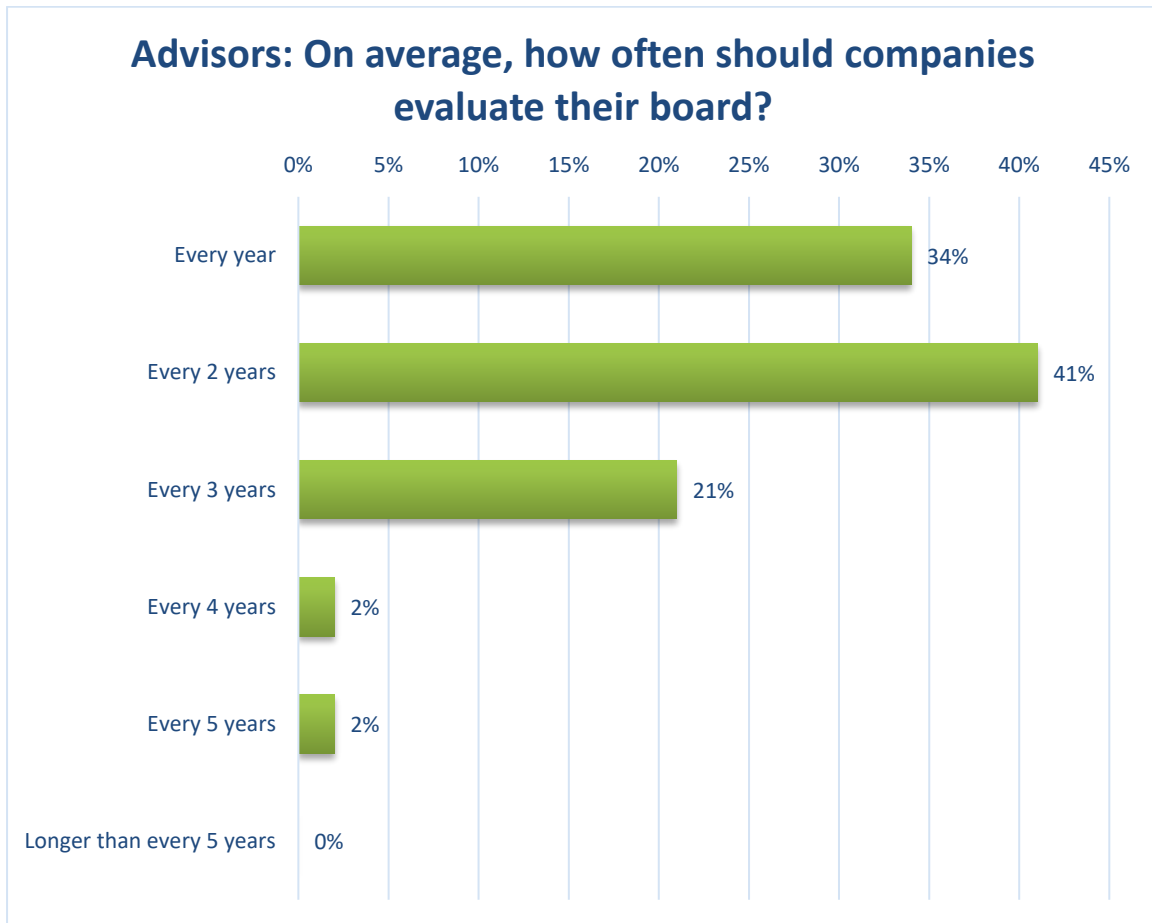
Frequency of board evaluations

A majority of companies evaluate their boards on an annual basis, however advisors were significantly more like to recommend that this takes place at every two or three years.¹⁰



⁹ Question to advisors: “How should small and mid-cap UK quoted companies evaluate the effectiveness of their boards?”

¹⁰ Question to companies: “On average, how often does your company evaluate its board?”; Question to advisors: “On average, how often should small and mid-cap UK quoted companies evaluate their boards?”



The survey results align with how most companies start the board evaluation process - with an in-house self-assessment approach led by the Chair. The use of an independent third-party to help facilitate the review would normally be adopted within a three-year cycle – the emphasis being on facilitation rather than doing a “board audit”.

With the majority of respondents seeing the process as an annual evaluation, if adopted this should ensure boards follow up feedback on performance on a timely basis whilst promoting the development of both individual and board objectives.

Question 4 for NEDs

Can you explain to an investor how your company conducts board evaluations and explain how the company benefits from its chosen approach?

5. NED remuneration, working hours, and number of board positions

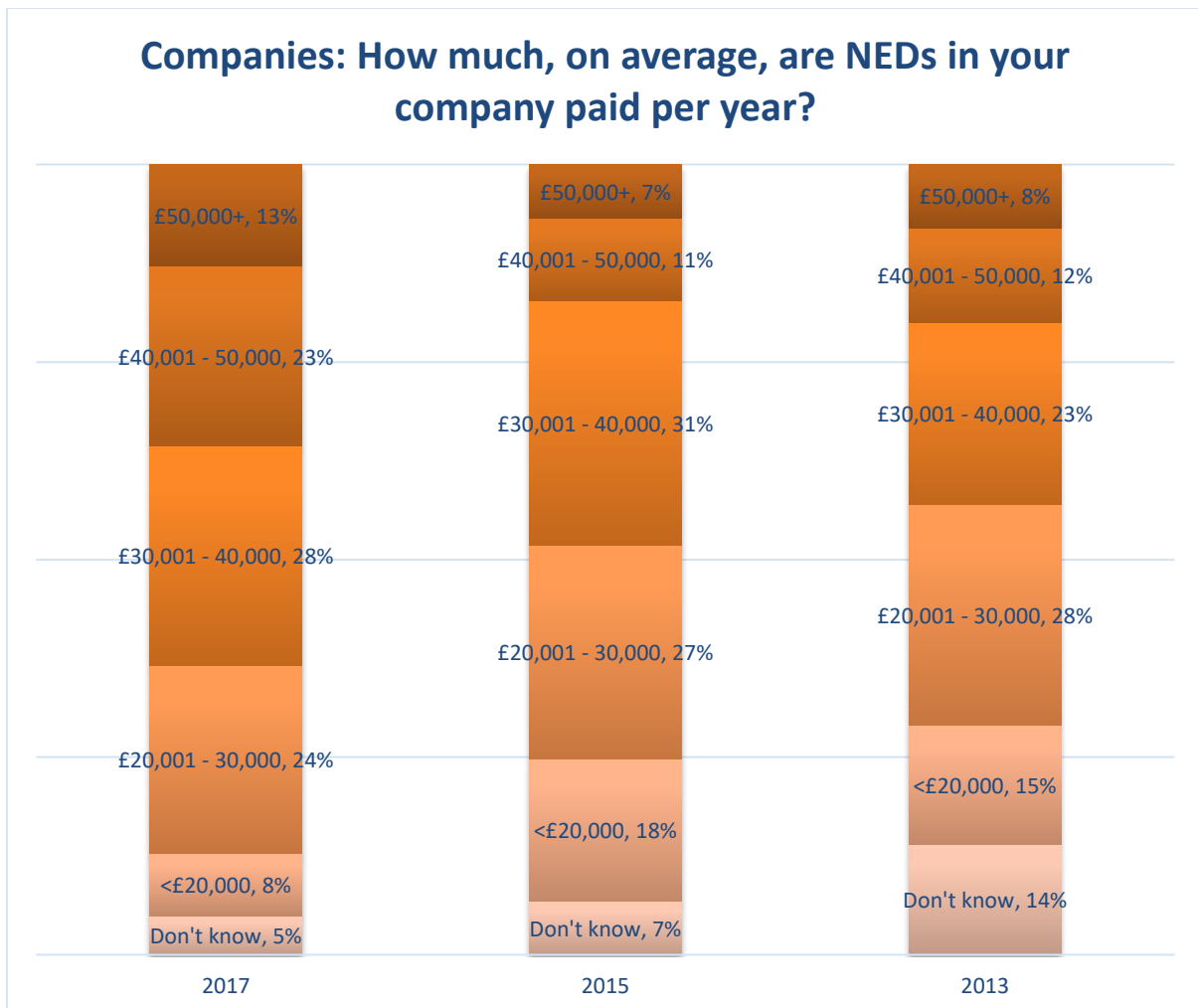
The *Sentiment Index* also examined a number of additional areas that do not specifically relate to individual principles of the QCA Code but provide some additional useful insight. These are in the areas of NED remuneration, expected working hours, and number of board positions held by NEDs.

NEDs have been getting an increase in their fees and remuneration

Our survey shows that the fee levels of NEDs have steadily increased since 2013.¹¹

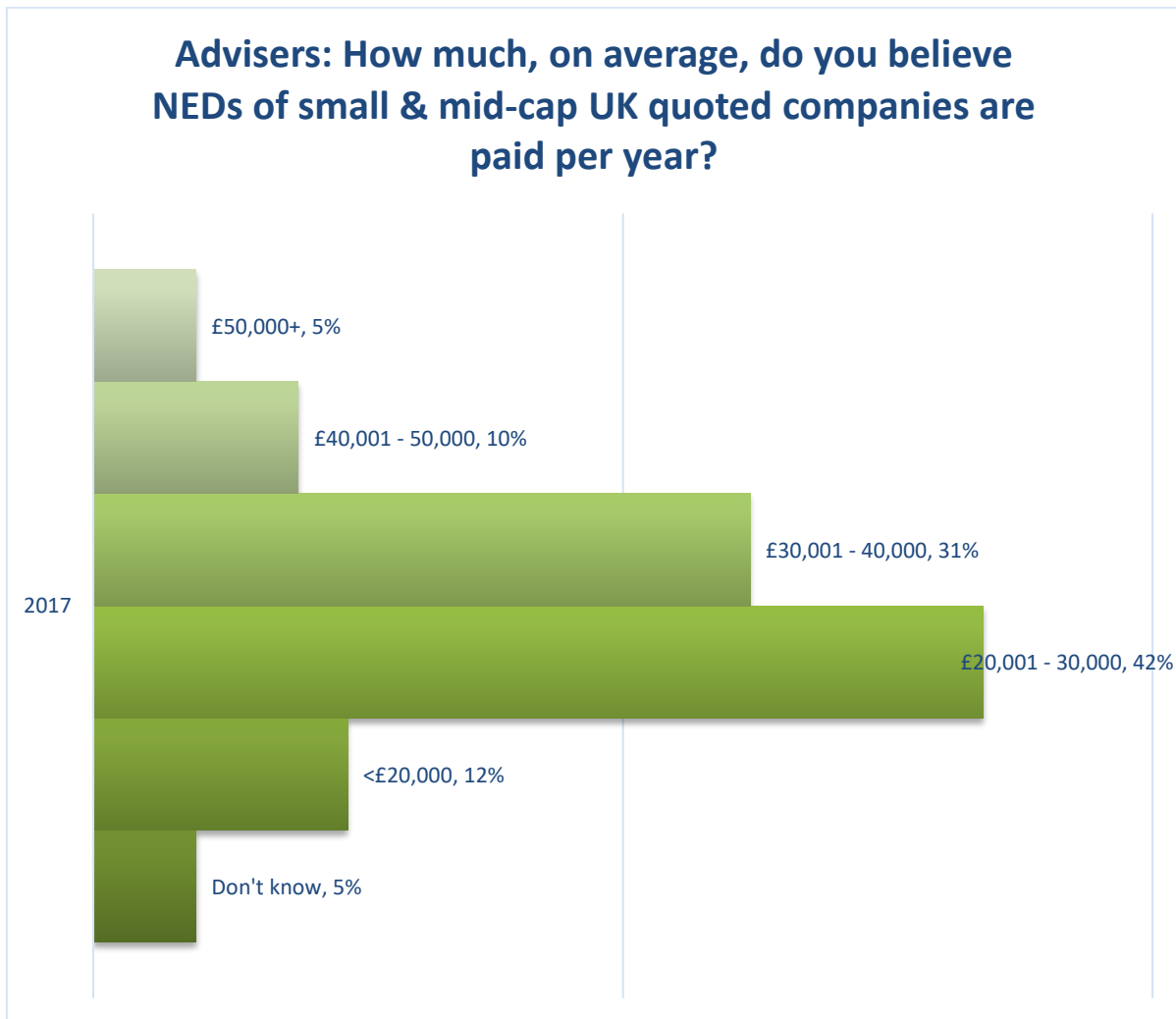
The mean annual remuneration for a NED over the past five years is:

- £39,460 in 2017
- £33,400 in 2015
- £31,185 in 2013



¹¹ Question to companies: "How much, on average, are non-executive directors in your company paid per year?"

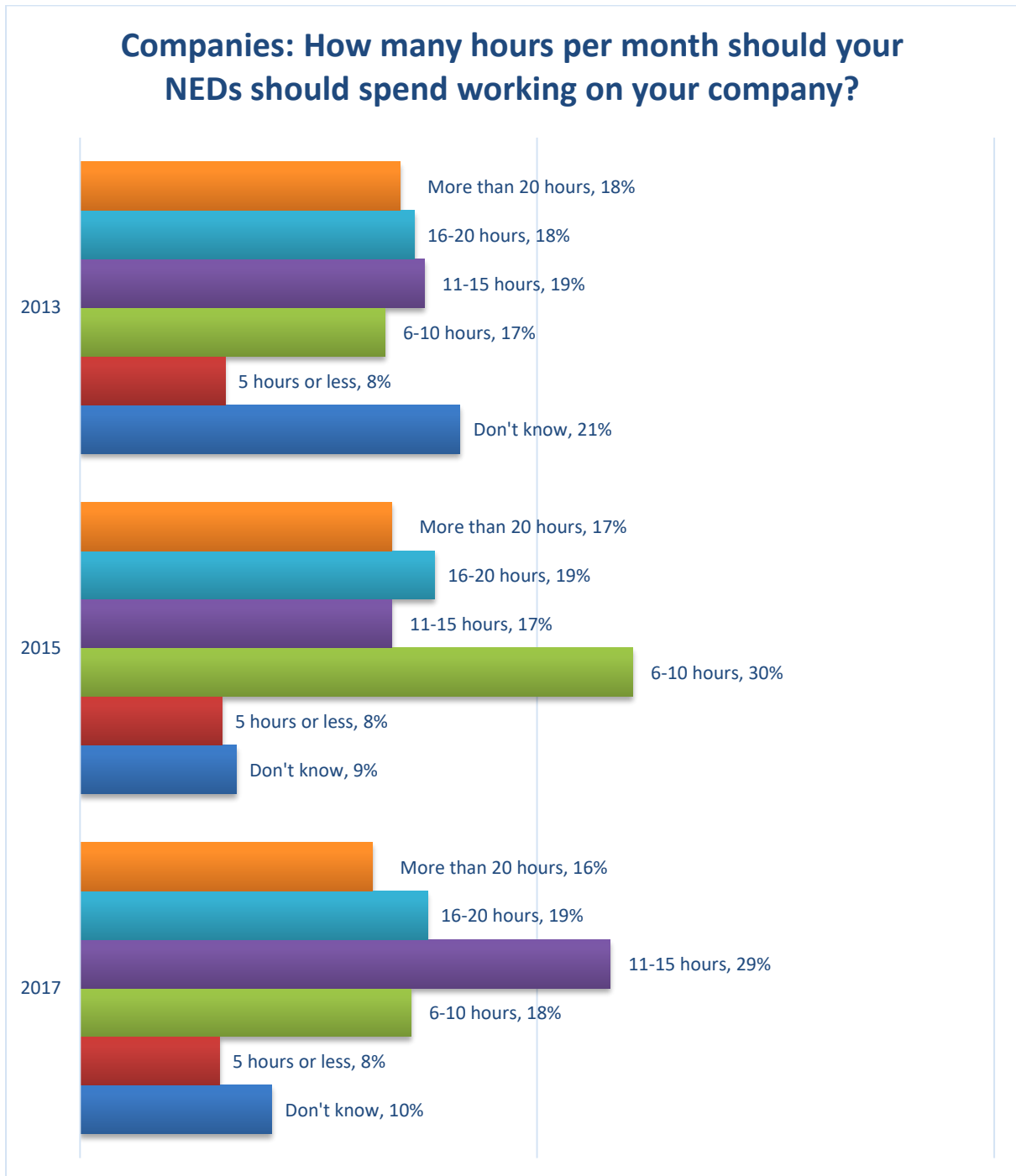
Notably advisors tend to underestimate the fees paid to NEDs by companies. The mean estimate of a NED fees by advisors in 2017 was £34,185 – more than £5k less than the figure reported by companies.¹²



¹² Question to advisors: “How much on average do you believe non-executive directors of small and mid-cap UK quoted companies are paid per year?”

NEDs are being expected to work less hours by companies

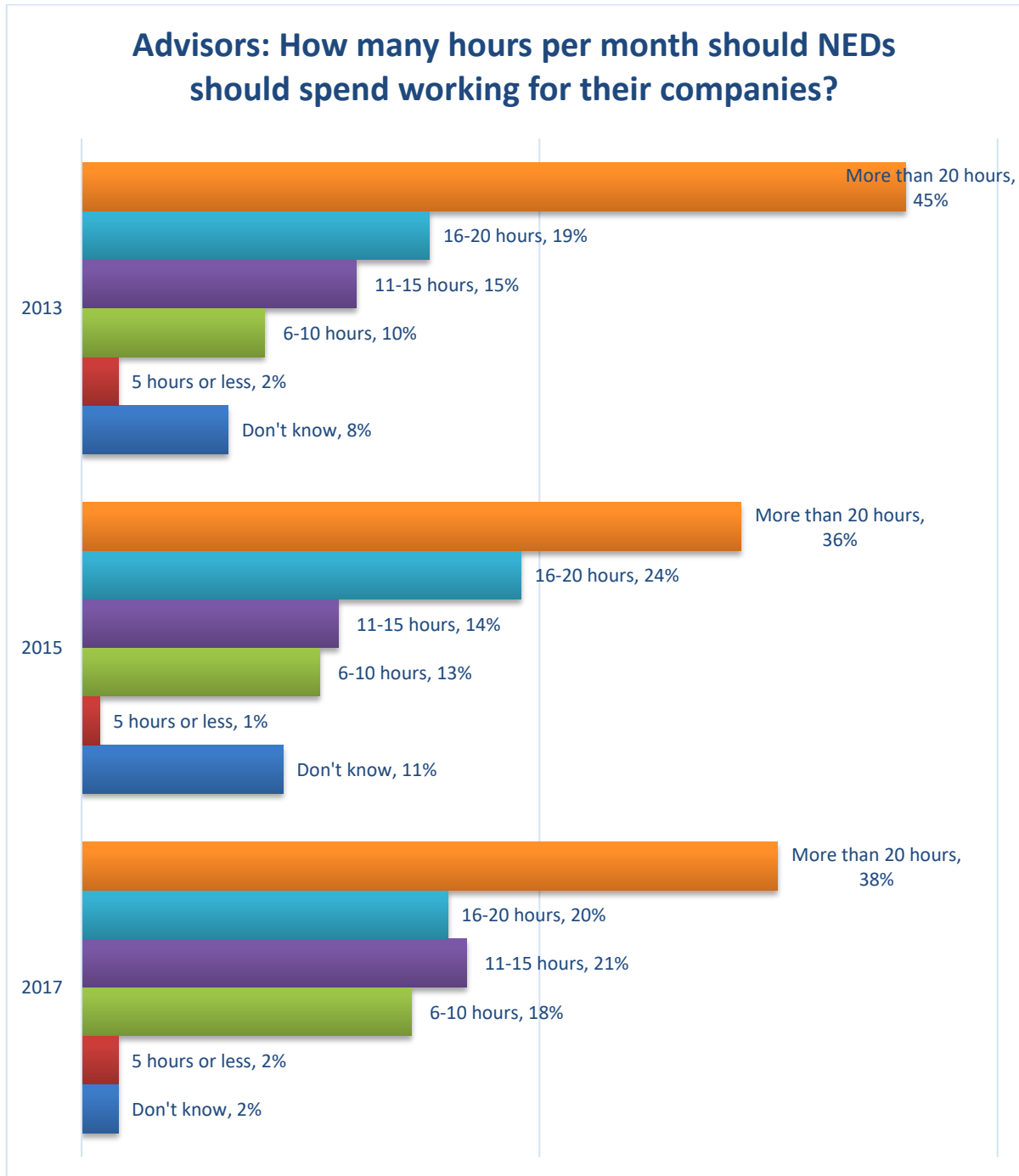
When companies were asked how many hours they think that NEDs should dedicate to their company, the mean was **16.0 hours**. This has declined from 17.4 hours in 2013 and 16.5 hours in 2015.¹³



¹³ Question to companies: “Roughly how many hours per month, on average, do your non-executive directors currently spend working for your company?”

Advisors believe that NEDs should be working longer for companies than the companies themselves do. The mean number of hours that advisors think NEDs should dedicate to a company is 20.7 hours – 5 hours more per month than the view from companies.¹⁴

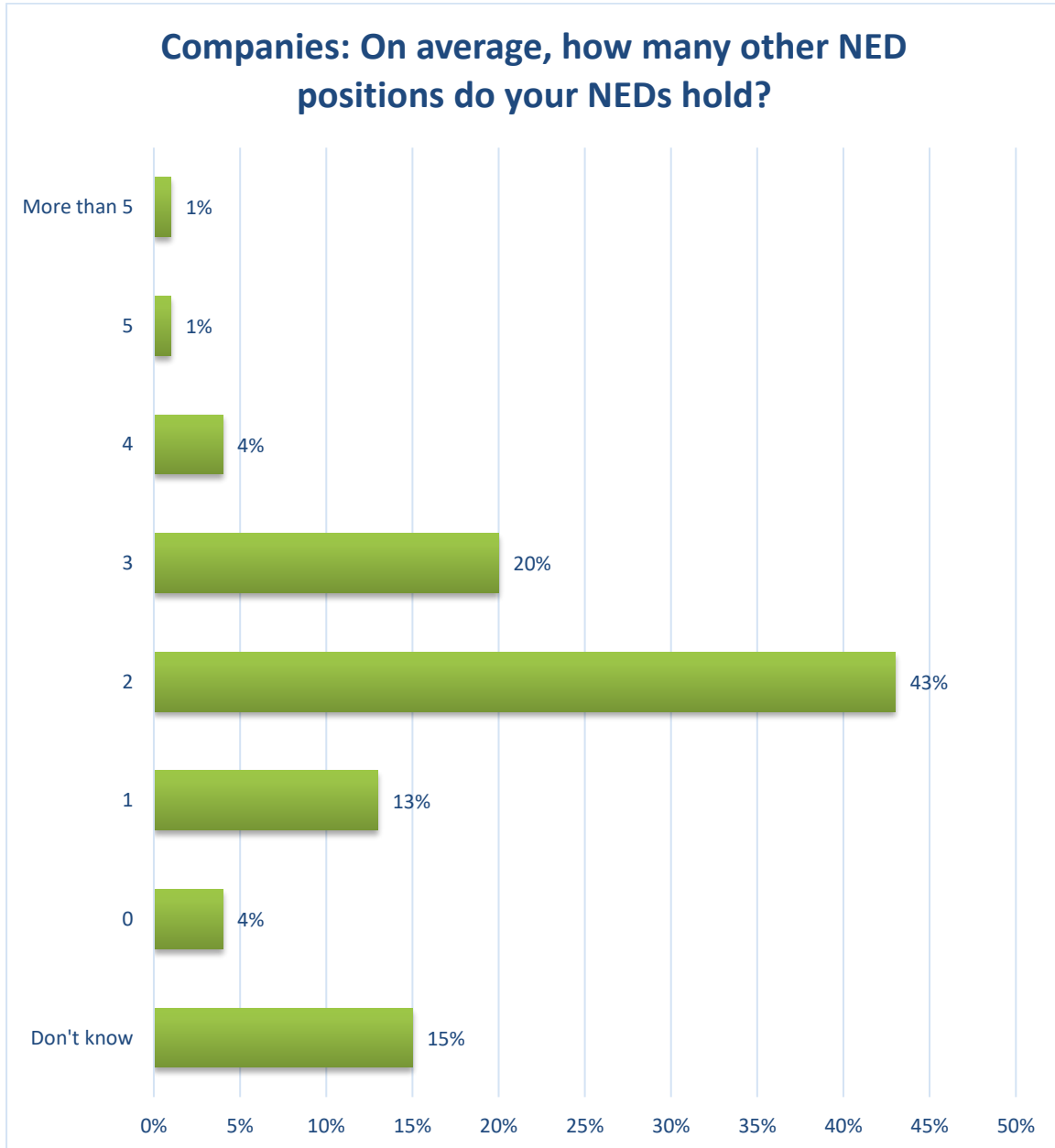
Historically, our survey has always shown that advisors expect NEDs to put in more hours than the companies themselves, but this has decreased over the years: In 2013 the mean figure was 24.3 hours per month, and in 2015 it was 22.5.



¹⁴ Question to advisors: “Roughly how many hours per month, on average, do you think non-executive directors of small and mid-cap UK quoted companies currently spend working for their companies?”

NEDs hold on average 3 NED positions

Companies reported that the mean number of *additional* NED positions that their NED holds is 2.2. This is down a fraction from 2015 when the mean was 2.3.¹⁵



When companies were asked what they believe the optimum number of *total* positions for a NED to hold, it was about the same as the actual reported figure. The mean was 3.3 NED positions being seen as optimum by companies (with them reporting that NEDs hold an average of 2.2 *additional* positions).

¹⁵ Question to companies: "On average, how many other non-executive director positions do your non-executive directors hold?"

Advisory companies held a similar view, with the mean just slightly higher at 3.5 total positions being seen as optimum for a NED.

The previous surveys in 2013 and 2015 looked at how an average NED was fairing. A comparison of the average position in numbers is summarised below:

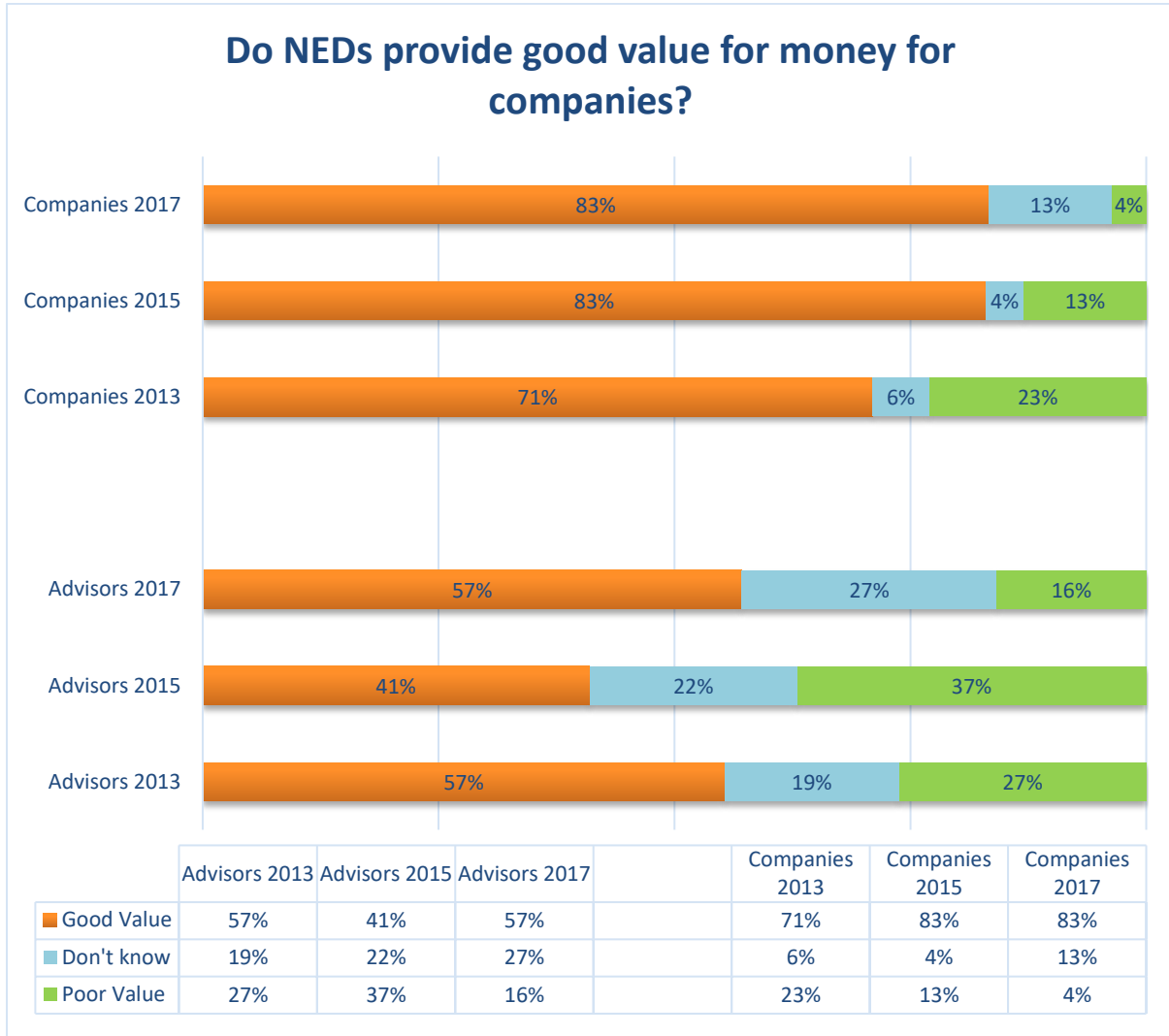
Comparison Area	2013 Position	2015 Position	2017 Position	% Change 2015 - 2017	Notes
<i>Fees per post</i>	£31,185	£33,400	£39,460	+ 18%	Overall NED fees are increasing
<i>Hours per month</i>	17.40	16.47	15.96	-3.1%	A reduction in hours is a worry given workload
<i>Optimum number of NED roles (rounded)</i>	3	3	4	+33%	More emphasis is placed on building a mixed portfolio

Companies believe NEDs are providing value for money, advisors less certain¹⁶

The belief from companies that NEDs provide good value for money for them is 83% in 2017, with those saying they provide poor value for money falling to just 4%. These figures have significantly improved over the years with almost a quarter of companies saying NEDs providing poor value for money in 2013.

The outlook of the advisors on NEDs' value is less positive. Although it has improved since 2015, only 57% think that they provide good value for money for companies in 2017 – on perceived lower pay too. This assessment gap of over 25% would indicate more needs to be done to communicate where value has been delivered. This should come through improved board performance evaluations.

¹⁶ Question to companies: "Do you feel your company gets good or poor value for money from your non-executive directors?"; Question to advisors: "Do you believe small and mid-cap UK quoted companies currently get good or poor value for money from their non-executive directors?"



NEDs are keen to benchmark their experience in terms of remuneration, hours worked and positions held as this type of information is not usually widely available. The summary presented indicates a positive trend for remuneration and for positions held, however a reduction in time spent in role is surprising as NEDs across all sectors would appear to be doing more, both in terms of meeting wider expectations and having to put in more time.

The assessment of 'value for money' is more subjective and a lower level external view may come from less visibility of the NEDs in action. Generally, NEDs need to do more in terms of self-promotion and it will be interesting to see how the new requirements of reporting how individual directors have met their Companies Act S172 duty of promoting the 'success of the company'. This new requirement, in parallel with on-going board performance evaluation output should help company stakeholders (internal and external) to make better value judgements on the work of NEDs.

Question 5 for NEDs
Can you explain to an investor how you dedicate sufficient time to the company given your other commitments?

6. Looking forward - five questions for NEDs to ask themselves

The problem that NEDs often find is that each organisation has its own characteristics, the dynamics will vary and much will depend on the man or woman running the board – the Chair's role is critical. As the leader of the board, the tone is very much set from the top. NEDs need to balance their own personal input with the collective view, as the board should work very much as a well-functioning team. Consequently, they must be an effective group. The mix of people, potentially with different views, and their own personal traits, preferences and behaviours, can in itself be a cocktail that may need to be slowly stirred and not shaken.

Against this backdrop it is a good time to reflect on how the NED community is evolving, both from their own perspective, and also from those who see them in action – advisors to the company. The concept of the 'effective board' is a more recognised feature and feedback has been captured on how this is developing, especially understanding the broader skills and experience at board-level.

The survey considers both the role of NEDs and board effectiveness in terms of seeking to improve the governance agenda, but a lot depends on the culture of the board itself and also the calibre of NED candidates coming through. The survey indicates trends are moving in the right direction whilst promoting areas of improvement needed to meet new challenges in the business environment.

Based on the five chapters of this paper, the QCA and NEDA have come up with five questions for NEDs to ask themselves to help them become better NEDs.

Five questions for NEDs to ask themselves

Can you explain to an investor:

1. Your company's business model in 30 seconds?
2. The skills that you bring to your company's board and where you could improve your skills and knowledge to help your performance?
3. How you are sufficiently independent from company management?
4. How your company conducts board evaluations and explain how the company benefits from its chosen approach?
5. How you dedicate sufficient time to the company given your other commitments?

Methodology

173 organisations completed an online survey that was facilitated by YouGov between 05/12/17 and 19/12/17. This respondent base was made up of:

- 109 small and mid-sized UK quoted companies
- 64 advisory companies working in the small and mid-cap sector

The responding sample is weighted by industry to be representative of small and mid-cap UK quoted companies, as derived from London Stock Exchange data, but the advisory companies are not weighted in any way.

This was the 19th wave of the QCA/YouGov Small & Mid-Cap Sentiment Index which has been monitoring the views and outlook for small and mid-size quoted companies since 2011.

Contact us

If you have any questions about anything covered in this paper, please contact:

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