RIGHT ACROSS THE BOARD

DAVID TILSTON DISCOVERS THAT HAVING BIG EGOS AND TAKING THEIR EYE OFF THE THINGS THAT REALLY MATTER ARE JUST SOME OF THE SHORTCOMINGS OF BOARD MEMBERS.

How a Board team pulls together during times of crisis, and how it prepares in moments of calm, is one of the most important practical issues in corporate governance today. This article looks at anecdotal evidence as to what can happen in practice, and tries to anticipate some of the pitfalls that might be witnessed over the next few years.

EVIDENCE AND ANECDOTES. The Higgs consultation document on non-executive directors (NEDs) has sparked welcome research into how Boards and their non-executives are performing. While there is a mixture of positive and negative comments, the emphasis in the debate is likely to be on what typically goes wrong and how it may be prevented.

A recent study called *Dynamic Boardrooms*[1], by Bird & Co Executive Search Consultants, included observations from directors on situations where Boards were not working well (see *Dynamic boardrooms* box). Some of the individual's responses are included in the *Boardroom blues* box.

A similar survey by KPMG showed that while NEDs felt confident in their level of knowledge in areas such as financial performance, cashflow analysis and projections, they felt exposed on issues that go beyond financial information. Some 40% did not feel they had sufficient knowledge of non-financial indicators, such as market, environmental, political and employment issues, that could have a material impact on the future performance of a company.

This is disappointing. Ideally, investors would hope that during favourable market conditions the Board will be developing sound strategies for growth, as well as understanding and testing the downside risks and the upside opportunities. When conditions turn, or the business faces an unexpected crisis, the management team needs to be prepared, with sufficient flexibility and cohesiveness to survive the challenge and protect shareholder value.

Anecdotal comments suggest otherwise. The cohesiveness of the team can be damaged by the egos of a powerful few on the Board (see *Dynamic boardrooms*). When problems strike it is all too easy for disharmony to emerge, with some directors

Dynamic boardrooms

It was clear that most respondents had experience of being on Boards that were either poorly run or totally dysfunctional, and there were a number of contributing factors behind this. Disruptive personalities and big egos in the CEO and other Board members were a significant problem. They were seen as de-stabilising the boardroom and several non-executive directors (NEDs) commented that it only took one disruptive individual to make it a nightmare for the chairman to handle.

The most critical issue of all was seen to be a lack of independence in some NEDs, whether this was manifested in a strong bias or in an economic reliance on income. Often, it might be an overt friendship with the chairman or CEO which prevented them from asking controversial questions. This might also prevent them firing the incompetent or dishonest executives, or from making the necessary changes to enable the business to thrive.

Many interviewees expressed the view that Boards are also difficult to manage when there is an imbalance created by a principal shareholder. It was felt that if owners were on the board, relationships round the table could become tense and awkward, and there was a tendency for those NEDs to micro-manage and play politics.

One result of the recent scandals of Enron, Marconi and others has been a growing trend for Boards to devote much of their time on examining trading results and accounts, at the expense of thinking about future strategies and external factors likely to impact the longer-term health of the company. Emphasis on robust strategic debate and investment decisions are often relegated in importance as a result of over-emphasis on the numbers.

Boardroom blues

■ "The biggest single problem round the boardroom table is ego." (CEO, Retail, FTSE 250)

■ "If people are struggling to make a contribution because there is somebody round the table with an unfortunate style that intimidates people, you have to get rid of them. Otherwise the boardroom becomes unbalanced." (Chairman, FTSE 100)

■ "You really need to establish harmony between non-executives and executives, but not to the degree that a non-executive director cannot be independent. The problem round a boardroom table in some companies is that the non-executive directors are not independent enough." (Chairman, Entertainment Sector, FTSE 250)

■ "Some of the worst boards are stuffed with the great and the good." (CEO, Media Sector, FTSE 250)

■ "My board spends 80% of the time looking backwards – 20% looking forward. It should be 50-50 at least." (Non-executive director, Entertainment Sector)

Key IFRS impacts include:

■ **Business combinations** Under the anticipated rules, adoption of purchase accounting will require recognition of goodwill as an asset but not require expensing through the income statement unless there is an impairment event. Impairment accounting provides investors with ongoing signals about the relative success or failure of a business combination. Companies should be aware of the need to prevent analysts from being surprised by impairment charges.

■ **Financial instruments** Companies can expect to face difficulties in implementing these complex rules, significant challenges in explaining them to analysts and investors, as well as increased potential volatility to earnings and equity.

'THE PARLOUS STATE OF THE CURRENT BUSINESS ENVIRONMENT AND ITS SHORT-TERM PROSPECTS ARE NOT COMFORTABLE FOR MANY INDUSTRIES AT PRESENT'

protecting their reputation at the expense of others and diverting their efforts towards internal disagreements. This may become even more pronounced when directors become potentially open to personal liabilities. When a problem arises and changes to the Board become necessary it may also be difficult to fill the gap. The NEDs may have a role to play here, but in most situations they will be unable to devote 100% of their time to a specific company because of their other commitments.

Bringing in an outsider or promoting an existing director or manager into the relevant role may also not be in the company's longer-term interests but may prove to be a short term necessity. Only the very largest of companies, with management succession options in place, are normally equipped to handle an unexpected Board vacancy at short notice.

RISKS OF THE FUTURE. We have unfortunately seen some significant adverse developments in the corporate world. WorldCom, Enron and Marconi have all hit the headlines for a variety of reasons, and the pace at which Arthur Andersen's reputation declined was alarming. We have also seen during the past 12 months adverse or unexpected developments at a variety of companies based in the UK, including MyTravel, Amey, WS Atkins, Bulmers, Anite, AIT, Shire Pharmaceuticals, British Energy, National Air Traffic Services and Cable & Wireless.

Most, if not all, of these companies have Board Committees and NEDs established to meet the necessary corporate governance requirements for listed companies, and include extensive commentary in their financial statements on how these requirements are met in practice.

While each company has its own specific set of circumstances a portfolio of potential risks begins to become apparent:

- accounting and reporting practices that do not reasonably reflect underlying economic reality (including appropriate recognition of sales revenue or cost);
- valuation practices on assets (including capitalisation of costs and goodwill) and contingent liabilities, particularly with regard to off-balance sheet exposures (which may be either financial exposures or commercial ones);
- triggers based on events such as credit rating downgrades, which require the group to meet specified financial obligations at the very moment they are not well placed to do so;
- insufficiently rigorous forecasting disciplines and incisive analysis to alert the Board to forthcoming issues on a timely basis;
- unexpected contingencies (such as pension fund shortfalls);
- strategic realignments that are not successful or significant shifts in the market;
- change of IT systems affecting management information or other finance systems that have unexpected consequences; and
- events that cause a loss of reputation, with knock-on effects from customers or key suppliers.

In addition, the parlous state of the current business environment and its short-term prospects are not comfortable for many industries at present. The economic tide has gone way out and rocks that have not been seen for a decade are now evident. This means the opportunity to be holed below the waterline is now more apparent than it has been for several years.

MORE CHANGES ARE IN THE PIPELINE. Finally, the whole system for measuring a company's results is up for reform over

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the next few years, with the introduction of International Financial Reporting Standards (IFRS). This is bound to lead to a number of unexpected changes to reported profits going forwards, to which the City could react strongly.

Recent research in KPMG & Goldman Sachs' *European White Paper on IFRS*[2], conducted among 80 European companies, reinforces this concern. The study concludes that the standards will introduce new complexities and prompt new volatility in reported numbers (see box: *Key IFRS impacts include*).

As a finance director, should you aim to get your likely accounting policy changes understood early, await the mass of companies to announce, or follow the herd? This is likely to pose a difficult investor relations problem to companies over the next 12 to 24 months as accepted practice becomes established. In addition, the auditing fraternity may be expected to become more vocal on what is acceptable for their purposes (to avoid future legal risks). Add to this the risk of changing computations of financial covenants, and the risk of depleted distributable reserves arising from the proposed expensing of share options, and there is plenty to worry finance directors and treasurers.

There must be a risk of a box-ticking mentality to extended corporate governance requirements going forwards. As with previous initiatives, the worry is that Boards become pre-occupied about following guidelines. NEDs may well become more vigilant. Such guidelines do not, and cannot, advise the Board how to act as a team, both ahead of and during an unexpected crisis.

Furthermore, the risk will be that even greater effort and cost will be devoted to corporate governance initiatives that do not bring the desired investor benefits but lull Boards and investors into a false sense of security. The previous initiatives have not stopped scandals or disappointments from emerging, therefore it is unreasonable to expect the forthcoming crop to do so either.

CONCLUSION. The general backdrop to improving corporate governance is therefore not encouraging. Many of the weaknesses may arise from the way Boards work (or not) as a team and accept constructive debate and criticism. There could well be considerable effort on improving corporate governance, at significant cost, as Boards seek to strengthen their performance. This comes at the same time as economic conditions remain difficult and new accounting standards come into force.

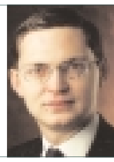
The risk will be that Boards concentrate on the wrong issues at this time of turbulence, worrying about external strictures, rather than cohesiveness and openness within the senior management team.

David Tilston is Finance Director at OverNet Data plc.
David.tilston@overnetdata.com

Notes: *[1]www.bird-co.com [2]www.kpmg.co.uk/kpmg/uk/image/IFRS_gms.pdf*

PROFILE

ALEXEI KUZNETSOV
SENIOR TAX MANAGER
ERNST & YOUNG



AGE	28	
EDUCATION & QUALIFICATIONS	1991	Secondary School #858, Moscow
	1996	Degree in Management, State University of Management (SUM), Moscow
	2000	Candidate of Economic Science degree, SUM
	2000	Association of Chartered Certified Accountants
	2002	AMCT
CAREER HISTORY	1996	Tax Consultant, Andersen, Moscow (including six-month secondment to Andersen, London)
	2000	Tax Manager, Andersen, Moscow
	2002	Senior Tax Manager, Ernst & Young, Moscow

"In January 2003, my eighth year in tax consultancy has begun. Throughout my career as a tax adviser I have specialised in the financial services industry and international tax projects. Over time, tax consulting on treasury management matters has become a big part of what I do. My experience includes advising on a broad range of trade and asset finance techniques, including leasing, factoring, eurobond issuance, inbound and outbound debt and equity investment structuring. I also speak at conferences on tax aspects of treasury management in Russia.

Since I started to work in tax consulting I have seen the Russian financial markets develop, become more integrated into the global financial markets, survive several crises and then re-consolidate and stabilise. Ever more complex financial transactions are being considered by us and our clients nowadays, while the law (despite some progress) struggles to keep pace with the commercial reality.

Understanding the industry and speaking the same language as treasurers is essential to quality tax consulting on treasury matters. That is why (in the absence of any comparable course in Russia) I decided to take the AMCT course. It has been rather challenging to be an overseas student as there are no tuition courses held in my country. Accordingly, I travelled to the UK to attend the courses, which I believe was instrumental in passing the exams."