

Business Risk Services

Newsletter Winter 2011

Welcome to the Winter edition of Grant Thornton's Business Risk Services (BRS) newsletter.

This edition focuses on the topics of board diversity and corporate governance for private companies, both of which have received their fair share of publicity during 2011 and we feel deserve a mention as we end the year.

Our main article overleaf addresses Board Diversity and what it means for companies and their boards. The core debate centres around the fact that as a board agenda item the matter of diversity should not be dealt with via a 'quota like' response. Instead diversity should be inherently imbedded within the standard board mechanism.

Following the board diversity debate we touch on the matter of corporate governance and what it means for private companies as the focus tends to typically fall on PLCs. This article gives you a taste of what we have addressed in detail in *Building Blocks for Business Success*, published in November 2011 by Grant Thornton and the Institute of Directors in Ireland (IOD).

We would like to wish all our readers a very Happy Christmas and a prosperous 2012.



Cian Blackwell
Partner, Business Risk Services



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We hope you find our newsletter informative. Please contact us directly if you would like to discuss any aspect of this content.

Board diversity—a review of recent changes and current trends

The debate on diversity of boards and board members has been reignited in the past year by several developments. In June 2010, the Financial Reporting Council (FRC) published the UK Corporate Governance Code, applying to FTSE 350 and Irish Stock Exchange main market companies.



Two issues received the lion’s share of the media coverage at the time—the requirement for directors to be appointed for one-year periods, and the requirement that the “search for board candidates should be conducted, and appointments made, on merit, against objective criteria and with due regard for the benefits of diversity on the board, including gender [1]”.

Expanding on this requirement—but also reflecting the change of government in the UK—Lord Davies of Abersoch was commissioned in 2010 to conduct a review of gender diversity on boards of listed companies. The report of Lord Davies [2] and his board was published in February 2011 and contained 10 principle recommendations, including:

- all FTSE 350 chairmen should disclose their targets for female representation on their board and should aim for a minimum of 25%; and
- quoted companies should disclose the proportion of women on the board, the proportion in senior executive positions, and the proportion in the workforce as a whole.

The report also recommended that the FRC amend the UK Corporate Governance Code to require listed companies to establish a policy concerning boardroom diversity. Following a consultation process

where the “vast majority” of responses were in favour of the proposed amendments [3], the FRC updated the Code to require all listed companies to include in a separate section of the annual report “a description of the board’s policy on diversity, including gender, any measurable objectives that it has set for implementing the policy and progress on achieving these objectives”. It also updated Principle B.6 to require the board evaluation process to consider “its diversity, including gender”.

The FRC has given listed companies a generous period of time to comply with the updated requirements—they are effective for financial years beginning on or after 1 October 2012, which for most companies means the year ended 31 December 2013, and thus we won’t see relevant disclosures until well in to 2014. This is intended to co-ordinate the updates with the schedule for other proposed updates to the Code, and avoid multiple smaller interim updates.

The FRC however, does encourage companies to implement change sooner than that, “strongly encourage[ing] all companies voluntarily to apply and report on the intended additions to the Code with immediate effect.”[4]

Despite this encouragement, change in gender balance on boards has been slow in both the UK and Ireland. The

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bi-annual “progress report”, monitoring implementation of the Davies recommendations [5] has shown that:

- only 33 FTSE 100 companies have heeded his recommendation to set themselves targets for the number of women they aim to have on their boards;
- since the review, women represent 22.5% of all new appointments to FTSE 100, some way short of the 33% recommended in the report; and
- the number of women now holding FTSE 100 board directorships has increased marginally, from 12.5% to 14.2%.

The rate of progress has been even slower in Ireland. Research by Grant Thornton[6] earlier this year, covering annual report disclosures from 2010, showed that women hold only 8% of board positions in companies listed on the main market of the Irish Stock Exchange, and that 43% of boards had no female representation at all. A survey by the Irish Times in October 2011[7], although covering a slightly smaller population, had consistent findings, indicating female representation of 7.5% on the boards of the top 25 companies on the ISE.

Despite this slow development, the FRC decided against specifying a minimum target for the percentage of female directors, stating that this

would in essence be considered a quota. Their view was that there is a risk that by introducing quotas, boards would engage in a fruitless exercise of ‘finding’ female non-executives solely to satisfy targets, with no regard for the actual intention of the quota, i.e. to improve board effectiveness. Although quotas are used in several other European countries, including France, Spain and Norway, they seem to be unlikely in the foreseeable future in Ireland or the UK.

Some commentators go further in their criticism of quotas, suggesting that it would lead to ‘token’ female non-executives, and actually undermine the position of all women on boards, regardless of the rationale for their appointment. And at least one notable commentator—Lucy Kellaway, a non-executive director and Financial Times journalist—believes the gender diversity debate is misguided, noting that “the obsession with women on boards seems all wrong”. [8] She goes on to point out that “what matters are the women on the staff, and making sure that the good ones get to the top.” Whilst Kellaway’s dismissal of the gender diversity argument[9] seems to be at odds with the mainstream, it does highlight the need to broaden that debate, from the narrow topic of ‘gender diversity on boards’, to two much broader topics—that of gender diversity in companies as a whole, and general diversity of thought and experience on boards.

Whilst gender diversity in companies as a whole is more a matter of employment equality than specifically corporate governance, general diversity on boards does very much fall into the realm of governance. In the original wording of the UK Corporate Governance Code as issued in June 2010, the FRC phrases its board diversity requirement in terms of diversity as a whole—“due regard for the benefits of diversity on the board, including gender”—mentioning gender diversity, but being careful not to limit it to that.

Board diversity is a far-reaching concept. Arguably, the gender issue has received the most consideration due to its quantitative nature—compared with skills diversity or diversity of experience, gender balance is easy to measure, compare and analyse.

But the difficulty of measuring diversity as a whole shouldn’t stop boards from making the effort to do so. The objective of the relevant provisions in the Code is not exclusively to increase the number of women on boards, but to increase the overall effectiveness of boards—the number of women should be seen as a means to an end, not an end in its own right. A sufficiently diverse board will bring a variety of skill sets, backgrounds, perspectives and experiences, which can all positively impact on the quality of decision making. Diversity of thought will be

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the result and will provide for more constructive board meetings.

The 2010 UK Corporate Governance Code introduced more than just diversity requirements—it also strengthened the requirement for board evaluations, introducing a requirement for external evaluations at least every three years. It is increasingly recognised that a board evaluation, in order to be an effective process rather than a box-ticking compliance exercise, needs to assess board dynamics and the behavioural aspects of the board's performance.

Although board dynamics can be even harder to quantify and assess than board diversity, the two tend to go hand in hand, and board evaluations—including those that boards are required to perform on themselves—will need to address diversity. In turn, the disclosure of board diversity and the evaluation process provides an opportunity for better-performing and more progressive boards to demonstrate their good practice to shareholders.



Cian Blackwell
Partner, Business Risk Services

(This article first appeared in the Chartered Accountants Ireland Governance Journal)

[1] Financial Reporting Council, *UK Corporate Governance Code*, June 2010; Principle B.2 (available at <http://www.frc.org.uk/corporate/ukcgcode.cfm>)

[2] Lord Davies of Abersoch, *Women on Boards*, February 2011 (available at <http://www.bis.gov.uk/news/topstories/2011/Feb/women-on-boards>)

[3] Financial Reporting Council, *Feedback Statement: Gender Diversity on Boards*, October 2011 (available at <http://www.frc.org.uk/press/pub2645.html>)

[4] Financial Reporting Council, *Feedback Statement: Gender Diversity on Boards*, October 2011; page 8

[5] Cranfield School of Management, *Women on Boards: 6 Month Monitoring Report*, October 2011 (available at <http://www.som.cranfield.ac.uk/som/dinamic-content/news/documents/wftse2011.pdf>)

[6] Grant Thornton, *Corporate Governance Review 2011* (available at <http://www.grantthornton.ie/Publications/Corporate-Governance-Review-2011>)

[7] Laura Slattery, 'You're on the board of a firm. Let me guess...you're a man?', *Irish Times*, 21 October 2011 (available at <http://www.irishtimes.com/newspaper/finance/2011/1021/1224306202853.html>)

[8] Lucy Kellaway, 'Female quotas would target the wrong women', *Financial Times*, 27 February 2011 (available at www.ft.com/intl/cms/s/0/c970093c-412b-11e0-bf62-00144feabdc0.html)

[9] See also: 'Everyone benefits from a beast in the boardroom', *Financial Times*, 9 October 2011 (available at www.ft.com/intl/cms/s/0/3bdb9b68-f0cb-11e0-aec8-00144feab49a.html)

Corporate governance for private companies—What? How? Does it add value?

The upheaval in trading conditions in the past few years has shown that it is difficult for businesses to cope with every eventuality and deal with constantly changing risks. Not surprisingly, many owners and managers have found that the approach to managing a business in an economic boom is ill-suited to managing it in a downturn. The principal focus for managers and owners is that their business operates in a profitable manner, and continues to do so regardless of external events and economic conditions. Businesses need to find ways to be more resilient and heighten their awareness of risks and changing circumstances.

Companies need to focus on governance mechanisms that contribute to their business – those that can be shown to add shareholder value if implemented well, rather than focusing on theoretical best practice or compliance and box-ticking.

The vast majority of private companies have, quite understandably, focused on the management of their business rather than its governance, and therefore are unlikely to have implemented many of the techniques discussed below. It is not intended that an organisation aims to implement all of these techniques/ recommendations so instead, we have prioritised a number of them for companies to evaluate first. In this way they can start small, with minimal investment, and continue to critically assess any resulting benefits and value as initiatives progress.

Owners and managers should carefully evaluate each recommendation, to make sure that it can deliver the required benefit without too much disruption or excessive cost. To assist with this process, we have included an example of a prioritised list, providing suggestions for the order in which to approach these changes.

In our experience, as businesses invest more time and effort in increasing the sophistication of their governance approach, it becomes easier to add further enhancements, and the return

on investment becomes easier to achieve.

Every company is different, and will have different priorities and levels of governance preparedness. The following list should serve merely as a suggestion for the order in which a company can approach the initiatives. The priority of each initiative will be influenced by the size of a company – for a medium to large private company, for example, the complexity and scale of business processes should increase the emphasis on risk, internal control and internal audit.

- 1 create a single document that describes your company's strategy;
- 2 add a non-executive director to the board;
- 3 separate board meetings from management meetings;
- 4 create an audit committee, and give it a formal role distinct from management;
- 5 create a formal role of chairman of the board;
- 6 formalise and strengthen crucial aspects of the managing director's role, by documenting responsibilities, linking remuneration to long-term performance, and ensuring a succession plan exists;
- 7 put in place a risk management process that identifies, categorises and assigns responsibility for all major risks;
- 8 review your management and financial information – decide

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what you really need, and determine which pieces of information support your key decisions;

- 9 create a flowchart for your most important process(es), adding narrative explanations where appropriate; identify the risks related to the processes, and the controls that mitigate those risks;
- 10 implement an internal audit function to review critical processes and controls, and check whether risks are being mitigated; and
- 11 collate all policies into a single policy database, making sure that it is comprehensive, clear and properly communicated to all staff.

If business owners have truly “bought into” the governance premise enough to pay serious consideration to the above, they also need to pay particular attention to key warning signs at times of financial stress, lean resources and work life balance fatigue.

Governance considerations for businesses in difficulty

Since many companies are already dealing with adverse conditions, directors and management should be on the lookout for any indicators, no matter how minor, of worsening circumstances. The guidance below provides some indicators that may point to the deterioration of a company’s financial situation, as well as some recommended actions for

directors to bear in mind in such circumstances.

Warning signs that a business may be in difficulty:

- customers are taking longer and longer to pay;
- suppliers are reluctant – or unwilling – to extend credit to the same extent as before; and
- bank facilities are due for renewal, and there is no firm commitment from the bank to continue to provide credit.

Essential actions to take when a business is in difficulty:

- be aware of the extent of duties owed by directors to shareholders, and act in accordance with those duties;
- be able to demonstrate that you did so:
 - ensure that appropriate information was requested and obtained from the management team where there is any suspicion of impending insolvency; and
 - ask appropriate questions and make sure that there is an audit trail of this, contained in board minutes, emails, etc.
- get external professional advice from an insolvency practitioner;
- take a proactive approach to resolving issues, particularly those involving cash flow and the availability of credit;
- hold board meetings frequently;
- ensure good quality, timely management information is available; and
- avoid incurring unnecessary expenditure – even to the extent of temporarily forgoing directors’ salaries to help the company through a difficult period.

Action points:

- be aware of the indicators of worsening financial conditions; and
- make sure that boards and management conduct their business in a prudent manner, avoiding reckless trading in the face of insolvency, and even the appearance of reckless trading.

The governance codes of today exist as part of the regulatory framework for many types of companies. In the main, these codes are created for

companies with external stakeholders, i.e. individuals or organisations who have a vested interest in the successful operation of the company, but have no direct control over the management of the company.

The purpose of governance codes, therefore, is largely to protect the interests of stakeholders. The three categories of companies most commonly considered to have large groups of external stakeholders are:

- listed companies (the stakeholders being their shareholders, both retail and institutional);
- public sector bodies (stakeholders being taxpayers and citizens); and
- financial institutions (stakeholders being account or policy holders, and in the case of institutions with systemic importance, all citizens).

Private companies are, not surprisingly, conspicuously absent from this list. Most private companies have a very small number of stakeholders, primarily the shareholders, and even where there is some external (non-management or non-executive) ownership of the company – for example in the case of private equity investments – this is generally by parties with strong links with management.

Most private companies have tended to view this as a lucky escape – the absence of external stakeholders means that nobody is loudly

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clamouring for the imposition of a governance framework on private companies, and the consequent regulatory burden can be avoided entirely.

Nevertheless, the experiences of the economic downturn have shown that the management techniques adopted in the previous decade are not necessarily appropriate to current circumstances, and in particular many companies, not just private ones, failed to deal with a changing risk environment.

The governance recommendations described above are designed to address exactly this – the risks, new and familiar, faced by businesses operating in current conditions.

Overall benefits

If chosen carefully, governance mechanisms can confer significant benefits on a business. Overall, good governance can, and should, result in the following:

- safeguarding the reputation of the company;
- supervising and controlling all levels of management;
- setting the right tone at the top;
- identifying opportunities for efficiency; and
- ensuring that the risks faced by the company are better understood and controlled.



Sara McAllister
Director, Business Risk Services

Contact us

Tony Thornbury

Head of Business Risk Services
T +353 (0)1 6805 613
E tony.thornbury@ie.gt.com

Cian Blackwell

Partner, Business Risk Services
T +353 (0)1 6805 710
E cian.blackwell@ie.gt.com

Sara McAllister

Director, Business Risk Services
T +353 (0)1 6805 716
E sara.mcallister@ie.gt.com

Mark Gahan

Manager, Business Risk Services
T +353(0)1 6805 878
E mark.gahan@ie.gt.com

24-26 City Quay, Dublin 2

Offices also in Limerick, Kildare and Galway

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