INSTITUTE OF DIRECTORS
IN IRELAND

Director and Board Research

A Series of Practical Research Reports on Key Boardroom Issues

Are non-executive directors of Irish plcs independent?

by Professor Niamh Brennan and Michael McDermott

The Institute of Directors Centre for Corporate Governance at University College Dublin

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1. Foreword

Over the last two years the Institute of Directors (IoD) in Ireland and University College Dublin have been working together to develop the IoD Centre for Corporate Governance at UCD. The Centre has a dual mandate: to provide training to directors and to support research in the area of corporate governance.

The Centre has already built up a strong profile and is fast becoming the leading provider of corporate governance training in Ireland. The Centre has received numerous endorsements and accolades from public and private sector organisations and now offers scheduled courses, in-house customised courses and professional development programmes for organisations. Plans are underway to launch an accredited programme of education for directors in 2004.

A main priority for the Centre is to develop its research capability and to become the leading source of corporate governance research in Ireland. The overall aim of the research facility is to promote dialogue about the future of corporate governance in general and the changing role of boards in particular. Specific goals are to identify important trends and events that might impact on the development of boards of directors and to predict how and when these might occur. Research projects to be published by the Centre will explore a variety of issues connected with boardroom practice and corporate governance.

We are delighted that the first report focuses on the independence of directors. Future reports from this collaborative venture, of which this is the first, will form part of a series of research reports of a practical nature into key boardroom issues.

Susan Thornber
Chief Executive
Institute of Directors in Ireland

2. Introduction

The role of non-executive directors has changed significantly since the Cadbury Report (1992) which highlighted the particular contribution that independent directors can make to the governance process. McKinsey (2002) highlights that investors believe companies should create more independent boards and achieve greater boardroom effectiveness through better director selection, more disciplined board evaluation processes and greater time commitment from directors. In this report we examine the issue of independence, both at a board level and at individual non-executive director level, for all companies listed on the Irish Stock Exchange, using information disclosed in company annual reports.

The topic of independence has been widely discussed and debated in recent times, yet there has never been agreement on what constitutes an independent director. This report examines the issue of independence of boards of directors and non-executive directors of companies listed on the Irish Stock Exchange and refers to the recommendations made in the recent Higgs Report in the UK. The report sheds some light onto Ireland's current position on the issue of board independence and addresses potential challenges and pitfalls facing Irish listed companies.

The lack of compliance by some companies with some of the provisions of the Combined Code highlights the limitations of using non-mandatory codes. It is likely that problem companies, most in need of following best practice, are least likely to adopt non-mandatory provisions.

3. The Study

The study was carried out by Professor Niamh Brennan, Academic Director of the Centre, and Michael McDermott an MBA student at UCD in 2001/02, on behalf of the IoD Centre for Corporate Governance at UCD.

The objective of the research is to assess the extent of the independence of boards of directors of companies listed on the Irish Stock Exchange. The research reviews independence from two perspectives:

(i) the first part examines the independence of boards of directors and board sub-committees by analysing board compositions as disclosed in the annual reports.

(ii) the second part examines the independence of individual non-executive directors by analysing disclosures in the annual reports, and applying specific determinants generally regarded as prerequisites for an independent director.

Nine research questions were examined:

Independence of board of directors

1. What is proportion of non-executive directors to executive directors on Irish plc boards?

Independence of individual directors

2. How many non-executive directors have previously held executive roles in the company?
3. How many non-executive directors have previously had relationships with the external auditors of the company?
4. How many non-executive directors have previously had business relationships with the company?
5. How many immediate family connections are there between non-executive directors and management? A 'family association' includes a director's spouse, parents, children, mothers and fathers-in-law, sons and daughters-in-law, brothers and sisters-in-law.
6. How many non-executive directors have held their positions for more than nine years?
7. How many non-executive directors serve as non-executive directors of other companies?
8. How much are non-executive directors paid by way of fees?

Independence of board sub-committees

9. To what extent have companies established audit, remuneration and nomination committees in accordance with recommended best practice of the Combined Code?

4. The Results

The population consists of all 81 companies listed on the Irish Stock Exchange. One company had to be excluded from the research due to difficulty in obtaining a copy of the company's annual report, leaving a sample of 80 plcs. Information was collected from the published annual reports of 80 companies listed on the Irish Stock Exchange on 17th July 2002. Of the 80 annual reports included in the study, 68 related to fiscal year 2001, three related to year 2002, and nine related to year 2000 (details are available from the authors on request).

Based on the information provided in the annual reports of Irish listed companies, the key findings are as follows:

- 32 (40%) companies do not have majority-independent boards
- Board size at 9.4 directors is below the UK average of between 12 and 13 members
- Biographical information on directors is provided by all 80 companies, varying from very basic to providing much unwarranted information. The biographical information reveals circumstances which would breach conditions for independence currently being recommended by the Higgs Report
- There is a lack of agreement as to what constitutes an independent director. The definition of an independent director requires clarification to prevent misinterpretation. The Higgs Report (2003) is a welcome move in this direction
- Inter-locking directorships are not as frequent as might be expected. The analysis highlighted only six situations of interlocking directorates of various degrees
- Most companies comply with the recommendation that non-executives should not participate in share option and pension schemes
- Fees paid by Irish-registered companies to non-executives are comparatively lower than their UK equivalents
- Only 41 (51%) companies comply with the recommendations for separate audit, remuneration and nomination committees
- There was insufficient disclosure provided by 36 companies (45% of the sample) in their annual reports to judge whether or not the board was independent. There were 19 companies seriously delinquent, with 127 insufficient disclosures – an average of almost 7 per company
- There were 49 companies in breach of independence as defined by the Higgs Report. There were 7 companies with 48 breaches – an average of almost 7 breaches per company. If the recommendations of the Higgs Report are implemented these companies will have considerable improvements to make for their boards to be judged properly independent.

A) *Independence of Board of Directors*

Table 1 shows that, of the 749 directors' biographies studied, 460 (61%) were non-executive directors and 289 (39%) were executive directors.
Board size was an average 9.4 directors, of which 5.8 (61%) were non-executives. The Higgs Report (A3.5) recommends that at least half the board (excluding the chairman) should comprise independent non-executive directors. Although first indications suggested that Irish listed companies were weighted towards majority-independent boards, further analysis showed 32 (40%) companies did not have majority-independent boards. Two companies failed to reach the Combined Code recommendation of having a one-third quota of non-executive directors while five companies had exactly the one-third quota. At the other extreme, seven boards had greater than 80% non-executive director representation, while four boards had supermajority-independent boards (i.e., only one executive director with all remaining directors being non-executive).

Table 1: Analysis of board of directors – by percent of non-executive directors

% Non-Executive Directors	No. Companies	Average number of: Executive Directors	Non-Executive Directors	Total
91% - 100%	4	0.8	12.8	13.5
81% - 90%	3	2.0	10.3	12.3
71% - 80%	14	2.2	7.1	9.3
61% - 70%	13	3.7	7.1	10.8
51% - 60%	14	3.9	5.4	9.4
33% - 50%	30	4.6	3.6	8.2
Less than 33%	2	4.5	1.5	6.0
Total	80	3.6	5.8	9.4
Total	80	289 (39%)	460 (61%)	749 (100%)

The Higgs report recommends (A3.1) that boards should not be so large as to become unwieldy but that they should be of sufficient size in relation to having available the appropriate balance of boardroom skills and experience. As shown in Table 2, average board size of 9.4 directors ranged from 26 directors down to three. Non-executive directors ranged from 24 to one, with an average of 5.8 non-executive directors. Of the five largest boards, three were former co-operatives. Five boards did not have the recommended minimum quota of three non-executive directors while 55 (69%) boards had between 3 - 6 non-executive directors.

Table 2: Analysis of board of directors – by number of non-executive directors

No. of Non-Executive Directors	No. Companies	Average number of: Executive Directors	Non-Executive Directors	Total
More than 12	4	5.0	17.3	22.3
11 – 12	6	3.0	11.3	14.3
9 – 10	6	4.3	9.5	13.8
7 – 8	4	4.3	7.3	11.5
5 – 6	21	3.6	5.4	9.0
3 – 4	34	3.4	3.4	6.8
1 – 2	5	3.4	1.6	5.0
Total	80	3.6	5.8	9.4

B) *Independence of individual directors*

i) Independence of Non-Executive Directors

The Cadbury code recommends that boards should include high calibre directors, and the Stock Exchange Listing Rules (para. 12.43(i)) requires biographical information on non-executive directors to be disclosed in annual reports. Biographical information on directors was provided by all 80 companies, varying from very basic to providing much unwarranted information.

ii) Non-Executive Directors with Former Executive Responsibility

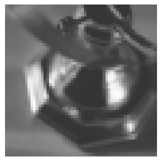
The Higgs Report (2003) suggests that a non-executive is not independent if s/he is a former employee (or had any other material connection within the previous five years). Table 3 identifies 41 (9%) non-executive directors as former executives of the company. Three non-executive directors had retired more than five years; 27 had retired within five years, and the retirement period for 11 former executives could not be ascertained due to insufficient information.

Table 3: Analysis of non-executive directors with former executive responsibility

		No. Directors	
No former executive responsibility		419	(91%)
Former executive responsibility:			
- retired more than five years	3		
- retired within five years	27		
- insufficient disclosure	11	41	(9%)
Total		460	(100%)

iii) Non-Executive Directors with Auditor Associations

The Higgs Report (2003) recommends (A3.4) that a person who has (within the last three years) a material business relationship with the company either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company, is not an independent director. This would include company external auditors. Four non-executive directors were identified as being former employees of the external auditors, and all four directors were members of their audit committees. The role of the audit committee is to ensure that an appropriate relationship exists between auditors and management. As the annual reports did not indicate the time lapsed since employment was terminated with the audit firm, independence of these non-executive directors could not be determined.



iv) *Non-Executive Directors with Business Associations*

Most companies provided details of solicitor and stockbroking firms retained by the company. This disclosure is not comprehensive and the research could only be completed to the extent of the information provided. For example, some stockbroking firms were known to have non-executive representation on the plc boards, yet the annual reports did not disclose the company's stockbroking affiliations. The research identified a number of boards where non-executive directors were current or former employees of solicitor and stockbroking firms or other businesses associated with the company. The annual reports did not indicate the time lapsed since the four non-executive directors terminated employment with their former business.

v) *Non-Executive Directors with Family Associations*

A person who has close family ties with any of the company's advisers, directors or senior employees does not qualify as an independent director under the Higgs recommendations (A3.4). A total of eleven directors representing six boards were identified as having immediate family associations with executive director(s) of the company.

vi) *Non-Executive Directors with more than Nine Years Service*

The Higgs Report (A7.3) recommends that non-executive directors serving nine years or more should be subject to annual re-election. For purposes of measuring independence of non-executive directors, this study has adopted this recommendation and considers board service beyond nine years (i.e. three x three-year terms) as an encumbrance to independence.

Of the 460 non-executive directors, Table 4 shows that 64 (14%) were identified as serving for periods longer than nine years, with one company accounting for the largest share with eight long serving directors on its board. Service periods of 123 (27%) non-executive directors could not be determined due to insufficient disclosure.

Table 4: Analysis of non-executive directors – years service

	No. Directors		
Up to nine years service		273	(59%)
More than nine years service:			
10 - 15 years service	39		
16 - 20 years service	8		
21 - 25 years service	8		
26 + years service	9	64	(14%)
Insufficient disclosure		123	(27%)
Total		460	(100%)

vii) Interlocking Directorates

With Ireland's small and close-knit business community, networking is often considered necessary for career advancement. However, in comparison with other countries (MacCanna et al. 1999), Ireland shows a comparatively lower occurrence of multiple directorships. Inter-locking of directorships (i.e. directors sitting on each others boards) were not as frequent as might be expected, probably due to the composition of Ireland's top 250 companies including semi-state companies (with political appointments) and multinationals (with directors who would be less integrated into Irish business networks). Recommendation A3.4 of the Higgs Report refers to cross-directorships or significant links with other directors through involvement in other companies or bodies as impeding independence. The analysis highlighted only six situations of interlocking directorates of various degrees.

viii) Fees for Non-Executive Director Services

The Cadbury Report (4.13) recommends that in order to safeguard their independence, non-executive directors should not participate in share option schemes, and their service as non-executive directors should not be pensionable by the company. The Higgs Report states (B1) that remuneration should be sufficient to attract and retain but not more than is necessary. Remuneration in share options should be avoided (B1.7). Most companies comply with these recommendations. A few companies grant share options to non-executive directors but this is the exception rather than the rule.

Fees varied according to company size, rank of non-executive chairman, non-executive deputy chairman, and non-executive director, and additional fees were also paid for board sub-committee duties. Generally, financial institutions and companies with larger boards made up the bulk of the above-average paying Irish-registered companies. Six companies did not disclose individual directors' remuneration, opting only to disclose total amounts.

Most non-executive directors received fees for their board service. A number of non-executive directors only received a small fee/no fee due to having served on the board for only a portion of the year. Of the 14 non-executives who received fees (i.e. excluding other remuneration) in excess of €100,000, six were with UK-registered companies, and five were chairmen of Irish financial institutions.

The Cadbury Report stated that non-executive director fees should 'recognise their contribution without undermining their independence'. Table 5 shows that of the 57 directors who received fees above €50,000, 32 were with Irish-registered companies, while five of the six highest paid Irish non-executives were chairmen of financial institutions. The Higgs Report (2003) (p.56) states that the average remuneration of a FTSE-100 non-executive director is £44,000 p.a., and for FTSE-350 non-executives amounts to £23,000. Appropriateness of fee levels is subjective but, on average, fees paid by Irish plcs to non-executives appear to be comparatively lower than their UK equivalent. This may be partly due to the lower size of plcs in Ireland compared with the UK. As recommended by the Cadbury Report, most companies excluded non-executive directors from share option schemes and company pensions.

Table 5: Analysis of companies – non-executive directors' fees

Average fees per company	No. Companies	Average fees per director	No. Companies
More than €70,000	3	More than €250,000	4
60,001 – 70,000	1	100,001 – 250,000	10
50,001 – 60,000	4	50,001 – 100,000	43
40,001 – 50,000	10	25,001 – 50,000	161
30,001 – 40,000	12	Up to €25,000	218
20,001 – 30,000	18		
Up to €20,000	26		
Insufficient disclosure	6	Insufficient disclosure	24
Total	80	Total	460

The Higgs Report recommends (A4.8) that no individual should chair the board of more than one major (FTSE 100) company. Non-executive directors should undertake that they have sufficient time for the position, taking account of their other commitments. In this context, a total of 37 non-executives hold directorships with two or more Irish plcs, with three non-executives each holding four directorships with total fees of €189,000, €156,000 and €220,000 respectively.

In addition to board fees, 71 non-executive directors also received fees for consulting and other services. Table 6 shows that 11 directors received payments greater than €100,000 for additional services provided by the individual to the company, of which seven were associated with two companies.

Table 6: Analysis of Non-Executive Directors' other remuneration

	No. Directors
More than €250,000	2
100,001 – 250,000	9
50,001 – 100,000	5
25,001 – 50,000	5
Up to €25,000	50
Total	71

c) Independence of board sub-committees

i) Independence of Board of Directors – Sub-Committees

Of the 80 sample companies, Table 7 shows that 41 (51%) had separate audit, remuneration and nomination committees. A further 21 (26%) companies had audit and remuneration committees, but did not have a separate nomination committee for reasons varying from board size to believing that the entire board of directors was a more appropriate forum to nominate and ratify appointments. Finally, three companies made no reference to any sub-committees.

ii) Nomination committee

The Combined Code advocates that, unless a board is small, a nomination committee should be established, and leaves the definition of a 'small board' open to interpretation. 33 (41%) companies elected not to establish a separate committee, which included significantly capitalised companies, stating their preference for the board as a whole to function as the nomination committee.

iii) Remuneration committee

Four companies had no remuneration committee, while five companies had executive director involvement on the committee. In a number of cases the function of both the remuneration and nomination committees was rolled into one.

iv) Audit committee

Six companies had no separate audit committee, and referred such audit duties to the full board of directors. Five companies had executive director involvement on the audit committee, while five companies were unable to meet the quota due to having less than three non-executive directors on the board.

Table 7: Analysis of board sub-committees

No. Companies	Audit Committee	Remuneration Committee	Nomination Committee
41	C	C	C
21	C	C	NC
1	C	PC	C
1	C	PC	NC
1	C	NC	NC
4	PC	C	C
3	PC	C	NC
2	PC	PC	NC
1	NC	C	C
1	NC	C	NC
1	NC	PC	NC
3	NC	NC	NC
80			

C = Full Compliance
PC = Part Compliance (i.e. less than requisite committee members or includes executive director)
NC = No Committee

d) Independence of Non-Executive Directors

The Stock Exchange Listing Rules (para.12.43(i)) require biographical information on non-executives but do not specify the degree of detail to be disclosed. The level of biographical disclosure, to assess director's independence, varied from providing inadequate to providing unwarranted information. In addition, insufficient disclosure was another concern, as summarised in Table 8. The insufficiency of data does not permit a full assessment of independence, and the study could only be completed to the extent that information was provided. It is difficult to systematically assess the extent to which data was not disclosed that should have been disclosed by companies, without having in-depth knowledge of the 80 firms in the research. However, a total of 162 instances of insufficient disclosure were found. The analysis also shows the breaches per company. There were 19 companies (24% of the sample) that had more than three insufficient disclosures per company. There were 127 insufficient disclosures in respect of these 19 companies, i.e., nearly 7 per company. These 19 companies are so much in breach of the disclosure requirements that it begs a question about what the Stock Exchange regulators and auditors are doing to ensure the Combined Code is being observed. It also questions the value of a non-mandatory Code.

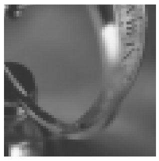


Table 8: Companies with insufficient disclosures							
Number of insufficient disclosures	Former Executive responsibility		Auditor Association	Business association/ affiliation	Years of board service	NED Fees	Total Breaches
	No. companies	Number of insufficient disclosures					
More than 31	19	9	1	1	102	14	127
3 insufficient disclosures	7	1	1	1	12	6	21
2 insufficient disclosures	4	1	1	1	5	-	8
1 insufficient disclosure	6	-	1	1	4	-	6
Zero	44	-	-	-	-	-	-
Total	80	11	4	4	123	20	162

In some cases, the biographical information clearly revealed circumstances which would breach conditions for independence currently being recommended by the Higgs Report. All the breaches are brought together in Table 9 to show the extent to which companies are currently breaching one or more of the Higgs Report recommendations on independence. For the 80 companies in the sample, a total of 115 breaches were found. There were 7 companies with more than 3 breaches each, totaling 48 breaches (i.e., nearly 7 breaches per companies). Again this begs the question: how proactive is the Irish Stock Exchange in ensuring compliance with its Combined Code? Is the Irish Stock Exchange more tolerant of breaches of the Combined Code than, for example, its near neighbour the London Stock Exchange?

Table 9: Companies with breaches of independence						
No. breaches		Former Executive responsibility	Business association/ affiliation	Family associations	Years of board service (9 yrs)	Total Breaches
	No. companies	Number of breaches				
More than 3	7	6	8	6	28	48
3 breaches	6	4	2	-	12	18
2 breaches	13	7	-	3	16	26
1 breaches	23	10	3	2	8	23
Zero	31	-	-	-	-	-
Total	80	27	13	11	64	115

5. Conclusions

Independence of Board of Directors
The study finds that only 48 (60%) companies had majority-independent boards. Board size at 9.5 directors is below the UK average of between 12 and 13 members (Bostock 1995; Conyon 1994).

This trend extends to the monitoring sub-committees where only 41 (51%) companies complied with the recommendations for separate audit, remuneration and nomination committees. The Cadbury report refers to the audit function and its objectivity and effectiveness as the cornerstone of corporate governance, yet only 65 (81%) companies consider it appropriate to establish a separate audit committee.

The findings of this study suggest that:
- Regulators do not introduce further codes of governance but rather underpin the implementation of best practices by enhancing existing codes.
- There is a lack of agreement as to what constitutes an independent director. The definition of an independent director requires clarification to prevent misinterpretation. The Higgs Report (2003) is a welcome move in this direction.
- There is a need for greater consistency in information being disclosed in the annual reports. This does not infer that more information is required but rather specific information on both executive and non-executive directors should be made explicit to prevent ambiguity.

Limitations of the research
Several limitations of the study should be acknowledged.
- The comprehensiveness of information provided in the annual report may be questionable. Companies may be reluctant to divulge voluntarily proprietary information. However, without specific disclosure requirements, the annual report may remain an interesting rather than an influential document.
- This study concurs with the popular press that business or personal associations can impede board independence. Other studies (Westphal 1999) suggest that in fact board effectiveness, and ultimately firm performance, can be enhanced by close relationships with management. Thus, rather than dividing directors into insiders and outsiders, a company can benefit by using team development techniques to develop a cohesive and effective board.

As regulators look to strengthen the role and responsibility of the independent director in overseeing and policing the conduct and behaviour of management, perhaps it is the rationale behind the behaviour that needs to be better understood. Principles and codes of corporate practice influence the behaviour of boards of directors, but it was the investor's relentless desire for double-digit earnings growth that had the greater influence on their behaviour. As the level of interest in honesty, transparency and corporate governance rises in proportion to the number of corporate disasters, so to must the markets and investment community come to admire these same qualities.

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7. The Authors

Professor Niamh Brennan

Niamh Brennan, a chartered accountant, is Michael MacCormac Professor of Management at University College Dublin. She is Academic Director of the Institute of Directors' Centre for Corporate Governance at UCD. Prof. Brennan is a non-executive director of Ulster Bank and is a former non-executive director of Lifetime Assurance, Bank of Ireland's life assurance subsidiary, of Coillte, the State forestry company and of Co-Operation Ireland. She is a member of the audit committee of the Department of Agriculture and Food and is former chairman and member of the audit committee of UCD. She has recently chaired the Commission on Financial Management and Control Systems in the Health Services.

Michael McDermott

Michael McDermott is a Fellow of the Chartered Institute of Management Accountants and holds a Master of Business Administration Degree from the Michael Smurfit School of Business, University College Dublin. Throughout his career, he has gained extensive work experience in Ireland and abroad. He worked for HJ Heinz in Ghana, West Africa and has held senior financial positions with General Motors and Electronic Data Systems (EDS) where he played a key role in developing the Irish and European IT Solutions Centre organisations. Michael is a management consultant and lives in Dublin.

INSTITUTE OF DIRECTORS
IN IRELAND

Institute of Directors in Ireland, 89 James's Street, Dublin 8.
Tel: 01 4084548 Fax: 01 4084550

Email: info@iodireland.ie
www.iodireland.ie