

**Alternative Perspectives on Independence of Directors**

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### **Abstract**

This paper examines the issue of independence of boards of directors and non-executive directors of companies listed on the Irish Stock Exchange. Based on information published in annual reports, the study found that most Irish listed companies were complying with the Combined Code's recommendations for a balanced board structure, albeit with only 60 per cent having majority-independent boards. The study found a lack of consistency in interpreting the definition of "independence", a lack of disclosure of information and, by applying criteria generally regarded as prerequisite to independence of non-executive directors, certain situations which imposed upon their independence.

**Keywords:** Director independence, Higgs Report, Irish plcs

## **Introduction**

The role of non-executive directors has changed significantly since the Cadbury Report (1992) highlighted the particular contribution that independent directors can make to the governance process. McKinsey & Company (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. The objective of this study is to examine the issue of independence, both at a board level and individual non-executive director level, for all companies listed on the Irish Stock Exchange, using information disclosed in company annual reports.

## **Regulatory framework**

The Irish Stock Exchange and London Stock Exchange regulations are for the purposes of this paper identical. Responding to public concerns in relation to creative accounting, high profile company failures and a lack of confidence in external auditors, a number of reports attempted to improve the standard of corporate governance, culminating in the Combined Code (London Stock Exchange, 1998). In April 2002, the UK Department of Trade and Industry launched a review on the role and effectiveness of non-executive directors including “independence” of non-executive directors, following a number of corporate debacles where board effectiveness has come under the spotlight. The resulting Higgs Report (Higgs, 2003) was published in January 2003. To the extent that the Higgs Report is adopted in the Listing Rules, it will have an effect equally in Ireland and in the UK.

This study examines compliance of companies listed on the Irish Stock Exchange with the recommendations of the Combined Code and with those of the Higgs Report in respect to board structure and issues related to independence of non-executive directors. Although the research was carried out in July 2002, prior to publication of the Higgs Report in January 2003, it anticipated many of the Higgs recommendations on independence of directors. This allowed the results to be assessed subsequently against the Higgs recommendations. The examination reveals an array of definitions for and interpretations of “independence”.

## **Literature review**

### ***Independence of boards of directors***

The extent to which boards and non-executive directors are independent varies depending upon business or personal associations with senior management (Mace, 1986; Patton and Baker, 1987). As a consequence, no common consensus exists as to a unique definition for independence.

Arguably, improvements in the independence of corporate boards ought to yield improvements in corporate performance. Independent directors are expected to be more effective in monitoring managers, thereby reducing the agency costs arising from the separation of ownership (shareholders) and control (managers) in day-to-day company management. Empirical evidence challenges the conventional wisdom that board independence produces better corporate performance (Bhagat and Black, 1997, 2002), stating that there is no evidence that companies with more independent boards perform better than other companies. Studies of outsider ratios and corporate performance have produced correlations ranging from positive (Pearce and Zahra, 1992) to negative (Beatty and Zajac, 1994). Some studies have found zero or near-zero effects (Buchholtz and Ribbens, 1994). Yermack (1996) found a negative relationship between the proportion of independent directors and corporate performance. Further doubt was cast by two UK studies (Vafeas and Theodorou, 1998; Laing and Weir, 1999) which failed to find a relationship between the proportion of non-executive directors and corporate performance. Other research has reported that a higher ratio of executive, not outside directors, is associated with higher R&D spend (Baysinger *et al.*, 1991), greater likelihood of CEO dismissal in times of financial crises (Ocasio, 1994) and higher firm performance (Pearce, 1983). These studies argue that executive directors, who have access to fuller information about their companies, are in a better position than outside directors to make decisions about critical areas of operation and performance.

On the other hand, the contrasting executive-dominated board is seen as a device for management entrenchment; there have been calls for boards to have a “substantial majority” of independent directors. Yet there are numerous anecdotes where apparently independent

boards have not prevented shareholder wealth destruction, (e.g. Enron had 15 so-called “independent” directors on its 17-member board) (Paltrow, 2002; United States Senate, 2002).

### *Independence of non-executive directors*

Proponents of board reform have long advocated non-executive director representation as a means of increasing the independence and effectiveness of boards (Bacon and Brown, 1973; Dayton, 1984; Waldo, 1985). However, defining “independence” and applying appropriate criteria to selecting non-executive directors is a question of judgement. What one person considers independent, the next person may not.

A UK survey (KPMG, 2002) of views on independence found that directors should not:

- Represent a specific shareholder or other single interest group (96 per cent);
- Participate in company share option or performance-related remuneration schemes (93 per cent);
- Have conflicting or cross directorships (89 per cent); or
- Have significant financial or personal ties to the company or its management which could interfere with the director’s loyalty to shareholders (96 per cent).

Furthermore, far more respondents considered directors not to be independent where they had been employees for more than five years (64 per cent). By contrast, only 25 per cent of respondents considered directors to lose their independent status when they had served as a director for more than five years.

### *Interlocking directorates*

Several theories on the influence of interlocking directorates on corporate behaviour have been proposed. Interlocking directorates may:

- (i) be a mechanism for collusion and cooperation (e.g. Koenig *et al.*, 1979; Burt 1983);
- (ii) enable companies to control, or monitor others (Pfeffer and Salancik, 1978; Mizruchi, 1982; Mizruchi and Stearns, 1994); and
- (iii) be a source of information on business practices (Useem, 1984; Davis, 1991; Haunschild, 1993).

Despite the range of studies, research has produced contradictory results on the issue of whether interlocking actually affects companies (Palmer *et al.*, 1995; Fligstein, 1995). Some research found positive effects of interlocking on company profits (e.g. Burt, 1983), while others found negative effects (Fligstein and Brantley, 1992). Fligstein and Brantley argue that interlocks do not influence a company's strategic choices.

Because of Ireland's small size and close-knit business community, it might be expected that there is a strong, closely connected network. Possibly because of features of Ireland's largest 250 companies (large number of foreign and private companies, only 14 per cent of sample comprising plcs), networks of interlocking directorates were relatively sparse compared with other countries (MacCanna *et al.*, 1999).

#### *Remuneration of non-executive directors*

Recent research indicates that remuneration for outside directors has significantly increased, largely due to the growth of stock-based compensation (Oppermann, 1997; Perry, 1999; Schellhardt, 1999). Perry documented that, for firms with independent boards whose outside directors receive stock options, the probability of CEO dismissal increases the more poorly the firm performs.

Bryan *et al.* (2000) studied the relationship between a set of company characteristics and outside director compensation, and concluded that outside board members are paid increasingly in a manner to mitigate agency problems (i.e. are paid increasingly in the form of shares and share options, and less in cash). They concluded that outside board compensation packages are designed largely around agency-cost reduction, arising from management oversight and control that is separate from ownership.

#### *Independence of boards of directors – sub-committees*

Many companies have adopted the monitoring sub-committee structure, which allows for a more detailed involvement of the non-executive directors in representing the interests of the shareholders. Klein's (1998) research on board committee structures states that independent

directors can only perform the monitoring function if they are embedded in the appropriate committee structure. However, both a US study (Klein, 1998) and a UK study (Vafeas and Theodorou, 1998) concluded that board subcommittee structures had no effect on corporate performance.

Nomination committees bring an objective approach to director selection (Bostock, 1995), and its presence signals to the market the company's attitude to board independence.

One of the doubts relating to the Cadbury Report (1992) was the assumption that the objectivity of the remuneration committee would control excessive executive pay. These doubts were reinforced by empirical research which showed that chief executives receive higher pay in firms which operate a remuneration committee, and not the reverse (Main and Johnston, 1993).

Paragraph D3.1 of the 1988 Combined Code states that the audit committee should have "at least three directors, all non-executive, with written terms of reference . . ." and "The members of the committee...should be named in the report and accounts". Business and academic press have persistently focused on audit committee composition as an important determinant of quality financial reporting (Vicknair *et al.*, 1993), and there is widespread agreement that audit committees should consist of independent directors to oversee the financial reporting process (Beasley, 1996). However, even independent audit committees do not always function as desired. As revealed in the case of Elan (see Pierce (2003) for a discussion of this case) and Allied Irish Banks plc (see McNee (2002) for a discussion of this case), the existence of a properly constituted audit committee did not guarantee that non-executive directors would identify/act on either internal control weaknesses or unusual accounting policies. As observed with Enron's audit committee, there was little incentive to perform their oversight responsibilities. Three of the six committee members lived outside the country, and the remaining three members received financial payments from Enron, suggesting their independence from management was limited. The audit committee chairman had held the position for 15 years, suggesting his independence could have been sacrificed by his long involvement with Enron.

## **Research questions and methodology**

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 in the impartial undertaking of their responsibilities. The research reviews independence from two perspectives:

- (i) the first part examines the independence of boards of directors and board subcommittees 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 are examined:

### *Independence of boards*

- 1. What is the 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 on boards of other companies with common non-executive directors?
- 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 1998 Combined Code?

### *Population and sample*

The population consists of all 81 companies listed on the Irish Stock Exchange on 17 July 2002 (70 fully listed, 11 listed on the Exploration Securities Market/Developing Companies Market). 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.

### *Data collection*

Information was collected from the published annual reports. 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). There were no relevant changes in corporate governance regulations, nor were there any other notable differences between the years (although it could be argued that the Enron scandal which came to light in late 2001 may have had some impact on the three 2002 annual reports).

## **Results**

### *Independence of boards of directors*

Table 1 shows that of the 749 directors' biographies studied, 460 (61 per cent) were non-executive directors and 289 (39 per cent) were executive directors.

| <b>Table 1: Analysis of board of directors – by percent of non-executive directors</b> |               |                                       |   |            |
|--|---------------|---------------------------------------|---|------------|
| Non-executive directors (%)  | No. Companies | Average number of executive directors | Average number of 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        |
| 33½–50   | 30            | 4.6                                   | 3.6                                       | 8.2        |
| Less than 33½  | 2             | 4.5                                   | 1.5                                       | 6.0        |
| Average  |               | 3.6                                   | 5.8                                       | 9.4        |
| Total  | 80            | 289 (39%)                             | 460 (61%)                                 | 749 (100%) |

Board size was an average 9.4 directors, of which 5.8 were non-executives. The Higgs Report was published in January 2003 after the research in this paper was conducted. It recommends (A3.5) 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 per cent) 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 per cent non-executive director representation, of which, surprisingly, none were financial institutions. Four boards had supermajority independent boards, i.e. only one executive director with all remaining directors being non-executive.

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. 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 per cent) boards had between three and six non-executive directors (Table 2).

| <b>Table 2: Analysis of board of directors – by number of non-executive directors</b> |               |                                       |   |       |
|---|---------------|---------------------------------------|---|-------|
| No. of non-executive directors  | No. Companies | Average number of executive directors | Average number of 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   |

### ***Independence of non-executive directors***

The Cadbury Report (1992) recommends that boards should include high-calibre directors. Although the Stock Exchange listing rules/yellow book requires biographical information on non-executive directors to be disclosed in annual reports (that requirement was dropped in 1999), biographical information on directors was provided by all 80 companies, varying from very basic to providing much seemingly unwarranted information. For example, Rapid Technology Group plc say of one of its directors that he “has extensive commercial experience and is a director of a number of companies in the computer software industry and other areas of Irish business” and of another that he “brings sales, service and operational experience to the board. He is a non-executive director of three other early stage software companies”. Barlo Group plc describes all of its non-executive directors as being “a director of a number of other companies”.

### ***Non-executive directors with former executive responsibility***

The Higgs Report 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 per cent) 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.

| <b>Table 3: Analysis of non-executive directors with former executive responsibility</b> |               |         |
|--|---------------|---------|
|  | 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%)  |

#### *Non-executive directors with auditor associations*

The Higgs Report recommends (A3.4) that a person is not an independent director if s/he 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. 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, and 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.

#### *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 (although it is accepted that this information could have been obtained from other sources). 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.

### *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 11 non-executive directors representing six boards were identified as having immediate family associations with executive director(s) of the company.

### *Non-executive directors with more than nine years of 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 ¥ three-year terms) as an encumbrance to independence.

Of the 460 non-executive directors, Table 4 shows that 64 (14 per cent) 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 per cent) non-executive directors could not be determined due to insufficient disclosure.

| <b>Table 4: Analysis of non-executive directors – years service</b> |               |          |
|---|---------------|----------|
| Years of service  | No. Directors |          |
| Up to 9   | 273           | (59%)    |
| 10–15   | 39            |          |
| 16–20   | 8             |          |
| 21–25   | 8             |          |
| 26 +  | <u>9</u>      | 64 (14%) |
| Insufficient disclosure   | 123           | (27%)    |
| Total   | 460           | (100%)   |

### *Interlocking directorates*

With Ireland's small and close-knit business community, networking is often considered necessary for career advancement. However, comparison with other countries shows a comparatively lower occurrence of multiple directorships (MacCanna *et al.*, 1999). Interlocking of directorships was 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.

#### *Fees for non-executive director services*

The Cadbury Report (1992) recommends (4.13) 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 (B1.7) that remuneration in share options should be avoided for non-executive directors. 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-listed companies. Six companies did not disclose individual director's 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-executive directors 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 (1992) 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,<sup>1</sup> 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 it 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 (1992), most companies excluded non-executive directors from share option schemes and company pensions.

| <b>Table 5: Analysis of companies – non-executive directors’ fees</b> |               |                           |               |
|---|---------------|---------------------------|---------------|
| 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             | 222           |
| 20,001–30,000   | 18            |                           |               |
| Up to €20,000   | 26            |                           |               |
| Insufficient disclosure   | 6             | Insufficient disclosure   | 20            |
| 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-executive directors hold directorships with two or more Irish plcs, with three non-executive directors 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.

| <b>Table 6: Analysis of non-executive directors' other remuneration</b> |               |
|---|---------------|
|   | 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            |

### ***Independence of boards of directors – sub-committees***

Of the 80 sample companies, Table 7 shows that 41 (51 per cent) had separate audit, remuneration and nomination committees. A further 21 (26 per cent) companies had audit and additional services provided by the individual to the company, of which seven were associated with two companies.

| <b>Table 7: Analysis of board sub-committees</b>  |                 |                        |                      |
|---|-----------------|------------------------|----------------------|
| 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                   |
| Total = 80  |                 |                        |                      |
| C=Full compliance   |                 |                        |                      |
| PC=Part compliance (i.e. less than requisite committee members or includes executive director). |                 |                        |                      |
| NC= No committee  |                 |                        |                      |



### ***Independence of boards of directors – sub-committees***

Of the 80 sample companies, Table 7 shows that 41 (51 per cent) had separate audit, remuneration and nomination committees. A further 21 (26 per cent) 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, although a number of companies did not have a nomination/remuneration/audit committee, there were three companies which did not have any of these sub-committees.

#### ***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. Thirty-three (41 per cent) 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.

#### ***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.

#### ***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.

### ***Independence of non-executive directors***

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. Tables 3, 4 and 5 have already shown incidences of insufficient disclosure,

which are summarised in Table 8. Table 8 also shows other incidences where insufficient disclosure was found of prior auditor/business relationships not disclosed in the annual report but known (mainly from the financial press) to exist. The insufficiency of data does not permit a full assessment of independence, and the study could only be completed to the extent of information provided. It is difficult to systematically assess the extent to which data were 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 number of insufficient disclosures per company. There were 19 companies (24 per cent 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 seven per company. These 19 companies are so inadequate in their disclosures that it begs a question about the value of a non-mandatory Code.

**Table 8: Companies with insufficient disclosures**

| No. insufficient disclosures       | No. companies | Former executive responsibility | Auditor association | Business association/ affiliation | Years of board service | NED fees | Total |
|------------------------------------|---------------|---------------------------------|---------------------|-----------------------------------|------------------------|----------|-------|
| Number of insufficient disclosures |               |                                 |                     |                                   |                        |          |       |
| More than 3                        | 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 disclosures         | 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 conflict with conditions for independence currently being recommended by the Higgs Report. These were discussed earlier in the context of Tables 3 and 4. All such cases are brought together in Table 9 to show the extent to which companies at the time of the research were not observing one or more of the Higgs Report recommendations on independence. For the 80 companies in the sample, a total of 115 instances of non-observance were found. There were seven companies with more than three breaches each, totalling 48 breaches (i.e. nearly

seven breaches per company). Again this begs the question: how proactive is the Irish Stock Exchange in ensuring high standards of compliance with its Combined Code? Is it to the advantage of the market that the comply-or-explain aspects of the voluntary combined code operate in the absence of any regulatory oversight? Is the Irish Stock Exchange more tolerant of breaches of the Combined Code than, for example, its near neighbour the London Stock Exchange?

| <b>Table 9: Companies not meeting Higgs' independence standards</b> |               |                                 |                                  |                     |                         |       |
|---|---------------|---------------------------------|----------------------------------|---------------------|-------------------------|-------|
| No. non-observations  | No. companies | Former executive responsibility | Business association/affiliation | Family associations | Board service > 9 years | Total |
| More than 3   | 7             | 6                               | 8                                | 6                   | 28                      | 48    |
| 3 insufficient disclosures  | 6             | 4                               | 2                                | -                   | 12                      | 18    |
| 2 insufficient disclosures  | 13            | 7                               | -                                | 3                   | 16                      | 26    |
| 1 insufficient disclosures  | 23            | 10                              | 3                                | 2                   | 8                       | 23    |
| Zero  | 31            | -                               | -                                | -                   | -                       | -     |
| Total   | 80            | 27                              | 13                               | 11                  | 64                      | 115   |

## Summary and conclusions

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 paper 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 Higgs Report in the UK.

The study finds that only 48 (60 per cent) companies had majority-independent boards. Board size at 9.4 directors is below the UK average of between 12 and 13 members (Conyon, 1994; Bostock, 1995). This trend extends to the monitoring sub-committees where only 41 (51 per cent) companies complied with the recommendations for separate audit, remuneration and nomination committees. The Cadbury Report (1992) refers to the audit function and its objectivity and effectiveness as the cornerstone of corporate governance, yet only 65 (81 per

cent) companies consider it appropriate to establish a separate audit committee, suggesting anecdotal evidence that some Irish companies pay only “lip service” to the recommendations.

Non-availability of information was a serious drawback to the research. In total, 162 instances of insufficient disclosure were found, with 19 (24 per cent) companies contributing 127 (78 per cent) of the non-disclosures.

Results indicate that Irish plcs have a long way to go to fully comply with the Higgs recommendations on independence of non-executive directors. Only 31 (38 per cent) companies had full Higgs-independent boards. The remaining 49 companies did not meet the Higgs definitions of independence 115 times. Of these, there were seven problem companies that did not meet the Higgs independence standards 48 times (i.e. almost seven times per company). Thus, 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.

### ***Implications for policymakers***

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.

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 sample comprising Irish listed companies contains a very diverse group of companies and it is questionable whether they should be treated on an equal basis. Firms vary considerably, notably in terms of size/market capitalisation. In reality a small

number of companies comprise approximately 70–80 per cent of market capitalisation.

- The comprehensiveness of information provided in the annual report may be questionable. Companies may be reluctant voluntarily to divulge 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. Conversely, 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 investors' 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 too must the markets and investment community come to admire these same qualities.

## **Note**

1. The Euro/sterling exchange rate between August 2001 and March 2002 (period of many annual reports) ranged from €1 = £1.55 to 1.64. Thus, €50,000 is equivalent to approximately £30,000/£32,000.

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