IT Law Today

Site Internet: www.informalaw.com
Date: 06.2007
Security Copy: 0706 IT Law Today (Non-execs article)
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The roles and risks of non-executive directors

According the Cadbury Report, non-executive directors (NEDs) should bring an independent judgement to bear on issues of strategy, performance and codes of conduct. Many serve as chairs of audit committees, but with no legal distinction between executive and non-executive positions, they are bound by the same duties and liabilities as their executive counterparts. This makes sign-off on company audits and financial statements a very significant and real responsibility. Liz Maloney, regional director of EMEA for ACL, argues that many non-executives lack the basic information to sign off in confidence.

The recent spate of high-profile corporate fraud cases being prosecuted has shocked many in the business world. With millions of pounds being misappropriated and hidden through falsified financial reports, the question being asked is: how can such startling financial irregularities be approved by executive boards and does this suggest collusion on a massive scale?

Despite the media hype, the answer in the vast majority of cases is no. Fraudulent activity is generally limited to very few individuals in the organisation, and it is the lack of accurate financial reporting and visibility of key controls, rather than company-wide conspiracy, that allows suspect transactions to slip through the net. For example, KPMG Forensic's recent profiling of the average corporate fraudster found that it was most likely to be a *'trusted male executive in the finance department, getting away with over 20 fraudulent acts over a period of up to five years or more'*.[1]

Of course, fraud is not the only thing keeping NEDs awake at night. The introduction of a host of regulations in the past decade is having a far-reaching impact on how businesses are run and the controls they must have in place. Effective compliance with such regulations are the responsibility of the business, and ultimately the board of directors.

Crucially in both scenarios, the law sees no difference in the liability between executive directors and NEDs – all are accountable. As such, boards must be aware of the appropriate corporate safeguards and the steps to take to minimise business risk. Furthermore, NEDs need to reconsider their roles, responsibilities and the risks to which they are exposed. Many are now doing so, becoming more reluctant to accept positions, with potentially significant control consequences for business.

The diversity of the board

An executive team containing members with a wealth of disparate knowledge and experience is a key component of a strong board. However, the recent headline fraud cases highlight the dangers in appointing inexperienced or *'celebrity'* NEDs, and may signal a sea change in appointment strategy.

In FTSE 100 companies, on average, NEDs comprise approximately half the board. In smaller listed companies, this figure drops to just over one third.[2] Having such a large proportion of NEDs present acknowledges the critical role they play in steering the company's strategy, performance and governance. Unlike executive directors, who are liable to become embroiled in the day-to-day operations, NEDs are able to focus on wider issues and, significantly, must interrogate the facts that they are given. In a report to the UK Government, the roles of the NED were outlined as follows:

> *'[NEDs] must be well-informed about the business, the environment in which it operates and the issues it faces … [They] need to be sound in judgement and to have an inquiring mind. They should question intelligently, debate rigorously and decide dispassionately.'*[3]

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Non-exec challenges

However, there is some evidence of a knowledge gap at board level. A recent survey of non-execs showed that less than one quarter received a formal briefing or induction after appointment. Furthermore, two thirds had not received any additional training or development of skills as part of their directorship.[4] This is incredibly significant because failing to equip these crucial individuals with the knowledge and tools they require to confidently carry out their roles opens the door to all manner of corporate risk.

The role of the non-exec is further challenged by the increasing complexities of modern business life. The past 20 years have seen a substantial change in the way in which business is conducted, due, in large part, to security, risk and regulatory issues. This greater focus on corporate governance has placed an increased onus on NEDs to ensure that the company and its employees are functioning within the law.

Auditing responsibilities

With 85% of NEDs serving on or chairing audit committees,[5] financial accountability consumes much of their time. Although NEDs are selected for the varied experience they can bring to the board, many find themselves requiring considerable financial and auditing knowledge, and an acute awareness of the company's internal business processes. They are put in the unenviable situation of being asked to sign off financial reports, for which they are personally accountable, despite not being trained auditors or risk assessors. As such, they must have complete (and often blind) trust in the integrity of the information provided by the business.

To serve on an audit committee is clearly a time-consuming and complex task. And unless a separate risk management team has been appointed, the committee must take up the mantel here as well. Though confidently signing off financial reports is a key aim of the committee, it is also charged with reviewing the company's internal financial control system, the risk management systems and overall compliance. Here, NEDs can add value by bringing to bear their experiences with systems and processes that have worked. Likewise, by viewing the financial controls with fresh eyes, they are able to identify possible problem areas that need attention; for example, an oversight allowing managers to approve their own expenses. However, without an indepth understanding of their role and of the specific business, this can be challenging.

With such a wide remit to fill, the pressures placed on the audit committee, and therefore NEDs, are considerable. It is telling that 45% of NEDs are less likely to accept an audit committee chairmanship now than they were 12 months ago, citing corporate governance and increasing regulation/legislation as major challenges.[6]

Gaining insight

With few NEDs having a career history in finance and audit, their effectiveness on the audit committee is greatly influenced by the tools and systems they have at their disposal. The most valuable asset for an NED is the complete visibility of the company's financial controls and transactions. If the internal controls in place have been tested and proved robust against the threat of fraud and other financial misnomers, the audit committee can be confident in the integrity of the reports they are signing off.

It is now becoming more common for businesses today to support their traditional quarterly or annual audit with continual monitoring of internal controls and transactions to provide full visibility of business operations. The resulting system allows internal auditors and financial controllers to question any anomaly as it occurs, rather than at the end of a cycle when workloads are high and considerable time has past between action and detection. For example, once a duplicate payment has been made (either through an innocent mistake or fraudulent activity), the chances of total recovery dwindle to 50–60%, and the cost of recovery can be significant.[7] This is why 5% of an organisation's turnover is lost to fraudulent activities each year.[8]

But the good news for NEDs is that by insisting on this kind of business control, not only can they dramatically reduce the risk of fraud, they are also able to increase revenues and,

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ultimately, profit shareholders, while assuring the integrity of financial controls and accuracy of reports.

Depending on technology

To add to the complexities of managing businesses today, every major enterprise is entirely dependent on technology to conduct business. This can be a blessing and a curse. On the one hand, technology can create a wonderful playground for internal and external fraudsters; on the other, it can provide very clear control mechanisms to limit fraud and business risk, while significantly improving business efficiency. The key to getting the balance right is an intelligent approach to IT. However, one thing is absolutely clear: technology, and particularly data analytics and monitoring tools, can significantly ease the burden currently being placed on NEDs.

Business protection, self-preservation

The very essence of business is that it changes and adapts to the market conditions placed upon it. Successful companies rely heavily on their boards to provide the guidance necessary to remain competitive and successful. Personal liability among directors may not ruffle the feathers of executive directors, who are better placed to ensure that daily operations are compliant with all laws and regulations. However, NEDs do not have the luxury of being involved at this level of the company and must rely on their executive counterparts to manage the process. While non-execs will have confidence in their business, they need a little more. They need the proof to back it up. Happily, non-execs are in the perfect position to insist on this, to make sure their client companies implement the tightest business processes and the right levels of financial analysis and management to ensure that they have the visibility to sign off audits, accounts and annual reports in complete confidence.

Box Out: Top tips for NEDs

1. Gain assurance – make sure that the business has a control system that reports against anomalies in its financial transactions and clearly shows how exceptions are highlighted and dealt with.
2. Continually monitor – do not just rely on ad hoc auditing. Quarterly or annual audits simply interrogate sample data and may miss the real business threats.
3. Reduce liability – ensure that financial control and monitoring become part of everyday business life, providing you with the most up-to-date and accurate information so that you can sign off accounts with total confidence.

Liz Maloney, regional director of EMEA, ACL Services

1 Profiling of a Fraudster, KPMG Forensic (*www.kpmg.co.uk/news/detail.cfm?pr=2859*).

2 Review of the Role and Effectiveness of NEDs, Derek Higgs, DTI, January 2003 (*www.dti.gov.uk/files/file23012.pdf*).

3 Ibid.

4 Ibid.

5 Concerns that still keep non-executives awake at night..., Ernst & Young, (*www.ey.com/uk/nonexecutivedirectors*).

6 Ibid.

7 Paystream Advisors, a research and consulting firm.

8 2006 Report to the Nation on Occupational Fraud and Abuse, Association of Certified Fraud Examiners.