

A Guide to Appointing Non-executive Directors

Business Information Factsheet
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Introduction

A non-executive director is a member of a company's board of directors who is not involved in the day-to-day management of the organisation, but is typically involved in planning, strategy and policymaking in relation to the company and its objectives. The appointment and conduct of all company directors, including non-executive directors, is regulated by the Companies Act 2006.

This factsheet outlines the potential advantages of inviting a non-executive director to join the board of a small company. It looks at the duties involved in the role, the legal responsibilities, the time commitment expected of non-executive directors, and how much they should be paid. It also considers how a business can go about finding and hiring a non-executive director.

How can non-executive directors help small firms?

A non-executive director can bring many benefits to a small business. These can include providing mentoring for the management team, access to a particular network of contacts, plus the benefit of their personal expertise, which may complement that of the executive team.

Non-executive directors have the advantage of being less involved in a company's everyday operational activities than the executive directors. They have a broader perspective and may be capable of comparing a business with others in its sector. This can lead to a more realistic view of a company's prospects as it ventures into new markets, deals with new suppliers and faces up to legislative changes.

Many smaller companies value non-executive directors for their financial expertise. Clearly this depends on the choice of individual, but a non-executive director with the right qualifications and experience can help a company as its directors face challenges of which they have little knowledge, such as raising finance or dealing with debt.

A non-executive director can also help a business to increase its customer base or find partners and suppliers by exploiting their network of contacts.

The need to demonstrate good corporate governance is important for small firms seeking loans or venture capital. Appointing a non-executive director indicates that a company's board is well run, and may help to reassure investors.

The role and responsibilities of the non-executive director

Many companies recruit non-executive directors to bring in specific expertise. Certain rules apply regardless of the size of company. Under the Companies Act 2006, a non-executive director has the same legal responsibilities as the executive directors. This means they must:

- Help lead the company within a framework of prudent and effective controls.
- Assess and manage risk.
- Provide an input into company strategy and ensure that the company has the resources to carry it out.
- Help set the company's values and standards.

In practice, this means bringing certain qualities to the company's decision-making. For example:

- Non-executive directors should be sufficiently independent to provide objective criticism and contribute to the development of strategy.
- They have a role to play in ensuring that executive directors are performing, by checking that objectives are being met and key information is being reported properly and on time.
- Non-executive directors often get involved in ensuring that financial information is accurate. In practice, this involves making sure that financial controls and risk management systems are in place and working effectively.
- Although such a procedure would be more common in a public company, a non-executive director may have some input into setting executive directors' pay and bonuses, and may have some influence over appointing and removing executive directors and senior managers, and in succession planning.

Allowing non-executive directors to carry out any of these functions effectively in a small private company depends on them being given a substantial amount of trust.

The Financial Reporting Council's (FRC) UK Corporate Governance Code provides a summary of good practice requirements for directorship and governance of listed public limited companies. It provides non-executive directors with a useful set of guidelines and a legal framework within which to work. The Code is not always applicable to small private companies, but it can provide useful terms of reference for directors of small firms. Go to www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code.aspx for more information and to download the Code.

The FRC has announced that it will carry out a fundamental review of the UK Corporate Governance Code based on issues raised in the Business, Energy and Industrial Strategy (BEIS) Select Committee's report on Corporate Governance, which was published in April 2017. Go to www.parliament.uk/business/committees/committees-a-z/commons-select/business-energy-industrial-strategy/news-parliament-2015/corporate-governance-report-published-16-17/ for more information about the Select Committee report.

See also BIF025, Duties of a Company Director, for more information about the role of company directors in general.

Choosing a non-executive director

Ideally, a non-executive director should have experience in business and a reputation for independence and integrity. Companies often hire a non-executive director who can help them fill a specific gap in their knowledge or abilities. As well as contributing to good corporate governance, a non-executive director might have extensive sector-specific knowledge or a particular area of business expertise.

With this in mind, company directors should assess existing skills and competencies within the board, and review the company's strategy, before drawing up a list of criteria for the non-executive director post. The list should consider practical issues such as the fees the non-executive director will be paid, the number of days they will work and the responsibilities they will be given.

Finding a non-executive director

- A common way to recruit a non-executive director is through existing professional contacts. For example, the company's bank manager or accountant may be able to recommend someone with a good reputation.
- Headhunting firms and executive search agencies may offer a service to match potential non-executive directors to a business. Companies should give the agency a clear idea of what they are looking for in terms of background, experience and proposed remuneration, along with a description of the sort of problems and opportunities the directors face.
- The Non Executive Directorship Exchange (The NED Exchange, www.nedexchange.co.uk) is an example of an organisation that advises companies seeking to recruit non-executive directors.

Appointing a non-executive director

Letters of appointment

Non-executive directors are often engaged under a 'letter of appointment' rather than a formal contract for services. The letter of appointment should include any conditions, duties, responsibilities, fees and expenses and time requirements in relation to the non-executive director's role. It should also cover confidentiality, directors' obligations and arrangements for the return of company documents on termination of the contract. In addition, it may include any specific provisions relating to conflicts of interest, induction into the company, insurance or access to independent professional advice.

The Institute of Directors (IoD) can provide further guidance about terms for appointing a non-executive director. For more information, go to www.iod.com/services/information-and-advice/resources-and-factsheets/details/letters-of-appointment-for-non-exec-directors.

Length of service of non-executive directors has come under increasing scrutiny in recent years. Ideally, companies should strike a balance between a short-term contract that might prevent a non-executive director contributing effectively to strategic aims, and the opposite extreme of an appointment that is automatically renewed year after year. A two- or three-year contract with the potential to renew may be a good starting point.

Fees and hours

There are wide variations in pay and time worked by non-executive directors, depending on the size of the company and the complexity of its affairs.

According to a 2014 benchmarking survey 'Life in the Boardroom' published in January 2015 (the most recent figures available) by the independent pay consultancy MM&K, non-executive directors in smaller companies earn around £1,500 per day and work an average of 23 days

per year. On average, they earn around £30,000, and according to the survey, their fees had not increased at all over the previous 18 months. Go to www.theqca.com/information-centre/markets/97912/mmandk-survey-highlights-trends-in-ned-remuneration.thtml for more details about the survey.

The UK Corporate Governance Code recommends that remuneration for non-executive directors should reflect the time commitment and responsibilities of the role, and should not, in general, include share options or other performance-related elements.

Tax issues

Under the Finance Act 2013, IR35 tax legislation which is intended to prevent avoidance of National Insurance (NI) Class 1 Contributions and tax payments has been extended to include fees paid to non-executive directors. Similar to executive directors, non-executive directors are considered to be 'office holders'. In general, their fees should be taxed as PAYE and subject to Class 1 NI contributions. For more information about IR35 rules, go to www.gov.uk/guidance/ir35-find-out-if-it-applies.

Companies are advised to seek professional advice about the tax and legal implications of specific remuneration packages for non-executive directors.

Hints and tips

- To avoid disruption to the board, involve all members in choosing and recruiting a non-executive director, and devise a clear plan for inducting the new board member.
- Make sure the duties of a non-executive director are clearly defined to avoid duplication of the responsibilities of existing board members.
- Be clear about expectations in relation to non-executive directors. Choosing the right person will ensure that the non-executive director makes a useful contribution to the company. The benefits to be gained from experience and prudence may not be easy to quantify in financial terms, so a formal letter of appointment should make it clear what the role will require.
- Ensure that there are no conflicts of interest. Non-executive directors frequently hold similar posts on other company boards. From the very beginning of the recruitment process, steps should be taken to ensure that potential non-executive directors have no conflicting interests and can devote the necessary time and energy to the company.

Further information

BIF023 Duties of a Company Secretary

BIF025 Duties of a Company Director

BIF459 A Guide to the Companies Act 2006

Useful publications

'The non-executive director role'

Chartered Institute of Personnel and Development (CIPD)

Website: www.cipd.co.uk/knowledge/strategy/governance/non-executive-directors

Useful contacts

The Institute of Directors (IoD) is a membership organisation representing company directors. It provides information as well as training materials and courses for non-executive directors.

Tel: (020) 7766 8866

Website: www.iod.com

The Chartered Institute of Personnel and Development (CIPD) is a membership body representing HR professionals and learning and development practitioners. It sets professional standards, accredits qualifications and runs training courses. It also publishes online resources covering HR management, organisational culture and workforce trends, in addition to information and resources relating to the employment of non-executive directors.

Tel: (020) 8612 6200

Website: www.cipd.co.uk

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