

Beyond the numbers: The Importance of the Independent Non-Executive Directors in the Corporate Governance

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Abstract

This paper is based on data and information gathered directly through interviews and information provided by and at ABC group (Real name is not disclosed for confidentiality). It aims at examining two key perspectives from the management by: i) using the international guidelines in terms of corporate governance, how to apply appropriately this framework into the context of Cambodia, and in effective and efficient way, and ii) what would be the current issues and problems and challenges, the organization has to overcome, in order to comply to the local rules. The other goal of the paper to look at how to apply a good governance strategy and understand the role of management in organizational development.

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Introduction

ABC Group is a medium-size, an ASEAN energy producer, and has offices and partnerships in Singapore, Malaysia, Vietnam, Thailand and Cambodia. ABC's Management, is looking to appoint two new directors for the Cambodian subsidiary, in order to further strengthen the foundation of its current corporate governance regime at the board level and aligned with the international recommendations. This report aims to highlight some key points and to present some recommendation to the board, for their consideration.

First, the objective of a good corporate governance relies on the solid constitution of the board. ABC Cambodia has currently 7 directors: 3 Executive Directors (CEO, CFO, CTO), 4 Non-Executive Directors. Lately, 1 Executive Director (ED) and 1 Non-Executive Director (NED) have announced their will to resign and need to be replaced. The ED belongs to the management team and is fully employed by the company. He receives salary, bonus and other employee benefits. He possesses inside information of the company as he knows both the operational and execution level. On the other side, the NED is basically not inside the company, and can be executive director in another company, his remuneration¹ is only directors fee (to make sure of independence). The NED is not a full-time staff like the ED, and by appointing him, the company expects him to bring external input and expertise and contribute to the growth and the development of the firm.

1 - Role of the two new directors

The new directors will collaborate closely with the chairman and the other directors of the board. They together will design the strategy (identification, assessment, monitoring), also set mission statement, vision, goals and financial objectives. In order to be successful and performing, the new director will have legal status like all current members. The size of the board should be maintained at 7, in order to maintain duality, generate more debate and discussions, more exchanged points of views, which should lead to an efficient team decision making.

The new directors will have the ability, the skills (diploma, certification), expertise and the experience. They possess some intellectual strength and have a recognized high ethical standard. KYC and due diligence procedures should also be done in a pre-check level.

According to Higgs report², the directors should be focused on : *(1) strategy to develop and evaluate in coordination with the Board, the chairman and CEO) and to make sure the execution is well pursued and aligned with the shareholders and stakeholders interests, (2) the performance (between the formation and the achieved performance ,*

¹ KPMG 2017, Report on NED Remuneration,
https://home.kpmg.com/content/dam/kpmg/my/pdf/KPMG_NEDReport2017_FINAL.pdf

² The Review of the role and effectiveness of non-executive directors,
<http://www.ecgi.org/codes/documents/higgsreport.pdf>

(3) Risk (to monitor, analyse, audit the current control system and check for failures in the policy framework, and make proposal to the board, (4) the people (referring to the constitution of the sub-committees, cf below)

2 - Non-Executive or Executive Director?

As the ED are directly employed and paid in the company, he/she will know very well the operations for the inside. A non-executive director has a non-operating function in the company. The presence of the NED will be then fruitful and necessary for challenging the managing team (in strategies, goals, finance) and avoid a situation of “groupthink”³ situation, which may lead to disaster. The presence of NED is important to help the board to scrutinize objectively the performance of the company, especially the CEO. The NED should not only be able to challenge, question the board, but also need to agree on the firm’s goals, and he should be impartial, have unbiased and independent opinions.

Referring to the *Higgs report*, having more NEDs in the board, makes it more effective. Their presence makes sure there will be a minimal influence of the executive directions of the strategies formulation and implementation. The NEDs make sure that the board pursue strategies that benefit for all the stakeholders (shareholders, customers, suppliers, employees and community). By being non-executives, they can confront the management and make sure there is no conflict of interest. The number of non-executive directors in board is important. The board should have more NEDs than EDs. If the 2 new replacing directors are ED, the board will be imbalanced, the number would be inadequate and it may lead to lesser control and a lesser scrutinized organization in terms of performance evaluation, as the executive directors will dominate the board. On the side, if the new directors are respectively 1 ED and 1 NED, the balance will be respected, and will keep the board strong, and will maintain this kind of duality, and be a place for debate and constructive discussions.

3 - The NED should be involved in the Audit Committee and Risk Committee.

The corporate governance guidelines recommend 4 different committees, such as audit, risk remuneration and nomination. The NEDs will be essential, as they are not in the operations. they can make the board more transparent, reliable, effective and efficient. They can objectively and independently analyse and see if the company functions properly.

The audit and risk committee shall be led by only NEDs. They will have to elaborate procedures/controls and update the audit process for internal/external control for example. Internal control should be consistent, in order to avoid abuse, fraud or

³ <https://www.investopedia.com/terms/g/groupthink.asp>

management overriding the control system. And the external control will be focus on the proper selection of external auditor.

Whereas the Audit committee oversee the finance and the process, and control system, the risk committee will mitigate the potential risks such as compliance risk, financial risk, operational risk and so on. Referring to ICAEW⁴, there are 5 classes of risk : *financial* (in case of acquisition, or merger with another company, new projects), *operational* (in the production level or operations level generally in sales/marketing and logistics), *compliance* (are we compliant with the countries law that we are operating in?), *business* (impact of acquisition the team cohesion and corporate culture) and *any other* risks (any kind of risk, for example reputation risk, legal, political, technological, natural disaster,). The risk committee will specifically identify, follow up, monitor the category of risk and report to the board.

For the setup of the Audit and Risk Committee, we would suggest that the members of the Audit Committee should have at least three⁵, including the new NED. The new member should be an Independent NED. The new appointed ED of the company should not be an audit committee member, even the Chairman, in order to avoid conflict of interest. The appointment of the new NED to the audit committee, should be made by the board on the recommendation of the nomination committee, in consultation with the audit committee chairman.

The NED will have to work with the audit committee in reviewing and approving the internal policy and procedures, ensure that the internal auditor has direct access to the board chairman and to the committee, be able to provide financial advice to the board (for instance to ensure that the annual reports accounts are fair, balanced, and understandable, and are provided timely to the shareholders). Also, the new director should be able to listen and protect the whistle-blowers⁶.

4 - In case of future separation of the Audit Committee and the Risk Committee⁷.

Ideally, the new director should be a NED for this committee. But appointing the new ED is possible, especially if the new ED has experience and expertise in the risk management. The task of risk management, would then be very specific and should be kept separated from the audit committee. The new director should have expertise, time and capacity in reviewing and approving the organization's risk management strategy

⁴Established in the UK in 1880, ICAEW has been at the forefront of the accountancy profession.
<https://www.icaew.com/-/media/corporate/files/technical/iaa/risk-assessment-and-internal-controls---continuing-challenges-for-auditors---final.ashx>

⁵ <https://www.icaew.com/technical/corporate-governance/uk-corporate-governance/audit-committees>

⁶ <https://www.investopedia.com/terms/w/whistleblower.asp>

⁷ PWC 2017, <https://www.pwc.dk/da/publikationer/2017/pwc-how-your-board-can-decide-if-it-needs-a-risk-committee.pdf>

(short term and long term), and will oversee risk management policies, monitor risks on different business operations.

The director should be a good communicator and keep ensuring that board is aware of the state of firm's internal control systems. The director is also a leader, he must assess the effectiveness of the organization and be able to provide recommendations and detect early warning signs and be able to proposed significant changes in the company's exposure to risks. A separate risk committee can definitely contribute to more robust organization, with a dedicated team focus on assessing risk, mitigating risk and being able to give recommendation for action.⁸

5 - The remuneration committee will be also a significant committee.

The NED will be joining the remuneration committee, which is responsible for determining the remuneration of the management (executive directors). His role is then to analyse the remuneration of all the levels of salaries and employees benefit and will need to propose a benchmarked (market rate) proposal and recommendation. Obviously, the ED cannot be appointed in the remuneration committee due to conflict of interest. The key roles of the committee will be also to design the policy and framework for its application in the ASEAN countries, for instance, the committee should work on defining the salaries benchmark in the region (including employees benefit, if remuneration package) and can elaborate performance-related schemes such as stock-based options bonus, on the success and milestones. The committee should also be able to terminate the contact and remuneration in case of failure or under-performance.

6 - About the Nomination Committee

The role of this committee is to be able to appoint, remove or fire the executive directors if not performing, and also be able to elaborate the succession planning. The new NED or ED, both could be eligible for this position. Before the appointment, we need to make sure that the new director who will take the role, possess the right balance between skills and expertise in the management of human resource. One of the key role is to review, oversee the structure of the company, to analyse the composition of board if necessary. The new director shall be able make recommendation to the board (increase, reduce, replace). And, on the practical level, he will be able to elaborate job description that is needed for the directors.

The succession planning is also important for the continuity of the company, the new director should be involved in the internal procedures, retirement, replacement process. For instance, if the company need to appoint a new audit Committee member, he need to make sure that the procedure is compliant with the company constitution, in term of re-election, and independence. For instance, his role is also to ensure that at least one member of the audit committee has significant, recent and relevant financial

⁸ *BNM 2013 The safety and soundness of financial institutions rely on the effectiveness of risk oversight and control functions* <https://www.bnm.gov.my/index.php?ch=57&pg=144&ac=159&bb=file>

experience. The new director with team will also need to define properly a Term of Reference of the audit committee.

7 - The Malaysian Governance Code

The Malaysian Code of Corporate Governance (MCCG) has been issued on 2000 and been revised on 2007 and 2012, and 2017. The MCCG has set up some guidelines and recommendations on the structure and the process which should be applied in the companies operating in Malaysia. To comply with the current regulation, the company should adopt the minimum of the standards set by the regulator, which are for example:

- *a clear role of the board in term of responsibility and leadership functions*
- *a strong boards composition, with clear policies and procedures and especially for the board members*
- *the board should ensure effectiveness of the NED*
- *ensure that financial statements are reliable source of information*
- *establish a sound risk management framework and procedures to ensure that information is comprehensive, accurate and timely disclosed*

The current nomination committee should definitely assist the company for recruitment of new directors and the annual assessment of the boards and its members. The remuneration committee will help to define a consistent remuneration policies and procedures to attract, retain and terminate directors.

8 - About the definition of “independence” (referring to new combined code in 2012⁹ in UK)

In case the chairman is the CEO, and not an independent NED, the majority of the Board should be of a majority of independent NEDs. By “independence” referring to the UK combined code, the independent NED should be:

- *not being an ex-employee or left the company more than 5 years*
- *not a business partner, whether direct or indirect, and more than 3 years*
- *no close family ties*
- *be paid with director's fees only (if ED works in another subsidiary)*
- *no cross-directorship with another company*
- *does not represent a significant shareholder*
- *should not be in the board for after 9 years*

The non-respect of the criteria, can disqualify the status of NED to an ED, and then will pose the question of an imbalanced board again. The executive management could then have more influence in the decision of the board, and the conflict of interest may again arise.

⁹ [https://www.frc.org.uk/getattachment/e322c20a-1181-4ac8-a3d3-1fcfbcea7914/UK-Corporate-Governance-Code-\(September-2012\).pdf](https://www.frc.org.uk/getattachment/e322c20a-1181-4ac8-a3d3-1fcfbcea7914/UK-Corporate-Governance-Code-(September-2012).pdf)

On the other hand, being compliant with the MCCG is based on voluntary act, and this for listed companies. There is no penalty for non-compliance, however the companies need to explain (“comply or explain”) in the annual report, how the company apply the recommended code of governance. In final, the aim of the code is to set a self-discipline mind-set and to raise market pressure on the companies, and also to strengthen the good corporate culture and make it being embedded in the firm’s code ¹⁰

The new MCCG has been also updated in 2017¹¹, drawing attention to *corporate excellence*. This new recommendation is based on the past lessons of financial crisis and governance failures and changes in market.

8 - About the definition in the Cambodian Code

The Corporate governance for companies in Cambodia is shaped through the Prakas (a regulation issued by a Minister). The first Prakas¹² on Corporate Governance was released on December 2010, to set up the specific requirements for Listed Public Enterprises. The Prakas is to ensure “good corporate governance” through formulating mechanisms to protect shareholder’s rights, organizing the management structure and corporate governance, defining the authority and obligations of the board of directors and setting up an effective control system.

In the Cambodian CG Code, a public limited company must have at least three directors but the board of directors must not exceed seven members. The board is required to have at least one independent director and one non-executive director as representatives of the private shareholders. Whereas, a private limited company must have one or more directors. The directors are required to manage the business and affairs of a company.

On the Article 19 of the Prakas on Corporate Governance for Listed Public Enterprise, further recommendations had provided such as: public limited companies are expected to be independent in judgment and action and take all reasonable steps to ensure the soundness of board of directors’ decisions. And these obligations include:

1. *acting in good faith for the benefit of the Listed Public Enterprise and shareholders as a whole;*
2. *exercising proper powers for the benefit of the Listed Public Enterprise as a whole;*
3. *performing duties carefully, skilfully, and diligently;*

¹⁰ SC Releases New Malaysian Code on Corporate Governance to Strengthen Corporate Culture https://www.sc.com.my/post_archive/sc-releases-new-malaysian-code-on-corporate-governance-to-strengthen-corporate-culture/

¹¹ Malaysian code on corporate governance <https://www.sc.com.my/wp-content/uploads/eng/html/cg/mccg2017.pdf>

¹² www.cambodiainvestment.gov.kh/wp-content/uploads/2011/09/Prakas-013.10-on-Corporate-Governance-for-Listed-Public-Enterprise_101215.pdf

4. *properly resolving any conflicts related to the interests of the Listed Public Enterprise;*
5. *not entering into any transactions, in which the directors have interests, except in compliance with approved policies and procedures;*
6. *not taking advantage of their position as a director;*
7. *not making improper use of information from the Listed Public Enterprise;*
8. *not accepting gifts from third parties; and*
9. *declaring any conflicts of interest related to the Listed Public Enterprise.*

The board of public limited company shall also approve and publish a *Code of Conduct* for directors and senior officers. The board of directors will elect a chairman among its members. The chairman may be removed from the office of chairman, but not from its position as a director, by a majority vote of the directors.

The rights and interests of minority shareholders shall be protected by the board of the Listed Public Enterprise, such rights include:

1. *the right to seek information (such as the financial statements of the company, its audited accounts, shareholder resolutions or any documents in relation to the affairs of the company that may be of interest to shareholders);*
2. *the right to voice opinion (i.e. right of expression and speech during a general meeting, provided that the statements are not considered as defamatory or abusive); and*
3. *the right to redress (for any damages resulting from negligence, misconduct or fraud caused by any members of the company).*

With the country's economy, Cambodia's private sectors and regulators need definitely to refine corporate governance to help corporations achieve sustainable growth. Also quoted by Sou Socheat, director general of the Securities and Exchange Commission of Cambodia (SECC)¹³: *"Good corporate governance is now key to build up a company's reputation and increase trust with partners and clients, helping improve the firm's bottom line. With the backdrop of globalisation, it is essential that Cambodian authorities prioritise the implementation of good corporate governance practices, both for SMEs and big corporations, in order to improve our reputation as a place for business"*.

The culture of strong corporate governance contributes to each employee having a much clearer understanding of its role and function within their corporation, and most of the Cambodian companies utilise resources more efficiently to assimilate it in their own corporate culture.

The implementation of corporate governance also requires the support from stakeholders, especially from the regulators of each sector. SECC has issued a lot of regulation for listed and non-listed companies to encourage them to abide by good corporate principles.

¹³ <https://www.khmertimeskh.com/50103714/cambodia-urged-to-focus-on-good-corporate-governance/>

Conclusion

The both new directors should also show and have high level of integrity, aligned with code of conducts in the industry and the firm.

The advantage of having majority of NED is to definitely improve our firm's organizational performance, to reduce groupthink, to bring independence, external views and expertise, to have debate and constructive discussions in the board. The disadvantage would be the costs (directors fees only), time (busy person), expertise (qualification, scientific knowledge), independence (in line with the criteria quoted above).

The other aspect we have to take into account is "*diversity* ", for example the parity between female and male directors¹⁴, to integrate different international expertise or even nationalities (Vietnam, Thailand, ...), from different industries, and also add more about the culture of Corporate Social Responsibility¹⁵ , in order to meet and fulfil the expectations of not only our shareholder but also our stakeholders.

¹⁴ "Promoting gender diversity on boards: SC will collaborate with industry groups and stakeholders to increase women's participation in boards of the top 100 companies on Bursa Malaysia from 16.8% currently, to 30% by 2020" https://www.sc.com.my/post_archive/sc-releases-new-malaysian-code-on-corporate-governance-to-strengthen-corporate-culture/

¹⁵ The Impact of Corporate Sustainability on Organizational Processes and Performance https://www.hbs.edu/faculty/Publication%20Files/SSRN-id1964011_6791edac-7daa-4603-a220-4a0c6c7a3f7a.pdf

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<http://www.ecgi.org/codes/documents/higgsreport.pdf>
- ICAEW. The *Institute of Chartered Accountants in England and Wales* with over 147000 members.
<https://www.icaew.com/-/media/corporate/files/technical/iaa/risk-assessment-and-internal-controls---continuing-challenges-for-auditors---final.ashx>
<https://www.icaew.com/technical/corporate-governance/uk-corporate-governance/audit-committees>
- PWC 2017 Publications
<https://www.pwc.dk/da/publikationer/2017/pwc-how-your-board-can-decide-if-it-needs-a-risk-committee.pdf>
- Bank Negara Malaysia BNM General Information. The Central Bank of Malaysia (BNM; Malay: Bank Negara Malaysia) is the Malaysian central bank. Established on 26 January 1959 as Central Bank of Malaya (Bank Negara Tanah Melayu), its main purpose is to issue currency, act as banker and adviser to the Government of Malaysia and regulate the country's financial institutions, credit system and monetary policy. Its headquarters is located in Kuala Lumpur, the federal capital of Malaysia.
http://www.bnm.gov.my/index.php?ch=en_about&pg=en_intro&lang=en
<https://www.bnm.gov.my/index.php?ch=57&pg=144&ac=159&bb=file>
- BNM Corporate Governance policy
<http://www.bnm.gov.my/index.php?ch=57&pg=137&ac=511&bb=file>
- Financial Reporting Council (FRC) - The UK Corporate Governance Code
[https://www.frc.org.uk/getattachment/e322c20a-1181-4ac8-a3d3-1fcfbcea7914/UK-Corporate-Governance-Code-\(September-2012\).pdf](https://www.frc.org.uk/getattachment/e322c20a-1181-4ac8-a3d3-1fcfbcea7914/UK-Corporate-Governance-Code-(September-2012).pdf)
The FRC regulate auditors, accountants and actuaries, and sets the UK's Corporate Governance and Stewardship Codes. They promote transparency and integrity in business. Their work is aimed at investors and others who rely on company reports, audit and high-quality risk management.
- Securities Commission Malaysia (SC). Established on 1 March 1993 under the Securities Commission Act 1993, the SC is a self-funding statutory body with

investigative and enforcement powers. It reports to the Minister of Finance and its accounts are tabled in Parliament annually

https://www.sc.com.my/post_archive/sc-releases-new-malaysian-code-on-corporate-governance-to-strengthen-corporate-culture/

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