RELEVANT TO ACCA QUALIFICATION PAPER P1 AND
PERFORMANCE OBJECTIVES 1, 2 AND 3

Independence as a concept in corporate governance

The concept of independence occurs at several points in the Paper P1 *Study Guide*. It is listed as one of the key underpinnings of corporate governance in Section A1d, it is a crucial quality possessed by both internal and external auditors (Sections B2b and B2c), and it is included in Section E5c as an ethical quality.

In corporate governance, independence is therefore important in a number of contexts. It is vital that external auditors are independent of their clients, that internal auditors are independent of the colleagues they are auditing, and that non-executive directors have a degree of independence from their executive colleagues on a board. But what do we mean by 'independence' as a concept?

Independence is a quality that can be possessed by individuals and is an essential component of professionalism and professional behaviour. It refers to the avoidance of being unduly influenced by a vested interest and to being free from any constraints that would prevent a correct course of action being taken. It is an ability to 'stand apart' from inappropriate influences and to be free of managerial capture, to be able to make the correct and uncontaminated decision on a given issue.

If, for example, an auditor is a longstanding friend of a client, the auditor may not be sufficiently independent of the client. Given that it is an auditor's job to act on behalf of shareholders and not the client, the friendship with the client may compromise the auditor's ability to effectively represent the interests of the shareholders. The auditor may not be as thorough as he ought to be, or he may be influenced to give the benefit of a doubt to the client when he should not be doing so.

The same could apply to non-executive directors (NEDs). In some countries, NEDs are referred to as independent directors to emphasise this very point. NEDs are appointed by shareholders in order to represent their interests on company boards. The primary fiduciary duty that NEDs owe is, therefore, to the company's shareholders. This means that they mustn't allow themselves to be captured or unduly influenced by the vested interests of other members of the company such as executive directors, trade unions or middle management.

Degrees of independence

A common problem in many organisational situations is ensuring independence where it could represent an ethical threat if absent. In real-life situations, friendships and networks build up over many years in which relationships exist at a number of different levels of intensity. Audit engagement partners can get to know clients very well over many years, for example, and serving together on boards can cement friendships between NEDs and executive members of a board.

Clearly then, there are varying degrees of independence. I find the use of continua helpful when describing a variable such as this. A continuum is a theoretical construct describing two extremes and a range of possible states between the two extremes. In the case of the continuum in Figure 1, the left-hand extreme describes the 'total independence' extreme. At this point, the parties in the relationship have no connection with each other, may not know the identity of each other and, therefore, have no reason at all to act other than with total dispassionate independence. On the other extreme on the right-hand side – the 'zero independence' end – the two parties are so intimate with each other they are incapable of making a decision without considering the effect of that decision on the other party.

Figure 1

TOTAL INDEPENDENCE | **ZERO INDEPENDENCE**

← **INCREASING INDEPENDENCE**

Of course, in real-life situations, the actual degree of independence is likely to be somewhere between the two extremes, but it is clearly desirable in most situations that the real position should be as near to the left of the continuum as possible. Any of the five main ethical threats can undermine or reduce a person's independence (self-interest, self-review, familiarity, advocacy, intimidation).

In some situations, company law or corporate governance codes make provisions to reduce threats to independence. It is often required, for example, to rotate engagement partners every so many years in an audit situation. Independence is also very important for NEDs, however, and it is to this that I now turn.

Independence and non-executive directors

So looking in a bit more detail at the roles of NEDs in particular, what are the specific benefits of NED independence? We have already discussed the fact that the primary fiduciary duty of a NED is to the company's shareholders. In order to increase NED independence, some shareholders prefer to bring new NEDs in from outside the industry in which the company competes. This is because a number of independence-threatening informal networks can build up within an industry over the years as staff move between competitor companies and as they collaborate in industry 'umbrella' bodies from time to time.

There is a debate about the pros and cons of appointing NEDs that have some industry experience compared to appointing NEDs from outside the industry in which the company in question competes. Previous industry involvement brings with it a higher technical knowledge of issues in that industry (which might be important), a network of contacts and an awareness of what the strategic issues are within the industry. While these might be of some benefit to a NED's contribution, the prior industry involvement might also reduce the NED's ability to be objective and uncontaminated by previously held views: in other words, they can make the NED less independent.

Accordingly, it is sometimes easier to demonstrate independence when NEDs are appointed from outside the industry. In addition to the benefits of the 'new broom' effect of bringing a fresh pair of eyes to a given problem, a lack of previous material business relationships will usually mean that a NED will not have any previous alliances or prejudices that will affect his or her independence.

In practice, many companies employ a mix of NEDs, and it is often this blend of talents and areas of expertise that is what makes a non-executive board effective. Technical input can be given by some NEDs, while wider political or regulatory insights might be provided by others. In large and highly visible companies, NEDs able to bring a social or political perspective to board deliberations can be strategically important. They may have retired senior government ministers or former chairmen of other large companies on their boards to give these insights. The fact that such people usually have no previous material business relationship with the company is seen as important in ensuring that they are materially independent.

Measures to increase NED independence

In order to enhance the independence of non-executive directors, a number of provisions are made in company law and in corporate governance codes. The nature of these provisions and their enforceability in law also varies with jurisdiction.

First, it is usually the case that NEDs should have – and have had – no business, financial or other connections with the company during the past few years (again, the period varies by country). This means that, for example, the NED should not have been a shareholder, an auditor, an employee, a supplier or a significant customer.

Second, cross-directorships are usually banned. This is when an executive director of Company A serves as a NED in Company B and, at the same time, an executive director of Company B serves as a NED at Company A. Such a relationship is considered to make the two boards too intimately involved with each other and potentially reduces the quality of the scrutiny that the two NEDs involved in the cross-directorship can bring.

Third, restrictions or total bans on share options for NEDs are often imposed. These are intended to help ensure that NEDs are able to stand slightly apart from the executive board and offer advice and scrutiny that are unhampered by vested interests such as short-termism on the company's share price.

Fourth, NED contracts sometimes allow them to seek confidential external advice (perhaps legal advice) on matters on which they are unhappy, uncomfortable or uncertain. This should be at the company's expense and helps the NED to gain outside, objective advice on the issue he or she is concerned about. Finally, NEDs are usually time-limited appointments (typically three years) and the number of terms that a NED can serve is also often limited, perhaps to two consecutive terms.

In conclusion, then, independence is an essential quality in a number of situations in corporate governance and in professional behaviour. Independence is sometimes enhanced and underpinned by regulation and legislation, but over and above that, it is expected of every professional person and of every professional accountant.

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