THE ROLE OF THE PROFESSIONAL DIRECTOR

By N.H. Routley

(Mr. Routley, a Director of several listed companies, spoke to a meeting of the New South Wales Branch of the Society on this subject on 21 October 1970.)

Opinions may differ as to what is a professional director. For the purposes of this address I have adopted the definition developed by Dr. J.M. Juran in his book "The Corporate Director", that a professional director is one who is almost wholly engaged as a director of a number of companies, and whose knowledge and experience is wide enough to entitle him to be considered as a professional. Almost invariably this involves him in having been at some stage in his career, a professional manager. The definition would exclude professional men still engaged in their professions but on a number of boards, and businessmen directors still actively engaged in their own businesses as owner or manager.

It is generally believed that there are not many of these men in Australia although in a survey conducted by Beckinsale & Co., some 13% of 973 directors described themselves as professional directors, and 5% of chairmen considered they were too. Mere membership of a number of boards does not, in my opinion, automatically entitle a person to the use of the term professional.

Of course professional directors are not necessarily any better than other directors their effectiveness being influenced by many things, including the circumstances existing in particular companies and the views of individual chairmen.

A professional director according to Dr. Juran, in the best sense is one who:

1. has been a manager with broad business experience,
2. has achieved recognition in management and commands public confidence,
3. has convictions, but can accept adverse board decisions without rancour,
4. understands relationships with operating management and works through the chief executive officer,
5. has superior knowledge and experience which enables him to bring to the board the most current thinking and experience,
6. is objective, dealing in principles and practices,
7. encourages development of sound policies programmes and plans,
8. can contribute to group thinking and can ask discerning questions.

They differ from other directors in that their experience covers a variety of boards, their time tables are usually more flexible, and their earned income is mainly from directors' fees.

As an occupation there are many hazards such as takeovers and legislation, which latter shows signs of becoming more onerous with every amendment. To set out consciously to become a professional director is an extremely difficult thing to do, and generally a number of years must pass before enough directorships are acquired.

Judging by statements that appear in the press and by the form of some contemplated amendments to the Companies Act, there is a great deal of misunderstanding about what the functions of a director should be.

For example, Mr. Justice Wallace on more than one occasion has complained about multiple directorships. My experience has been that men with a number of directorships are more likely to be able to devote time when there is a crisis than those who are directors of one company, but at the same time have a full time job as a businessman or as a member of a profession.

Then there are the people who have little time for outside directors, believing that only those who work in the business can really understand what the company is all about. Whilst admitting that there are some very successful companies with no outside directors, it would seem that there is an increasing number of companies convinced of the advantages of having at least some directors who can be expected to have views independent of those of the managing director (which is not the case in some companies controlled by employee directors).

Many people confuse the functions of directors with those of management. It is not reasonable to expect outside directors in receipt of modest fees to devote much more time to the company than is involved in regular and special directors' meetings. Frequently when a takeover is involved a great many hours are supplied free by the outside directors.

"Visiting the factory" is often considered by some people to be one of the outside director's most important functions. Whilst not decrying the need for occasional visits for morale purposes I sometimes wonder whether much of the time spent in this way is really worthwhile. There are not that many people competent to take in much of a useful nature in a quick walk through a factory.

Complaints have been made by some management men that they never get any worthwhile ideas from outside directors. Sometimes this is so because their opinions are not sought, and it has happened with egotistical managing directors that ideas are only worthwhile if thought of by them.

There is far too much branding of outside directors by their primary qualifications, without regard to what they have been doing since they qualified. A man may have been trained as an engineer, accountant or lawyer but for many years has been occupied in top level management activities; and yet he is frequently referred to by his original qualification. One of the most astute directors on financial matters I have ever known was trained as an engineer and had no formal training in finance. Many lawyers particularly in U.S.A. have been very efficient directors.

Then there is the tendency in some circles to class some outside directors as poor performers because a particular company in which they are a director has a relatively poor stock exchange performance. There could be hundreds of reasons for this performance being poor, particularly if the industry is one which is engaged in basic commodities where returns have been traditionally low. Many directors of low earning rate companies work a great deal harder than those on the boards of the glamour stocks, some of which owe their superior performance to a lucky situation.

Companies Act proposed amendments

The lack of understanding of the functions of an outside director is reflected in some of the amendments currently being discussed. One of the proposals is that directors are to take reasonable steps "to satisfy themselves that all known bad debts have been written off, and that adequate provision has been made for doubtful debts".

They are also to take reasonable steps "to ensure that any current assets which are unlikely to realise in the ordinary course of business their value as shown in the accounting records, are written down to an amount which they might be expected to realise".

According to counsel "ensure" means to pledge one's credit to, to warrant, to guarantee, and "reasonable steps" import into the obligation a duty of carrying out some kind of personal investigation.

Anyone with any knowledge of the immense amount of detail involved in the debtors' accounts and stock sheets of a great many companies, not only large ones, must appreciate what a ridiculous imposition this requirement is, if as is believed by counsel, a director cannot successfully defend an action (often based on hindsight) by pleading that he relied on management whom he had good reason to trust, to see that the requirements of the Act were carried out.

One large finance company has over 250,000 debtors' accounts, the value of which is determined by an adequate system of internal control. Imagine the time it would take for any director to even examine the accounts, let alone form any worthwhile opinion about their value.

Some functions of directors

The responsibilities of a professional director are not different from those of any other director, but the role he plays should be superior in some respects because of his greater experience and knowledge. In a short address like this it is not possible to cover the whole field of activities of a professional director, and I have therefore confined my observations to some of the more important functions which occur mainly in manufacturing companies.

Return on investment

Some companies are not very familiar with the various ways in which performance in relation to investment can be measured. About 1924 the Dupont Company in U.S.A. arrived at the conclusion that to effectively measure the performance of their various plants and products, they needed monthly information for each division which would show:

(a) Profit before tax as a percentage of sales

(b) The rate of capital turnover calculated by dividing the value of sales by the value of assets used

(c) By combining (a) and (b) determining the return on investment.

Admittedly they could have arrived at the return on investment (i.e. assets) by dividing profit by assets, but this would have ignored the capital turnover factor.

An example of this method would be:

$$\frac{\text{Profit}}{\text{Sales}} \quad \text{say} \quad \frac{10}{120} \qquad \times \qquad \frac{\text{Sales}}{\text{Assets}} \quad \text{say} \quad \frac{120}{100}$$

$$= 8.33\% \qquad\qquad = 1.2 \text{ times}$$

$$8.33\% \times 1.2 \text{ equals } 10\% \text{ on assets}$$

Of course to be able to do this, it is necessary to have the monthly figures for profits and stocks by divisions, and some Australian companies still have to reach this stage.

If we are to achieve greater efficiency in a company it is very desirable that each divisional manager's task of achieving a reasonable return on the assets under his control be made clear to him, and that the results be regularly reviewed at director level.

The method of calculating return on the value of the assets has many advantages over a calculation based on shareholders' funds because it is very easy to allocate assets to divisions.

More needs to be done in some companies to make management more conscious of their inadequate return on investment.

Stock turn and control

So much has been written about this subject that it is hardly possible to write anything new. Yet despite the information that is available, many Australian companies are almost certainly carrying too much stock. They should be made to disclose their turnover so that some critics can have a go at them.

It is not unusual in Sydney retail circles to calculate stock turn by dividing the value of sales by the average value of stock at cost. This gives a completely false and overstated figure of the rate of stock turn. The cost of goods sold rather than the sales figure should be used. To my knowledge there is only one public company which regularly publishes in its annual report its rate of stock turn. (J. Blackwood & Son Ltd.). It is obvious from that company's last report that this figure is probably the most significant control figure apart from the profit.

Frequently it is not possible to tell from the summarised monthly balance sheet why stocks are too high. With enough persistence directors can secure a detailed breakdown of the stocks with comparisons either with some previous figure, or preferably with the budget or desired level. The rate of turn should be regularly calculated.

Some managers contend that there is too much work involved in such returns and yet some companies of which I am a director have found it a useful control not involving too much time to prepare.

A useful guide to the attitude of management to the preparation of reliable results is the attention given to the writing off of obsolete stocks. In my opinion all companies having stocks of any magnitude should report to the board at least yearly the amount written off stocks. A consistently small figure combined with obviously slow rates of turn almost always indicate a reluctance to face facts. A professional director is generally in a better position to judge what is an acceptable rate of stock turn because of his knowledge of other companies and access that he has to publications supplying this information.

Debtors

Bad habits in paying accounts have developed in recent years in certain trades and a constant battle to keep debtors as current as possible is the normal scene in most manufacturing companies. Despite this, some companies do a very much better job than others - for example one company I know of never has more than 10% of its debtors (retailers) overdue more than 90 days. Another of about the same size has 25%. The difference is said to be due to the lax credit policies of competitors making it necessary to do the same.

Frequently the professional director can see that there must be some other reason because the company concerned has a large enough share of the market to take a more determined stand.

In finance companies a control on the extent of instalments in arrears is one of the most important management functions and yet in some retail companies doing their own time payment sales and collections, no continuous record is kept on the extent of the arrears, thus resulting in a much larger total of overdue accounts. This is sometimes justified on the ground that the policy keeps the customer buying but it may be an inefficient use of capital.

Borrowing

Some businessmen too young to have experienced liquidity problems in the depression have an attitude of mind that it will always be possible in these prosperous days to renew loans on their due date. The absence of a monthly balance sheet sometimes prevents a clear view of the overall position from month to month, and there is too much dependance on the overdraft as the only indicator of the liquidity position. Excessive pre-occupation with high gearing and the profit benefits to be gained by borrowing instead of raising share capital, can be modified and controlled by experienced directors in the long term interests of the business.

Use of shares in takeovers and the purchase of businesses

Frequently because of a lack of proper understanding of the true worth of shares, the benefits to be gained by taking over other companies with shares standing in the market at a high premium, are overstated.

In its simplest form this mania compares the dividend to be provided with the profits to be earned by the company taken over, no proper regard being paid to the diluting effect on the earnings per share.

The professional director can be of great value in assessing the true worth of a business which management may be very keen to takeover. Large amounts are paid for goodwill sometimes far in excess of the real value. Probably at least 50% of the listed companies in Sydney are selling for less than their assets value, and yet takeovers of some of these are effected with no subsequent benefit being apparent in the profit return on investment.

Management education

As a guess probably half the public company directors have no direct association with any form of management education nor are many of them aware of what is being done in this field. Amongst those who are interested in the subject there is general agreement that much more needs to be done, although of course, over the past 25 years a great deal has been accomplished. Many people are not aware that during that time there has been an average enrolment in the management courses of the N.S.W. Technical Colleges of some 5,000 people apart from the thousands who have attended courses at the Australian Institute of Management.

If a company does not have as one of its directors someone who is interested in management education, then it could be at a serious disadvantage compared with companies which are aware of the need for executive development and are doing something about it.

Budgets

Whilst the majority of public companies no doubt have budgets of one kind or another, the quality and comprehensiveness varies tremendously. Little respect can be had for those companies which merely make a forecast of next year's sales and profit, the usual reason being stated to be that other budgets are too difficult in their business.

Unless a director is familiar with a comprehensive budget as prepared in a well run company he is not likely to realise what can be done, nor to insist on the introduction of proper control methods.

Business to-day is so complex that a familiarity with modern techniques seems to be essential, not in all directors of a company, but at least in one or some. Being informed about the success achieved in other businesses with some of these techniques must make the professional director of more value to a company than one without such knowledge. His ability to ask the right questions must do so too.