

ICSA'S
**CORPORATE GOVERNANCE
HANDBOOK**

2nd Edition

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Preface

When I wrote the previous edition of this book less than 12 months ago, I was aware that the ever-changing subject of corporate governance would not stand still. Work led by ICSA to address the issue of boardroom behaviours was already underway and was but one development on the horizon amongst many. The FRC *Guidance on Board Effectiveness* published in March 2011 is illustrative of how an innovative approach to the familiar question of how to get the best out of those seated at the board table can be developed.

The fast-moving nature of corporate governance should make it challenging enough for those called upon to put it into practice, but with each company being a unique entity with its own distinctive set of issues and circumstances, there is, unfortunately, no off-the-peg solution that can simply be prescribed.

The test with which directors, company secretaries and their advisers are faced is not only to find their own effective governance answers but to continually update those answers against a backdrop of changing legislative and best practice requirements. To quote the preface to the UK Corporate Governance Code: 'boards must think deeply, thoroughly and on a continuing basis, about their overall tasks and the implications of these for the roles of their individual members'.

Looking at an old issue and coming up with a new answer is rarely easy. Regular refreshing of the board and bringing together a diverse group of people with potentially different views can help, as can looking at the issue from a different angle. In the FRC *Guidance on Board Effectiveness* the point is made that the process of preparing the company's narrative reports and disclosures 'can prompt the board to reflect on the quality of its governance, and what actions it might take to improve its structures, processes and systems'. The message is clear – reviewing practices is not simply a job reserved for the once-a-year board evaluation; every opportunity should be taken to be on the lookout for ways to enhance practices.

Governance guidance requirements tend to be, by their very nature, non-prescriptive and rather broad-brush. A casual reader may therefore be tempted to consider them somewhat obvious and self-explanatory. However by drilling down into the detail of apparently sweeping statements, considering the

intention and rationale behind them and perhaps even considering in greater depth a common-place word contained within them, ideas not previously considered can emerge. The purpose of this book therefore, is not only to assemble in one convenient volume the current requirements and best practice guidance covering the various governance issues faced by boards, but also to provoke the reader to consider issues afresh.

I remain indebted to Mark Womersley of Osborne Clarke, author of the first edition looseleaf and on which this work is based. I am also grateful to the Institute of Chartered Secretaries and Administrators for inviting me to prepare this new edition as well as for their on-going support. I am always impressed by the extent, quality and worth of the resources and guidance published by ICSA and would commend, to anyone interested in the subject of governance, the ICSA website as an invaluable source of practical help and inspiration.

I am also extremely grateful to my husband, Richard, and our two beautiful children, Matthew and Henry. Their never-ending love, support and many cups of tea have provided me with the space, time and liquid refreshment needed to update this publication.

Bernadette Barber
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Maintaining an effective board

■ The board's role and good governance

6.1 The opening principle of the UK Corporate Governance Code requires that the company should be headed by an 'effective board' and describes the primary role of an effective board in rather dry terms as being 'to provide entrepreneurial leadership ... within a framework of prudent and effective controls which enables risk to be assessed and managed'. This definition of a board's primary role remained unchanged following the 2009 review of the Combined Code, however the FRC *Guidance on Board Effectiveness* has taken this old definition and shone a new light on it, reflecting the shift in emphasis in the 2010 UK Corporate Governance Code from compliance with the letter to compliance with the spirit.

6.2 In the preface to *Guidance*, the important point is made that whilst clarity of roles, responsibilities, accountability and transparency are all important features of effective governance, they are not on their own sufficient. An effective board is envisaged as being one which 'develops and promotes its collective vision of the company's purpose, its culture, its values and the behaviours it wishes to promote in conducting its business'. The clear message is that the board's role cannot be narrowly defined, for example purely by reference to profitability and other financial measures, but includes taking a lead in setting the company's standards and ensuring that those standards are applied across all aspects of the business.

6.3 The *Guidance* sets out particular functions which it expects an effective board to perform, including:

- providing direction for management;
- demonstrating ethical leadership, displaying and promoting behaviours consistent with the culture and values it has defined for the organisation;
- creating a performance culture which drives value creation without exposing the company to excessive risk of value destruction;

- making well-informed and high-quality decisions based on a clear line of sight into the business;
- creating the right framework for helping directors to meet their statutory and regulatory duties;
- being accountable, particularly to those that provide the company's capital; and
- thinking carefully about its governance arrangements and embracing evaluation of their own effectiveness.

6.4 The Guidance attempts to paint a picture of what an effective board would look like and identifies a number of key drivers affecting a board's effectiveness. It encourages boards to think not only about the formal structures they have in place but also their roles, behaviours and group interaction. In doing so it brings into sharper focus than ever before the human side of boardroom life, recognising that processes and procedures can only ever support the collective efforts of the individuals who make up a governing body.

6.5 Different directors and the company secretary have particular roles to play within the board and how those individuals carry out those roles as well as how they interact as a group can have an immense impact on the effectiveness of the board as a whole. Individual roles are examined in subsequent chapters but the remainder of this chapter is devoted to examining the characteristics of an effective board and how an effective board can be developed and nurtured through appropriate recruitment, development and evaluation processes. The work of the nomination committee is therefore particularly relevant and is covered in some detail.

■ Providing direction and making decisions

6.6 As the governing body, it is incumbent on the board to provide direction and leadership for the organisation and its management. The board in many ways sets the tone for the entire organisation, influencing culture and behaviours through its decisions and leadership. This culture-defining responsibility is relevant across all aspects of the board's work. The specific responsibilities which make up that work are examined in Chapter 3. As required by the UK Corporate Governance Code, certain matters will be reserved to the board alone and a framework established for delegating other matters to committees or to management. Once that framework is in place, it should be clear which decisions and issues need to be referred to the board but it may still be necessary to nurture a culture of openness among the executive team, so that they bring those items to the board at a stage when genuine debate is still possible, rather than seeking a mere rubber-stamping exercise.

6.7 The use of committees to assist the board in its work is common practice even for non-listed companies, which are not required by regulation to maintain separate audit, remuneration and nomination committees. This is because a well-defined committee structure can be of enormous benefit, not least because it can prevent the board agenda becoming too full and facilitate more detailed consideration of important issues in a more specialised environment. However, whilst a committee structure undoubtedly offers these benefits, responsibility for the key areas of audit, risk and remuneration must be retained by the board and final decisions on these areas must be taken by the board as a whole. In order for the board to adequately discharge these responsibilities, it is important that sufficient time is set aside in full board meetings for the work of the committees to be properly reported and recommendations explained and to enable proper discussion of actions and board decisions which flow from their work. Moreover, regular reviews of each committee's terms of reference and the relationship between committees and the board should be carried out.

6.8 In order for the board to consider in an effective manner the issues brought to them and to minimise the risk of poor decisions being made, it is important that good processes are in place. Much of the groundwork for creating those processes is laid outside of the boardroom, starting with the creation of agendas which cover the right issues and ensure that the board's valuable time is well spent. Once an agenda has been set, high-quality papers and, where appropriate, external advice, are required in order to ensure that board meeting attendees are well briefed and therefore well prepared to make a positive contribution to the board's deliberations. In recent times there has been much emphasis on the need for directors to commit sufficient time to their duties in order to carry them out to a high standard. Part of that time commitment needs undoubtedly to be reserved by them to read and consider the papers circulated in advance of the meeting. Papers which provide good analysis and make clear relevant timescales and the decisions required to be made by the board, as well as addressing responsibilities and the scale and nature of possible risks, ensure that directors' preparation time can be well spent.

6.9 The FRC *Guidance on Board Effectiveness* makes some suggestions for the processes which might be undertaken, particularly in the case of complex or significant issues, to optimise the chances of good decisions being made by the board. These include describing in the board papers the process that has been used to arrive at the proposal being presented so that directors who have not previously been involved in the proposal can assess how appropriate the process for arriving at the proposal has been, as well as assessing the proposal itself. A multi-staged process is also suggested as having possible benefits in

some instances, providing boards an opportunity to consider concepts at an early stage, which is followed by the presentation of an outline proposal for discussion and then finally the proposal for decision. Other strategies include commissioning independent reports, establishing sole-purpose committees and convening additional meetings. The Guidance also recommends that past decisions, in particular those which subsequently proved to have poor outcomes, are regularly reviewed in order to learn lessons not just about the decision itself but also about the decision-making processes employed at the time.

6.10 Processes such as those described above form only one aspect of good decision-making however. In order to maximise the chances of good decisions being taken, it is imperative that a board has the right people in place – people who are appropriately skilled, knowledgeable and sufficiently experienced to understand the issues before them and bring good judgement to bear and who are sufficiently independent, proactive and critical to engage in challenging debate. Complacent or intransigent attitudes, conflicts of interest, inappropriate reliance on previous experience or an imbalanced board dominated by a small group are examples of factors which can all-too-easily endanger good decision-making. Regular refreshing of the board and ensuring a diverse mix of personal attributes can guard against many of these factors. The issue of board diversity is examined next.

■ Board diversity

6.11 Research undertaken as preparation for the Higgs Report, and numerous other more recent surveys, have found that the typical PLC board is ‘pale, male and stale’ – that is, dominated by white males, with an under-representation of directors who are either female or drawn from ethnic minorities. The findings of the 2003 Tyson Report which examined ethnicity as well as gender are also relevant, and a persuasive case for greater boardroom diversity has been made by research that suggests that companies with more diverse boards tend to be better managed. The Equalities Office publication *Increasing Diversity on Public and Private Sector Boards* (2009) explored the benefits of, and barriers to, diversity at board level. The benefits identified include a wider portfolio of skills at the top, a better feel for and understanding of customer needs, an increased ability to recognise new markets, and improved corporate social responsibility. Much of the focus on boardroom diversity has tended to concentrate on the proportion of women in office, and there is a lack of equivalent information about, for example, ethnic minorities or people with disabilities; however it is reasonable to assume that the barriers experienced by these groups are similar to those experienced by

women and that the benefits of increasing board diversity would be better achieved by removing all such barriers. Barriers to the recruitment of individuals from underrepresented groups inherent in some selection processes can include a lack of awareness of vacancies, weak links between women and certain minority groups and selection consultants, unconscious bias and unclear selection criteria. The most common argument for increasing boardroom diversity is undoubtedly that doing so can help avoid so-called 'group-think', common where bodies of people share similar backgrounds, experiences and biases. For this reason, diversity in board composition is specifically identified in the FRC *Guidance on Board Effectiveness* as being an important driver of a board's effectiveness.

6.12 While issues of diversity go beyond those of gender, the subject of women on boards is the most high-profile issue of the diversity debate. Since 1999 annual comparisons have been carried out by the Cranfield University School of Management in its Female FTSE Index which charts the number of female directors on the boards of FTSE companies. This indicates a slow increase from a low base. According to the 2010 report, 12.5% of all directors of FTSE 100 companies were female, compared with 6.9% in 1999. A higher proportion of FTSE 100 non-executives were female (15.6%, compared with 10.8%), with only 5.5% (compared with 2.0% in 1999) of FTSE 100 executive directors being women. More than a fifth of the companies in the FTSE 100 had no female board members at all. Achieving greater diversity in the boardroom has also attracted international attention. There are some strong advocates of a quota system imposed by law. In Norway the boards of public companies must by law meet a quota of 40% female board members, with delisting being a sanction for failure to meet the target. Despite initial concerns, the initiative has been deemed a success, both in terms of increasing the number of women on boards as well as the value of their individual contributions.

6.13 In response to concerns that progress in the UK towards gender-balanced boardrooms was too slow, the Government commissioned Lord Davies of Abersoch to review the situation, to identify the barriers to women attaining board appointments and to make recommendations to increase the proportion of women on private sector boards. His 2011 report *Women on Boards*, made a number of recommendations aimed at increasing the supply of suitably qualified and experienced women candidates for board appointments and the demand for such women for those roles. Almost 90% of the respondents to the review's consultation opposed the introduction of mandatory quotas for women on boards and, as a result, the report stopped short of recommending such a measure and instead opted for a voluntary regime, under which, amongst other things:

- Chairmen of FTSE 350 companies are expected to announce the percentage of women they expect to have on their boards by 2013 and 2015. FTSE 100 companies are expected to achieve at least 25% female representation by 2015.
- Chief Executives are expected to review the proportion of women they aim to have within their Executive Committees by 2013 and 2015.
- All quoted companies will be required to publish statistics for the proportion of women on their boards, holding senior management roles and employed by the organisation as a whole.
- The FRC is urged to amend the UK Corporate Governance Code to require listed companies to establish, and publish annually, a policy on boardroom diversity including measurable objectives.

6.14 The FRC has indicated that it will carry out a consultation on whether to amend the UK Corporate Governance Code in order to require companies to publish their policy on boardroom diversity; however in the meantime, Lord Davies' report has made it clear that, should a voluntary approach not lead to swift and radical changes in board diversity, mandatory measures may well follow. At EU level, changes are also afoot, with a 2011 Green Paper on *The EU Corporate Governance Framework* identifying board diversity as being 'at the heart of good governance'. The possibility of legislative changes being made as a result of the outcome of the Green Paper consultation process was explicitly stated. Clearly companies need to respond to these concerns with positive action to genuinely increase the variety of views, skills, backgrounds and experiences of those on their boards if a less flexible statutory regime is not to be imposed.

6.15 In direct response to concerns over diversity and the need to remove unnecessary barriers to achieving board appointments, the Supporting Principle to UK Corporate Governance Code Principle B.2 requires that 'the search for board candidates should be conducted, and appointments made, on merit, against objective criteria and with due regard for the benefits of diversity on the board, including gender'. This explicit obligation to consider gender is clearly intended to accelerate the pace of cultural change needed to bring about real boardroom diversity.

■ **Appointing the right people to the board**

6.16 As discussed above, appointing directors who are able to make a positive contribution to the board, help the board reach good decisions and maximise the chances of the company's long-term success is identified within the FRC *Guidance on Board Effectiveness* as a key element of board effectiveness. Code Provision B.2.1 requires the board to establish a nomination committee, which

should 'lead the process for board appointments and make recommendations to the board'. The nomination committee therefore clearly has a vital role to play in assisting the board to discharge its recruitment responsibilities as set out in Code Principle B.2 which states:

'There should be a formal, rigorous and transparent procedure for the appointment of new directors to the board.'

6.17 Criticism has been levelled at the director appointment process and, despite pressure over recent years to increase the accessibility of vacancies, reviews such as Lord Davies' *Women on Boards* continue to identify weaknesses in procedures. These include the failure to advertise positions, the high level of informality when short-listing candidates, and the absence of rigorous interview procedures. At the heart of this censure lies concern over the likely impairment of board effectiveness resulting from a failure to appoint the best available persons to the company's board. Artificial restrictions on the pool of candidates can only ever increase the likelihood that the best potential candidate may be missed. Designing recruitment processes so as to remove those artificial barriers is part of the challenge faced by nomination committees charged with overseeing board appointments.

6.18 The requirement to plan for and make recommendations to the board for new appointments is at the core of the list of responsibilities placed on the nomination committee. Once the committee has identified the need for a new appointment, whether through succession planning or otherwise, careful organisation is required in order to satisfy the requirement in Code Principle B.2 that there must be a 'formal, rigorous and transparent procedure for the appointment of new directors to the board'. Table 6.1 describes a list of the main stages involved in handling a typical new director appointment.

Table 6.1 Stages in appointing a director

Stage 1:	Defining the job description and capability requirements
	As a first step, the committee should evaluate the needs of the board, taking into account the balance of skills, independence, knowledge and experience, and any currently identified succession issues and the company's agreed strategic priorities. For a non-executive role where it is envisaged the appointee will be a member of a particular committee, specific technical skills and knowledge may be relevant. The results of this process should then inform the drafting of the capabilities and time commitment required and the job description. The appointment of an executive search agency should be considered.

Table 6.1 *continued*

Stage 2:	Advertising the post and short-listing candidates
	The committee should know how best to attract candidates from a wide range of backgrounds. Advertising is likely to secure a better representation of candidates drawn from the public or voluntary sector, who will not be known in the normal business circles. For this reason the report <i>Women on Boards</i> encourages companies to periodically advertise board vacancies. If advertising is not used, this must be explained to shareholders in the annual report. A short-list of candidates should be drawn up, taking the advice of search agents as appropriate. The possibility of recruiting from internal candidates should not be ignored.
Stage 3:	Implementing a process to select a preferred candidate
	Short-listed candidates should be invited to interview. The committee should prepare the interview beforehand, agreeing the points to be raised with each candidate. Questioning should be rigorous, but fair. A committee member with a material conflict of interest (e.g. a prior association with a candidate) should declare it and decline to be involved. When questioning candidates the committee should be prepared to think outside the normal tramlines. In particular, the FRC <i>Guidance on Board Effectiveness</i> recommends that a diversity of personal attributes among candidates be considered including 'intellect, critical assessment and judgement, courage, openness, honesty and tact, the ability to listen, forge relationships and develop trust' as well as diversity of psychological type, background and gender.
Stage 4:	Bringing nomination to the board
	The committee's nomination to the appointment should be brought to the full board for approval. The nomination should be supported by a summary of the reasons for the committee's conclusions, and should contain essential information as to the proposed contractual terms of the appointment.
Stage 5:	Agreeing specific terms of the appointment
	Having obtained the board's approval, the committee should agree the detailed terms of the appointment, subject to their being formalised in writing. The committee should be mindful of the board's published remuneration policy, and should take legal advice.

6.19 Special considerations arise for the nomination committee and the board generally on the appointment of the chairman and non-executive directors. These are covered in Chapters 7 and 9 on the chairman and non-executive directors respectively.