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Corporate Governance:

Essential for HR Professionals and Employment Lawyers

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Corporate governance: essentials for HR Professionals and Employment Lawyers

The following paragraph from the Cadbury Report has been the generally accepted definition of corporate governance since 1992:

> 'Corporate governance is the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place . The responsibilities of the board include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The board's actions are subject to laws, regulations and the shareholders in general meeting.'

A company with a good corporate governance strategy will have established procedures and committees to facilitate and monitor the relationships between its board, management and the shareholders. The underlying principles of good corporate governance are accountability, transparency, probity and focus on the sustainable success of the company over the long-term.

The corporate governance environment in the UK has been evolving since the late 1980s following a number of high profile corporate scandals. In 1992, a committee chaired by Sir Adrian Cadbury issued the Cadbury Report on corporate governance. Over a number of years, the Cadbury Report and other recommendations have been brought together into a single code of recommended corporate governance now known as the UK Corporate Governance Code (the UKCG Code) (previously known as the Combined Code). The principles and provisions of the UKCG Code are supplemented by the best practice guidelines published by a number of institutional shareholder committees, including the National Association of Pension Funds (NAPF) and Pensions Investment Research Consultants Ltd (PIRC).

The UKCG Code and most institutional investor guidelines are aimed at listed companies, but the principles of good governance will also be relevant to many smaller or unlisted companies, especially those with boards that have delegated powers to executive directors or board committees.

The UK Corporate Governance Code

The UKCG Code is not a rigid set of rules but consists of main principles, supporting principles and provisions which give a framework for companies to operate within. The UKCG Code is not an exhaustive set of rules; it is a guide towards good governance.

References: The UK Corporate Governance Code (PDF)

The UKCG Code operates on the basis of a 'comply or explain' approach. Companies should comply with the UKCG Code's principles and provisions unless they consider that a different approach is more appropriate to their circumstances. Where a company does not comply with the UKCG Code, it must explain why it hasn't complied.

The principles and provisions cover, amongst other matters, best corporate governance practice in relation to:

- the role of non-executive directors
- the appointment of directors and the nomination committee
- remuneration of directors and the remuneration committee
- corporate reporting, risk management, internal control principles, the audit committee and, if relevant, the risk committee, and
- matters specifically reserved to the decision of the board

The Quoted Companies Alliance (an independent membership organisation) has published its own 'Corporate Governance Code for Small and Mid-Size Quoted Companies', which is widely recognised as an industry standard for those growing companies for which the UK Corporate Governance Code is not applicable. This includes standard listed companies and those on AIM and the ICAP Securities and Derivatives Exchange. The QCA Code adopts key elements of the UK Corporate Governance Code, current policy initiatives and other relevant guidance and then applies these to the needs and particular circumstances of small and mid-size quoted companies on a public market.

References: QCA website: Corporate Governance Code for Small and Mid-Size Quoted Companies 2013 (PDF - fee payable)

The role of non-executive directors

A main principle of the UKCG Code is that the board and its committees should have the appropriate balance of skills, experience, independence and knowledge of the company to enable them to discharge their respective duties and responsibilities effectively.

References: UKCG Code, main principle B.1 (PDF)

The board should include an appropriate combination of executive and non-executive directors (and, in particular, independent non-executive directors) such that no individual or small group of individuals can dominate the board's decision taking.

As part of their role as members of a unitary board, non-executive directors should:

- constructively challenge and help develop proposals on strategy
- scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance
- satisfy themselves on the integrity of financial information and that financial controls and systems of risk management are robust and defensible, and
- determine appropriate levels of remuneration of executive directors and have a prime role in appointing, and where necessary removing, those executive directors

The Institute of Chartered Secretaries and Administrators (ICSA) has published various guidance for individuals considering becoming non-executive directors and those in post.

ICSA guidance on induction of directors

ICSA guidance on liability of non-executive directors: care, skill and diligence

The nomination committee

The UKCG Code provides that there should be a formal, rigorous and transparent procedure for the appointment of new directors to the board and that:

References: UKCG Code, provision B.2.1 (PDF)

- 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, and
- the board should satisfy itself that plans are in place for orderly succession for appointments to the board and to senior management, so as to maintain an appropriate balance of skills and experience within the company and on the board and to ensure progressive refreshing of the board

The UKCG Code provisions state that there should be a nomination committee to lead the process for board appointments and make recommendations to the board.

The remuneration committee

The UKCG Code provisions state that there should be a nomination committee to lead the process for board appointments and make recommendations to the board. The UKCG Code states that companies should have in place a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors, and that no director should be involved in deciding his own remuneration. A listed company should establish a remuneration committee to ensure compliance with the UKCG Code.

References: UKCG Code, principle D.2 (PDF)

The remuneration committee should be given delegated responsibility for setting the remuneration of all executive directors and the chairman, including pension rights and any compensation payments. The committee is also expected to recommend and monitor the level and structure of remuneration for senior management.

The audit committee

One of the UKCG Code's main principles is that boards of listed companies should establish formal and transparent arrangements for considering how they should apply the corporate reporting and risk management and internal control principles and for maintaining an appropriate relationship with the company's auditor, in particular by establishing an audit committee.

References: The UKCG Code, main principle C.3 (PDF)

The risk committee

The board is responsible for:

- determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives, and

- maintaining sound risk management and internal control systems

The UKCG Code does not require companies to establish a risk committee, although it does acknowledge that some companies may choose to establish a risk committee to review the company's internal control and risk management systems.

The final report of the Walker review (published in November 2009) recommends that the board of a FTSE 100-listed bank or life insurance company should always establish a board risk committee separate from the audit committee.

Matters reserved for the board

The UKCG Code requires boards of listed companies to establish a formal schedule of matters specifically reserved for their decision. It also requires a listed company's annual financial report to contain a statement of how the board operates, which should include a high-level statement of which types of decisions are to be taken by the board and which are to be delegated to management.

References: UKCG Code, provision A.1.1

Directors' remuneration

Many of the principles of good corporate governance impact on the remuneration of directors in both listed and unlisted companies.

Boardroom diversity

The UKCG Code was amended in September 2012 to include (amongst other things) new provisions regarding boardroom diversity. These provisions apply to accounting periods beginning on or after 1 October 2012.

The provisions of UKCG Code relating to effectiveness and appointments to the board require listed companies to include in their annual report to shareholders a separate section describing the work of the nomination committee, including the process it has used in relation to board appointments. This should include:

References: The UKCG Code, code provision B.2.4

- a description of the board's policy on diversity, including gender
- any measurable objectives that it has set for implementing the policy, and
- progress on achieving the objectives

The UKCG Code also requires the board of each listed company to undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors. As part of that evaluation, the board should also consider the board's diversity, including gender diversity in addition to other criteria listed in the Code.

References: The UKCG Code, supporting principle B.6